TARRANT APPAREL GROUP
Form 10-K/A
June 09, 2009

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K/A

Amendment No. 1

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

For the fiscal year ended December 31, 2008

or

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

For the transition period from _______ to _______

Commission File Number: 0-26006

TARRANT APPAREL GROUP

(Exact name of registrant as specified in its charter)

California	**95-4181026**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification Number)**

801 South Figueroa Street, Suite 2500

Los Angeles, California 90017

(Address of principal executive offices) (Zip code)

Registrant s telephone number, including area code: (323) 780-8250

Securities registered pursuant to Section 12(b) of the Act:

Title of Each Class	Name of Each Exchange on which Registered
Common Stock	Nasdaq Global Market

Securities registered pursuant to Section 12(g) of the Act:

None

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

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

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 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, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer, and smaller reporting company in Rule 12b-2 of the Exchange Act.

Large accelerated filer ¨ Accelerated filer ¨ Non-accelerated filer ¨ Smaller reporting company x

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

The aggregate market value of the Common Stock held by non-affiliates of the Registrant on June 30, 2008 was $11,070,229, based upon the closing price of the Common Stock on that date.

Number of shares of Common Stock of the Registrant outstanding as of March 13, 2009: 30,543,763.

DOCUMENTS INCORPORATED BY REFERENCE

None.

EXPLANATORY NOTE

We are filing this Amendment No. 1 to Annual Report on Form 10-K/A for the year ended December 31, 2008 (the Amendment), to amend our Annual Report on Form 10-K for the year ended December 31, 2008, which was originally filed with the Securities and Exchange Commission (the SEC) on March 19, 2009 (the Original Annual Report). The Company is filing this Amendment in response to comments received from the SEC. The following Items amend the Original Annual Report, as permitted by the rules and regulations of the SEC.

Except as described above, no other changes have been made to the Original Annual Report. This Amendment continues to speak as of the date of the Original Annual Report, and we have not updated the disclosures contained therein to reflect any events which occurred at a date subsequent to the filing of the Original Annual Report. Accordingly, this Amendment should be read in conjunction with the Original Annual Report.

As a result of these amendments, we are also filing as exhibits to this Amendment the certifications pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. Because no financial statements are contained within this Amendment, we are not including certifications pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

PART I

Item 3. LEGAL PROCEEDINGS

Settlement of American Rag Cie Litigation

On December 23, 2008, Tarrant Apparel Group and our wholly-owned subsidiary, Private Brands, Inc., entered into a Settlement Agreement with American Rag Cie, LLC (ARC LLC), American Rag Cie II (ARC II) and certain other parties providing for a settlement and release of all claims with respect to our previously disclosed litigation with ARC LLC and ARC II.

On February 1, 2008, we filed and served a cross-complaint against ARC LLC and ARC II in the action American Rag CIE v. Private Brands, Inc., Superior Court of the State of California, County of Los Angeles, Central District, Case No. BC 384428 (the Action). The original action had been filed on January 28, 2008 by ARC LLC against Private Brands. ARC LLC owns the trademark American Rag Cie, which trademark had been licensed to Private Brands on an exclusive basis throughout the world except for Japan and pursuant to which Private Brands sells American Rag Cie branded apparel to Macy s Merchandising Group and has sub-licensed to Macy s Merchandising Group the right to manufacture certain categories of American Rag Cie branded apparel in the United States. The primary subject of the lawsuit was our continued rights under the license agreement.

Pursuant to the Settlement Agreement, the parties agreed to the following actions:

- Dismissal of the Action by all parties and release of claims asserted in the Action;

- Redemption by ARC LLC of our 45% membership interest in ARC LLC, and redemption by American Rag Compagnie of our 5,000 shares in American Rag Compagnie, in each case without payment of cash consideration to us; and

- Amendment of the License Agreement with respect to the American Rag Cie trademark.

As a result of the Settlement Agreement, we no longer own an equity interest in ARC LLC or American Rag Compagnie, and continue to license rights to the American Rag Cie trademark.

Other Matters

From time to time, we are involved in various routine legal proceedings incidental to the conduct of our business. Our management does not believe that any of these legal proceedings will have a material adverse impact on our business, financial condition or results of operations, either due to the nature of the claims, or because our management believes that such claims should not exceed the limits of the our insurance coverage.

PART II

Item 7. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following management s discussion and analysis should be read together with the Consolidated Financial Statements of Tarrant Apparel Group and the Notes to Consolidated Financial Statements included elsewhere in this Form 10-K. This discussion summarizes the significant factors affecting the consolidated operating results, financial condition and liquidity and cash flows of Tarrant Apparel Group for the fiscal years ended December 31, 2006, 2007 and 2008. Except for historical information, the matters discussed in this Management s Discussion and Analysis of Financial Condition and Results of Operations are forward looking statements that involve risks and uncertainties and are based upon judgments concerning various factors that are beyond our control. See Cautionary Statement Regarding Forward-Looking Statements and Item 1A. Risk Factors.

Overview

Tarrant Apparel Group is a design and sourcing company for private label and private brand casual apparel serving mass merchandisers, department stores, branded wholesalers and specialty chains located primarily in the United States. Our private brands include American Rag Cie and Marisa K.

We generate revenues from the sale of apparel merchandise to our customers that we have manufactured by third party contract manufacturers located outside of the United States. Revenues and net income (loss) for the years ended December 31, 2006, 2007 and 2008 were as follows (dollars in thousands):

Revenues and Net Income (Loss):	**2006**	**2007**	**2008**
Total net sales	$ 232,402	$ 243,721	$ 195,308
Net income (loss)	$ (22,221)	$ 1,748	$ (11,081)

Cash flows for the years ended December 31, 2006, 2007 and 2008 were as follows (dollars in thousands):

Cash Flows:	**2006**	**2007**	**2008**
Net cash provided by (used in) operating activities	$ 15,047	$ 12,476	$ (5,563)
Net cash provided by (used in) investing activities	$ (5,071)	$ 21,455	$ (204)
Net cash provided by (used in) financing activities	$ (10,713)	$ (34,345)	$ 10,489

Significant Developments in 2008

Private Label

Private label business has been our core competency for over twenty years, and involves a one to one relationship with a large, centrally controlled retailer with whom we can develop product lines that fit with the characteristics of their particular customer. Private label sales in 2008 were $147.2 million compared to $198.8 million in 2007. The dwindling consumer demand and the global credit crunch have accelerated the consolidation amongst vendors, wholesalers and retailers. While the emphasis on fashion products continues, the demand for quality products at lower price points has increased even more.

Private Brands

We launched our private brands initiative in 2003, pursuant to which we acquired ownership of or license rights to a brand name and sell apparel products under this brand, generally to a single retail company within a geographic region. Private brands sales in 2008 were $48.1 million compared to $44.9 million in 2007. During 2008, we owned or licensed rights to the following private brands:

American Rag Cie: During the first quarter of 2005, we extended our agreement with Macy s Merchandising Group through 2014, pursuant to which we exclusively distribute our American Rag Cie brand through Macy s Merchandising Group s national Department Store organization of more than 600 stores. Net sales of American Rag Cie branded apparel totaled $46.1 million in 2008 compared to $43.3 million in 2007.

Alain Weiz: We have previously sold Alain Weiz apparel exclusively to Dillard s Department Stores. From January 1, 2007, we were able to sell our licensed brand Alain Weiz to specialty stores and department stores. Net sales of Alain Weiz branded apparel totaled $131,000 in 2007. The Alain Weiz brand was discontinued in mid 2007 after disappointing performance.

Marisa K: This brand was being sold to specialty stores and boutiques. Net sales of Marisa K branded apparel totaled $1.1 million in 2007 and 2008. The sale of this brand was discontinued in the second quarter of 2008.

During 2008, we were involved in litigation with American Rag Cie, LLC and American Rag Cie II with respect to our licensed rights to the American Rag Cie trademark. American Rag Cie, LLC owns the trademark American Rag Cie , which has been licensed to us on an exclusive basis throughout the world except for Japan and pursuant to which we sell American Rag Cie branded apparel to Macy s Merchandising Group and have sub-licensed to Macy s Merchandising Group the right to manufacture certain categories of American Rag Cie branded apparel in the United States. In December 2008, we settled this litigation. For a further description of the settlement see Item 3. Legal Proceedings of this Annual Report on Form 10-K.

In connection with the settlement agreement, on December 23, 2008, Private Brands, Inc. and American Rag Cie, LLC entered into an Amended License Agreement. The Amended License Agreement amends and restates our prior license agreement for the American Rag Cie trademark effective October 1, 2008 to, among other things, extend the initial term of the agreement to September 30, 2018, with six consecutive ten-year automatic renewal terms; amend the territory to consist of the United States, Canada, Mexico and Bermuda; reduce the annual guaranteed minimum royalties and revise the royalty rates; clarify the provisions with respect to calculation of royalties and reporting; and amend the termination provisions. The amendments to the license agreement primarily were with respect to provisions that gave rise to our dispute with American Rag Cie, LLC. While the amendments to the license agreement are significant in that they eliminate what historically has been a basis for dispute between the parties, we do not anticipate that the amendments to our license agreement will have a material impact on our business, financial condition or results of operations.

Acquisition Proposal

On April 25, 2008, Gerard Guez and Todd Kay, our founders, executive officers and directors, originally announced to our Board of Directors their intention to acquire all of the outstanding publicly held shares of our common stock for $0.80 per share in cash in a going private transaction. On February 26, 2009, following approval of the proposed acquisition by the Special Committee of our Board of Directors formed to review the proposal, we entered into a definitive agreement and plan of merger with Sunrise Acquisition Company, LLC (an entity owned by Mr. Guez and Mr. Kay), Sunrise Merger Company, Mr. Guez and Mr. Kay. If the merger transaction contemplated by the agreement is completed, each share of our common stock, other than shares held directly or indirectly or Mr. Guez or Mr. Kay, would be converted into the right to receive $0.85 in cash and Tarrant Apparel Group would become a wholly-owned subsidiary of Sunrise Acquisition Company. Completion of the proposed acquisition is subject to various closing conditions, including approval by the holders of at least 66 2/3% of the outstanding shares of our common stock and other customary conditions to closing.

We will be filing a definitive proxy statement and other documents concerning the proposed acquisition with the Securities and Exchange Commission. Shareholders are urged to read the proxy statement when it becomes available and any other relevant documents filed with the SEC because they will contain important information on the proposed transaction.

Bankruptcy of Mervyn s LLC

On July 29, 2008, Mervyn s commenced an action for reorganization in bankruptcy. On July 16, 2008, we had stopped all shipments to Mervyn s LLC and made a demand for the return of goods totaling $1.3 million which we had shipped in the previous ten days, and we collected $600,000 of this amount. On August 8, 2008, we recommenced shipping to Mervyn s, under a much shorter credit term, goods that were produced for Mervyn s prior to the bankruptcy action. We received substantially all payments for all goods shipped to Mervyn s subsequent to August 8, 2008 under the newly agreed upon payment arrangement. On October 17, 2008, Mervyn s announced that it planned to pursue liquidation in its bankruptcy proceeding. In the fourth quarter of 2008, we wrote off $2.2 million of accounts receivable from Mervyn s to uncollectible bad debt expense due to the uncertainty of any distribution from the bankruptcy estate. On the remaining $152,000 non-recourse factored receivable, we recorded an allowance for returns and discounts of $76,000.

Mervyn s was the most significant customer of our FR TCL-Chazzz/MGI division, representing approximately 22% and 37% of sales of this division in the first six months of 2008 and in the twelve months of 2007, respectively. As a result of the initial bankruptcy filing in July 2008, we immediately performed an assessment of the goodwill relating to this division pursuant to SFAS 142. After taking the two step analysis required by SFAS 142, we concluded that due to the Mervyn s bankruptcy filing and the significant reduction of business from another retail customer serviced by the FR TCL-Chazzz/MGI division, the fair value of the reporting unit was less than the carrying value and we therefore recorded an impairment charge to goodwill of $5.3 million in the second quarter of 2008. Subsequently we did not recognize any additional impairment charge to goodwill relating to this division as of December 31, 2008. See Notes 8 of the Notes to Consolidated Financial Statements.

Nasdaq Deficiency Notice

On October 21, 2008, we received written notification that Nasdaq has suspended its bid price and market value of publicly held shares requirements for continued listing on the exchange through Friday, January 16, 2009, and in December 2008, Nasdaq further extended this suspension through April 17, 2009. On April 2, 2008, we were initially notified by The Nasdaq Stock Market that we were not in compliance with Nasdaq Marketplace Rule 4450(a)(5) because shares of our common stock had closed at a per share bid price of less than $1.00 for 30 consecutive business days. In accordance with Marketplace Rule 4450(e)(2), we were provided with 180 calendar days to regain compliance. We held a special meeting of shareholders on September 4, 2008 and obtained shareholders approval to a reverse stock split, which may be implemented by our board of directors with a range of 1-for-1.5 to 1-for-4 if necessary to assist with regaining compliance with the Nasdaq minimum bid price requirement. On October 2, 2008, we received a Nasdaq Staff Determination Letter indicating that we had failed to regain compliance with the $1.00 minimum bid price requirement for continued listing and that our securities were therefore subject to delisting from The Nasdaq Global Market. On October 3, 2008, we requested a written hearing before a Nasdaq Listing Qualifications Panel to review the Staff s determination. The hearing, which was scheduled for November 20, 2008, has been cancelled due to the suspension of the bid price requirement. Nasdaq will not take any action through April 17, 2009 to delist our shares for the bid price deficiency. If we are still deficient in bid price at the close of business on April 17, 2009, Nasdaq will contact us to reschedule a hearing before a Nasdaq Listing Qualifications Panel.

Critical Accounting Policies and Estimates

Our discussion and analysis of our financial condition and results of operations are based upon our consolidated financial statements, which have been prepared in accordance with generally accepted accounting principles in the United States of America. The preparation of these financial statements requires us to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosures of contingent assets and liabilities. We are required to make assumptions about matters, which are highly uncertain at the time of the estimate. Different estimates we could reasonably have used or changes in the estimates that are reasonably likely to occur could have a material effect on our financial condition or result of operations. Estimates and assumptions about future events and their effects cannot be determined with certainty. On an ongoing basis, we evaluate estimates, including those related to allowance for returns, discounts and bad debts, inventory, notes receivable reserve, valuation of long-lived and intangible assets and goodwill, accrued expenses, income taxes, stock options valuation, contingencies and litigation. We base our estimates on historical experience and on various assumptions believed to be applicable and reasonable under the circumstances. These estimates may change as new events occur, as additional information is obtained and as our operating environment changes. In addition, we are periodically faced with uncertainties, the outcomes of which are not within our control and will not be known for prolonged period of time.

We believe our financial statements are fairly stated in accordance with generally accepted accounting principles in the United States of America and provide a meaningful presentation of our financial condition and results of operations.

We believe the following critical accounting policies affect our more significant judgments and estimates used in the preparation of our consolidated financial statements. For a further discussion on the application of these and other accounting policies, see Note 1 of the Notes to Consolidated Financial Statements.

Accounts Receivable Allowance for Returns, Discounts and Bad Debts

We evaluate the collectibility of accounts receivable and chargebacks (disputes from the customer) based upon a combination of factors. In circumstances where we are aware of a specific customer s inability to meet its financial obligations (such as in the case of bankruptcy filings or substantial downgrading of credit sources), a specific reserve for bad debts is taken against amounts due to reduce the net recognized receivable to the amount reasonably expected to be collected. For all other customers, we recognize reserves for bad debts and uncollectible chargebacks based on our historical collection experience. If collection experience deteriorates (for example, due to an unexpected material adverse change in a major customer s ability to meet its financial obligations to us), the estimates of the recoverability of amounts due to us could be reduced by a material amount.

As of December 31, 2008, the balance of the allowance for returns, discounts and bad debts was $552,000, compared to $2.0 million at December 31, 2007.

Inventory

Our inventories are stated (valued) at the lower of cost (first-in, first-out) or market. Under certain market conditions, we use estimates and judgments regarding the valuation of inventory to properly value inventory. Inventory adjustments are made for the difference between the cost of the inventory and the estimated market value and charged to operations in the period in which the facts that give rise to the adjustments become known.

Long-Lived Assets

We account for long-lived assets, which include property and equipment, in accordance with the provisions of Statement of Financial Accounting Standards (SFAS) No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets. SFAS No. 144 requires that long-lived assets be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability is measured by comparing the carrying amount of an asset to the expected future net cash flows generated by the asset. If it is determined that the asset may not be recoverable, and if the carrying amount of an asset exceeds it estimated fair value, an impairment charge is recognized to the extent of the difference.

We assessed whether events or changes in circumstances have occurred that potentially indicate the carrying amount of long-lived assets may not be recoverable. We concluded that there were no such events or changes in circumstances during 2006, 2007 or 2008. Net property and equipment balance of $1.5 million and $2.0 million at December 31, 2007 and 2008, respectively.

Intangible Assets and Goodwill

We have adopted SFAS No. 142, Goodwill and Other Intangible Assets. We assess the need for impairment of identifiable intangibles with indefinite lives (not subject to amortization), and goodwill with a fair-value-based test on an annual basis or more frequently if an event occurs or circumstances change that would more likely than not reduce the fair value of a reporting unit below its carrying amount. Factors considered important that could trigger an impairment review include, but are not limited to, the following:

- a significant underperformance relative to expected historical or projected future operating results;

- a significant change in the manner of the use of the acquired asset or the strategy for the overall business; or

- a significant negative industry or economic trend.

We utilized the discounted cash flow methodology to estimate fair value. At December 31, 2008, we had a goodwill balance of $3.3 million, as compared to a goodwill balance of $9.9 million at December 31, 2007. During the year ended December 31, 2007, we did not recognize any impairment related to goodwill. During the year ended December 31, 2008, we recognized $6.7 million for impairment charges related to goodwill. See Note 8 of the Notes to Consolidated Financial Statements.

Impairment of Goodwill

Goodwill in the accompanying consolidated balance sheets represents the excess of costs over fair value of net assets acquired in previous business combination. SFAS No. 142, Goodwill and Other Intangible Assets, requires that goodwill and other indefinite lived intangibles be tested for impairment using a two-step process. The first step is to determine the fair value of the reporting unit, which may be calculated using a discounted cash flow methodology, and compare this value to its carrying value. If the fair value exceeds the carrying value, no further work is required and no impairment loss would be recognized. The second step is an allocation of the fair value of the reporting unit to all of the reporting unit s assets and liabilities under a hypothetical purchase price allocation.

On July 29, 2008, Mervyn s LLC filed for bankruptcy protection. Mervyn s was the most significant customer of our FR TCL-Chazzz/MGI division, representing approximately 22% and 37% of sales of this division in the first six months of 2008 and in the twelve months of 2007, respectively. As a result of the bankruptcy filing, we immediately performed an assessment of the goodwill relating to this division pursuant to SFAS 142. After taking the two step analysis outlined above, we concluded that due to the Mervyn s bankruptcy filing and the significant reduction of business from another retail customer serviced by the FR TCL-Chazzz/MGI division, the fair value of the reporting unit was less than the carrying value and we therefore recorded an impairment charge to goodwill of $5.3 million in the second quarter of 2008. Subsequently we did not recognize any additional impairment charge to goodwill relating to this division as of December 31, 2008.

On December 23, 2008, we entered into a Settlement Agreement with American Rag Cie LLC and American Rag Cie II providing for a settlement and release of all claims with respect to our previously disclosed litigation with American Rag Cie LLC and American Rag Cie II. As a result of the Settlement Agreement, the parties agreed to dismiss all pending litigation and release all claims. We also returned our 45% membership interest in American Rag Cie LLC, and our 5,000 shares in American Rag Compagnie. We recorded an impairment of goodwill of $1.4 million in the fourth quarter of 2008 as a result of the disposition of our equity interest in American Rag Cie LLC and American Rag Compagnie. See Note 6 of the Notes to Consolidated Financial Statements.

License Agreements and Royalty Expenses

We enter into license agreements from time to time that allow us to use certain trademarks and trade names on certain of our products. These agreements require us to pay royalties, generally based on the sales of such products, and may require guaranteed minimum royalties, a portion of which may be paid in advance. Our accounting policy is to match royalty expense with revenue by recording royalties at the time of sale at the greater of the contractual rate or an effective rate calculated based on the guaranteed minimum royalty and our estimate of sales during the contract period. If a portion of the guaranteed minimum royalty is determined not to be recoverable, the unrecoverable portion is charged to expense at that time. See Note 13 of the Notes to Consolidated Financial Statements regarding various agreements we have entered into.

Royalty expense for each of the three fiscal years ended December 31, 2006, 2007 and 2008 was $2.8 million, $1.9 million and $1.6 million, respectively.

Foreign Currency Translation

Assets and liabilities of our Hong Kong subsidiaries are translated at the rate of exchange in effect on the balance sheet date; income and expenses are translated at the average rates of exchange prevailing during the year. The functional currency in which we transact business in Hong Kong is the Hong Kong dollar. At December 31, 2006, we had one open foreign exchange forward contract with a maturity of less than one year. Hedge ineffectiveness resulted in a loss totaling $196,000 during 2006. At December 31, 2007 and 2008, we had no open foreign exchange forward contracts. Hedge ineffectiveness resulted in a gain of $196,000 during 2007.

Transaction gains or losses, other than inter-company debt deemed to be of a long-term nature, are included in net income (loss) in the period in which they occur. Foreign currency gains and losses resulting from translation of assets and liabilities related to our Hong Kong subsidiaries were insignificant in 2006, 2007 and 2008.

Revenue Recognition

Revenue is recognized at the point of shipment for all merchandise sold based on FOB shipping point. For merchandise shipped on landed duty paid (or LDP) terms, revenue is recognized either at the point our goods leave Customs for direct shipments or at the point our goods leave our warehouse, or at the point our goods arrive at the customers warehouse where title is transferred, net of an estimate of returned merchandise and discounts. Customers are allowed the rights of return or non-acceptance only upon receipt of damaged products or goods with quality different from shipment samples. We do not undertake any after-sale warranty or any form of price protection.

We often arrange, on behalf of manufacturers, for the purchase of fabric from a single supplier. We have the fabric shipped directly to the cutting factory and invoice the factory for the fabric. Generally, the factories pay us for the fabric with offsets against the price of the finished goods.

Stock-Based Compensation

On January 1, 2006, we adopted SFAS No. 123 (revised 2004), Share-Based Payment, (SFAS No. 123(R)) which requires the measurement and recognition of compensation expense for all share-based payment awards made to employees and directors based on estimated fair values. SFAS No. 123(R) supersedes our previous accounting under Accounting Principles Board Opinion (APB) No. 25, Accounting for Stock Issued to Employees for periods beginning in fiscal 2006. In March 2005, the SEC issued Staff Accounting Bulletin (SAB) No. 107 relating to SFAS No. 123(R). We have applied the provisions of SAB No. 107 in our adoption of SFAS No. 123(R).

We adopted SFAS No. 123(R) using the modified prospective transition method, which requires the application of the accounting standard as of January 1, 2006, the first day of our fiscal year 2006. Our financial statements as of and for the years ended December 31, 2006, 2007 and 2008 reflect the impact of SFAS No. 123(R). Stock-based compensation expense related to employees or directors stock options recognized under SFAS No. 123(R) during the years ended December 31, 2006, 2007 and 2008 was $187,000, $771,000 and $257,000, respectively. Basic and dilutive earnings per share for the year ended December 31, 2006 were decreased by $0.01 from $(0.72) to $(0.73) as a result of the additional stock-based compensation recognized. Basic and dilutive earnings per share for the year ended December 31, 2007 were decreased by $0.02 from $0.08 to $0.06 as a result of the additional stock-based compensation recognized. Basic and dilutive earnings per share for the year ended December 31, 2008 were not materially affected by the additional stock-based compensation recognized.

The fair value of each option granted to employees and directors is estimated on the date of grant using the Black-Scholes option-pricing model (Black-Scholes model) with the following weighted average assumptions used for grants in 2006 and 2007: weighted-average volatility factors of the expected market price of our common stock of 0.7 for 2006 and 2007, weighted-average risk-free interest rates of 5.075% for 2006 and 3.9% to 4.67% for 2007, dividend yield of 0% for 2006 and 2007, and weighted-average expected life of the options of 6.25 years for 2006 and 0.06 years to 6.18 years for 2007. There were no options granted in 2008.

Income Taxes

As part of the process of preparing our consolidated financial statements, we are required to estimate income taxes in each of the jurisdictions in which we operate. The process involves estimating actual current tax expense along with assessing temporary differences resulting from differing treatment of items for book and tax purposes. These timing differences result in deferred tax assets and liabilities, which are included in our consolidated balance sheets. We record a substantial valuation allowance to reduce our deferred tax assets to the amount that is more likely than not to be realized. We have considered future taxable income and ongoing tax planning strategies in assessing the need for the valuation allowance. Increases in the valuation allowance result in additional expense to be reflected within the tax provision in the consolidated statement of operations.

In addition, accruals are also estimated for audits regarding U.S. tax issues based on our estimate of whether, and the extent to which, additional taxes will be due. We routinely monitor the potential impact of these situations and believe that amounts are properly accrued for. If we ultimately determine that payment of these amounts is unnecessary, we will reverse the liability and recognize a tax benefit during the period in which we determine that the liability is no longer necessary. We will record an additional charge in our provision for taxes in any period we determine that the original estimate of a tax liability is less than we expect the ultimate assessment to be. See Note 12 of the Notes to Consolidated Financial Statements for a discussion of current tax matters.

In June 2006, the Financial Accounting Standards Board (FASB) issued Interpretation No. 48, Accounting for Uncertainty in Income Taxes - An Interpretation of FASB Statement No. 109 (FIN48). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise s financial statements in accordance with SFAS No. 109, Accounting for Income Taxes. FIN 48 also prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return that results in a tax benefit. Additionally, FIN 48 provides guidance on de-recognition, income statement classification of interest and penalties, accounting in interim periods, disclosure, and transition. We adopted the provisions of FIN 48 on January 1, 2007. As a result of the implementation of FIN 48, we recognized no material adjustment for unrecognized tax benefits but reduced retained earnings as of January 1, 2007 by approximately $1 million attributable to penalties accrued as a component of income taxes payable. As of the date of adoption, our unrecognized tax benefits totaled approximately $8.9 million.

We and our subsidiaries file income taxes returns in the U.S., Hong Kong, Luxembourg, Mexico and various state jurisdictions. We are currently subject to an audit by the State of New York for the years 2003 to

2005, but are not currently being audited by other states or subject to non-U.S. income taxes jurisdictions for years open in those taxing jurisdictions.

In January 2004, the Internal Revenue Service (IRS) completed its examination of our Federal income taxes returns for the years ended December 31, 1996 through 2001. The IRS had proposed adjustments to increase our income taxes payable for these years under examination. In addition, in July 2004, the IRS initiated an examination of our Federal income taxes return for the year ended December 31, 2002. In December 2007, we received a final assessment from the IRS of $7.4 million for the years ended December 31, 1996 through 2002, and in the first quarter of 2008, we entered into a final settlement agreement with the IRS. Under the settlement, which totals $13.9 million, including $6.5 million of interest, we agreed to pay the IRS $4 million in March 2008, and an additional $250,000 per month until repayment in full. The settlement with the IRS is within amounts accrued for as of December 31, 2007 in our financial statements, and we therefore do not anticipate the settlement to result in any additional charges to income other than interest and penalties on the outstanding balance. Due to the negotiated settlement, we reclassified the IRS and state tax liabilities from uncertain tax positions to current payable on December 31, 2007. In March 2008, we paid the IRS $4 million in accordance with the settlement terms. Due to the installment agreement with the IRS in March 2008, we reclassified $5.2 million of income taxes payable from current payable to long-term as of December 31, 2008.

The total unrecognized tax benefits as of January 1, 2007 were $8.9 million, excluding interest, penalties and related income taxes benefits and would be recorded as a component of income taxes expense if recognized. We recognize interest accrued related to unrecognized tax benefits and penalties as a component of income taxes expense. As of January 1, 2007, the accrued interest and penalties were $8.0 million and $1.2 million, respectively, excluding any related income taxes benefits. During 2007, we de-recognized uncertain tax positions through negotiations and settlement with various tax jurisdictions. After the settlements, there was no unrecognized tax benefit as of December 31, 2007 and 2008. As of December 31, 2007, the accrued interest and penalties were $7.2 million and $142,000, respectively. As of December 31, 2008, the accrued interest and penalties were $4.8 million and $332,000, respectively.

In many cases, the uncertain tax positions are related to tax years that remain subject to examination by the relevant tax authorities. Federal and state statutes are open from 2003 through the present period. Hong Kong statutes are open from 2001, Luxembourg from 2008 and Mexico from 2001.

Debt Covenants

Our debt agreements require certain covenants including a minimum level of EBITDA and specified tangible net worth; and required interest coverage ratio and leverage ratio as discussed in Note 9 of the Notes to Consolidated Financial Statements. If our results of operations erode and we are not able to obtain waivers from the lenders, the debt would be in default and callable by our lenders. In addition, due to cross-default provisions in our debt agreements, substantially all of our long-term debt would become due in full if any of the debt is in default. In anticipation of us not being able to meet the required covenants due to various reasons, we either negotiate for changes in the relative covenants or an advance waiver or reclassify the relevant debt as current. We also believe that our lenders would provide waivers if necessary. However, our expectations of future operating results and continued compliance with other debt covenants cannot be assured and our lenders actions are not controllable by us. If projections of future operating results are not achieved and the debt is placed in default, we would be required to reduce our expenses, including by curtailing operations, and to raise capital through the sale of assets, issuance of equity or otherwise, any of which could have a material adverse effect on our financial condition and results of operations. During 2008, we breached a negative covenant prohibiting cash advances to third parties. The advances were fully repaid during 2008. A waiver was obtained in March 2009. As of December 31, 2008, we were in violation of the EBITDA and tangible net worth covenants and waivers of the defaults were obtained in March 2009 from our lenders.

Derivative Activities

Warrant Derivatives

SFAS No. 133 Accounting for Derivative Instruments and Hedging Activities requires measurement of certain derivative instruments at their fair value for accounting purposes. In determining the appropriate fair value, we use the Black-Scholes model. Derivative liabilities are adjusted to reflect fair value at each reporting period, with any increase or decrease in the fair value being recorded in consolidated statements of operations as adjustment to fair value of derivative. At December 31, 2006, there was income of $511,000 recorded as adjustment to fair value of derivative in our consolidated statements of operations. See Note 9 of the Notes to Consolidated Financial Statements

Foreign Currency Forward Contract

We source our products in a number of countries throughout the world and, as a result, are exposed to movements in foreign currency exchange rates. The primary purpose of our foreign currency hedging activities is to manage the volatility associated with foreign currency purchases of materials in the normal course of business. We utilize derivative financial instruments consisting primarily of forward currency contracts. These instruments are intended to protect against exposure related to financing transactions and income from international operations. We do not enter into derivative financial instruments for speculative or trading purposes. We may enter into certain foreign currency derivative instruments that do not meet hedge accounting criteria.

SFAS No. 133 requires measurement of certain derivative instruments at their fair value for accounting purposes. All derivative instruments are recorded on our balance sheet at fair value; as a result, we mark to market all derivative instruments. Derivative liabilities are adjusted to reflect fair value at each period end, with any increase or decrease in the fair value being recorded in consolidated statements of operations as adjustment to fair value of derivative. During the year ended December 31, 2006, we entered into foreign currency forward contracts to hedge against the effect of exchange rate fluctuations on cash flows denominated in foreign currencies and certain inter-company financing transactions. This transaction was undesignated and as such an ineffective hedge. At December 31, 2006, we had one open foreign exchange forward contract which had a maturity of less than one year. Hedge ineffectiveness resulted in a loss of $196,000 in our consolidated statements of operations as of December 31, 2006. At December 31, 2007 and 2008, we had no open foreign exchange forward contracts. Hedge ineffectiveness resulted in a gain of $196,000 in our consolidated statements of operations as of December 31, 2007.

New Accounting Pronouncements

For a description of recent accounting pronouncements including the respective expected dates of adoption and effects on results of operations and financial condition, see Note 1 of the Notes to Consolidated Financial Statements.

Results of Operations

The following table sets forth, for the periods indicated, certain items in our consolidated statements of income as a percentage of net sales:

	Years Ended December 31,		
	2006	2007	2008
Net sales	98.1%	92.0%	84.3%
Net sales to related party	1.9	8.0	15.7
Total net sales	100.0	100.0	100.0
Cost of sales	76.6	72.7	66.2
Cost of sales to related party	1.6	7.2	14.6
Total cost of sales	78.2	79.9	80.8
Gross profit	21.8	20.1	19.2
Selling and distribution expenses	4.7	6.0	5.7
General and administration expenses	11.6	10.0	14.9
Royalty expenses	1.2	0.8	0.8
Goodwill impairment charge			3.4
Loss on notes receivable-related parties	11.7		
Terminated acquisition expenses		0.8	
Adjustment to fair value of long-term receivable related parties		0.3	
Income (loss) from operations	(7.4)	2.2	(5.6)
Interest expense	(2.6)	(1.7)	(0.4)
Interest income	0.5	0.0	0.1
Interest in income of equity method investee	0.0	0.0	0.1
Other income	0.2	1.7	1.0
Adjustment to fair value of derivative	0.1	0.1	
Loss on equity method investment			(0.5)
Other expense	(0.2)	(2.0)	(0.0)
Income (loss) before provision (credit) for income taxes and minority interest	(9.4)	0.3	(5.3)
Provision (credit) for income taxes	0.2	(0.4)	0.4
Minority interest	0.0	0.0	0.0
Net Income (loss)	(9.6)%	0.7%	(5.7)%

Comparison of 2008 to 2007

Total net sales decreased by $48.4 million, or 19.9%, from $243.7 million in 2007 to $195.3 million in 2008. Sales of private label in 2008 were $147.2 million compared to $198.8 million in 2007 with the decrease resulting primarily from reduced demand by our customers due to the economic downturn and bankruptcies of customers such as Mervyn s. The decrease of private label sales in 2008 was partially offset by a $11.3 million increase in sales to a related party. Private brands sales in 2008 totaled $48.1 million compared to $44.9 million in 2007 with the increase primarily from increased sales to Macy s Merchandising Group.

Gross profit consists of total net sales less product costs, direct labor, duty, quota, freight in, brokerage, warehouse handling and markdown. Gross profit for 2008 was $37.6 million, or 19.2% of total net sales, compared to $48.9 million, or 20.1% of total net sales for 2007, representing a decrease of $11.3 million or 23.2%. The decrease in gross profit for 2008 was primarily caused by a decrease in the total amount of sales.

Selling and distribution expenses decreased by $3.6 million, or 24.6%, from $14.7 million in 2007 to $11.1 million in 2008. As a percentage of total net sales, these variable expenses decreased from 6.0% in 2007 to 5.7%

in 2008. The decrease in selling and distribution expenses was primarily due to reduction in staff cost and advertising expense.

General and administrative expenses increased by $4.9 million, or 20.0%, from $24.3 million in 2007 to $29.2 million in 2008. As a percentage of total net sales, these expenses increased from 10.0% in 2007 to 14.9% in 2008. Included in general and administrative expenses in 2008 was a charge of $848,000 resulting from liquidated damages imposed by U.S. Customs on two of our overseas vendors, a $2.2 million uncollectible bad debt expense related to Mervyn s and a $1.6 million reserve on a long-term due from related parties. Included in general and administrative expenses in 2007 was a $1.0 million reserve on a long-term due from related parties.

Adjustment to fair value of long-term due from related party was $0.8 million, or 0.3% of total net sales in 2007. Based on the repayment history of the related parties and the litigation they are currently subject to, we estimated that our receivable of $3.4 million would take approximately three years for collection in full. In 2007 we therefore made a $1.0 million reserve, then fair-valued the balance of this asset using our weighted average cost of capital as the discount rate and a term of three years as the discount period. There was no such adjustment in 2008. See Note 6 of the Notes to Consolidated Financial Statements.

Royalty expenses decreased by $282,000, or 15.1%, from $1.9 million in 2007 to $1.6 million in 2008. The decrease was caused by lowered royalty rates in the fourth quarter of 2008 under the amended license agreement resulting from settlement of the American Rag Cie litigation. See Note 6 of the Notes to Consolidated Financial Statements. As a percentage of total net sales, these expenses remained at 0.8% in 2007 and 2008.

Goodwill impairment charges were $6.7 million in 2008, compared to no such charge in 2007. These expenses in 2008 included $5.3 million related to our FR TCL-Chazzz/MGI division due to Mervyn s bankruptcy filing and the significant reduction of business from another retail customer, and $1.4 million related to our Private Brands American Rag division due to the disposition of our 45% membership interest in American Rag Cie, LLC which owns the trademark American Rag CIE in connection with settlement of the litigation. See Note 6 and Note 8 of the Notes to Consolidated Financial Statements.

Terminated acquisition expenses in 2007 were $2.0 million, or 0.8% of total net sales, compared to no such expense in 2008. These expenses consisted of the non-refunded portion of a deposit in the amount of $250,000 and other expenses including due diligence and legal fees incurred in connection with our proposed acquisition of The Buffalo Group. The transaction was mutually terminated on April 19, 2007. See Note 7 of the Notes to Consolidated Financial Statements .

Loss from operations was $11.0 million in 2008, or (5.6)% of total net sales, compared to income from operation of $5.2 million in 2007, or 2.2% of total net sales as a result of the factors discussed above.

Interest expense decreased by $3.3 million, or 80.3%, from $4.1 million in 2007 to $809,000 in 2008. As a percentage of total net sales, this expense decreased from 1.7% in 2007 to 0.4% in 2008. The decrease was primarily due to decreased borrowings and interest rates under our credit facilities and the repayment of our term loan facility in September 2007.

Interest income increased by $105,000, or 62.5%, from $169,000 in 2007 to $274,000 in 2008.

Interest in income of equity method investee represented our 45% share of equity interest in the owner of the trademark American Rag Cie and the operator of American Rag retail stores. Interest in income of equity method investee decreased by $68,000 or 43.3%, from $156,000 in 2007 to $89,000 in 2008.

Other income decreased by $2.1 million, or 50.6%, from $4.1 million in 2007 to $2.0 million in 2008. Included in other income in 2007 was a gain of $3.8 million on notes receivable related parties. See Note 5 of the Notes to Consolidated Financial Statements . Other income in 2008 included a gain on rescission on common stock due to settlement of $915,000 and $500,000 from the sale of an entity in Mexico.

Adjustment to fair value of derivative was $196,000 in 2007, compared to $0 in 2008.

Loss on equity method investment was $899,000 in 2008 or 0.5% of total net sales, compared to no such expense in 2007. The loss was caused by the disposition of our 45% membership interest in American Rag Cie, LLC in connection with settlement of the litigation with American Rag Cie, LLC in December 2008. See Note 6 of the Notes to Consolidated Financial Statements.

Other expenses decreased by $4.9 million, or 97.8%, from $5.0 million in 2007 to $111,000 in 2008. Other expenses of $5.0 million in 2007 consisted of expensing all the financing and related expenses and the remaining value of the warrants issued to lenders and the placement agent upon repayment of our term loan. See Note 9 of the Notes to Consolidated Financial Statements .

Income (loss) before provision (credit) for income taxes and minority interest was $713,000 in 2007 and $(10.4) million in 2008, representing 0.3% and (5.3)% of total net sales, respectively.

Provision for income taxes was $692,000 in 2008 compared to credit for income taxes of $1.0 million in 2007, representing 0.4% and (0.4)% of total net sales, respectively. The tax credit in 2007 was primarily a result of write-backs of FIN 48 accruals after our settlements of some uncertain tax positions with the State and Federal tax authorities.

Income allocated to minority interest in 2007 was $6,000 compared to $0 in 2008, for the minority partner in PBG7, LLC s 25% share in the income.

Net income (loss) was $1.7 million in 2007 as compared to $(11.1) million in 2008, representing 0.7% and (5.7)% of total net sales, respectively.

Comparison of 2007 to 2006

Total net sales increased by $11.3 million, or 4.9%, from $232.4 million in 2006 to $243.7 million in 2007. The increase in total net sales was primarily due to increased sales in our private label business which amounted to $198.8 million in 2007 compared to $181.2 million in 2006. The increase in 2007 came primarily from sales to New York & Co and Seven Licensing Company, and was partially offset by decreased sales to Kohl s and Mervyn s. Private brands sales in 2007 totaled $44.9 million compared to $51.2 million in 2006. Sales of Jessica Simpson , House of Dereon and Alain Weiz brands were discontinued in 2007, compared to sales of these brands amounting to $16.7 million in 2006. The loss in the sales of these brands was partially offset by an increase of $9.6 million in sales of the American Rag Cie brand in 2007.

Gross profit for 2007 was $48.9 million, or 20.1% of total net sales, compared to $50.6 million, or 21.8 % of total net sales for 2006, representing a decrease of $1.7 million or 3.4%. The decrease in gross profit for 2007 was primarily caused by a $1.5 million loss on the sale of Mexico fabric inventory in 2007 after the completion of the Tavex transaction selling all our assets in Mexico for cash.

Selling and distribution expenses increased by $3.7 million, or 33.7%, from $11.0 million in 2006 to $14.7 million in 2007. As a percentage of total net sales, these variable expenses increased from 4.7% in 2006 to 6.0% in 2007. The increase in selling and distribution expenses was primarily caused by the increased expenses incurred in establishing new brands such as Marisa K and increased advertising expenses on American Rag Cie brand in 2007 due to more advertising efforts.

General and administrative expenses decreased by $2.6 million, or 9.5%, from $26.9 million in 2006 to $24.3 million in 2007. As a percentage of total net sales, these expenses decreased from 11.6% in 2006 to 10.0% in 2007. The main reduction in general and administrative expenses in 2007 resulted from the settlement of the Jessica Simpson litigation and the reimbursement to us of $3.0 million of legal expenses we previously incurred in the litigation. This reduction was partially offset by a $1.0 million reserve on a long-term due from related parties.

Adjustment to fair value of long-term due from related party was $0.8 million, or 0.3% of total net sales in 2007 compared to $0 in 2006. Based on the repayment history of the related parties and litigation they are currently subject to, we estimated that our receivable of $3.4 million will take approximately three years for collection in full. We therefore in 2007, after we made a $1.0 million reserve as discussed previously, then fair-valued the balance of this asset using our weighted average cost of capital as the discount rate and a term of three years as the discount period. See Related party transactions.

Royalty expenses decreased by $951,000, or 33.8%, from $2.8 million in 2006 to $1.9 million in 2007. The decrease was caused by the discontinued sales under the Jessica Simpson license in 2007, compared to $1.1 million of royalty paid on the brand in 2006. As a percentage of total net sales, these expenses decreased from 1.2% in 2006 to 0.8% in 2007.

Loss on notes receivable-related parties was $27.1 million or 11.7% of total net sales in 2006, compared to no such expense in 2007. During 2006, the purchasers of our Mexico assets ceased providing fabric and were not making payments under the notes. We evaluated the recoverability of the notes receivable and recorded a loss on the notes receivable in an amount equal to the outstanding balance less the value of the underlying assets securing the notes. See Note 5 of the Notes to Consolidated Financial Statements .

Terminated acquisition expenses in 2007 were $2.0 million, or 0.8% of total net sales, compared to no such expense in 2006. These expenses consisted of the non-refunded portion of a deposit in the amount of $250,000 and other expenses including due diligence and legal fees incurred in connection with our proposed acquisition of The Buffalo Group. The transaction was mutually terminated on April 19, 2007. See Note 7 of the Notes to Consolidated Financial Statements .

Loss from operations was $17.2 million in 2006, or (7.4)% of total net sales, compared to income from operation of $5.2 million in 2007, or 2.2% of total net sales. The higher revenue in 2007 as well as the absence of any further charge for the write-down on notes receivable accounted for the improvement in the operating results in 2007 compared to 2006.

Interest expense decreased by $1.9 million, or 32.0%, from $6.1 million in 2006 to $4.1 million in 2007. As a percentage of total net sales, this expense decreased from 2.6% in 2006 to 1.7% in 2007. The decrease was primarily due to decreased borrowings under our credit facilities and the repayment of our term loan facility in September 2007. Also included in interest expense in 2006 was $711,000 of debt discount related to intrinsic value of the conversion option of debentures and the remaining value of the warrants issued to holders of debentures as a result of the repayment of the debentures in June 2006.

Interest income decreased by $1.0 million, or 85.7%, from $1.2 million in 2006 to $169,000 in 2007. Interest earned from the notes receivable-related party amounted to $901,000 in 2006, compared to no such income in 2007.

Interest in income of equity method investee represented our 45% share of equity interest in the owner of the trademark American Rag Cie and the operator of American Rag retail stores. Interest in income of equity method investee increased by $76,000 or 96.3%, from $80,000 in 2006 to $156,000 in 2007. The increase came mainly from increased royalty paid by our subsidiary Private Brands, Inc. on increased sales to Macy s.

Other income increased by $3.8 million, or 1,119.5%, from $336,000 in 2006 to $4.1 million in 2007. Included in other income in 2007 was a gain of $3.8 million on notes receivable related parties. See Note 5 of the Notes to Consolidated Financial Statements . Adjustment to fair value of derivative was $196,000 in 2007, compared to $315,000 in 2006.

Other expenses increased by $4.5 million, or 1,042.6%, from $436,000 in 2006 to $5.0 million in 2007. Other expenses in 2006 consisted of a payment of $400,000 upon the termination of the license agreements with

Cynthia Rowley. Other expenses of $5.0 million in 2007 consisted of expensing all the financing and related expenses and the remaining value of the warrants issued to lenders and the placement agent upon repayment of our term loan. See Note 9 of the Notes to Consolidated Financial Statements .

Income (loss) before provision (credit) for income taxes and minority interest was $(21.8) million in 2006 and $713,000 in 2007, representing (9.4)% and 0.3% of total net sales, respectively. Loss before provision for income taxes in 2006 included the loss on notes receivable related parties of $27.1 million.

Provision for income taxes was $453,000 in 2006 compared to credit for income taxes of $1.0 million in 2007, representing 0.2% and (0.4)% of total net sales, respectively. The tax credit in 2007 was primarily a result of write-backs of FIN 48 accruals after our settlements of some uncertain tax positions with State and Federal tax authorities.

Loss allocated to minority interest in 2006 was $21,000, for the minority partner s 25% share in the loss of PBG7, LLC. Income allocated to minority interest in 2007 was $6,000, for the minority partner in PBG7, LLC s 25% share in the income.

Net income (loss) was $(22.2) million in 2006 as compared to $1.7 million in 2007, representing (9.6)% and 0.7% of total net sales, respectively. Included in the $22.2 million net loss in 2006 was a loss on notes receivable related parties of $27.1 million.

Quarterly Results of Operations

The following table sets forth, for the periods indicated, certain items in our consolidated statements of income in millions of dollars and as a percentage of total net sales:

	Quarter Ended							
	Mar. 31 2007	**Jun. 30 2007**	**Sep. 30 2007**	**Dec. 31 2007**	**Mar. 31 2008**	**Jun. 30 2008**	**Sep. 30 2008**	**Dec. 31 2008**
Total net sales	$ 56.1	$ 60.1	$ 70.2	$ 57.3	$ 50.5	$ 51.3	$ 56.0	$ 37.5
Gross profit	12.3	12.6	12.9	11.1	10.0	11.0	9.3	7.3
Operating income (loss)	0.1	2.5	2.7	(0.1)	(0.1)	(5.4)	(0.3)	(5.2)
Net income (loss)	(1.0)	0.8	1.6	0.3	(0.2)	(5.3)	0.2	(5.8)

	Quarter Ended							
	Mar. 31 2007	**Jun. 30 2007**	**Sep. 30 2007**	**Dec. 31 2007**	**Mar. 31 2008**	**Jun. 30 2008**	**Sep. 30 2008**	**Dec. 31 2008**
Total net sales	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
Gross profit	22.0	20.9	18.4	19.3	19.9	21.4	16.6	19.3
Operating income (loss)	0.1	4.2	3.8	(0.1)	(0.1)	(10.5)	(0.6)	(13.8)
Net income (loss)	(1.8)	1.3	2.3	0.5	(0.5)	(10.3)	0.4	(15.4)

As is typical for us, quarterly total net sales fluctuated significantly because our customers typically place bulk orders with us, and a change in the number of orders shipped in any one period may have a material effect on the total net sales for that period.

Liquidity and Capital Resources

We had cash and cash equivalents of approximately $5.2 million at December 31, 2008.

The global banking crisis is affecting the availability of working capital to us, our vendors and our customers. Some vendors who extended us credit have experienced difficulties with their banks and have been forced to reduce the credit terms extended to us. We are also experiencing more rejection and withdrawal of customer credits by our factor and in a number of occasions, have been left with the option of either undertaking the credit risk internally or liquidating the finished goods at a loss. If the conditions in the banking and credit markets, and the overall economic conditions in general, do not improve, our liquidity may be materially and adversely affected.

We have significantly strengthened our balance sheet and improved our liquidity since 2007. The sale of all our Mexico assets for cash enabled us to repay our most expensive loans and as a result our financing cost has since substantially decreased. The IRS settlement and installment repayment plan removed a significant uncertainty in our financial condition which we have operated under for the past several years.

Our liquidity requirements arise from the funding of our working capital needs, principally inventory, finished goods shipments-in-transit, work-in-process and accounts receivable, including receivables from our contract manufacturers that relate primarily to fabric we purchase for use by those manufacturers. Our primary sources for working capital and capital expenditures are cash flow from operations, borrowings under our bank and other credit facilities, issuance of long-term debt, sales of equity and debt securities, and vendor financing. In the near term, we expect that our operations and borrowings under bank and other credit facilities will provide sufficient cash to fund our operating expenses, capital expenditures and interest payments on our debt. In the long-term, we expect to use internally generated funds and external sources to satisfy our debt and other long-term liabilities.

Our liquidity is dependent, in part, on customers paying on time. Any abnormal chargebacks or returns may affect our source of short-term funding. Any changes in credit terms given to major customers may have an impact on our cash flow. Suppliers credit is another major source of short-term financing and any adverse changes in their terms will have negative impact on our cash flow.

Other principal factors that could affect the availability of our internally generated funds include:

- deterioration of sales due to weakness in the markets in which we sell our products;
- decreases in market prices for our products;
- increases in costs of raw materials;
- increase in uncollectible accounts due to defaults; and
- changes in our working capital requirements.

Principal factors that could affect our ability to obtain cash from external sources include:

- the creditworthiness of our customers;
- financial covenants contained in our current or future bank and debt facilities; and
- volatility in the market price of our common stock or in the stock markets in general.

Certain of our private brands product lines are generally associated with higher selling, general and administrative expenses, due to significant design, development, and marketing costs compared to our private label business.

Cash flows for the years ended December 31, 2006, 2007 and 2008 were as follows (dollars in thousands):

Cash Flows:	2006	2007	2008
Net cash provided by (used in) operating activities	$ 15,047	$ 12,476	$ (5,563)
Net cash provided by (used in) investing activities	$ (5,071)	$ 21,455	$ (204)
Net cash provided by (used in) financing activities	$ (10,713)	$ (34,345)	$ 10,489

Net cash used in operating activities was $5.6 million in 2008, as compared to net cash provided by operating activities in 2007 of $12.5 million and in 2006 of $15.0 million. Net cash used in operating activities in 2008 resulted primarily from a net loss of $11.1 million, an increase of $14.7 million of due from related parties and a decrease of accrued expenses of $2.8 million and income taxes payable of $7.1 million. The above was offset by a decrease in accounts receivable of $16.8 million, a decrease in inventory of $6.1 million and impairment charges of goodwill of $6.7 million. Increase of due from related parties represents accounts receivable due from Seven Licensing Company and the increase was caused by a substantial increase in sales to Seven Licensing Company in 2008 as compared to the prior year. The reduction in income taxes payable was primarily the result of tax payments amounting to $6.3 million made in 2008 in connection with the settlement with the IRS relating to tax examinations for prior years. The decrease in accounts receivable are due primarily to reduced sales to unrelated parties in 2008 and the decrease in inventory similarly resulted mainly from reduced sales levels in 2008.

During 2008, net cash used in investing activities was $204,000, as compared to net cash provided by investing activities of $21.5 million in 2007 and net cash used in investing activities of $5.1 million in 2006. Net cash used in investing activities in 2008 resulted primarily from purchases of fixed assets of $942,000, including leasehold improvements of $626,000 to our New York offices, offset by collections of advances from shareholders/officers of $301,000 and net proceeds from sale of marketable securities of $242,000.

During 2008, net cash provided by financing activities was $10.5 million as compared to net cash used in financing activities of $34.3 million in 2007 and $10.7 million in 2006. Net cash provided by financing activities in 2008 resulted primarily from $9.6 million of our long-term borrowings and $885,000 on our short-term bank borrowings. The increase in borrowing was mainly the result of borrowing funds to pay our income taxes liabilities during the year in connection with the IRS settlement.

Debt Obligations

The following table summarizes our debt obligations:

	December 31, 2007	December 31, 2008
Short-term bank borrowings:		
Import trade bills payable DBS Bank and Aurora Capital	$ 4,600,293	$ 4,000,602
Bank direct acceptances DBS Bank	1,222,998	3,591,801
Other Hong Kong credit facilities DBS Bank	3,921,927	3,037,963
	$ 9,745,218	$ 10,630,366
Long-term obligations:		
Equipment financing	$ 5,338	$
Debt facility and factoring agreement GMAC CF	2,997,793	12,606,796
	3,003,131	12,606,796
Less current portion	(3,003,131)	(12,606,796)
	$ 0.00	$ 0.00

DBS Bank Credit Facility

In June 2006, our subsidiaries in Hong Kong, Tarrant Company Limited, Marble Limited and Trade Link Holdings Limited, entered into a new credit facility with DBS Bank (Hong Kong) Limited (DBS), which replaced our prior letter of credit facility for up to HKD 30 million (equivalent to US $3.9 million). Under this facility, we may arrange for letters of credit and acceptances. The maximum amount our Hong Kong subsidiaries could borrow under this facility at any time was US $25 million. In November 2008, the maximum amount was temporarily decreased to $22 million. In March 2009, the maximum amount is reduced to $20 million as a result of the bank s policy of cutting back credit to corporate clients. The interest rate under the letter of credit facility is equal to the Hong Kong Dollar Standard Bills Rate quoted by DBS minus 0.5% if paid in Hong Kong Dollars, which interest rate was 5.75% per annum at December 31, 2008, or the U.S. Dollar Standard Bills Rate quoted by DBS plus 0.5% if paid in any other currency, which interest rate was 3.84% per annum at December 31, 2008. This is a demand facility and is secured by a security interest in all the assets of the Hong Kong subsidiaries, by a pledge of our office property where our Hong Kong office is located, which is owned by Gerard Guez and Todd Kay, and by our guarantee. The DBS facility includes customary default provisions. In addition, we are subject to certain restrictive covenants, including that we maintain a specified tangible net worth, and a minimum level of EBITDA at December 31, 2008, specified interest coverage ratio and leverage ratio and a limitation on mergers or acquisitions in excess of a specified amount. As of December 31, 2008, we were in violation with the EBITDA and tangible net worth covenants and a waiver was obtained on March 11, 2009. As of December 31, 2008, $8.8 million was outstanding under this facility. In addition, $7.7 million of open letters of credit was outstanding and $5.5 million was available for future borrowings as of December 31, 2008.

Revolving Credit Facility GMAC Commercial Finance

On June 16, 2006, we expanded our previously existing credit facility with GMAC Commercial Finance, LLC (GMAC CF) by entering into a new Loan and Security Agreement and amending and restating our previously existing Factoring Agreement with GMAC CF. This is a revolving credit facility and initially had a term of 3 years. In February 2009, we entered into a consent and amendment pursuant to which GMAC CF approved the proposed acquisition by Gerard Guez and Todd Kay, the maximum amount of the credit facility was reduced to $40 million, and the credit facility was extended for an additional year. This extension is subject to an opt-out provision which allows GMAC to terminate the credit facility with a notice of 60 business days after the proposed acquisition is closed. The amount we may borrow under this credit facility is determined by a percentage of eligible accounts receivable and inventory, up to a maximum of $40 million, and includes a letter of credit facility of up to $2 million. Interest on outstanding amounts under this credit facility is payable monthly and accrues at the rate of the prime rate plus 0.5%. Our obligations under the GMAC CF credit facility are secured by a lien on substantially all our domestic assets, including a first priority lien on our accounts receivable and inventory. This credit facility contains customary financial covenants, including covenants that we maintain minimum levels of EBITDA and interest coverage ratio and limitations on additional indebtedness. This facility includes customary default provisions, and all outstanding obligations may become immediately due and payable in the event of a default. The facility bore interest at 3.75% per annum at December 31, 2008. During 2008, we breached a negative covenant prohibiting cash advances to third parties. The advances were fully repaid during 2008. A waiver was obtained on March 17, 2009. As of December 31, 2008, we were in violation of the EBITDA covenant and a waiver was obtained on March 17, 2009. A total of $12.6 million was outstanding with respect to receivables factored under the GMAC CF facility at December 31, 2008.

The amount we can borrow under the factoring facility with GMAC CF is determined based on a defined borrowing base formula related to eligible accounts receivable. A significant decrease in eligible accounts receivable due to the aging of receivables, can have an adverse effect on our borrowing capabilities under our credit facility, which may adversely affect the adequacy of our working capital. In addition, we have typically experienced seasonal fluctuations in sales volume. These seasonal fluctuations result in sales volume decreases in the first and fourth quarters of each year due to the seasonal fluctuations experienced by the majority of our customers. During these quarters, borrowing availability under our credit facility may decrease as a result of decrease in eligible accounts receivables generated from our sales.

Equipment Loans

We had one equipment loan outstanding during 2008. The loan bore interest at 4.75% payable in installments through 2008, which we paid off in May 2008.

Letters of Credit

From time to time, we open letters of credit under an uncommitted line of credit from Aurora Capital Associates which issues these letters of credits out of Israeli Discount Bank. As of December 31, 2008, $1.8 million was outstanding under this facility and $1.2 million of letters of credit was open under this arrangement. We pay a commission fee of 2.25% on all letters of credits issued under this arrangement.

The effective interest rates on bank borrowings as of December 31, 2007 and 2008 were 12.7% and 4.2%, respectively.

The credit facility with GMAC CF prohibits us from paying dividends or making other distributions on our common stock. In addition, GMAC CF prohibits our subsidiaries that are borrowers under the facility from paying dividends or making other distributions to us. The credit facility with DBS Bank prohibits our Hong Kong subsidiaries from paying any dividends or making other distributions or cash advances to us.

We have financed our operations from our cash flow from operations, borrowings under our bank and other credit facilities, issuance of long-term debt, and sales of equity and debt securities. Our short-term funding relies very heavily on our major customers, banks and suppliers. From time to time, we have had temporary over-advances from our banks. Any withdrawal of support from these parties will have serious consequences on our liquidity.

We may seek to finance future capital investment programs through various methods, including, but not limited to, borrowings under our bank credit facilities, issuance of long-term debt, sales of equity securities, leases and long-term financing provided by the sellers of facilities or the suppliers of certain equipment used in such facilities.

We do not believe that the moderate levels of inflation in the United States in the last three years have had a significant effect on net sales or profitability.

Contractual Obligations and Commercial Commitments

Following is a summary of our contractual obligations and commercial commitments available to us as of December 31, 2008 (in millions):

		Payments Due by Period			
Contractual Obligations	**Total**	**Less than 1 year**	**Between 2-3 years**	**Between 4-5 years**	**After 5 years**
Long-term debt (1)	$ 13.1	$ 13.1	$	$	$
Operating leases	$ 8.9	$ 1.5	$ 3.1	$ 2.2	$ 2.1
Minimum royalties	$ 8.3	$ 0.5	$ 1.4	$ 1.8	$ 4.6
Total Contractual Cash Obligations	$ 30.3	$ 15.1	$ 4.5	$ 4.0	$ 6.7

(1) Includes interest on long-term debt obligations. Based on outstanding borrowings as of December 31, 2008, and assuming all such indebtedness remained outstanding during 2008 and the interest rates remained unchanged, we estimate that our interest cost on long-term debt would be approximately $473,000.

		Amount of Commitment Expiration per Period			
Commercial Commitments Available to Us	**Total Amounts Committed to Us**	**Less than 1 year**	**Between 2-3 years**	**Between 4-5 years**	**After 5 years**
Lines of credit	$ 80.0	$ 80.0			
Letters of credit (within lines of credit)	$ 25.0	$ 25.0			
Total Commercial Commitments	$ 80.0	$ 80.0			

Off-Balance Sheet Arrangements

At December 31, 2008 and 2007, we did not have any relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance or special purpose entities, which would have been established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes. As such, we are not exposed to any financing, liquidity, market or credit risk that could arise if we had engaged in such relationships.

Related Party Transactions

For a description of certain related party transactions, see Item 13. Certain Relationships and Related Transactions, Director Independence of this Annual Report on Form 10-K.

PART III

Item 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS, AND DIRECTOR INDEPENDENCE

Review and Approval of Related Person Transactions

We have adopted, by resolution of our Board of Directors, a policy that any transactions between us and any of our affiliates or related parties, including our executive officers, directors, shareholders who own 5% or more of our common stock, the family members of those individuals and any of their affiliates, must (1) be approved by a majority of the members of the Board of Directors and by a majority of the disinterested members of the Board of Directors and (2) be on terms no less favorable to us than could be obtained from unaffiliated third parties.

In early 2008, we learned that two entities from which we have purchased finished goods, Star Source, LLC and AJG Inc. dba Astrologie, are beneficially owned by an adult son of Charles Ghailian, one of our former executive officers. We purchased $8.7 million, $10.4 million and $6.5 million of finished goods from Star Source, LLC and AJG Inc. dba Astrologie for the years ended December 31, 2006, 2007 and 2008, respectively. The policies described above for review and approval of related party transactions were not followed with respect to the transactions with these entities because the relationship with Mr. Ghailian was not previously known to us, and no waiver of these policies has been granted, retroactively or otherwise, for the transactions with Star Source and Astrologie. Upon becoming aware of the relationship, we immediately commenced an investigation of the transactions. Based on the investigation, we determined that the purchases from these parties were made at prices in excess of market prices that we could have obtained from unaffiliated third parties, which determination Mr. Ghailian disputed. Mr. Ghailian resigned his position with us in May 2008. Following our investigation, in July 2008 we entered into a settlement agreement with Mr. Ghailian providing for settlement and mutual release of claims. Pursuant to the agreement, Mr. Ghailian delivered to us 1.5 million shares of our common stock for cancellation and we agreed to pay Mr. Ghailian $195,000 for consulting services to be performed by Mr. Ghailian from July 2, 2008 to October 31, 2008. The 1.5 million shares of common stock returned to us by Mr. Ghailian were fair valued at $915,000 on July 2, 2008 based on the closing price of our common stock on that date.

Reportable Related Person Transactions

Other than the employment arrangements described elsewhere in this Proxy Statement and the transactions described below, since January 1, 2008, there has not been, nor is there currently proposed, any transaction or series of similar transactions to which we were or will be a party:

- in which the amount involved exceeds $120,000; and
- in which any director, executive officer, shareholder who beneficially owns 5% or more of our common stock or any member of their immediate family had or will have a direct or indirect material interest.

In January 2009, we relocated to our new principal executive offices on Figueroa Street in Los Angeles, California, which we sublease from Seven Licensing Company, LLC, an entity beneficially owned by Gerard Geuz, our Chairman and Interim Chief Executive Officer. We lease our former executive offices and warehouse on Washington Boulevard in Los Angeles, California from GET, a corporation which is owned by Gerard Guez, and Todd Kay, our Vice Chairman. The sublease for the Figueroa Street facility has an initial term of nine months. Our lease for the executive offices and warehouse on Washington Boulevard has a term of five years expiring in 2011, with an option to renew for an additional five year term. We will continue to pay rent on the premises until the earlier of the termination of the sublease for the Figueroa Street premises or such time as the Washington Blvd. building is leased to another party or sold. Additionally, we lease our office space and warehouse in Hong Kong from Lynx International Limited, a Hong Kong corporation that is owned by

Messrs. Guez and Kay. Our lease for the office space and warehouse in Hong Kong has expired and we are currently renting on a month to month basis. We paid $1.1 million in 2008 in rent for office and warehouse facilities at these locations. On May 1, 2006, we sublet a portion of our executive office in Los Angeles, California and our sales office in New York to Seven Licensing for a monthly payment of $25,000 on a month-to-month basis. We received $300,000 in rental income from this sublease for the year ended December 31, 2008.

From time to time in the past, we had advanced funds to Mr. Guez. These were net advances to Mr. Guez or payments paid on his behalf before the enactment of the Sarbanes-Oxley Act in 2002. The promissory note documenting these advances contains a provision that the entire amount together with accrued interest is immediately due and payable upon our written demand. The greatest outstanding balance of such advances to Mr. Guez during 2008 was approximately $1,944,000. At December 31, 2008, the entire balance due from Mr. Guez totaling $1.6 million was reflected as a reduction of shareholders equity. All amounts due from Mr. Guez bore interest at the rate of 7.75% during the period. Total interest paid by Mr. Guez was $137,000 for the year ended December 31, 2008. Mr. Guez paid expenses on our behalf of approximately $437,000 for the year ended December 31, 2008, which amounts were applied to reduce accrued interest and principal on Mr. Guez s loan. These amounts included fuel and related expenses incurred by 477 Aviation, LLC, a company owned by Mr. Guez, when our executives used this company s aircraft for business purposes. Since the enactment of the Sarbanes-Oxley Act in 2002, no further personal loans (or amendments to existing loans) have been or will be made to our officers or directors.

Azteca Production International, Inc. (Azteca) is owned by the brothers of Gerard Guez. We purchased $1.1 million, $499,000 and $0 of finished goods, fabric and service from Azteca and its affiliates for the years ended December 31, 2006, 2007 and 2008, respectively. Our total sales of fabric and service to Azteca in 2006, 2007 and 2008 were $9,000, $0 and $0, respectively. Based on the repayment history of Azteca and litigation which Azteca is currently subject to, we estimated that our receivable of $3.4 million will take approximately three years for collection in full. In 2007, we therefore made a $1.0 million reserve and then fair-valued the balance of this asset using our weighted average cost of capital as the discount rate and a term of three years as the discount period. We did not receive any payment during 2008 so we made an additional reserve of $1.5 million in the general and administrative expense in the fourth quarter of 2008. As a result, the amount owed by Azteca recorded on the consolidated balance sheets was $0 as of December 31, 2008. Net amount due from this related party as of December 31, 2007 was $1.5 million.

On September 1, 2006, our subsidiary in Hong Kong, Tarrant Company Limited, entered into an agreement with Seven Licensing to act as its buying agent to source apparel merchandise. Seven Licensing is beneficially owned by Gerard Guez. Total sales to Seven Licensing for the year ended December 31, 2008 was $30.7 million. Net amounts due from this related party as of December 31, 2008 and $21.6 million. Of the $21.6 million due from this related party at December 31, 2008, $13.8 million was overdue and $8.0 million was subsequently repaid.

We purchased $8.7 million, $10.4 million and $6.5 million of finished goods from Star Source, LLC and AJG Inc. dba Astrologie for the years ended December 31, 2006, 2007 and 2008, respectively. Star Source, LLC and AJG Inc. dba Astrologie are beneficially owned by an adult son of one of our former employees who resigned in May 2008.

On April 25, 2008, Gerard Guez and Todd Kay, our founders, executive officers and directors, originally announced to our Board of Directors their intention to acquire all of the outstanding publicly held shares of our common stock for $0.80 per share in cash in a going private transaction. On February 26, 2009, following approval of the proposed acquisition by the Special Committee of our Board of Directors formed to review the proposal, we entered into a definitive agreement and plan of merger with Sunrise Acquisition Company, LLC (an entity owned by Mr. Guez and Mr. Kay), Sunrise Merger Company, Mr. Guez and Mr. Kay. If the merger transaction contemplated by the agreement is completed, each share of our common stock, other than shares held directly or indirectly or Mr. Guez or Mr. Kay, would be converted into the right to receive $0.85 in cash and Tarrant Apparel Group would become a wholly-owned subsidiary of Sunrise Acquisition Company. Completion of the proposed acquisition is subject to various closing conditions, including approval by the holders of at least 66 2/3% of the outstanding shares of our common stock and other customary conditions to closing.

Director Independence

As required under The NASDAQ Stock Market listing standards, a majority of the members of a listed company s Board of Directors must qualify as independent, as affirmatively determined by the Board of Directors. The Board of Directors consults with our counsel to ensure that the Board s determinations are consistent with relevant securities and other laws and regulations regarding the definition of independent, including those set forth in pertinent listing standards of the NASDAQ, as in effect from time to time. Consistent with these considerations, after review of all relevant transactions or relationships between each director, or any of his or her family members, and the Company, its senior management and its independent auditors, the Board has affirmatively determined that the following five directors are independent directors within the meaning of the applicable NASDAQ listing standards: Messrs Farouze, Koffman, Mizrachi, Mani and Simbal. In making this determination, the Board found that none of these directors had a material or other disqualifying relationship with the Company.

PART IV

Item 15. Exhibits, Financial Statement Schedules

(a)(1) Financial Statements. (Previously filed with the Original Annual Report)

(2) Financial Statement Schedules. (Previously filed with the Original Annual Report)

(3) Exhibits.

10.23	Settlement Agreement by and between American Rag Cie, LLC, American Rag Cie II, World Denim Bar, LLC, Café Beau Soleil, LLC, Mark I. Werts and Larry Russ, on the one hand, and Tarrant Apparel Group, Private Brands, Inc., Gerard Geuz and Todd Kay, on the other hand.
31.1	Certificate of Chief Executive Officer pursuant to Rule 13a-14(a) under the Securities and Exchange Act of 1934, as amended.
31.2	Certificate of Chief Financial Officer pursuant to Rule 13a-14(a) under the Securities and Exchange Act of 1934, as amended.

SIGNATURES

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

TARRANT APPAREL GROUP

By: /s/ GERARD GUEZ
Gerard Guez

Interim Chief Executive Officer

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

Signature	Title	Date
/s/ GERARD GUEZ **Gerard Guez**	Chairman of the Board of Directors and Interim Chief Executive Officer (Principal Executive Officer)	June 9, 2009
* **Todd Kay**	Vice Chairman of the Board of Directors	June 9, 2009
/s/ PATRICK CHOW **Patrick Chow**	Chief Financial Officer and Director (Principal Financial and Accounting Officer)	June 9, 2009
* **Milton Koffman**	Director	June 9, 2009
* **Stephane Farouze**	Director	June 9, 2009
* **Mitchell Simbal**	Director	June 9, 2009
* **Joseph Mizrachi**	Director	June 9, 2009
* **Simon Mani**	Director	June 9, 2009

* By:	/s/ Gerard Guez
	Gerard Guez, Attorney-in-fact