

XOMA LTD /DE/  
Form 8-K  
March 01, 2011

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UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 8-K

CURRENT REPORT

Pursuant to Section 13 or 15(d) of the  
Securities Exchange Act of 1934

Date of Report (Date of earliest event reported): February 24, 2011

XOMA LTD.  
(Exact name of registrant as specified in its charter)

BERMUDA  
(State or other jurisdiction of incorporation)

0-14710  
(Commission File Number)

52-2154066  
(IRS Employer Identification No.)

2910 Seventh Street, Berkeley, California  
(Address of principal executive offices)

94710  
(Zip Code)

Registrant's telephone number, including area code (510) 204-7200

Not applicable  
(Former name or former address, if changed since last report)

Check the appropriate box below if the Form 8-K filing is intended to simultaneously satisfy the filing obligation of the registrant under any of the following provisions (see General Instruction A.2 below):

- ☐ Written communications pursuant to Rule 425 under the Securities Act (17 CFR 230.425)
- ☐ Soliciting material pursuant to Rule 14A-12 under the Exchange Act (17 CFR 240.14a-12)
- ☐ Pre-commencement communications pursuant to Rule 14d-2(b) under the Exchange Act (17 CFR 14d-2(b))

- o Pre-commencement communications pursuant to Rule 13e-4(c) under the Exchange Act (17 CFR 240.13e-4(c))
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Item 5.02. Compensatory Arrangements of Certain Officers.

(e) The Board of Directors (the “Board”) of XOMA Ltd. (the “Company”), in connection with its annual review of the compensation of the Company’s officers and following the recommendation of the Compensation Committee of the Board, has approved salary increases for 2011, has determined that management successfully achieved corporate objectives for 2010 in excess of the minimum required by the CEO Incentive Compensation Plan (the “CICP”) and the Management Incentive Compensation Plan (the “MICP”) in order to make awards thereunder and has made awards thereunder. The following sets forth the amount of 2011 salary and the amount of each such award for each of the executive officers who were named in the Summary Compensation Table of the Company’s 2010 Proxy Statement: Steven B. Engle (Chairman of the Board, Chief Executive Officer and President) - 2011 salary of \$551,550, and \$246,130 awarded under CICP; Patrick J. Scannon, M.D., Ph.D. (Executive Vice President and Chief Scientific Officer) - 2011 salary of \$410,940, and \$179,539 awarded under MICP; Fred Kurland (Vice President, Finance and Chief Financial Officer) - 2011 salary of \$332,100, and \$166,681 awarded under MICP; Christopher J. Margolin (Vice President, General Counsel and Secretary) - 2011 salary of \$355,720, and \$146,660 awarded under MICP; and Charles C. Wells (Vice President, Human Resources and Information Technology) - 2011 salary of \$319,945, and \$132,721 awarded under MICP.

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SIGNATURE

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

Dated: March 1, 2011

XOMA LTD.

By: /s/ Christopher  
J. Margolin  
Christopher  
J. Margolin  
Vice  
President,  
General  
Counsel and  
Secretary

share, which was paid on June 3, 2008 to stockholders of record at the close of business on May 28, 2008; entered into an amendment to its revolving credit facility, which extends the maturity date of the Amended Credit Facility to the earlier of December 31, 2008 or the termination of the Kmart Agreement and reduces the revolving commitments thereunder to \$50,000,000 (inclusive of a \$25,000,000 sub-limit for letters of credit) as discussed in Note 13 Credit Facility of our Notes to Consolidated Financial Statements in this Form 10-Q; approved planned reductions in workforce and eliminated three executive officer positions, which are intended to reduce the Company's operating expenses and further align its workforce with its anticipated staffing needs, as discussed in Note 5 Reduction in Workforce of our Notes to Consolidated Financial Statements in this Form 10-Q; and terminated its retiree medical and retiree life insurance plan for all active employees who were eligible to participate in such plan and for all retiree participants, effective June 6, 2008, as discussed in Note 3 Summary of Significant Accounting Standards of our Notes to Consolidated Financial Statements in this Form 10-Q.

**Overview**

The following points highlight the first six months of operations in 2008 as compared to the first six months in 2007 for the Company and our financial condition as of June 28, 2008:

as of June 28, 2008 we operated in 1,383 Kmart stores compared with 1,389 stores on June 30, 2007, and we operated in 833 Rite Aid stores on June 28, 2008 in the western region of the United States, compared with 854 stores on June 30, 2007;

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operating profit increased to \$28.4 million for the six month period ended June 28, 2008 as compared to an operating profit of \$21.5 million for the six month period ended June 30, 2007, primarily the result of the termination of the retiree medical and life insurance plan (\$22.3 million) and lower selling, general and administrative costs (\$2.2 million) which offset the effects of lower sales (\$36.4 million) and lower gross profit (\$19.0) million;

the Company used \$16.1 million in cash from operating activities during the first six months of 2008 as compared to providing cash of \$8.5 million from operating activities for the first six months of 2007, primarily related to the change in vendor terms and lower sales in the first six months of 2008; and

as of June 28, 2008, the Company had \$29.4 million of cash and cash equivalents with no loans outstanding under the Amended Credit Facility. Outstanding standby letters of credit as of June 28, 2008 were \$7.1 million. The Company had \$32.9 million available for additional borrowings under the Amended Credit Facility as of June 28, 2008.

***Kmart Relationship***

Our business relationship with Kmart is extremely important to us. The licensed footwear departments in Kmart provide substantially all of our sales and profits.

As discussed in more detail in Note 1 ( Nature of Company; Expiration of Agreement with Kmart; and Plan of Liquidation ) of our Notes to Consolidated Financial Statements in this Form 10-Q, on April 3, 2008, we entered into the Master Agreement Amendment, which amended certain provisions of the Kmart Agreement, including, among other things, Kmart's purchase of the inventory (excluding damaged or unsaleable inventory) associated with the Kmart business upon the termination of the Kmart Agreement.

***Product Sourcing***

Product sourcing in the family footwear business is driven by relationships with foreign manufacturers. Approximately 97% of our products are imported by us and manufactured in China where the cost of labor has increased. A portion of our footwear product is comprised of petrochemical products where prices have fluctuated dramatically over the past year. Furthermore, higher product prices could result from China's July 2005 currency revaluation which allows the value of the Yuan to link to a trade-weighted basket of currencies rather than being pegged to the U.S. dollar at a fixed rate. Although we pay for finished goods in U.S. dollars, we have experienced higher product costs for our goods, which have not been fully offset by price increases for our merchandise. Also, as a result of these issues, the Company has shifted certain manufacturing production to lower cost regions of China. It is possible that the Company could experience lower product quality and/or late shipments in these new factories which could unfavorably impact the Company's financial results. The Company has experienced low, single digit cost increases for our products which we do not believe will be fully offset by price increases and we therefore expect will have a negative impact on our margins and profitability for the remainder of this fiscal year.

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**Results of Operations Three months ended June 28, 2008 versus  
Three months ended June 30, 2007**

The following is a discussion of the results of operations for the three months ended June 28, 2008 compared with the three months ended June 30, 2007 (in millions):

**Second Quarter 2008 versus Second Quarter 2007**

			<b>% of Sales</b>	<b>% of Sales</b>
	<b>2008</b>	<b>2007</b>	<b>-</b>	<b>-</b>
Net Sales	<b>\$ 153.2</b>	\$ 173.4	<b>100.0</b>	100.0
Gross Profit	<b>48.3</b>	60.7	<b>31.5</b>	35.0
SG&A Expenses	<b>38.5</b>	37.1	<b>25.1</b>	21.4
Depreciation/Amortization	<b>1.0</b>	2.1	<b>0.7</b>	1.2
Gain on Cancellation of Retiree Benefit Plan	<b>22.3</b>		<b>14.6</b>	
Operating Profit	<b>\$ 31.1</b>	\$ 21.5	<b>20.3</b>	12.4

***Net Sales***

Net sales decreased \$20.2 million, or 11.7%, to \$153.2 million in 2008 compared with \$173.4 million in 2007. Shoemart sales were approximately \$148.9 million in 2008 and \$166.9 million in 2007. Shoemart comparable store sales decreased 10.3% due to the Easter calendar shift, lower clearance sales and lower customer traffic levels. Shoemart store counts were down on average by 0.4% during the second quarter as there were 1,383 stores in operation in 2008 versus 1,389 stores in 2007. Rite Aid sales were also down due to a 16.5% comparable store sales decline and store counts that were down on average by 2.4%.

***Gross Profit***

Gross profit decreased \$12.4 million, or 20.4%, to \$48.3 million in 2008 compared with \$60.7 million in 2007. The weaker gross margin is primarily attributed to the 11.7% sales decline during the quarter. The balance of the gross profit decline was due to an additional inventory reserve of \$2.4 million which is required since Kmart is obligated per the Master Agreement Amendment to pay only 40% of book value for all seasonal inventories as of December 31, 2008. In addition, severance and benefit related changes within cost of sales (\$1.5 million) and higher fuel and delivery costs (\$0.7 million) also contributed to the gross profit decline versus 2007.

***SG&A Expenses***

SG&A expenses increased \$1.4 million, or 3.8%, to \$38.5 million in 2008 compared with \$37.1 million in 2007. The increase was due to \$2.1 million of charges in the second quarter to reflect the cost of severance and other benefits for associates that have been informed of their expected termination dates in 2008 and 2009.

***Depreciation and Amortization***

Depreciation and amortization decreased \$1.1 million to \$1.0 million in 2008 compared with \$2.1 million in 2007. The decrease is due to lower amortization costs since the Company ceased trademark amortization with the sale of these trademarks in April 2008.

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## FOOTSTAR, INC. and SUBSIDIARY COMPANIES

***Gain on Cancellation of Retiree Benefit Plan***

In connection with the previously announced anticipated wind-down of the Company's business at the end of 2008, the Company terminated its retiree medical and retiree life insurance plan for all active employees who had been eligible to participate in such plan and for all retiree participants effective June 6, 2008. As a result of this termination, during the second quarter of 2008, the Company eliminated its accumulated postretirement benefit obligation of approximately \$14.6 million and its unamortized net gain and prior service costs included in accumulated other comprehensive income of \$7.7 million, and recorded a gain of approximately \$22.3 million.

***Operating Profit***

Operating profit increased \$9.6 million to \$31.1 million in 2008 compared with \$21.5 million in 2007 primarily for the reasons described above.

**Results of Operations Six months ended June 28, 2008 versus Six months ended June 30, 2007**

The following is a discussion of the results of operations for the six months ended June 28, 2008 compared with the six months ended June 30, 2007 (in millions):

**First Six Months 2008 versus First Six Months 2007**

			<b>% of Sales</b>	<b>% of Sales</b>
	<b>2008</b>	<b>2007</b>	<b>2008</b>	<b>2007</b>
Net Sales	<b>\$ 271.1</b>	\$ 307.5	<b>100.0</b>	100.0
Gross Profit	<b>82.6</b>	101.6	<b>30.5</b>	33.0
SG&A Expenses	<b>73.7</b>	75.9	<b>27.2</b>	24.7
Depreciation/Amortization	<b>2.8</b>	4.2	<b>1.0</b>	1.4
Gain on Cancellation of Retiree Benefit Plan	<b>22.3</b>		<b>8.2</b>	
Operating Profit	<b>\$ 28.4</b>	\$ 21.5	<b>10.5</b>	7.0

***Net Sales***

Net sales decreased \$36.4 million, or 11.8%, to \$271.1 million in 2008 compared with \$307.5 million in 2007. Shoemart sales were approximately \$262.7 million in 2008 and \$295.2 million in 2007 for an 11.0% decrease during the first six months of 2008. The Shoemart sales decline was the result of comparable store sales that were down 10.6% and store counts that were down 0.4% on average throughout the first six months of 2008. The Shoemart comparable store sales decline was due to lower customer traffic levels and weaker selling across all product categories on full-priced merchandise. Rite Aid comparable store sales decreased 12.5% during the first six months of 2008.

***Gross Profit***

Gross profit decreased \$19.0 million to \$82.6 million in 2008 compared with \$101.6 million in 2007. The 18.7% decrease in gross profit dollars was largely the result of the 11.8% decrease in sales during the first six months of 2008. The balance of the gross profit decline was due to an additional inventory reserve of \$2.4 million which is required since Kmart is obligated per the Master Agreement Amendment to pay only 40% of book value for all seasonal inventories as of

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December 31, 2008. In addition, higher fuel and delivery costs (\$0.3 million) also contributed to the gross profit decline versus 2007. The Company has experienced low, single digit cost increases for our products which we do not believe will be fully offset by price increases and we therefore expect will have a negative impact on our margins and profitability for the remainder of the year.

***SG&A Expenses***

SG&A expenses decreased \$2.2 million, or 2.9%, to \$73.7 million in 2008 compared with \$75.9 million in 2007. The decrease in SG&A expenses was largely due to lower administrative costs during the first six months of 2008 due to lower compensation and benefit costs due to lower headcount (\$1.2 million), lower professional fees (\$1.3 million) and lower general and administrative expenses (\$1.8 million). Offsetting these decreases was approximately \$2.1 million of charges to reflect the cost of severance and other benefits for associates that have been informed of their expected termination dates in 2008 and 2009.

***Depreciation and Amortization***

Depreciation and amortization decreased \$1.4 million to \$2.8 million in 2008 compared with \$4.2 million in 2007. The decrease is due to lower amortization costs since the Company ceased trademark amortization with the sale of these trademarks in April 2008.

***Gain on Cancellation of Retiree Benefit Plan***

In connection with the previously announced anticipated wind-down of the Company's business at the end of 2008, the Company terminated its retiree medical and retiree life insurance plan for all active employees who had been eligible to participate in such plan and for all retiree participants effective June 6, 2008. As a result of this termination, during the second quarter of 2008, the Company eliminated its accumulated postretirement benefit obligation of approximately \$14.6 million and its unamortized net gain and prior service costs included in accumulated other comprehensive income of \$7.7 million, and recorded a gain of approximately \$22.3 million.

***Operating Profit***

Operating profit increased \$6.9 million to \$28.4 million in 2008 compared with \$21.5 million in 2007 primarily due to the reasons noted above.

***Liquidity and Capital Resources***

Our primary uses of cash are funding working capital requirements and operating expenses. The Company also expects to incur severance and other costs in connection with the anticipated wind-down of its business. Further, we could experience shifts in working capital requirements not consistent with past periods. The Company intends to fund its cash requirements through current balances in cash and cash equivalents and cash flows from operations, supplemented by borrowings available under the revolving credit facility (the Amended Credit Facility), as needed. The Amended Credit Facility matures on the earlier of December 31, 2008 or the termination of the Kmart Agreement. At June 28, 2008, we had cash and cash equivalents of \$29.4 million and \$32.9 million of availability under the Amended Credit Facility.



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On May 11, 2008, the Company announced that its Board of Directors declared a \$1.00 per share special cash distribution to stockholders of record as of May 28, 2008. The distribution totaling \$21.3 million was paid on June 3, 2008 from balances in cash and cash equivalents and did not cause the Company to borrow under the Amended Credit Facility. Lender consent to such declaration and payment was provided for under the Amended Credit Facility effective as of May 9, 2008.

Subsequent to our emergence from Chapter 11 on February 7, 2006 through June 28, 2008, we made payments to creditors totaling \$127.7 million, including interest where applicable. These payments exclude claims for approximately \$0.3 million which we currently expect will be paid, with interest where applicable, upon final resolution.

Net cash used in operating activities for the first six months of 2008 was \$16.1 million, primarily consisting of net income of \$28.9 million, depreciation and amortization of \$2.8 million and a decrease in accounts receivable of \$2.3 million, offset by gain on termination of retiree medical plan of \$22.3 million, an increase in inventories of \$11.5 million, a decrease in accounts payable of \$12.5 million (see discussion below relating to the change in payment terms to various suppliers) and other miscellaneous items of \$3.8 million. Net cash provided by operating activities for the first six months of 2007 was \$8.5 million primarily consisting of net income of \$22.3 million, depreciation and amortization of \$4.2 million, and other miscellaneous items of \$0.5 million, partially offset by an increase in inventories of \$11.4 million and a decrease in accounts payable and accrued expenses of \$7.1 million.

In light of the anticipated termination of the Kmart Agreement by the end of December 2008, we began providing more current payment terms (shifting from 60 days to 30 days) to various suppliers in the first quarter of fiscal 2008, which we do not expect to impair or have an adverse material impact on our liquidity or results of operations.

Cash provided by investing activities was \$13.0 million and cash used in financing activities was \$21.9 million in the first six months of 2008 compared to using \$0.3 million in cash in investing activities and \$105.3 million in cash in financing activities in the first six months of 2007. Cash provided by investing activities in 2008 related to our sale of intellectual property in April 2008. Cash outflows from financing activities in the 2008 period reflect the Company's special cash distribution of \$1.00 per common share totaling \$21.3 million paid in June 2008. Cash outflows from financing activities in the 2007 period reflected the Company's special cash distribution of \$5.00 per common share totaling \$104.8 million paid in April 2007.

Cash provided by discontinued operations for the first six months of 2008 was \$0.6 million due to a settlement of a class action lawsuit relating to the Company's Athletic segment which was discontinued in 2004.

Factors that could affect our short and long term liquidity include, among other things, maintaining the support of our key vendors and lender, retaining key personnel, the payment of any further dividends or distributions, the impact of subsequent financial results and the timing of the wind-down of our current businesses, many of which are beyond our control. In addition, the Company has experienced low, single digit cost increases for our products which we do not believe will be fully offset by price increases and we therefore expect will have a negative impact on our gross profit and operating income for the remainder of this fiscal year. Because the Company had not

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identified a course of action to replace its current business, we are planning to wind-down our Kmart business and all our other business by not later than December 31, 2008 and expect to propose a plan of dissolution to our stockholders in 2009 after the scheduled expiration of the Kmart Agreement. Although we cannot reasonably assess the impact of all of these or other uncertainties, we believe that our cash balances, cash generated from operations, and borrowings available under our Amended Credit Facility, if needed, will be sufficient to fund our current business plan, working capital needs and anticipated expenses for at least the next twelve months.

The Company's Board of Directors has considered, and could determine in the future, in its discretion, to approve and declare further distributions or dividends to stockholders. There can be no assurance that any such distributions or dividends will be paid or, if to be approved, in what amount or amounts or the timing thereof. All future dividends and distributions would be in the absolute discretion of the Board of Directors with consent as required by our lender in connection with our Amended Credit Facility.

**Amended Credit Facility**

On May 9, 2008, the Company entered into the Amended Credit Facility with Bank of America, N.A. The Amended Credit Facility reflects a voluntary reduction in total commitments available from \$100 million to \$50 million and letter of credit sub-limit from \$40 million to \$25 million. The amount we may borrow under the Amended Credit Facility continues to be limited to total commitments or, if lower, the calculated borrowing base, based upon eligible inventory and accounts receivable and other terms determined in accordance with the Amended Credit Facility. Loans under the Amended Credit Facility bear interest, at our option, either at the alternate base rate, as defined, plus a variable margin of 0.0% to 0.5% or the London Interbank Offered Rate ( LIBOR ) plus a variable margin of 1.75% to 2.50%. The variable margin is based upon quarterly excess availability levels specified in the Amended Credit Facility. A quarterly fee of 0.3% per annum is payable on the unused balance. The Amended Credit Facility reflects an extension in maturity date to the earlier of December 31, 2008, or the termination of the Kmart Agreement, from November 30, 2008 or thirty days prior to the termination of the Kmart Agreement.

The Amended Credit Facility is secured by a perfected first priority security interest in substantially all of the assets of the Company and contains various affirmative and negative covenants, representations, warranties and events of default to which we are subject, including certain financial covenants and restrictions such as limitations on additional indebtedness, other liens, dividends, distributions, investments, disposal of assets, stock repurchases and capital expenditures. The Company is required to maintain a minimum excess availability level at all times, equal to at least 10% of the borrowing base. In addition, if at any time minimum excess availability falls below 10% of the borrowing base, the Company's fixed charge coverage ratio for the period of four consecutive fiscal quarters most recently ended must be less than 1.10 to 1.00. If an event of default occurs under the Amended Credit Facility, the lender may declare all amounts outstanding immediately due and payable and may exercise any rights and remedies they may have by law or agreement, including the ability to cause all or any part of the collateral to be sold. The Company is currently in compliance with all of its covenants under the Amended Credit Facility.

On April 3, 2008, the Company entered into the IP Purchase Agreement and a Master Agreement Amendment. Under the terms of the IP Purchase Agreement, the Company sold to Sears Brands substantially all intellectual property, including intellectual property related to the Company's

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Kmart business, for a purchase price of approximately \$13.0 million. We were required to and did obtain lender consent under our revolving credit facility in connection with this sale and the amendment of the Kmart Agreement. We enter into standby letters of credit to secure certain obligations, including insurance programs and duties related to the import of our merchandise. As of June 28, 2008, we had \$7.1 million of standby letters of credit outstanding under our Amended Credit Facility. The Company anticipates that certain standby letters of credit will be required after the Amended Credit Facility matures and as such, expects to cash collateralize such obligations in a manner acceptable to the issuer of any such standby letters of credit.

There were no borrowings under the Amended Credit Facility during the first six months of fiscal 2008. As of July 26, 2008 we had no loans outstanding, standby letters of credit totaling \$7.1 million and \$32.0 million of additional availability under the Amended Credit Facility.

**Critical Accounting Estimates**

Our discussion of results of operations and financial condition relies on our condensed consolidated financial statements that are prepared based on certain critical accounting estimates that require management to make judgments and estimates that are subject to varying degrees of uncertainty. We believe that investors need to be aware of these estimates and how they impact our financial statements as a whole, as well as our related discussion and analysis presented herein. While we believe that these accounting estimates are based on sound measurement criteria, actual future events can and often do result in outcomes that can be materially different from these estimates or forecasts.

The critical accounting estimates and related risks described in our Annual Report on Form 10-K for the fiscal year ended December 29, 2007 are those that depend most heavily on these judgments and estimates. As of June 28, 2008, the retiree medical benefits critical accounting estimate in our 2007 Annual Report on Form 10-K is no longer applicable due to the termination of the retiree medical plan in June 2008. Excluding the retiree medical benefits critical accounting estimate, there have been no material changes to any critical accounting estimate contained in our 2007 Annual Report on Form 10-K.

**ITEM 3. Quantitative and Qualitative Disclosures About Market Risk**

**Derivatives**

As of June 28, 2008, we were not materially exposed to changes in the underlying values of our assets or liabilities nor were we materially exposed to changes in the value of expected foreign currency cash flows. We historically have not entered into derivative instruments for any purpose other than to manage our interest rate exposure. That is, we do not hold derivative financial investments for trading or speculative purposes.

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**Interest Rates**

As of June 28, 2008, the Company had no outstanding loans and \$7.1 million of standby letters of credit outstanding under its Amended Credit Facility. Revolving loans under our Amended Credit Facility bear interest at rates that are tied to market rates such as the LIBOR, prime rate and federal funds rate and therefore our condensed consolidated financial statements could be exposed to market risk related to fluctuations in interest rates to the extent that the Company borrows in the future. Additionally, we have not entered into financial instruments for hedging purposes.

**Foreign Exchange**

A significant percentage of the Company's products are sourced or manufactured offshore, with China accounting for approximately 97% of all sources. Our offshore product sourcing and purchasing activities are currently, and have been historically, denominated in U.S. dollars, and, therefore, we do not currently have material exposure to cash flows denominated in foreign currencies nor have net foreign exchange gains or losses been material to operating results in the reporting periods presented in this report.

Historically, China's national currency, the Yuan, was pegged to the U.S. dollar at a fixed rate. However, in July 2005, the Chinese government revalued the Yuan allowing its value to now link to a trade-weighted basket of currencies. If the exchange rate of the Chinese Yuan were to continue increasing versus the U.S. dollar, the Company may experience higher product costs with regards to inventory purchased from China.

**ITEM 4. Controls and Procedures**

The Company has established controls and procedures designed to ensure that information required to be disclosed in the reports that the Company files or submits under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the Commission's rules and forms and is accumulated and communicated to management, including the principal executive officer and principal financial officer, to allow timely decisions regarding required disclosure. The Company's management, with the participation of our President and Chief Executive Officer and Chief Financial Officer—Senior Vice President, conducted an evaluation of the effectiveness of the design and operation of our disclosure controls and procedures (as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the "Exchange Act")) as of the end of the period covered by this report (the "Evaluation Date"). There are inherent limitations to the effectiveness of any system of disclosure controls and procedures, including the possibility of human error and the circumvention or overriding of the controls and procedures. Accordingly, even effective disclosure controls and procedures can only provide reasonable assurance of achieving their control objectives. Based on such evaluation, the President and Chief Executive Officer and Chief Financial Officer—Senior Vice President concluded that, as of the Evaluation Date, our disclosure controls and procedures were effective at a reasonable assurance level.

No changes in the Company's internal control over financial reporting have occurred during the quarterly period covered by this report that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

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**PART II. OTHER INFORMATION**

**ITEM 1. Legal Proceedings**

The information set forth under the caption "Litigation Matters" in Note 14 ("Commitments and Contingencies") of the Notes to the Consolidated Financial Statements is incorporated herein by reference.

**ITEM 1A. Risk Factors**

The risk factors included in the Company's Annual Report on Form 10-K for the fiscal year ended December 29, 2007, under "Item 1A. Risk Factors" and "Item 7. Management's Discussion and Analysis - Factors to Consider", should be reviewed and considered. In addition, certain modified risk factors have been included below:

***Liquidation of the Company's Businesses***

**The Company is planning to wind-down its Kmart business and all our other businesses by not later than December 31, 2008. This will include a liquidation and wind-down of the Company's business, including proposing a plan of dissolution to our stockholders, which is expected to occur in 2009.**

The Board of Directors of the Company adopted a plan of liquidation in May 2008, which provides for the complete liquidation of the Company by providing for the sale of certain assets and the wind-down of the Company's business as described in that plan and distributions of available cash to stockholders as determined by the Board of Directors.

Under the terms of the plan of liquidation, the Company contemplates submitting a plan of dissolution to the Company's stockholders in 2009 after the expiration of the Kmart Agreement. In connection with the wind-down of our current business, we continue to evaluate all of our remaining assets that would be available for possible sale, including our corporate headquarters. We cannot assure you that we will be successful in the sale of our corporate headquarters or any other saleable assets, if any, on the terms or at the time we may expect or plan for.

**In connection with a plan of liquidation and dissolution, there can be no assurance as to the amount, if any, of cash or other property that could be distributed to our stockholders or the timing of any such future distribution.**

Although we presently anticipate that a plan of liquidation and dissolution would be presented for approval of stockholders as soon as practicable in 2009, our Board has no fixed timetable for when any distribution to our stockholders may occur due to the many contingencies and uncertainties inherent in winding down and liquidating a business.

A proposed plan of liquidation and dissolution will be subject to approval and adoption by the Company's stockholders.

Under a plan of liquidation and dissolution the Company's remaining assets would be sold or otherwise disposed of, known liabilities would be paid or provided for, reserves would be

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established for contingent liabilities and any remaining cash would ultimately be distributed to stockholders.

Following the termination of our Kmart business by no later than December 31, 2008, it is expected that the Company will have limited or no new revenue generation sources or activities and that it would not engage in further revenue-generating activities except for winding down the business of the Company, selling or disposing of any of its remaining saleable assets and satisfying and providing for its liabilities and claims.

The amount and timing of any distributions to stockholders would be determined by our Board (or the trustee of a liquidating trust if our assets and liabilities are transferred to a liquidating trust pursuant to a plan of liquidation and dissolution), in its sole discretion, and would depend, in part, on our ability to settle or otherwise resolve and provide for all of our remaining liabilities and contingencies and convert any remaining assets into cash.

As we pursue liquidation and dissolution of our business, uncertainties as to the amount of our liabilities and the disposition value, if any, of our remaining assets make it impractical to predict the net value which might ultimately be distributable to our stockholders. The amount and timing of any distribution in connection with any decision to liquidate and dissolve would depend upon many factors, including:

- approval of a plan of liquidation and dissolution by our stockholders;

- the amounts deemed necessary by our Board to pay and provide for all of our liabilities and obligations, including potential liabilities and obligations;

- the amounts deemed necessary by our Board to satisfy any known or unknown contingent liabilities;

- the timing and proceeds of any of our saleable assets; and

- any future developments, events or circumstances which may impact or adversely change the results of any plan of liquidation.

The amount of any liquidation distribution would be based upon each of these factors, many of which are beyond our control, as well as the amount of funds necessary to complete the liquidation and dissolution of our business. If the Board determines that material contingent liabilities exist, including any asserted or threatened litigation, any distribution may be reduced or delayed. Depending upon the circumstances at the time, costs and expenses for professional fees and other costs and expenses of a liquidation and dissolution may be significant.

No assurance can be given that available cash and any amounts received on any sale of assets will be adequate to provide for our obligations, liabilities, expenses and claims and to make cash distributions to stockholders. We also cannot assure you that any distribution in liquidation would equal the price or prices at which our common stock has recently traded or may trade in the future.

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FOOTSTAR, INC. and SUBSIDIARY COMPANIES

***Kmart Agreement***

**There can be no assurance that issues will not arise in connection with any of the obligations, adjustments and payments to occur on the termination of our Kmart Agreement.**

As discussed in Note 1 ( Nature of Company; Expiration of Agreement with Kmart; and Plan of Liquidation ) of our Notes to Consolidated Financial Statements in this Form 10-Q, in April 2008 we entered into the Master Agreement Amendment, which amended certain provisions of the Kmart Agreement, including, among other things, Kmart's purchase of the inventory associated with the Kmart business at the termination of that agreement. Upon the termination of the Kmart Agreement, each of the Company and Kmart has significant obligations to be satisfied to the other party. In light of the significant adjustments and amounts payable in connection with the termination of the Kmart Agreement, including determinations as to purchase price to be paid by Kmart for inventory, there is no assurance that the parties will in all instances be able to resolve all remaining obligations to be satisfied and all amounts payable between them upon and in connection with the termination of this business.

***Certain issues in winding-down our business***

**As our Kmart business winds down, we may encounter problems and other issues which may adversely impact our Kmart Agreement and our other business operations and our financial results.**

We have been operating our business with Kmart for over forty years. The Kmart business currently accounts for substantially all of our net sales and net profits and is expected to terminate by no later than December 31, 2008. We could potentially encounter numerous problems and issues in winding down and terminating this business and all of our other operations, many of which may be beyond our control.

We could potentially have issues with our suppliers and other vendors which may be concerned with the pending termination of our business, and we could potentially encounter problems with merchandise production, shipments or quality;

We may encounter difficulty retaining or replacing our store personnel or administrative or management personnel;

In connection with scaling back and winding down our business in anticipation of the termination of the Kmart Agreement, we will incur cash charges in connection with severance costs and may likely incur cash and non-cash special charges in connection with exit activities and potential other charges or matters.

**As we scale back our business operations we anticipate reducing our workforce.**

As discussed in Note 5 ( Reduction in Workforce ) of the Notes to the Consolidated Financial Statements, in connection with the wind-down of the Company's business, the Board has approved plans to reduce the Company's workforce by approximately 130 employees in 2008 and 88 employees in 2009.

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## FOOTSTAR, INC. and SUBSIDIARY COMPANIES

**We do not currently expect to generate any material revenues or operating income as an independent company following the termination of our current business.**

As discussed in Note 1 ( Nature of Company; Expiration of Agreement with Kmart; and Plan of Liquidation ) of our Notes to Consolidated Financial Statements in this Form 10-Q, we sold to Sears Brands substantially all of the Company's intellectual property related to our Kmart business in April 2008. Following the termination of our Kmart Agreement, which we expect to occur by no later than December 31, 2008, we do not expect to own or manage any material revenue-producing assets and we will not generate any meaningful revenues. We will endeavor to operate the Company on a scaled back basis. However, we will continue to incur significant costs to maintain our ongoing administrative operations and continued corporate existence as well as costs to wind-down our business, without corresponding revenues.

*See Forward-Looking Statements in Item 2 for additional risk factors to consider.*

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

The following matters were submitted to a vote of stockholders at the Company's Annual Meeting of Stockholders held on June 17, 2008.

1. The election of two Class II directors to the Company's Board of Directors, to hold office for a term which will expire at the 2011 annual meeting of stockholders or until their successors are chosen and qualified:

Nominee	For	Withheld
Adam W. Finerman	8,616,503	17,096
Gerald F. Kelly, Jr.	8,616,385	17,214

Jordan Grayson, who received 5,042,078 votes For and 11,235 Withheld, and Zachary Prenskey, who received 5,042,069 votes For and 11,244 Withheld, were not elected as Class II directors.

Jonathan M. Couchman, Eugene I. Davis, Michael O. Hara, Steven D. Scheiwe, Jeffrey A. Shepard and Alan I. Weinstein continued to serve as members of the Company's Board of Directors.

2. The ratification of the appointment of Amper, Politziner & Mattia, P.C. as the Company's independent registered public accounting firm for the 2008 fiscal year was approved by the following vote:

For	Against	Abstain
10,643,509	10,273	3,033,130
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FOOTSTAR, INC. and SUBSIDIARY COMPANIES

3. The stockholder proposal to adopt a resolution to repeal any changes made by the Company's Board of Directors to the Company's Bylaws since February 7, 2006 and prior to and including the date of the Annual Meeting was not approved because it did not receive sufficient votes. Such proposal received the following votes:

For	Against	Abstain
5,035,401	8,436	9,477

**ITEM 6. Exhibits**

- 2.1 Plan of Complete Liquidation of Footstar, Inc. (incorporated by reference to Exhibit 2.1 of Footstar, Inc.'s Current Report on Form 8-K filed on May 09, 2008).
- 10.1 Intellectual Property Purchase Agreement, dated as of April 3, 2008, by and among Footstar Corporation, Sears Brands LLC and Sears Holdings Corporation (incorporated by reference to Exhibit 10.1 of Footstar, Inc.'s Current Report on Form 8-K filed on April 04, 2008).
- 10.2 Master Agreement Amendment, dated as of April 3, 2008, by and among Footstar, Inc., Kmart Corporation, certain affiliates of Kmart Corporation and Sears Holdings Corporation (incorporated by reference to Exhibit 10.2 of Footstar, Inc.'s Current Report on Form 8-K filed on April 04, 2008).
- 10.3 First Amendment to an Amended and Restated Exit Credit Agreement dated May 9, 2008 by and among Footstar, Inc. and Footstar Corporation as Borrowers, the Lenders from time to time party thereto, Bank of America, N.A., as Administrative Agent for itself and the Lenders, as swingline lender, as issuing bank and as collateral agent (incorporated by reference to Exhibit 10.1 of Footstar, Inc.'s Current Report on Form 8-K filed on May 09, 2008).
- 10.4 First Amendment, dated June 17, 2008, to the 2006 Non-Employee Director Stock Plan.
- 31.1 Certification of President and Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Certification of Chief Financial Officer Senior Vice President pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1 Certifications pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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FOOTSTAR, INC. and SUBSIDIARY COMPANIES

**SIGNATURES**

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

Footstar, Inc.

Date: August 6, 2008

By: /s/ Jeffrey A. Shepard  
Jeffrey A. Shepard  
President and Chief Executive Officer

Date: August 6, 2008

By: /s/ Michael J. Lynch  
Michael J. Lynch  
Chief Financial Officer    Senior Vice President

Date: August 6, 2008

By: /s/ Craig M. Haines  
Craig M. Haines  
Vice President, Controller, Principal Accounting  
Officer

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