

AMERICAN APPAREL, INC  
Form 10-Q  
August 14, 2012  
Table of Contents

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, DC 20549

FORM 10-Q

☒ QUARTERLY REPORT PURSUANT TO SECTION 13 or 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended June 30, 2012

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 No. 001-32697

American Apparel, Inc.  
(Exact Name of Registrant as Specified in Its Charter)

Delaware	20-3200601
(State or Other Jurisdiction of Incorporation or Organization)	(I.R.S. Employer Identification No.)

747 Warehouse Street, Los Angeles, California	90021
(Address of Principal Executive Offices)	(Zip Code)
Registrant's Telephone Number, Including area code: (213) 488-0226	

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes ☒ No ☐

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

Large accelerated filer	<input type="checkbox"/>	Accelerated filer	<input type="checkbox"/>
-------------------------	--------------------------	-------------------	--------------------------

Non-accelerated filer	<input type="checkbox"/>	(Do not check if a smaller reporting company)	Smaller reporting company	<input checked="" type="checkbox"/>
-----------------------	--------------------------	-----------------------------------------------	---------------------------	-------------------------------------

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

The number of shares of the registrant's common stock issued and outstanding as of August 1, 2012 was approximately 109,827,752 and 106,162,962.

---

Table of Contents

AMERICAN APPAREL, INC.

TABLE OF CONTENTS

<u>Part I-Financial Information</u>	<u>5</u>
Item 1. <u>Financial Statements</u> (unaudited)	<u>5</u>
<u>Condensed Consolidated Balance Sheets - June 30, 2012 and December 31, 2011</u>	<u>5</u>
<u>Condensed Consolidated Statements of Operations and Comprehensive Loss - Three and Six Months Ended June 30, 2012 and 2011</u>	<u>6</u>
<u>Condensed Consolidated Statements of Cash Flows - Six Months Ended June 30, 2012 and 2011</u>	<u>7</u>
<u>Notes to Condensed Consolidated Financial Statements</u>	<u>9</u>
Item 2. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	<u>28</u>
Item 3. <u>Quantitative and Qualitative Disclosures About Market Risk</u>	<u>43</u>
Item 4. <u>Controls and Procedures</u>	<u>44</u>
<u>Part II-Other Information</u>	<u>45</u>
Item 1. <u>Legal Proceedings</u>	<u>45</u>
Item 1A. <u>Risk Factors</u>	<u>49</u>
Item 2. <u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	<u>49</u>
Item 3. <u>Defaults Under Senior Securities</u>	<u>49</u>
Item 4. <u>Mine Safety Disclosures</u>	<u>49</u>
Item 5. <u>Other Information</u>	<u>49</u>
Item 6. <u>Exhibits</u>	<u>49</u>
<u>Signatures</u>	<u>51</u>

Table of Contents

Unless the context requires otherwise, all references in this report to the “Company,” “Registrant,” “we,” “our,” and “us” refer to American Apparel, Inc., a Delaware corporation, together with its wholly owned subsidiary, American Apparel (USA), LLC, and its other direct and indirect subsidiaries.

**SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS**

This Quarterly Report on Form 10-Q, including the documents incorporated by reference herein, contains forward-looking statements within the “safe harbor” provisions of the Private Securities Litigation Reform Act of 1995. All statements in this Quarterly Report on Form 10-Q other than statements of historical fact are “forward-looking statements” for purposes of these provisions. Statements that include the use of terminology such as “may,” “will,” “expects,” “believes,” “plans,” “estimates,” “potential,” or “continue,” or the negative thereof or other and similar expressions are forward-looking statements. In addition, in some cases, you can identify forward-looking statements by words or phrases such as “trend,” “potential,” “opportunity,” “believe,” “comfortable,” “expect,” “anticipate,” “current,” “intention,” “position,” “assume,” “outlook,” “continue,” “remain,” “maintain,” “sustain,” “seek,” “achieve,” and similar expressions. Any statements that refer to projections of our future financial performance, our anticipated growth and trends in our business, our goals, strategies, focuses and plans and other characterizations of future events or circumstances, including statements expressing general expectations or beliefs, whether positive or negative about future operating results or the development of our products and any statement of assumptions underlying any of the foregoing are forward-looking statements. Forward-looking statements in this report may include, without limitation, statements about:

- future financial condition and operating results;
- our ability to remain in compliance with financial covenants under our financing arrangements;
- our ability to extend, renew or refinance our existing debt;
- our liquidity, operating results and projected cash flows;
- our plan to make continued investments in advertising and marketing;
  - our growth, expansion and acquisition prospects and strategies, the success of such strategies, and the benefits we believe can be derived from such strategies;
- the outcome of investigations, enforcement actions and litigation matters, including exposure, which could exceed expectations;
- our intellectual property rights and those of others, including actual or potential competitors, our personnel, consultants, and collaborators;
- operations outside the United States;
- trends in raw material costs and other costs both in the industry, and specific to the Company;
- the supply of raw materials and the effects of supply shortages on our financial condition, and results of operations;
- economic and political conditions;
- overall industry and market performance;
- the impact of accounting pronouncements;
- our ability to improve manufacturing efficiency at our production facilities;
- management's goals and plans for future operations; and
- other assumptions described in this Quarterly Report on Form 10-Q underlying or relating to any forward-looking statements.

The forward-looking statements in this report speak only as of the date of this report and caution should be taken not to place undue reliance on any such forward-looking statements, which are qualified in their entirety by this cautionary statement. Forward-looking statements are subject to numerous assumptions, events, risks, uncertainties and other factors, including those that may be outside of our control and that change over time. As a result, actual results and/or the timing of events could differ materially from those expressed in or implied by the forward-looking statements and future results could differ materially from historical performance. Such assumptions, events, risks, uncertainties and other factors include, among others, those described



Table of Contents

under Part II, Item IA and elsewhere in this report and in the Company's Annual Report on Form 10-K for the year ended December 31, 2011 (filed with the United States Securities and Exchange Commission (the "SEC") on March 14, 2012) as well as in other reports and documents we file with the SEC and include, without limitation, the following:

- our ability to generate or obtain from external sources sufficient liquidity for operations and debt service;
- changes in the level of consumer spending or preferences or demand for our products;
- our liquidity, operating results and projected cash flows;
- disruptions in the global financial markets;
- consequences of our significant indebtedness, including our ability to comply with our debt agreements and generate cash flow to service our debt;
- our ability to maintain compliance with the exchange rules of the NYSE MKT, LLC.;
- the highly competitive and evolving nature of our business in the U.S. and internationally;
- our ability to effectively carry out and manage our strategy, including growth and expansion both in the U.S. and internationally;
- loss of U.S. import protections or changes in duties, tariffs and quotas, and other risks associated with international business;
- intensity of competition, both domestic and foreign;
- technological changes in manufacturing, wholesaling, or retailing;
- risks that our suppliers or distributors may not timely produce or deliver our products;
- loss or reduction in sales to our wholesale or retail customers or financial nonperformance by our wholesale customers;
- the adoption of new accounting standards or changes in interpretations of accounting principles;
- our ability to pass on the added cost of raw materials to our wholesale and retail customers;
- the availability of store locations at appropriate terms and our ability to identify and negotiate new store locations effectively and to open new stores and expand internationally;
- our ability to attract customers to our stores;
- seasonality and fluctuations in comparable store sales and margins;
- our ability to successfully implement our strategic, operating, financial and personnel initiatives;
- our ability to maintain the value and image of our brand and protect our intellectual property rights;
- changes in the cost of materials and labor, including increases in the price of raw materials in the global market;
- our ability to improve manufacturing efficiency at our production facilities;
- location of our facilities in the same geographic area;
- our relationships with our lenders and our ability to comply with the terms of our existing debt facilities;
- risks associated with our foreign operations and foreign supply sources, such as disruption of markets, changes in import and export laws, currency restrictions, and currency exchange rate fluctuations;
- adverse changes in our credit ratings and any related impact on financial costs and structure;
- continued compliance with U.S. and foreign government regulations, legislation, and regulatory environments, including environmental, immigration, labor, and occupational health and safety laws and regulations;
- the risk that information technology systems changes may disrupt our supply chain or operations and our ability to upgrade our information technology infrastructure, and other risks associated with the systems that operate our online retail operations;
- litigation and other inquiries, and investigations, including the risks that we or our officers will not be successful in defending any proceedings, lawsuits, disputes, claims or audits, and that exposure could exceed expectations or insurance coverages;
- our ability to effectively manage inventory levels;
- changes in key personnel, our ability to hire and retain key personnel, and our relationship with our employees;

material weaknesses in internal controls;  
costs as a result of operating as a public company;  
general economic conditions, including increases in interest rates, geopolitical events, other regulatory changes and inflation or deflation;  
disruptions due to severe weather or climate change; and  
disruptions due to earthquakes, flooding, tsunamis or other natural disasters.

All forward-looking statements included in this document are made as of the date hereof, based on information available to us as of the date hereof, and we assume no obligation to update any forward-looking statements.

## PART I-FINANCIAL INFORMATION

## Item 1. Financial Statements (unaudited)

## American Apparel, Inc. and Subsidiaries

## Condensed Consolidated Balance Sheets

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

	June 30, 2012	December 31, 2011*
<b>ASSETS</b>		
<b>CURRENT ASSETS</b>		
Cash	\$7,777	\$10,293
Trade accounts receivable, net of allowances of \$2,226 and \$2,195 at June 30, 2012 and December 31, 2011, respectively	23,123	20,939
Prepaid expenses and other current assets	10,149	7,631
Inventories, net	180,944	185,764
Restricted cash	5,918	—
Income taxes receivable and prepaid income taxes	2,041	5,955
Deferred income taxes, net of valuation allowance of \$12,003 at both June 30, 2012 and December 31, 2011	84	148
Total current assets	230,036	230,730
PROPERTY AND EQUIPMENT, net	63,893	67,438
DEFERRED INCOME TAXES, net of valuation allowance of \$61,770 at both June 30, 2012 and December 31, 2011	1,500	1,529
OTHER ASSETS, net	31,291	25,024
<b>TOTAL ASSETS</b>	<b>\$326,720</b>	<b>\$324,721</b>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
<b>CURRENT LIABILITIES</b>		
Cash overdraft	\$2,512	\$1,921
Revolving credit facilities and current portion of long-term debt	74,848	50,375
Accounts payable	34,433	33,920
Accrued expenses and other current liabilities	37,578	43,725
Fair value of warrant liability	15,143	9,633
Income taxes payable	781	2,445
Deferred income tax liability, current	58	150
Current portion of capital lease obligations	1,046	1,181
Total current liabilities	166,399	143,350
LONG-TERM DEBT, net of unamortized discount of \$31,945 and \$20,183 at June 30, 2012 and December 31, 2011, respectively	96,051	97,142
CAPITAL LEASE OBLIGATIONS, net of current portion	1,288	1,726
DEFERRED TAX LIABILITY	98	96
DEFERRED RENT, net of current portion	21,731	22,231
OTHER LONG-TERM LIABILITIES	12,236	12,046
<b>TOTAL LIABILITIES</b>	<b>297,803</b>	<b>276,591</b>
<b>COMMITMENTS AND CONTINGENCIES</b>		
<b>STOCKHOLDERS' EQUITY</b>		
Preferred stock, \$0.0001 par value per share, authorized 1,000 shares; none issued	—	—
Common stock, \$0.0001 par value per share, authorized 230,000 shares; 109,657 shares issued and 105,993 shares outstanding at June	11	11



Edgar Filing: AMERICAN APPAREL, INC - Form 10-Q

30, 2012 and 108,870 shares issued and 105,588 shares outstanding at  
December 31, 2011

Additional paid-in capital	170,887	166,486	
Accumulated other comprehensive loss	(3,807	) (3,356	)
Accumulated deficit	(136,017	) (112,854	)
Less: Treasury stock, 304 shares at cost	(2,157	) (2,157	)
TOTAL STOCKHOLDERS' EQUITY	28,917	48,130	
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	\$ 326,720	\$ 324,721	

\* Condensed from audited financial statements.

See accompanying notes to condensed consolidated financial statements.

## American Apparel, Inc. and Subsidiaries

## Condensed Consolidated Statements of Operations and Comprehensive Loss

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

(unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2012	2011	2012	2011
Net sales	\$ 149,462	\$ 132,804	\$ 282,122	\$ 248,871
Cost of sales	70,426	60,378	133,030	112,807
Gross profit	79,036	72,426	149,092	136,064
Selling expenses	55,312	50,278	110,241	100,252
General and administrative expenses (including related party charges of \$230 and \$207 for the three months ended June 30, 2012 and 2011, respectively, and \$551 and \$451 for the six months ended June 30, 2012 and 2011, respectively)	24,304	26,370	49,226	52,474
Retail store impairment	129	1,002	129	1,652
Loss from operations	(709)	(5,224)	(10,504)	(18,314)
Interest expense	10,267	7,752	19,820	14,883
Foreign currency transaction loss (gain)	1,776	(263)	826	(1,074)
Unrealized loss (gain) on change in fair value of warrants and purchase rights	1,377	(13,000)	2,028	(15,100)
(Gain) loss on extinguishment of debt	—	—	(11,588)	3,114
Other expense (income)	24	(20)	152	(55)
(Loss) income before income taxes	(14,153)	307	(21,742)	(20,082)
Income tax provision	1,119	520	1,421	876
Net loss	\$(15,272)	\$(213)	\$(23,163)	\$(20,958)
Basic and diluted loss per share	\$(0.14)	\$—	\$(0.22)	\$(0.26)
Weighted average basic and diluted shares outstanding	105,924	89,111	105,810	81,668
Net loss (from above)	\$(15,272)	\$(213)	\$(23,163)	\$(20,958)
Other comprehensive (loss) income item:				
Foreign currency translation, net of tax	(782)	211	(451)	1,414
Other comprehensive (loss) income, net of tax	(782)	211	(451)	1,414
Comprehensive loss	\$(16,054)	\$(2)	\$(23,614)	\$(19,544)

See accompanying notes to condensed consolidated financial statements.

American Apparel, Inc. and Subsidiaries  
Condensed Consolidated Statements of Cash Flows  
(Amounts in thousands)  
(unaudited)

	Six Months Ended June 30,	
	2012	2011
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>		
Cash received from customers	\$280,131	\$248,714
Cash paid to suppliers, employees and others	(285,400)	(252,752)
Income taxes refunded (paid)	808	(2,030)
Interest paid	(3,868)	(2,550)
Other	(133)	125
Net cash used in operating activities	(8,462)	(8,493)
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>		
Capital expenditures	(7,599)	(4,727)
Proceeds from sale of fixed assets	70	68
Restricted cash	(5,932)	—
Net cash used in investing activities	(13,461)	(4,659)
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>		
Cash overdraft	591	(2,148)
Repayments of expired revolving credit facilities, net	(48,324)	(836)
Borrowings under current revolving credit facilities, net	42,878	—
Borrowings (repayments) of term loans and notes payable	29,994	(7)
Payment of debt issuance costs	(4,699)	(1,213)
Net proceeds from issuance of common stock and purchase rights	—	14,418
Proceeds from equipment lease financing	—	3,100
Repayment of capital lease obligations	(572)	(651)
Net cash provided by financing activities	19,868	12,663
<b>EFFECT OF FOREIGN EXCHANGE RATE ON CASH</b>	(461)	(286)
<b>NET DECREASE IN CASH</b>	(2,516)	(775)
CASH, beginning of period	10,293	7,656
CASH, end of period	\$7,777	\$6,881

See accompanying notes to condensed consolidated financial statements.

American Apparel, Inc. and Subsidiaries  
Condensed Consolidated Statements of Cash Flows (continued)  
(Amounts in thousands)  
(unaudited)

	Six Months Ended June 30,	
	2012	2011
<b>RECONCILIATION OF NET LOSS TO NET CASH USED IN OPERATING ACTIVITIES</b>		
Net loss	\$(23,163	) \$(20,958
Depreciation and amortization of property and equipment, and other assets	11,502	12,983
Retail store impairment charges	129	1,652
Loss on disposal of property and equipment	20	71
Share-based compensation expense	4,384	2,445
Unrealized loss (gain) on change in fair value of warrants and purchase rights	2,028	(15,100
Amortization of debt discount and deferred financing costs	5,250	3,564
(Gain) loss on extinguishment of debt	(11,588	) 3,114
Accrued interest paid-in-kind	10,702	8,781
Foreign currency transaction loss (gain)	826	(1,074
Allowance for inventory shrinkage and obsolescence	(288	) (75
Bad debt expense	23	343
Deferred income taxes	(58	) 608
Deferred rent	(417	) (1,378
Changes in cash due to changes in operating assets and liabilities:		
Trade accounts receivables	(2,015	) (501
Inventories	4,557	(12,294
Prepaid expenses and other current assets	(2,917	) 2,282
Other assets	(3,902	) (1,439
Accounts payable	72	9,606
Accrued expenses and other liabilities	(5,828	) 639
Income taxes receivable / payable	2,221	(1,762
Net cash used in operating activities	\$(8,462	) \$(8,493
<b>NON-CASH INVESTING AND FINANCING ACTIVITIES</b>		
Property and equipment acquired, and included in accounts payable	\$455	\$375
Reclassification of Lion Warrant from equity to debt	—	11,339
Conversion of debt to equity	—	4,688
Issuance of warrants at fair value	—	5,036

See accompanying notes to condensed consolidated financial statements.

American Apparel, Inc. and Subsidiaries  
Notes to Condensed Consolidated Financial Statements  
For the Three and Six Months Ended June 30, 2012 and 2011  
(Amounts and shares in thousands, except per share amounts)  
(unaudited)

Note 1. Organization and Business

American Apparel, Inc. and its subsidiaries (collectively the "Company") is a vertically-integrated manufacturer, distributor, and retailer of branded fashion basic apparel products and designs, manufactures and sells clothing and accessories for women, men, children and babies. The Company sells its products through the wholesale distribution channel supplying t-shirts and other casual wear to distributors and screen printers, as well as direct to customers through its retail stores located in the United States, and internationally. In addition, the Company operates an online retail e-commerce website. At June 30, 2012, the Company operated a total of 252 retail stores in 20 countries, including the United States, Canada and 18 other countries.

Liquidity and Management's Plan

As of June 30, 2012, the Company had approximately \$7,777 in cash and \$3,022 of availability for additional borrowings under the Crystal Credit Agreement and Bank of Montreal Credit Agreement (as defined in Note 6). Additionally, the Company had outstanding \$38,867 on the \$50,000 revolving credit facility under the Crystal Credit Agreement, \$30,000 of term loans outstanding under the Crystal Credit Agreement, \$5,924 outstanding on a C\$11,000 revolving credit facility under the Bank of Montreal Credit Agreement, and \$95,700 (including paid-in-kind interest of \$6,505 and net of discount \$31,945) of term loans outstanding under the Lion Credit Agreement (as defined in Note 7).

On March 13, 2012, the Company replaced its existing revolving credit facility of \$75,000 with Bank of America ("BofA") with a \$80,000 senior secured credit facility with Crystal Financial LLC ("Crystal") and other lenders. The Crystal Credit Agreement calls for the \$80,000 to be allocated between an asset based revolving credit facility of \$50,000 and term loan of \$30,000 that matures on March 13, 2015. Among other provisions, the Crystal Credit Agreement requires that the Company maintain an arrangement similar to a traditional lockbox and contains certain subjective acceleration clauses. In addition, Crystal may at its discretion, adjust the advance restriction and criteria for eligible inventory and accounts receivable. Proceeds from the Crystal Credit Agreement were used to repay the existing revolving credit facility with BofA, fees and expenses related to the transaction, and for general working capital purposes. See Note 6.

In connection with the Crystal Credit Agreement, the Company entered into a seventh amendment to the Lion Credit Agreement, which among other things: (i) consented to the Crystal Credit Agreement, (ii) extends the maturity date of the term loan with Lion to December 31, 2015, (iii) modified certain financial covenants and covenants related to capital expenditures and (iv) requires a minimum of 5% of each interest payment on the outstanding principal in cash starting on September 1, 2012.

As a result of these financing transactions described above, the Company believes that it will have sufficient financing commitments to meet funding requirements for the next twelve months.

The C\$11,000 Bank of Montreal Credit Agreement matures in December 2012. While the Company intends to negotiate an extension of this credit agreement, it does not believe that this credit agreement represents a material component of the Company's current or future capital requirements.

The Company is in the process of executing a plan, which was commenced in late 2010, to improve its operating performance and financial position. This plan includes optimizing production levels at the Company's manufacturing facilities including raw material purchases and labor; streamlining the logistics operations; Web platform refinement; reducing corporate expenses; merchandise price rationalization in the wholesale and retail channels; store renovations; and improving merchandise distribution and allocation procedures. The Company will continue to develop other initiatives intended to either increase sales, reduce costs or improve liquidity. There can be no assurance that plans to

improve operating performance and financial position will be successful.

Note 2. Summary of Significant Accounting Policies

Principles of Consolidation and Basis of Presentation

The accompanying unaudited condensed consolidated financial statements include the accounts of American Apparel, Inc. and its wholly-owned subsidiaries. All intercompany accounts and transactions have been eliminated upon consolidation. Certain reclassifications have been made to the prior year's condensed consolidated financial statements and related footnotes to conform them to the 2012 presentation.

The accompanying unaudited condensed consolidated financial statements of the Company and its wholly owned subsidiaries have been prepared by the Company, in accordance with accounting principles generally accepted in the United States ("GAAP") for interim financial information, and are presented in accordance with the requirements of Form 10-Q and Rule 10-01 of Regulation S-X, and have not been audited. Accordingly, these unaudited condensed consolidated financial statements do not include all of the information and notes required by GAAP for complete financial statements and should be read in conjunction with the consolidated financial statements and notes thereto for the fiscal year ended December 31, 2011 included in the Company's Annual Report on Form 10-K. In the opinion of management, the interim unaudited condensed consolidated financial statements included herein contain all adjustments, including normal recurring adjustments, considered necessary to present fairly the Company's financial position, the results of operations and cash flows for the periods presented.

The operating results and cash flows of the interim periods presented herein are not necessarily indicative of the results to be expected for any other interim period or the full year.

#### Use of Estimates

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities and disclosures of contingent assets, and liabilities at the date of the financial statements, and reported amounts of revenues, and expenses during the reporting period.

Management bases its estimates on historical experience and on various assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets, and liabilities that are not readily apparent from other sources. The most complex and subjective estimates include: inventory valuation and obsolescence; valuation and recoverability of long-lived assets, including the values assigned to goodwill, property and equipment; fair value calculations, including derivative liabilities such as warrants; contingencies, including accruals for the outcome of current litigation and self-insurance liabilities; and income taxes, including uncertain tax positions and recoverability of deferred income taxes.

On a regular basis, management reviews its estimates utilizing currently available information, changes in facts and circumstances, historical experience, and reasonable assumptions. After such reviews, and if deemed appropriate, those estimates are adjusted accordingly. Actual results could differ from those estimates.

#### Restricted Cash

Restricted cash primarily represents cash collateral on standby letters of credit, the value of which was previously deducted against the availability of the Company's prior revolving credit agreement, and certain other obligations. The standby letters of credit are predominantly used as collateral for the Company's workers' compensation program (see Note 14).

#### Concentration of Credit Risk

Financial instruments, which potentially subject the Company to credit risk consist primarily of cash (the amounts of which may, at times, exceed Federal Deposit Insurance Corporation limits on insurable amounts) and trade accounts receivable (including credit card receivables), relating substantially to the Company's U.S. Wholesale segment. The Company mitigates its risk by investing through major financial institutions. The Company had approximately \$6,198 and \$9,549 held in foreign banks at June 30, 2012 and December 31, 2011, respectively.

The Company mitigates its risks related to trade receivables by performing on-going credit evaluations of its customers and adjusts credit limits based upon payment history and the customer's current credit worthiness, as determined by the review of their current credit information. The Company also maintains an insurance policy for certain customers based on a customer's credit rating and established limits. Collections and payments from customers are continuously monitored. One customer in the Company's U.S. Wholesale segment accounted for 20.8% and 16.3% of the Company's total accounts receivables as of June 30, 2012 and December 31, 2011, respectively. The Company maintains an allowance for doubtful accounts, which is based upon historical experience and specific customer collection issues that have been identified. While bad debt expenses have historically been within expectations and allowances established, the Company cannot guarantee that it will continue to experience the same credit loss rates that it has in the past.

#### Fair Value Measurements

The Company's financial instruments are primarily composed of cash, restricted cash, accounts receivable (including credit card receivables), accounts payable, revolving credit borrowings and term loan. The fair value of cash, restricted cash, accounts receivable, accounts payable, and variable rate borrowings closely approximates their carrying value due to their short maturities.

The valuation techniques utilized are based upon observable and unobservable inputs. Observable inputs reflect market data obtained from independent sources, while unobservable inputs reflect internal market assumptions. These two types of inputs



create the following fair value hierarchy:

Level 1 – Quoted prices in active markets for identical assets or liabilities.

Level 2 – Observable inputs other than Level 1 prices such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the related asset or liabilities.

Level 3 – Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of assets or liabilities.

The Company utilizes observable market inputs (quoted market prices) when measuring fair value whenever possible. For fair value measurements categorized within Level 3 of the fair value hierarchy, the Company's accounting and finance department, who report to the Chief Financial Officer, determine its valuation policies and procedures. The development and determination of the unobservable inputs for Level 3 fair value measurements and fair value calculations are the responsibility of the Company's accounting and finance department and are approved by the Chief Financial Officer.

As of June 30, 2012, there were no transfers in or out of Level 3 from other levels in the fair value hierarchy.

The fair value of the fixed rate term note is estimated using a projected discounted cash flow analysis based on unobservable inputs including interest payments, principal payments and discount rate, and is classified within Level 3 of the valuation hierarchy. An increase or decrease in the discount rate assumption, in isolation, can significantly decrease or increase the fair value of the term note (see Note 8).

The fair value of each warrant is estimated using either a Monte Carlo simulation model or the Binomial Lattice option valuation model. Significant observable and unobservable inputs include stock price, exercise price, annual risk free rate, term, and expected volatility, and are classified within Level 3 of the valuation hierarchy. An increase or decrease in volatility, in isolation, can significantly increase or decrease the fair value of the warrant (see Notes 8 and 11).

The fair value of indefinite-lived assets, which consists exclusively of goodwill, is measured on a non-recurring basis in connection with the Company's annual goodwill impairment test. The fair value of the reporting unit to which goodwill has been assigned, is determined using a projected discounted cash flow analysis based on unobservable inputs including gross profit, discount rate, working capital requirements, capital expenditures, depreciation and terminal value assumptions, and are classified within Level 3 of the valuation hierarchy. An increase or decrease in the discount rate assumption and/or the terminal value assumption, in isolation, can have a significant effect on the fair value of the reporting unit.

Retail stores that have indicators of impairment and whose carrying value of assets are greater than their related projected undiscounted future cash flows, are measured for impairment by comparing the fair value of the assets against their carrying value. Fair value of the assets is estimated using a projected discounted cash flow analysis based on unobservable inputs including gross profit and discount rate, and is classified within Level 3 of the valuation hierarchy. An increase or decrease in the discount rate assumption, in isolation, can significantly decrease or increase the fair value of the assets, which would have an effect on the impairment recorded.

#### Income Taxes

The Company recognizes deferred tax liabilities and assets for the expected future tax consequences of events that have been included in the financial statements or tax returns. Deferred tax assets and liabilities are determined based on the difference between the financial statement, and tax basis of assets, and liabilities using enacted tax rates in effect for the year in which the differences are expected to reverse. The Company estimates the degree to which tax assets and credit carryforwards will result in a benefit based on expected profitability by tax jurisdiction. A valuation allowance for such tax assets and loss carryforwards is provided when it is determined that it is more likely than not that those assets will not be realized. If it becomes more likely than not that a tax asset will be realized, the related valuation allowance of such assets would be reversed.

Management makes judgments as to the interpretation of the tax laws that might be challenged upon an audit and cause changes to previous estimates of tax liabilities. In management's opinion, adequate provisions for income taxes have been made for all years. If actual taxable income by tax jurisdiction varies from estimates, additional allowances or reversals of reserves may be necessary.

The Company's foreign domiciled subsidiaries are subject to foreign income taxes on earnings in their respective jurisdictions. The Company elected to have their foreign subsidiaries, except for its subsidiaries in Brazil, Canada, Korea, China, Spain, Italy and Ireland, consolidated in the Company's U.S. federal income tax return. The Company will generally be eligible to receive tax credits on its U.S. federal income tax return for most of the foreign taxes paid. The Company accounts for uncertain tax positions in accordance with Accounting Standards Codification ("ASC") 740

—“Income Taxes”, and gross unrecognized tax benefits at June 30, 2012 and December 31, 2011 are included in other long-term liabilities in the accompanying condensed consolidated balance sheets. The Company accrues interest and penalties, if incurred, on unrecognized tax benefits as components of the income tax provision in the accompanying condensed consolidated statements of operations.

#### Accounting Standards Updates

Beginning in the quarter ended March 31, 2012, the Company enhanced its fair value measurement application and disclosures as a result of adopting new requirements issued by the Financial Accounting Standards Board ("FASB") in May 2011. The new rules include revisions to the standards for the use of fair value measurements and additional disclosures for: (i) all transfers between Level 1 and Level 2 of the fair value hierarchy; (ii) Level 3 measurements; and (iii) hierarchy classifications used for assets and liabilities whose fair value is disclosed only in the footnotes. The new rules did not have a material impact on the Company.

#### Subsequent Events

The Company has evaluated events that occurred subsequent to June 30, 2012 and through the date the financial statements were available to be issued. Management concluded that no additional subsequent events required disclosure in these financial statements other than those disclosed in these notes to these financial statements.

#### Note 3. Inventories

The components of inventories are as follows:

	June 30, 2012	December 31, 2011
Raw materials	\$19,868	\$18,326
Work in process	1,915	2,468
Finished goods	162,795	168,902
	184,578	189,696
Less reserve for inventory shrinkage and obsolescence	(3,634	) (3,932
Total, net of reserves	\$180,944	\$185,764

Inventories are stated at the lower of cost or market. Cost is primarily determined on the first-in, first-out (FIFO) method. The cost elements of inventories include materials, labor and overhead. For the three and six months ended June 30, 2012 and 2011, no one supplier provided more than 10% of the Company's raw material purchases.

The Company identifies potentially excess and slow-moving inventories by evaluating turn rates, inventory levels and other factors and provides reserves for such identified excess and slow-moving inventories. At June 30, 2012 and December 31, 2011, the Company had a lower of cost or market reserve for excess and slow-moving inventories of \$2,466 and \$2,050, respectively.

The Company establishes a reserve for inventory shrinkage for each of its retail locations and its warehouse. The reserve is based on the historical results of physical inventory counts. The Company had a reserve for inventory shrinkage in the amount of \$1,168 and \$1,882 at June 30, 2012 and December 31, 2011, respectively.

#### Note 4. Property and Equipment

Depreciation and amortization expense relating to property and equipment (including capitalized leases) is recorded in cost of sales and operating expenses. For the three and six months ended June 30, 2012, depreciation and amortization expense was \$5,650 and \$11,502, respectively. For the three and six months ended June 30, 2011, depreciation and amortization expense was \$6,349 and \$12,983, respectively.

The Company evaluates its retail stores for indicators of impairment, specifically related to under-performance or operating losses relative to expected historical or projected future operating results. Stores whose carrying value of assets are greater than their related projected undiscounted future cash flows, are measured for impairment by comparing the fair value of the assets against their carrying value. The fair value of the assets is estimated using a projected discounted cash flow analysis (Level 3 in the fair value hierarchy). The key assumptions used in the estimates of projected cash flows were sales, gross margins, and payroll costs. These forecasts were based on historical trends and take into account recent developments, as well as the Company's plans and intentions.



For the three and six months ended June 30, 2012, the Company incurred impairment charges of \$129 relating to a store closure in Canada. For the three and six months ended June 30, 2011, the Company incurred impairment charges of \$1,002 and \$1,652, respectively primarily related to certain retail store leasehold improvements and key money in the International and the U.S. Retail segments.

#### Note 5. Accrued Expenses and Other Current Liabilities

The components of accrued expenses and other current liabilities are as follows:

	June 30, 2012	December 31, 2011
Compensation, bonuses and related taxes	\$8,089	\$11,339
Workers' compensation and other self-insurance reserves (Note 14)	5,522	5,318
Sales, value and property taxes	3,884	3,721
Gift cards and store credits	4,536	6,939
Loss contingencies	1,500	1,575
Accrued vacation	911	790
Deferred revenue	745	892
Deferred rent	2,193	2,170
Other	10,198	10,981
Total accrued expenses	\$37,578	\$43,725

#### Note 6. Revolving Credit Facilities and Current Portion of Long-Term Debt

Revolving credit facilities and current portion of long-term debt consists of the following:

	June 30, 2012	December 31, 2011
Revolving credit facility (Crystal), maturing March 2015	\$38,867	\$—
Term loan (Crystal), maturing March 2015	30,000	—
Revolving credit facility (Bank of America), replaced in March 2012	—	48,324
Revolving credit facility (Bank of Montreal), maturing December 2012	5,924	1,995
Current portion of long-term debt (Note 7)	57	56
Total revolving credit facilities and current portion of long-term debt	\$74,848	\$50,375

The Company incurred interest charges of \$10,267 and \$19,820 for the three and six months ended June 30, 2012, respectively, and \$7,752 and \$14,883 for the three and six months ended June 30, 2011, respectively, for all outstanding borrowings. The interest charges subject to capitalization for the three and six months ended June 30, 2012 and 2011 were not significant.

#### Revolving Credit Facility and Term Loan - Crystal

On March 13, 2012, the Company replaced its existing revolving credit facility of \$75,000 with BofA with a \$80,000 senior secured credit facility with Crystal Financial LLC ("Crystal" and the credit facility the "Crystal Credit Agreement"), and other lenders. The Crystal Credit Agreement calls for the \$80,000 to be allocated between an asset based revolving credit facility of \$50,000 and term loan of \$30,000. Borrowings under the Crystal Credit Agreement are subject to certain borrowing reserves based on eligible inventory and accounts receivable. In addition, the initial borrowing base under the revolving credit facility was increased by \$12,500 for the value associated with the American Apparel brand name. This initial increase will be ratably reduced to \$0 during the period from April 13, 2012 through September 1, 2012. The Crystal Credit Agreement matures on March 13, 2015 and is collateralized by substantially all of the Company's U.S. assets, and equity interests in certain of its foreign subsidiaries. The amount available for additional borrowings on June 30, 2012 was approximately \$1,957.

Among other provisions, the Crystal Credit Agreement requires that the Company maintain an arrangement similar to a traditional lockbox and contains certain subjective acceleration clauses. In addition, Crystal may at its discretion, adjust the advance restriction and criteria for eligible inventory, and accounts receivable. Consequently, the amounts outstanding under the Crystal Credit Agreement are classified as a current liability.



As of June 30, 2012, interest under the agreement was 9.5% (the 90-day LIBOR at 0.5% plus 9.0%) and also includes an unused facility fee ranging from 0.375% to 1.0% on the unused portion of the revolving credit facility, payable monthly. The Crystal Credit Agreement also includes an early termination fee if the term loan is prepaid or if the commitments under the revolving credit facility are permanently reduced of (a) 3.0% if such payment or reduction occurs in the first year, (b) 2.0% if such payment or reduction occurs in the second year, and (c) 0.0% thereafter. In connection with the financing from Crystal, the Company entered into an amendment to the Lion Credit Agreement (see Notes 7 and 11).

Proceeds from the Crystal Credit Agreement were used to repay the existing BofA Credit Facility, fees and expenses related to the transaction and for general working capital purposes.

Significant covenants in the Crystal Agreement include a minimum excess availability covenant, which requires the Company to maintain minimum excess availability of the greater of (1) \$8,000 or (2) 10.0% of the borrowing base. If the excess availability falls below this minimum, then the Company will be required to maintain a fixed charge coverage ratio not less than 1.00:1.00 to be calculated monthly on a consolidated trailing twelve-month basis and continuing until the excess availability exceeds this minimum for sixty consecutive days. The Crystal Credit Agreement also includes an annual limitation of the Company's capital expenditures at its domestic subsidiaries to no more than \$17,000 for the year ending December 31, 2012 and \$25,000 for each year thereafter.

The Crystal Credit Agreement contains cross-default provisions with the Lion Credit Agreement and the Bank of Montreal Credit Agreement, whereby an event of default occurring under the Lion Credit Agreement or the Bank of Montreal Credit Agreement would cause an event of default under the Crystal Credit Agreement.

During the six months ended June 30, 2012, the Company's excess availability was below the minimum amount and as a result, it was required to maintain the fixed charge coverage ratio. As of June 30, 2012, the Company was in compliance with the required financial covenants of the Crystal Credit Agreement.

#### Revolving Credit Facility - Bank of America

The Company had a revolving credit facility of \$75,000 with BofA, which was replaced with the Crystal Credit Agreement on March 13, 2012.

#### Revolving Credit Facility - Bank of Montreal

The Company's wholly-owned subsidiaries, American Apparel Canada Wholesale, Inc. and American Apparel Canada Retail Inc. (collectively, the "CI Companies"), have a line of credit with Bank of Montreal (the "Bank of Montreal Credit Agreement") that provides for borrowings up to C\$11,000 with a fixed maturity date of December 30, 2012, bearing interest at 7.0% (the bank's prime rate at 3.0% as of June 30, 2012 plus 4.0% per annum payable monthly). This line of credit is secured by a lien on the CI Companies' accounts receivable, inventory and certain other tangible assets. Available borrowing capacity at June 30, 2012 was \$1,065.

The Bank of Montreal Credit Agreement contains a fixed charge coverage ratio, tested at the end of each month, which measures the ratio of earnings before interest, taxes, depreciation and amortization ("EBITDA") less cash income taxes paid, dividends paid and unfinanced capital expenditures divided by interest expense plus scheduled principal payments of long-term debt, debt under capital leases, dividends, and stockholder loans and advances, for the Company's Canadian subsidiaries. The ratio must be not less than 1.25 to 1.00. The Bank of Montreal Credit Agreement also restricts the Company's Canadian subsidiaries from entering into operating leases that would lead to payments under such leases totaling more than \$8,500 in any fiscal year, and imposes a minimum excess availability covenant, which requires the Company's Canadian subsidiaries to maintain at all times minimum excess availability of 5.0% of the revolving credit commitment under the facility.

Additionally, the Bank of Montreal Credit Agreement contains cross-default provisions with the Crystal Credit Agreement and the Lion Credit Agreement, whereby an event of default occurring under the Crystal Credit Agreement, and Lion Credit Agreement would cause an event of default under the Bank of Montreal Credit Agreement.

As of June 30, 2012, the Company was in compliance with all required financial covenants of the Bank of Montreal Credit Agreement.





## Note 7. Long-Term Debt

Long-term debt consists of the following:

	June 30, 2012	December 31, 2011
Long-term debt with Lion (a)	\$95,700	\$96,760
Other	408	438
Total long-term debt	96,108	97,198
Current portion of debt	(57)	(56)
Long-term debt, net of current portion	\$96,051	\$97,142
(a) Including accrued interest paid-in-kind of \$6,505 and \$17,550 and net of unamortized discount of \$31,945 and \$20,183 at June 30, 2012 and December 31, 2011, respectively.		

## Lion Credit Agreement

On March 13, 2009, the Company entered into an \$80,000 term loan with Lion Capital LLP (the "Lion Credit Agreement"). Pursuant to the Lion Credit Agreement, Lion made term loans to the Company in an aggregate principal amount equal to \$80,000. The original term loans under the Lion Credit Agreement were scheduled to mature on December 13, 2013 and bore interest at a rate of 15% per annum, payable quarterly in arrears. Effective June 23, 2010 and on February 18, 2011, the Lion Credit Agreement was amended to increase the interest rate to a range between 15% and 18% per annum depending on certain financial covenants relating to the ratio of Total Debt to Consolidated EBITDA for the trailing four quarters and Consolidated EBITDA for the trailing twelve months. For the three and six months ended June 30, 2012, the Company did not meet these financial covenants and as a result, the interest rate was 18% per annum. On March 13, 2012, in connection with the Crystal Credit Agreement (see Note 6), the Company entered into a seventh amendment to extend the maturity date of the Lion Credit Agreement to December 31, 2015, as described below.

At the Company's option, accrued interest may be paid (i) entirely in cash, (ii) paid half in cash and half in-kind, or (iii) entirely in-kind. In connection with the seventh amendment (described below), beginning on September 1, 2012, the Company will be required to pay a portion of its interest in cash. The Company's obligations under the Lion Credit Agreement are secured by a second lien on substantially all of the assets of the Company. The Lion Credit Agreement is subordinated to the Crystal Credit Agreement and contains customary representations, and warranties, events of default, affirmative covenants and negative covenants (which impose restrictions and limitations on, among other things, dividends, investments, asset sales, capital expenditures, and the ability of the Company to incur additional debt and liens), and certain financial covenants. The Company is permitted to prepay the loans in whole or in part at any time at its option, with no prepayment penalty.

Significant covenants in the Lion Credit Agreement include an annual limitation of the Company's capital expenditures to \$30,000. Other covenants under the Lion Credit Agreement have been modified over time in connection with amendments.

Seventh Amendment - On March 13, 2012, in connection with the new credit agreement with Crystal Financial (see Note 6), the Company entered into a seventh amendment to the Lion Credit Agreement, which among other things: (i) consented to the Crystal Credit Agreement, (ii) extends the maturity date to December 31, 2015, (iii) reduced the minimum Consolidated EBITDA amounts for any twelve consecutive months as determined at the end of each fiscal quarter and, (iv) modifies certain other financial covenants, including covenants related to capital expenditures. The amendment also required that the Lion Warrant be amended (see Note 11). In addition, the seventh amendment modifies the Lion Credit Agreement to provide for interest at a rate of 5% per annum to be paid in cash commencing on the interest accruing from and after September 1, 2012 (with the remainder of the interest under the Lion Credit Agreement payable in-kind or in cash at the option of the Company).

In connection with the March 13, 2012 amendment, the Company evaluated the change in cash flows in connection with the amendment to the Lion Credit Agreement. The Company determined that there was a greater than 10% change between the present values of the existing debt and the amended debt causing an extinguishment of debt. The Company recorded the modified debt and related warrant at its fair value and recognized a gain of \$11,588 on extinguishment of existing debt. This gain on extinguishment was determined by calculating the difference of the net

carrying amount of the Lion debt of \$116,507 (which includes the principal, paid-in-kind interest, fair value of the Lion Warrant, unamortized discount and unamortized deferred financing cost immediately prior to the amendment) and the fair value of the modified debt of \$104,919 (which includes the fair value of modified debt, fair value of the modified Lion Warrant and amendment related fees). The difference between the carrying net amount of the existing debt of \$121,140 and the fair value of the modified debt of \$86,898 was recorded as a discount to the modified debt, and will be recognized as interest expense using the effective interest method over the remaining term of the Lion Credit Agreement.

Amortization of debt discount included in interest expense was \$1,921 and \$4,114 for the three and six months ended June 30,

2012, respectively, and \$1,816 and \$2,975 for the three and six months ended June 30, 2011, respectively.

The Lion Credit Agreement contains certain cross-default provisions by which noncompliance with covenants under the Crystal Credit Agreement, the Bank of Montreal Credit Agreement and certain other existing and potential agreements also constitutes an event of default under the Lion Credit Agreement. As of June 30, 2012, the Company was in compliance with the required financial covenants of the Lion Credit Agreement.

#### Note 8. Fair Value of Financial Instruments

The fair value of the Company's financial instruments are measured on a recurring basis. The carrying amount reported in the accompanying condensed consolidated balance sheets for cash, accounts receivable (including credit card receivables), accounts payable and accrued expenses approximates fair value because of the short-term maturity of those instruments. The carrying amount for borrowings under the revolving credit facilities with Crystal and the Bank of Montreal and the term loan with Crystal approximates fair value because of the variable market interest rate charged to the Company for these borrowings. The fair value of the term loan with Lion was estimated using a discounted cash flow analysis and a yield rate that was estimated using yield rates for publicly traded debt instruments of comparable companies with similar features. The fair value of each warrant was estimated using either a Monte Carlo simulation model or the Binomial Lattice option valuation model.

The Company did not have any assets or liabilities categorized as Level 1 as of June 30, 2012.

The carrying amounts and fair values of the Company's financial instruments are presented below as of June 30, 2012:

	Carrying Amount	Fair Value
<b>Liabilities</b>		
Long-term debt with Lion, net of discount of \$31,945 and including interest paid-in-kind of \$6,505 (Level 3)	\$95,700	\$94,020
Lion Warrant (Level 3)	—	(a) 15,079
SOF Warrant (Level 3)	—	(a) 64
	\$95,700	\$109,163

(a) no cost is associated with these liabilities (see Note 11)

The following summarizes the activity of Level 3 inputs measured on a recurring basis:

Fair Value Measurements of Common Stock Warrants and Purchase Rights using Significant Unobservable Inputs (Level 3)	Six Months Ended June 30,	
	2012	2011
Balance at January 1,	\$9,633	\$993
Additions	—	36,803
Adjustment resulting from change in value recognized in earnings	2,028	(18,289)
Gain on extinguishment of debt (see Note 7)	3,482	—
Balance at June 30,	\$15,143	\$19,507

#### Note 9. Income Taxes

Income taxes for the three and six months ended June 30, 2012 were computed using the effective tax rate estimated to be applicable for the full fiscal year, which is subject to ongoing review and evaluation by management. In accordance with ASC 740, "Income Taxes", the Company evaluates whether a valuation allowance should be established against the net deferred tax assets based upon the consideration of all available evidence and using a "more likely than not" standard. Significant weight is given to evidence that can be objectively verified. The determination to record a valuation allowance is based on the recent history of cumulative losses and current operating performance. In conducting the analysis, the Company utilizes an approach, which considers the current year loss, including an assessment of the degree to which any losses are driven by items that are unusual in nature and incurred to improve future profitability. In addition, the Company reviews changes in near-term market conditions and any other factors arising during the period, which may impact its future operating results.

The Company incurred a loss from operations for the three and six months ended June 30, 2012 and also incurred a loss for the year ended December 31, 2011. Based primarily upon recent history of cumulative losses and the results of operations for the three and six months ended June 30, 2012, the Company determined that it is more likely than

not it will not realize benefits

16

---

from the deferred tax assets in certain jurisdictions. The Company will not record income tax benefits in the condensed consolidated financial statements until it is determined that it is more likely than not that the Company will generate sufficient taxable income in the respective jurisdictions to realize the deferred income tax assets. As a result of the analysis, the Company determined that a full valuation allowance against the net deferred tax assets in certain jurisdictions, primarily in the U.S., and a partial valuation allowances in certain foreign jurisdictions, is required. At June 30, 2012, the Company recorded valuation allowances against its current and non-current deferred tax assets totaling \$73,773. At June 30, 2012 the Company had federal net operating loss carryforwards of approximately \$75,679. Section 382 of the Internal Revenue Code in the United States limits the utilization of net operating losses when ownership changes, as defined by that section, occur. The Company has not completed an analysis of its Section 382 ownership changes to determine whether the utilization of certain of its net operating loss carryforwards in the United States is limited.

Management makes judgments as to the interpretation of the tax laws that might be challenged upon an audit and cause changes to previous estimates of tax liability. In addition, the Company operates within multiple taxing jurisdictions and is subject to audit in these jurisdictions. The Company is currently subject to audit under the statute of limitations by the Internal Revenue Service for the calendar years ended December 31, 2008 through December 31, 2011. The Company and its subsidiaries' state and foreign tax returns are open to audit under similar statute of limitations for the calendar years ended December 31, 2007 through December 31, 2011, depending on the particular jurisdiction. The Company's uncertain tax positions are related to tax years that remain subject to examination by the relevant taxing authorities. The Company recognizes interest and penalties related to unrecognized tax benefits as a component of the income tax expense in the accompanying condensed consolidated statement of operations. At June 30, 2012, the Company had accumulated interest and penalties accrued of \$56. In management's opinion, adequate provisions for income taxes have been made for all years. If actual taxable income by tax jurisdiction varies from estimates, additional allowances or reversals of reserves may be necessary.

The Company is being audited by the Canadian Revenue Agency ("CRA") for the years ended December 31, 2005 through December 31, 2007. In connection with the audit, the CRA issued a proposed adjustment disallowing certain management fees. The Company is being audited by the U.S. Internal Revenue Service for the years ended December 31, 2008 through December 31, 2010. The Company is also currently being audited by various state jurisdictions.

#### Note 10. Related Party Transactions

For a description of loans made by Lion to the Company and a description of the warrants issued by the Company to Lion (see Notes 7 and 11).

#### Personal Guarantees by the Company's CEO

As of June 30, 2012, the CEO of the Company has personally guaranteed the obligations of American Apparel under four property leases aggregating \$8,548 in obligations. Additionally, the CEO of the Company has personally guaranteed the obligations of the Company with one vendor aggregating \$300.

#### Lease Agreement Between the Company and a Related Party

In December 2005, the Company entered into an operating lease, which commenced on November 15, 2006, for its knitting facility with a related company ("American Central Plaza, LLC"), which is partially owned by the CEO and the Chief Manufacturing Officer ("CMO") of the Company. The Company's CEO holds an 18.75% ownership interest in American Central Plaza, LLC, while the CMO holds a 6.25% interest. The remaining members of American Central Plaza, LLC are not affiliated with the Company. The lease expired in November 2011, and was subsequently extended for the next five years on substantially the same terms. Rent expense (including property taxes and insurance payments) for the three and six months ended June 30, 2012 was \$156 and \$403, and for the three and six months ended June 30, 2011 was \$156 and \$311, respectively.

#### Payments to Morris Charney

Morris Charney, ("Mr. M. Charney"), is the father of the Company's CEO and serves as a director of American Apparel Canada Wholesale Inc. and a director of American Apparel Canada Retail Inc. Day to day operations of these two Canadian subsidiaries are handled by management and other employees of these subsidiaries, none of whom performs any policy making functions for the Company. Management of American Apparel sets the policies for American Apparel and its subsidiaries as a whole. Mr. M. Charney does not perform any policy making functions for the

Company or any of its subsidiaries. Instead, Mr. M. Charney only provides architectural consulting services primarily for stores located in Canada and, in limited cases, in the United States. Mr. M. Charney was paid architectural consulting and director fees amounting to \$74 and \$148 for the three and six months ended June 30, 2012, and \$51 and \$140 for the three and six months ended June 30, 2011, respectively.

## Employment Agreement with the Company's CEO

In March 2012 the Company's Board of Directors approved a three-year employment agreement with Mr. Charney commencing on April 1, 2012 that will automatically extend for successive one-year periods unless earlier terminated by the Company. The agreement provides for, among other things, a minimum annual base compensation of \$800 plus performance bonuses and the right to receive 7,500 shares of the Company's common stock, subject to performance hurdles and other terms, and conditions as described in the agreement. See Note 12.

## Note 11. Stockholders' Equity

## Common Stock Warrants

## Lion Warrants

On March 13, 2012, in connection with the new credit agreement with Crystal Financial, LLC, the Company entered into an amendment to the Lion Credit Agreement (see Note 7), which required that the warrants issued to Lion be amended to, among other things, extend the term of the warrants to February 18, 2022 and add a provision pursuant to which, if American Apparel does not meet a certain quarterly EBITDA amount, the exercise price of the warrants would be reduced by \$0.25 (a one-time adjustment for the first violation of such covenant; subsequent violations would not result in further adjustment). The effectiveness of the amendment to the Lion Warrant will be subject to the approval by the Company's stockholders. As of March 31, 2012, the Company did not meet the EBITDA requirement, and, as a result, the exercise price of the existing Lion warrants was reduced by \$0.25 to \$0.75 per share. The fair value for each of the warrant issuances during the six months ended June 30, 2012 were estimated using the Monte Carlo simulation valuation model. The fair value for the warrants at June 30, 2012 was estimated using the Binomial Lattice option valuation model. On a weighted average basis, the calculations assumed a stock price of \$0.89, exercise price of \$0.83, volatility of 76.52%, annual risk free rate of 2.16%, and a term of 9.87 years.

As of June 30, 2012, the fair value of the 21,606 Lion Warrants was estimated to be \$15,079 and was recorded as a liability in the accompanying condensed consolidated balance sheet.

## SOF Warrants

As a result of the change in exercise price for the Lion Warrants on March 31, 2012, the exercise price of the SOF Warrant was changed to \$2.148 per share. As of June 30, 2012, the value of the SOF Warrant was estimated using the Binomial Lattice option valuation model to be \$64 and was recorded in the accompanying condensed consolidated balance sheet. The calculation as of June 30, 2012 was based on a contractual remaining term of 1.5 years, exercise price of \$2.148, interest rate of 0.26%, volatility of 64.52% and no dividends.

The following table summarizes common stock warrants issued, forfeited, expired and outstanding (shares in thousands):

	Number of Shares	Weighted Average Exercise Price	Weighted Average Contractual Life (Years)
Outstanding - January 1, 2012	22,606	\$1.05	6.0
Issued <sup>(1)</sup>	44,212	0.90	7.5
Forfeited <sup>(1)</sup>	(44,212)	1.03	—
Expired	—	—	—
Outstanding - June 30, 2012	22,606	\$0.81	9.3
Fair value - June 30, 2012	\$15,143		

<sup>(1)</sup> Issued and forfeited warrants represents repriced shares.

## Earnings Per Share

The Company presents earnings per share ("EPS") utilizing a dual presentation of basic and diluted EPS. Basic EPS includes no dilution and is computed by dividing net loss available to common stockholders by the weighted average number of common shares outstanding for the period. Diluted EPS includes the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock.

The Company had common stock under various options, warrants and other agreements at June 30, 2012 and 2011. The weighted average effects of 56,903 and 101,356 shares at June 30, 2012 and 2011, respectively, were excluded from the calculations of net loss per share for the three and six months ended June 30, 2012 and 2011, because their impact would have





been anti-dilutive.

A summary of the potential stock issuances under various options, warrants and other agreements that could have a dilutive effect on the shares outstanding as of June 30, 2012 and 2011 are as follows:

	2012	2011
SOF Warrants	1,000	1,000
Lion Warrants	21,606	21,606
Shares issuable to Mr. Charney based on market conditions <sup>(1)</sup>	20,416	38,000
Contingent shares issuable to Mr. Charney based on market conditions <sup>(2)</sup>	2,112	2,112
Contingent shares issuable to Mr. Charney based on performance factors <sup>(3)</sup>	7,500	—
Purchase Option - Investors <sup>(4)</sup>	—	27,443
Purchase Option - Mr. Charney <sup>(4)</sup>	—	2,334
Employee Options & Restricted Shares	4,269	8,861
	56,903	101,356

<sup>(1)</sup> Included Charney Anti-Dilution Rights pursuant to the April 26, 2011 Investor Purchase Agreement

<sup>(2)</sup> Pursuant to the March 24, 2011 conversion of debt to equity

<sup>(3)</sup> Pursuant to his employment agreement commencing April 1, 2012

<sup>(4)</sup> Pursuant to the April 26, 2011 Investor Purchase Agreement

The table above does not include additional warrants that may be issuable to Lion pursuant to the anti-dilution provisions under the Lion Credit Agreement such as in the event anti-dilutive shares are issued to Mr. Charney pursuant to the Charney Anti-Dilution Rights.

#### Note 12. Share-Based Compensation

##### Plans Description

##### 2007 Plan

On December 12, 2007, the Company's stockholders approved the 2007 Performance Equity Plan (as amended, the "2007 Plan"). The 2007 Plan authorizes the granting of a variety of incentive awards, the exercise or vesting of which would allow up to an aggregate of 11,000 shares of the Company's common stock to be acquired by the holders of such awards. The purpose of the 2007 Plan is to enable the Company to offer its employees, officers, directors and consultants whose past, present and/or potential contributions to the Company has been, are or will be important to the success of the Company, an opportunity to acquire a proprietary interest in the Company. The 2007 Plan provides for various types of incentive awards including, but not limited to: incentive stock options, non-qualifying stock options, reload stock options, restricted stock and stock appreciation rights. The 2007 Plan enables the compensation committee to exercise its discretion to determine virtually all terms of each grant, which allowed the Company to respond to changes in compensation practices, tax laws, accounting regulations and the size and diversity of its business. As of June 30, 2012, there were approximately 1,068 shares available for future grants under the 2007 Plan.

##### 2011 Plan

On June 21, 2011 the Company's Board of Directors and stockholders approved the American Apparel, Inc. 2011 Omnibus Stock Incentive Plan (the "2011 Plan"). The 2011 Plan authorizes the granting of a variety of incentive awards, the exercise or vesting, of which would allow up to an aggregate of 10,000 shares of the Company's common stock to be acquired by the holders of such awards. The purpose of the 2011 Plan is to provide an incentive to selected employees, directors, independent contractors, and consultants of the Company or its affiliates, and provides that the Company may grant options, stock appreciation rights, restricted stock, and other stock-based and cash-based awards. The 2011 Plan provides for each of the Company's non-employee directors to automatically receive an annual stock grant, equal to the number of shares of the Company's common stock having an aggregate market value of \$80, at the beginning of each year of Board service. As of June 30, 2012, there were approximately 8,589 shares available for future grants under the 2011 Plan.

Restricted Share Awards - The following table summarizes shares of restricted stock that were granted, vested, forfeited and outstanding under the 2007 and 2011 Plans (shares in thousands):

	Number of Restricted Shares	Weighted Average Grant Date Fair Value	Weighted Average Remaining Vesting Period (in years)
Non-vested - January 1, 2012	3,186	1.45	\$ 1.45
Granted	761		0.86
Vested	(219)	)	0.73
Forfeited	(159)	)	1.18
Non-vested - June 30, 2012	3,569		\$ 1.38
			1.4

Vesting of the restricted share awards to employees may be either immediately upon grant or over a period of four to five years of continued service by the employee in equal annual installments. Share-based compensation is recognized over the vesting period based on the grant-date fair value.

Stock Option Awards - The following table summarizes stock options granted, forfeited, expired and outstanding (shares in thousands):

	Number of Shares	Weighted Average Exercise Price	Weighted Average Contractual Remaining Life (Years)	Aggregate Intrinsic Value
Outstanding - January 1, 2012	950	\$ 1.06	9.5	
Granted	—	—	—	
Forfeited	—	—	—	
Expired	(250)	) 1.75	—	
Outstanding - June 30, 2012	700	\$ 0.82	9.3	
Vested (exercisable) - June 30, 2012	350	\$ 0.82	9.3	\$ —
Non-vested (exercisable) - June 30, 2012	350	\$ 0.82	9.3	\$ —

#### Share-Based Compensation Expense

During the three months ended June 30, 2012 and 2011, the Company recorded share-based compensation expense of \$2,542 and \$1,574, respectively, related to its share-based compensation awards that are expected to vest. During the six months ended June 30, 2012 and 2011, the Company recorded share-based compensation expense of \$4,384 and \$2,445, respectively, related to its share-based compensation awards that are expected to vest. No amounts have been capitalized. As of June 30, 2012 unrecorded compensation cost related to non-vested awards was \$13,517, which is expected to be recognized through 2015.

CEO Anti-Dilution Rights - During the three months ended June 30, 2012 and 2011, the Company recorded share-based compensation expense (included in the above) associated with Mr. Charney's certain anti-dilution rights of \$1,247 and \$611, respectively. During the six months ended June 30, 2012 and 2011, the Company recorded share-based compensation expense of \$2,494 and \$611, respectively. As of June 30, 2012, unrecorded compensation cost was \$4,536, which is expected to be recognized through 2015.

CEO Performance-Based Award - Pursuant to an employment agreement with Mr. Charney commencing on April 1, 2012, the Company provided to the CEO rights to 7,500 shares of the Company's stock (see Note 10). The shares are issuable in three equal installments, one per each measurement period, only upon the achievement of certain EBITDA targets for each of fiscal 2012, 2013 and 2014. The grant date fair value of the award is based on the share price of \$0.75 and will be recognized over the related service and amortization period in three probability-weighted terms of 1.2, 2.1 and 3.1 years corresponding to the three measurement periods. During the three and six months ended June 30, 2012, the Company recorded share-based compensation expense of \$859. As of June 30, 2012, unrecorded compensation cost was \$4,766, which is expected to be recognized through 2015.



#### Non-Employee Directors

On April 1, 2012 and July 2, 2012, the Company issued a quarterly stock grant to each non-employee director of approximately 12 and 11 shares of common stock, based upon the closing prices of \$0.82 and \$0.90 per share, respectively. In addition, Messrs. Danzinger and Igelman each received an additional 23 shares for services performed during the second half of 2011. The share-based compensation is reflected in operating expenses in the accompanying condensed consolidated statements of operations.

#### Note 13. Commitments and Contingencies

##### Operating Leases

The Company conducts retail operations under operating leases, which expire at various dates through September 2022. The Company's primary manufacturing facilities and executive offices are currently under a long-term lease, which expires on July 31, 2019. Operating lease rent expense (including real estate taxes and common area maintenance costs) was approximately \$19,029 and \$37,816 for the three and six months ended June 30, 2012, respectively, and \$19,906 and \$39,262 for the three and six months ended June 30, 2011, respectively. The Company did not incur any significant contingent rent during these periods. Rent expense is allocated to cost of sales (for production-related activities), selling expenses (primarily for retail stores) and general and administrative expenses in the accompanying condensed consolidated statements of operations.

##### Sales Tax

The Company sells its products through its wholesale business, retail stores and the internet. The Company operates these channels separately and accounts for sales and use tax accordingly. The Company is periodically audited by state taxing authorities and it is possible they may disagree with the Company's method of assessing and remitting these taxes. The Company believes that it properly assesses and remits all applicable state sales taxes in the applicable jurisdictions and has accrued approximately \$289 as of June 30, 2012 and as of December 31, 2011 for state sales tax contingencies.

##### Advertising

At June 30, 2012 and December 31, 2011, the Company had approximately \$2,523 and \$4,378, respectively, in open advertising commitments, which primarily relate to print advertisements in various newspapers and magazines, as well as outdoor advertising during the remainder of 2012.

#### Note 14. Workers' Compensation and Other Self-Insurance Reserves

The Company uses a combination of third-party insurance and/or self-insurance for a number of risks including workers' compensation, medical benefits provided to employees, and general liability claims. General liability costs relate primarily to litigation that arises from store operations. Self-insurance reserves include estimates of both filed claims carried at their expected ultimate settlement value and claims incurred but not yet reported. The Company's estimated claim amounts are discounted using a rate of 0.62% with a duration that approximates the duration of the Company's self-insurance reserve portfolio. As of June 30, 2012 the undiscounted liability amount was \$14,904. The Company's liability reflected on the accompanying condensed consolidated balance sheets represents an estimate of the ultimate cost of claims incurred as of the balance sheet dates. In estimating this liability, the Company utilizes loss development factors based on Company specific data to project the future development of incurred losses. Loss estimates are adjusted based upon actual claim settlements and reported claims. These projections are subject to a high degree of variability based upon future inflation rates, litigation trends, legal interpretations, benefit level changes and claim settlement patterns. Although the Company does not expect the amounts ultimately paid to differ significantly from its estimates, self-insurance reserves could be affected if future claim experience differs significantly from the historical trends and the assumptions applied.

The workers' compensation liability is based on an estimate of losses for claims incurred, but not paid at the end of the period. Funding is made directly to the providers and/or claimants by the insurance company. To guarantee performance under the workers' compensation program, as of June 30, 2012 and December 31, 2011, the Company had issued standby letters of credit in the amounts of \$3,326 and \$5,492, respectively, with three insurance companies being the beneficiaries, through a bank. At June 30, 2012, the Company recorded a total reserve of \$14,653, of which \$3,931 is included in accrued expenses and \$10,722 is included in other long-term liabilities on the accompanying condensed consolidated balance sheets. At December 31, 2011, the Company recorded a total reserve of \$14,189, of which \$3,598 is included in accrued expenses and \$10,591 is included in other long-term liabilities on the

accompanying condensed consolidated balance sheets. These reserves for potential losses on existing claims are believed to be for potential losses, which are probable and reasonably estimable.

The Company self-insures its health insurance benefit obligations while the claims are administered through a third party administrator. The medical benefit liability is based on estimated losses for claims incurred, but not paid at the end of the period. Funding is made directly to the providers and/or claimants by the insurance company. At June 30, 2012 and

December 31, 2011, the Company's total reserve of \$1,591 and \$1,720, respectively, was included in accrued expenses in the accompanying condensed consolidated balance sheets.

**Note 15. Business Segment and Geographic Area Information**

The Company reports the following four operating segments: U.S. Wholesale, U.S. Retail, Canada, and International. The Company believes this method of segment reporting reflects both the way its business segments are managed and the way the performance of each segment is evaluated. The U.S. Wholesale segment consists of the Company's wholesale operations of sales of imprintable apparel products to distributors and third party screen printers in the United States, as well as the Company's online consumer sales to U.S. customers. The U.S. Retail segment consists of the Company's retail operations in the United States, which was comprised of 140 retail stores operating in the United States, as of June 30, 2012. The Canada segment includes retail, wholesale and online consumer operations in Canada. As of June 30, 2012, the retail operations in the Canada segment were comprised of 36 retail stores. The International segment includes retail, wholesale and online consumer operations outside of the United States and Canada. As of June 30, 2012, the retail operations in the International segment were comprised of 76 retail stores operating in 18 countries outside the United States and Canada. All of the Company's retail stores sell the Company's apparel products directly to consumers.

The Company's management evaluates performance based on a number of factors; however, the primary measures of performance are net sales and income or loss from operations of each business segment, as these are the key performance indicators reviewed by management. Operating income or loss for each segment does not include unallocated corporate general and administrative expenses, interest expense and other miscellaneous income/expense items. Corporate general and administrative expenses include, but are not limited to: human resources, legal, finance, information technology, accounting, executive compensation and various other corporate level expenses.

The following tables represents key financial information of the Company's reportable segments before unallocated corporate expenses:

	Three Months Ended June 30, 2012				
	U.S. Wholesale	U.S. Retail	Canada	International	Consolidated
Wholesale net sales	\$36,598	\$—	\$3,379	\$2,848	\$42,825
Retail net sales	—	48,121	11,175	34,900	94,196
Online consumer net sales	6,832	—	487	5,122	12,441
Total net sales to external customers	43,430	48,121	15,041	42,870	149,462
Gross profit	11,951	31,328	9,393	26,364	79,036
Income from segment operations	5,987	437	105	3,550	10,079
Depreciation and amortization	1,611	2,682	374	983	5,650
Capital expenditures	2,109	410	304	1,086	3,909
Retail store impairment charges	—	—	129	—	129
Deferred rent expense (benefit)	47	(277)	(50)	(129)	(409)

	Three Months Ended June 30, 2011				
	U.S. Wholesale	U.S. Retail	Canada	International	Consolidated
Wholesale net sales	\$32,945	\$—	\$3,337	\$2,786	\$39,068
Retail net sales	—	40,359	10,582	32,853	83,794
Online consumer net sales	5,194	—	444	4,304	9,942
Total net sales to external customers	38,139	40,359	14,363	39,943	132,804
Gross profit	10,533	27,685	8,075	26,133	72,426
Income (loss) from segment operations	5,094	(1,510)	(547)	3,900	6,937
Depreciation and amortization	2,015	2,592	409	1,333	6,349
Capital expenditures	301	1,645	53	165	2,164
Retail store impairment charges	—	68	—	934	1,002
Deferred rent (benefit) expense	(84)	(127)	(414)	78	(547)



	Six Months Ended June 30, 2012				
	U.S. Wholesale	U.S. Retail	Canada	International	Consolidated
Wholesale net sales	\$70,518	\$—	\$6,234	\$5,070	\$81,822
Retail net sales	—	90,730	21,095	63,603	175,428
Online consumer net sales	14,247	—	1,050	9,575	24,872
Total net sales to external customers	84,765	90,730	28,379	78,248	282,122
Gross profit	23,709	59,616	16,461	49,306	149,092
Income (loss) from segment operations	12,513	(2,667)	(2,609)	4,147	11,384
Depreciation and amortization	3,349	5,327	713	2,113	11,502
Capital expenditures	3,202	1,854	816	1,727	7,599
Retail store impairment charges	—	—	129	—	129
Deferred rent expense (benefit)	96	(160)	(98)	(255)	(417)

	Six Months Ended June 30, 2011				
	U.S. Wholesale	U.S. Retail	Canada	International	Consolidated
Wholesale net sales	\$62,061	\$—	\$5,753	\$4,654	\$72,468
Retail net sales	—	77,379	20,302	58,814	156,495
Online consumer net sales	10,728	—	937	8,243	19,908
Total net sales to external customers	72,789	77,379	26,992	71,711	248,871
Gross profit	21,621	52,424	16,031	45,988	136,064
Income (loss) from segment operations	11,537	(6,505)	(1,427)	2,279	5,884
Depreciation and amortization	4,182	5,288	842	2,671	12,983
Capital expenditures	1,341	2,679	132	575	4,727
Retail store impairment charges	—	177	2	1,473	1,652
Deferred rent expense (benefit)	152	(1,046)	(436)	(48)	(1,378)

Reconciliation of reportable segments combined income from operations for the three and six months ended June 30, 2012 and 2011 to the consolidated (loss) income before income taxes is as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2012	2011	2012	2011
Consolidated income from operations of reportable segments	\$10,079	\$6,937	\$11,384	\$5,884
Unallocated corporate expenses	(10,788)	(12,161)	(21,888)	(24,198)
Interest expense	(10,267)	(7,752)	(19,820)	(14,883)
Foreign currency transaction (loss) gain	(1,776)	263	(826)	1,074
Unrealized (loss) gain on change in fair value of warrants and purchase rights	(1,377)	13,000	(2,028)	15,100
Gain (loss) on extinguishment of debt	—	—	11,588	(3,114)
Other (expense) income	(24)	20	(152)	55
Consolidated (loss) income before income taxes	\$(14,153)	\$307	\$(21,742)	\$(20,082)



Net sales by geographic location of customer for the three and six months ended June 30, 2012 and 2011, are as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2012	2011	2012	2011
United States	\$91,550	\$78,498	\$175,494	\$150,168
Canada	15,041	14,363	28,379	26,992
Europe (excluding United Kingdom)	16,823	18,200	31,590	32,902
United Kingdom	11,477	9,638	20,751	17,411
South Korea	2,959	2,689	4,920	4,738
Japan	5,079	3,471	9,039	5,949
Australia	3,528	3,208	6,487	5,721
Other foreign countries	3,005	2,737	5,462	4,990
Total consolidated net sales	\$149,462	\$		