3D ADVISORS

This 3DAdvisors Report Covers:
✓ **Insider Trading**: Insider Trading Behavior
✓ **Accounting**: Quality of Earnings Issues
✓ **Governance:** Corporate Governance Issues
✓ **Fundamentals:** Analysis of fundamentals
Deception: Deception detection analysis

New Competition + Weak Balance Sheet =Trouble
Iconix Brand Group Inc. (NASDAQ:ICON)

July 14, 2009

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Business Description

Iconix Brand Group Inc. licenses, markets, and provides a portfolio of consumer brands. As of December 31, 2008, it owned 17 iconic consumer brands: Candie's, Bongo, Badgley Mischka, Joe Boxer, Rampage, Mudd, London Fog, Mossimo, Ocean Pacific/OP, Danskin, Rocawear, Cannon, Royal Velvet, Fieldcrest, Charisma, Starter, and Waverly. In addition, the Company, through a 50% investment in Scion LLC joint venture, owns the Artful Dodger brand. It licenses its brands worldwide through approximately 200 direct-to-retail and wholesale licenses for use across a range of product categories, including footwear, fashion accessories, sportswear, home products and décor, and beauty and fragrance. The Company was formerly known as Candie's, Inc. and changed its name to Iconix Brand Group Inc. in July 2005.

Key Statistics

Sector:	Last Close:	Market Cap:	Avg Vol (3m):
Consumer Goods	**$15.19**	**$909.44M**	**1,251,330**
Industry:	52 Wk Range:	Trailing P/E:	Shrs Out:
Textile – Apparel, Footwear & Accessories	**$5.11-$17.95**	**13.41**	**59.87M**
F/T Employees:	FYE:	Forward P/E:	Short % of Float:
82	**31-Dec**	**10.55**	**10.90%**

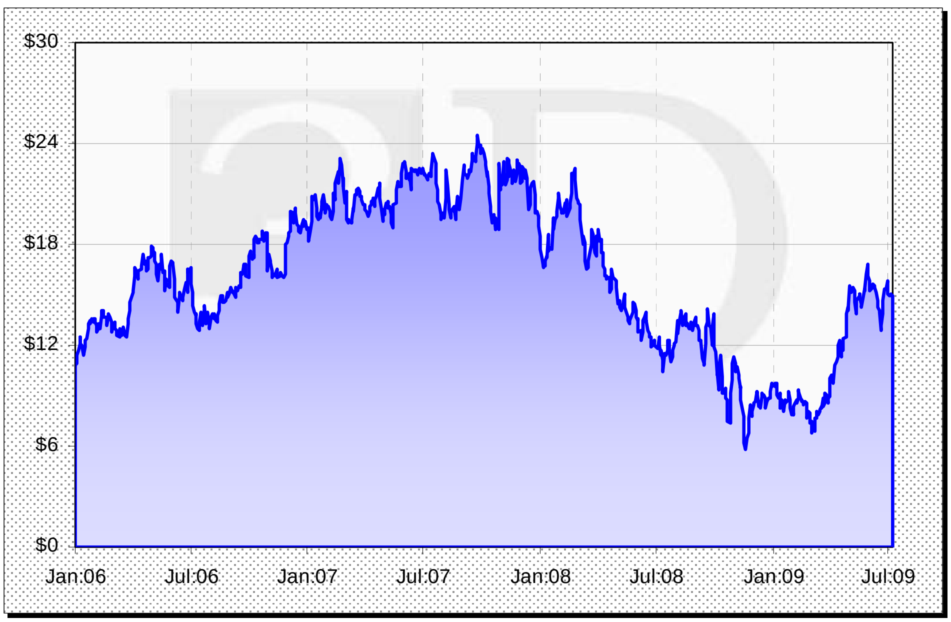
Summary of 3DAdvisors Findings for ICON

- **Fundamentals:** Executives in charge of strategy leave to become competitors
- **Accounting:** Balance sheet will make it hard to execute business model
- **Accounting:** Useful life assumption of trademarks highly questionable
- **Fundamentals:** Mudd brand problems may be evidence of difficulties ahead
- **Insider Trading:** CEO switches from buyer to seller; violates short-swing rule
- **Governance:** CEO employment agreement over-the-top generous

Discussion of 3DAdvisors Findings for ICON

Our probe into Iconix, initiated by us as a result of a subtle but highly unusual trading profile, soon took us down several fascinating paths involving different individuals and corporate entities with connections back to the Company. As we pressed on, it became evident that each path had, at one time or another, crossed that of the others, hinting at a complex set of relationships and events that date back to the very beginning of the Iconix brand ownership model and the brands the Company first acquired. The web of players, all of whom had dealings directly with the Company in its early days and later emerged as competitors, spins a captivating tale of intrigue, betrayal and (most likely) resentment, especially given that Iconix, in our view, is exposed with a risky business model, weak balance sheet and aggressive accounting practices that could put the stock in serious jeopardy if events continue to unfold in a fashion unfavorable to the Company. The story told by the behavioral and fundamental evidence we have gathered has convinced us to move forward with the name even though it falls just slightly under our normal $1 billion market capitalization minimum.

Figure 1. ICON Daily Closing Price 01/03/06 through 07/09/09. Source: Reuters



For those not familiar with the Iconix model, the Company acquires the rights to brands, typically past their prime of retail popularity, then licenses the use of the names to discount or promotionally oriented retailers, such as Wal-Mart, Target and Kohl's, who manufacture the related products thus taking on inventory and production risks. In return Iconix commits resources to advertising and marketing and collects "minimum royalties" from its licensees (usually 4% to 10%). Iconix brand names number 17 and include Candie's, Bongo, Badgley Mischka, Joe Boxer, Rampage, Mudd, London Fog, Mossimo, Ocean Pacific/OP, Danskin, Rocawear, Cannon, Royal Velvet, Fieldcrest, Charisma, Starter and Waverly.

Iconix's founder, Chairman and Chief Executive Officer **Neil Cole** (51), comes from an interesting retailing pedigree. His brother is Kenneth Cole (55), who is founder, Executive Chairman and Chief Creative Officer of Kenneth Cole Productions Inc. (NYSE:KCP) and he is the son of Charles Cole, founder of El Greco, a ladies shoe company. Both Neil and Kenneth learned the retail ropes from their father but it was Kenneth who had the early successes. Neil, on the other hand, had suffered a couple of career flops before Iconix. Unlike his brother, who moved directly into retail, Neil went to Hofstra Law School, where he focused on trademark law.

The younger Cole's first efforts were brand strategies that required him to assume the risk of manufacturing and inventory management. The first venture was New Retail Concepts (NRC), where he introduced the now-defunct "No Excuses" line of jeans. Then came Candie's, which did achieve some level of popularity, but the company did manufacture its own product and eventually found itself in trouble with the SEC for inflating sales through dubious accounting methods. The Candie's board found that Cole was unaware of the fraud, but he was nevertheless fined $75,000 by the SEC for approving a press release containing false figures. Thus, his early failures, which were caused by business model and accounting problems eventually led him in 2004 to the brand licensing strategy that Iconix employs today. We begin with an overview of that strategy, and why it too may be in trouble.

<u>Fundamentals: Executives in charge of strategy leave to become competitors</u>

The Iconix strategy clearly requires brand acquisitions at reasonable prices. The fact that many of its acquired brands were in declining growth modes made their acquisitions that much more challenging as it had to be determined whether resurrection of the brand was possible. To this, Cole utilized outsider expertise, either as consultants, board members, previous owners of acquired properties, or a combination thereof, to aid Iconix in the acquisition process. There were two individuals who were particularly important to the Company in this manner, both of whom we profile below:

- **Robert D'Loren** (51): D'Loren joined the Iconix board in November of 2003. In June of 2005, one day after resigning from the board, his company, UCC Capital Corp., was retained as the exclusive Iconix strategic advisor on acquisitions for a three-year term. D'Loren received 50,000 stock options in the deal and UCC was entitled to receive a percentage of gross revenues in acquisitions it was involved in. D'Loren has been credited for being the brainchild, while still with ICON, of the concept involving the shifting of financial risk to licensees.[1] One year later, after UCC advised ICON on three deals (Joe Boxer, Rampage and Mudd), Iconix terminated its consulting arrangement with D'Loren. UCC also received $2.5 million on a later deal, Mossimo. Subsequently, UCC executed a reverse merger and was acquired by NexCen Brands which made D'Loren its President and CEO. By November, NexCen entered the ring by acquiring Athlete's Foot Brands. This started a string of acquisitions of consumer branded products business including Bill Blass, Maggie Moo's International, Marble Slab Creamery, Waverly, Pretzel Time Franchising, Pretzelmaker Franchising, The Shoe Box and The Great American Cookie Company.

  Though the NexCen model, which focused on licenses to franchisees, differed from Iconix which licensed to retailers, there should be little doubt that its basic model was

[1] Butler, Elisabeth, "Brand Central: NexCen aims to buy, rejuvenate retail brands", Crain's New York Business.com, April 22, 2007.

cloned from that of Iconix. In the same article cited above, D'Loren referred to his company, NexCen, as "An Iconix on Steroids". Steroids indeed, as after one year and the flurry of acquisitions, the Company essentially became a "splat" overnight when it was discovered, in May of 2008, that changes in certain "cash distribution priorities" in the Company's January, 2008 amended credit facility forced the acceleration of $21 million in repayments to its lenders. This risk was not disclosed in the Company's SEC Form 10-K issued in March of 2008. The shortfall brought the Company to its knees and forced the exit of its CFO, David Meister. NexCen, like Iconix, carried trademarks as its largest asset, amounting to 56% of total assets. Although we will provide more on this later, we note that Iconix trademarks amounted to 77% of its total assets as of 03/31/09. With the credit crisis already pinching companies like NexCen by June of 2008, D'Loren found he was unable to finance new acquisitions. It was end-game for the Company.

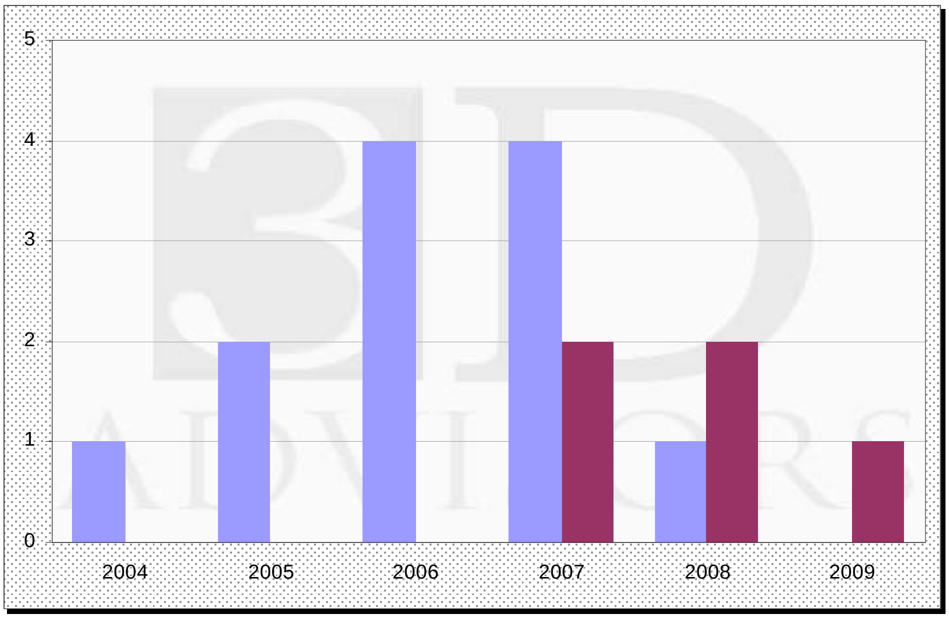
- **William Sweedler** (42): Sweedler entered the Iconix fold in July of 2005 when he sold Joe Boxer to the Company for $80 million. He was given a board seat and named President of the Joe Boxer Division with a salary of $450,000 plus revenue-based royalty bonuses and options for 1.42 million Iconix shares. In a mirror image of the D'Loren situation one year earlier, Sweedler would resign his board position in June of 2006 and immediately was given a new consulting agreement. Under his consulting term he was to be paid $1 million for bringing in three deals he had been working on for Iconix along with warrants to purchase 400,000 Iconix shares which would vest in one-third tranches at the closing of each deal. By November, 2006 he received $333,333 in cash and 133,333 of the warrants as a result of the acquisition, by Iconix, of Ocean Pacific. But it then appears that Sweedler disappeared from Iconix immediately following the OP deal.

Sweedler's disappearance from all visible connection with Iconix, however, did not mean he was out of the picture. Indeed, he surfaced with his own private equity firm poised to compete directly with Iconix. To say he had the benefit of deep pockets may be an understatement. Sweedler's firm, Windsong Brands, LLC, partnered up with **Barry Sternlicht** (Starwood Hotels) and **Marvin Traub** (former Bloomingdale CEO for 22 years) to buy the Ellen Tracy clothing brand from Liz Claiborne in April of 2008. They had also acquired the Caribbean Joe brand, along with other names, in an acquisition of CJ Apparel Group. In May of 2008, they partnered to acquire the Carlos Falchi brand of accessories and handbags. To date, Windsong Brands, either independently or though partnering with Traub and Sternlicht, has secured the ownership of 8 brands: Patron (premium-brand tequila), Field & Stream (distributed through Dick's Sporting Goods), Joe's Jeans, Ellen Tracy, Caribbean Joe, Atlantis Weather Gear, Sharper Image and Carlos Falchi. Many of these properties were acquired while cash-strapped Iconix has been relatively dormant on the acquisition front since 2007. In fact, the only acquisition Iconix has done since was in October 2008 when it acquired Waverly from NexCen just after its collapse (see Figure 2 below).

It appears that Sweedler, with better financial backing, has put together an effective competitor to Iconix and has managed to pick up a number of brands that would appear to be of the sort that would be attractive to Iconix. And now, it is quite evident that bad blood remains between the two entities: The current Iconix General Counsel, **Andrew Tarshis** signed his current employment agreement in November of 2008. The Non-competition/Non-solicitation section contained a truly interesting "Sweedler Clause" [our term; the bolding below is ours]:

Without intending to limit the generality of the foregoing, the Executive hereby agrees that during the Non-Compete Term he shall not have interest in or render any services within or outside the Territory to William Sweedler or an affiliate thereof, including without limitation any entity with which such person is affiliated or associated.

Figure 2. Number of Acquisitions Completed by Iconix (Blue Bars) and Windsong Brands (Red Bars), 2004 through 2009. Source: ICON SEC Filings.



Accounting: Balance sheet will make it hard to execute business model

In all likelihood, Iconix has not been in a financial position to effectively compete with Sweedler or anyone else for new brands as they become available; a problem that can be critical to a business such as this that requires acquisitions to keep its growth going.

Iconix remains strapped by its heavy debt load. Its term loan payments equal 50% of the excess cash flow from the Company's subsidiaries. For 2008, this consumed $39 million which is in addition to quarterly principal payments equal to 1% of the principal amount outstanding. The thin level of working capital means its guaranteed royalty payments from licensees of the Company's brands moves in and out of its bank accounts very rapidly. Clearly cash is tight, and as a consequence servicing the Company's long-term debt has to be one of its greatest challenges. With virtually every asset used as collateral, it is doubtful that much, if any, borrowing capacity remains. Hence, the Company's recent June sale of 10 million shares of common stock, described below, provided a much needed infusion of capital.

Available cash net of restricted cash dropped to just $38 million at 3/31/2009 and, as suggested above, its credit facility may offer as little as $37 million (as of

3/31/2009) in additional liquidity. It managed to make only one acquisition in 2008 while a well-financed Windsong Brands (Sweedler) bobbled up multiple properties. Though the Company did raise a much needed $150 million in its June secondary offering of 10 million shares at $15 (800,000 which came from selling insiders; more on this later), it still does not offer all that much breathing room for acquisitions when one considers the current portion of long-term debt stood at $46.5 million at 03/31/09.

In the 1Q09, the Company made a $44 million loan payment on long-term debt. It took all of the cash generated by operations in the quarter, along with a chunk of existing cash on hand, in order to make the payment. With the Company's tight cash flow situation, we would imagine that CFO **Warren Clamen** is keeping a weather eye on the June 2012 maturity date for its Convertible Senior Subordinated Notes which were placed in a private offering to "certain institutional investors". Albeit three years out, upon conversion, it is apparent that the Company will have to shell out at least $287.5 million in cash, according to the following disclosure in the risk section of the 2008 SEC Form 10-K [bolding is ours]:

> We may not have sufficient cash to pay, or may not be permitted to pay, the cash portion of the consideration that we will be required to pay when our 1.875% convertible senior subordinated notes become due in June 2012, herein referred to as our convertible notes.
>
> Upon conversion of the convertible notes, we will be required to pay to the holder of such notes a cash payment equal to the par value of the notes. **This part of the payment must be made in cash, not in shares of our common stock. As a result, we will be required to pay a minimum of $287.5 million in cash to holders of the convertible notes upon their conversion.** If we do not have sufficient cash on hand at the time of conversion, we may have to raise funds through debt or equity financing. Our ability to raise such financing will depend on prevailing market conditions. Further, we may not be able to raise such financing within the period required to satisfy our obligation to make timely payment upon any conversion. In addition, the terms of any current or future debt may prohibit us from making these cash payments or otherwise restrict our ability to make such payments and/or may restrict our ability to raise any such financing. In particular, the terms of our outstanding term loan facility restrict the amount of proceeds from collateral pledged to secure our obligations thereunder that may be used by us to make payments in cash under certain circumstances, including payments to the convertible notes holders upon conversion. A failure to pay the required cash consideration upon conversion would constitute an event of default under the indenture governing the convertible notes, which might constitute a default under the terms of our other debt.

Even with this additional cash requirement looming just a couple of years out, the recent infusion of equity capital has given the Company some short-term ability to step up to the acquisition plate anew. It will be interesting to see whether potential competitive bids, however, force purchase prices higher than they would have been without the likes of Windsong in the picture.

The Company has been talking about its 50% owned joint venture in China, Iconix China, formed in November of 2008. Iconic initially contributed $2 million to the venture with a total commitment of $5 million. In the deal, Iconix contributed “substantially all rights to its brands in the China Territory”. One interesting component of the deal was that the Company was able to record a non-cash gain of $2.6 million related to its contribution of those trademarks. The gain was included in licensing revenue in the 4Q08. The Company’s share of the venture lost $500,000 dollars in 2008 and, through the 1Q09, another $300,000, as the venture recorded revenues of $100,000 dollars vs. expenses of $700,000 for the period.

On a final note, amidst the obvious pressure placed on the Company by its relatively weak balance sheet, the near-term strategy for making guidance appears to be as much about cost cutting as anything else, which was clear in the 4Q08 conference call in this response from CEO Neil Cole to a related question:

> We basically looked at every part of the business and have adjusted accordingly. We've taken down expenses roughly about $16 million. We were planning to increase advertising substantially over last year, and we've decided to keep it flat. We think with the help we're getting from our retail partners, it will be sufficient spending somewhere around $21 million in advertising, supplemented, as I said, by what we get from Wal-Mart and Kohl's and our partners. Headcount, we've taken down -- we reduced somewhere around $5 million, $6 million in salary and stock incentives. Also tightened up every aspect of the business, whether it be rent and some of the others. We were going to build a big new showroom -- we stopped and we're not building. We're just being very careful. We've also lowered our interest expense about $4 million with what's -- that's one of the good things happening in the world today as far as where LIBOR is. So a combination across the board we think we've adjusted the overhead, so that we can continue to grow earnings with a decrease in top line…

So, in order to preserve or improve earnings for 2009, the Company is not counting on top-line growth in the near-term, but rather expects to achieve guidance through reduced expenses. We would not expect to see much of an improvement in the Company’s financial position anytime soon.

<u>Accounting: Useful life assumption of trademarks highly questionable</u>

If one were to ask what the biggest risk facing Iconix is, our answer would unquestionably be “trademarks”. The $1.06 billion in trademarks on the Company’s balance sheet represent a staggering 77% of total assets. Add in goodwill and one sees that 83% of total assets are intangibles. While it is generally true that investors often treat asset impairment with a big yawn, the banks who are holding $600 million of long-term debt backed in part by the Company’s trademarks definitely will not. If that’s not enough, keep in mind that intangibles are all considered to have perpetual lives by the Company and consequently are not subject to amortization expense. It is interesting to contemplate whether a retail brand, subject to the whims of fashion and all of the normal vagaries of the market place, not to mention the impact of current economic realities, really has an indefinite life and therefore not subject to amortization. At some point, perhaps as early as year-end 2009, it is not unreasonable to think that the auditors are going to question that concept.

Iconix would no doubt argue that it is too early to even consider impairment of the assets values for the brands it has recently acquired, but we wonder what the experience has been in similar circumstances at other companies. On the 4Q08 conference call, an analyst question showed we are not alone in wondering about the exposure stemming from the potential write down of intangibles. We found management's response interesting:

> **Analyst:** Given kind of the new run rate we're experiencing here, kind of with the consumer spending globally on discretionary apparel and home items, and you've had a lot of acquisitions over the last few years. Is there anything in terms of your intangibles that…have you tested those recently, and are there any write-downs that may potentially be coming?
>
> **Warren Clamen, CFO:** To answer your question we have tested them recently and there are no write-downs coming.
>
> **Analyst:** So that's an annual test, so you've done that, so should we be OK for 2009 or are you testing them more frequently?
>
> **Warren Clamen, CFO:** No, that's the annual test and we should be OK unless…we test them on an annual basis.

We note how Clamen seems to have almost specified an exception to the annual testing that might have required more frequent testing for impairment. He checked himself, however, but then Neil Cole decided to chime in:

> **Neil Cole, Chairman and CEO:** One of the benefits of our model is we have guaranteed royalties for pretty much all of our brands, so it gives good comfort that they all are performing.

Yet in the 2008 SEC Form 10-K (filed 03/02/09), the risk section describes how license revenue is concentrated among a few large licensees and that if any of them choose not to renew or simply renegotiate lower minimum royalty payments, it could have a substantial impact on revenue and cash flow.[2] This is exactly what happened when the Company renegotiated its exclusive deal with K-Mart to use the Joe Boxer brand in September 2006. Since 2004, K-Mart's sales of the brand failed to generate enough royalties to meet its contracted minimum payments to Iconix. The Company agreed to expand the deal with K-Mart to include use of the brand by Sears and extend the term from the original 2007 out to 2010, but it also agreed to cut the minimum royalty payment in half, "as a result of which our revenues from this license were substantially reduced".

Even though each of the major licensing deals Iconix has with major retailers is short-lived and generally runs just 2 or 3 years, the K-Mart experience shows that they are subject to renegotiation at any time. The current retail environment, combined with potential competitive pressure from Windsong Brands if not others, strongly suggests that most of the major retailers are going to pressure the Company for better deals sooner rather than later. If nothing else, we know that Wal-Mart, Kohl's and Target are not shy about pressuring suppliers for the best deal, especially if they sense a negotiating advantage.

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[2] Iconix Brand Group Inc. 2008 SEC Form 10-K, filed 03/02/09, page 17.

To this, we point to another interesting exchange from the 4Q08 conference call:

> **Analyst:** On the retail side, you guys have a good view into the consumer, obviously. Have you noticed, within some of your brands at retail, have the price points been changing there, or have they been relatively consistent on your brands?
>
> **Neil Cole:** Yes, I think the price points generally are coming down a little bit, and people are getting a little more competitive in the market, and obviously retailers are being more promotional, so we are seeing…sometimes we're seeing the same amount of units going out the door but still being down a couple of points. So I do think there will be pricing pressure on a lot of our brands, pretty much on all brands, over the next few months.

The Company projects $210 to $220 million on the revenue line for 2009, claiming that about 70% is guaranteed by way of minimums. The truth of the matter is that as they get closer to the end of the agreements and if the chains are just paying the minimums due to low volumes, renewals on even existing terms will be very difficult if not impossible, and if sales really dry up, the deals are subject to renegotiation at any time. This, we would submit, is a built-in risk in the Company's business model.

<u>Fundamentals: Mudd brand problems may be evidence of difficulties ahead</u>

The Mudd brand was acquired by Iconix in 2006 and has expanded well beyond the affordable flare-legged woman's jeans it was founded on in 1995 and today includes women's shoes, intimates, eyewear, bags, hats, and jewelry as well as a wide array of clothing products. Mudd brand products had been sold through J.C. Penney's, Kohl's, and Target among others. Not long after the acquisition, the brand stumbled, and the Company negotiated a deal with Kohl's in December of 2008 to make Kohl's the exclusive licensee of the Mudd brand. As a result of the new arrangement, Mudd royalties ceased for a period of six months, but Kohl's is expected to rollout its new Mudd campaign this month (July). The Mudd situation led to an interesting exchange during the 4Q09 conference call that we found difficult to ignore. Cole's rambling response doesn't really answer the analyst question but instead tries to divert attention away from the possibility that other minimum payments could be reduced in the current environment by touting past growth and listing all the great retailers they have relationships with:

> **Analyst:** So currently you are trading at six times GAAP EPS, four times cash EPS, about the lowest valuation in the group even though you have one of the best models in the group. So I guess The Street is saying that if Mudd is vulnerable, perhaps all the guaranteed minimum income is in jeopardy. I think this is an erroneous conclusion but I was just wondering if you could just address these concerns.
>
> **Neil Cole:** It's tough to address the Street, and the stock price, hopefully it will take care of itself in the long run. But I think we've addressed it over the last three years. The Company has gone from $60 million royalty up to $217 million worth of royalty, and we have partnerships with the best, we think, retailers in America, or the world that are going to do well in this environment, and we have

> three deals with Wal-Mart, we have three deals with Target, we have two deals with Kohl's. Some of the best retailers, the best credits, and our business continues to grow and prosper.
>
> And obviously you get frustrated when you look at the stock -- but what's going on in the world today -- but we just have to stay focused and we just have to continue to execute. Yes, some of the brands where we thought they were going to bring in $20 million might bring in $18 million or $19 million in this economy, and sales have been off because retailers are managing inventories tightly, but we just to have stay focused, and we will come out incredibly strong on the other end, as we continue to perform.

We would liken Cole's answer to how a football coach, in the midst of a mediocre season, might answer tough questions about whether or not his team will make the playoffs. Of course, if the team suffers no injuries and executes all of its game plans, the coach (looking to keep his job) would expect good things. To us, the situation faced by Iconix is that with Mudd off the market for six months and a planned re-launching in the latter half of 2009, the Company very well may be concerned about the possibility of a failed or, at least, a tainted brand with no assurance of being accepted when re-launched. One wonders if the re-launching may be as much an attempt to avoid writing down the related trademark assets carried on the balance sheet as it is a desire to preserve the revenue stream.

<u>Insider Trading: CEO switches from buyer to seller, violates short-swing rule</u>

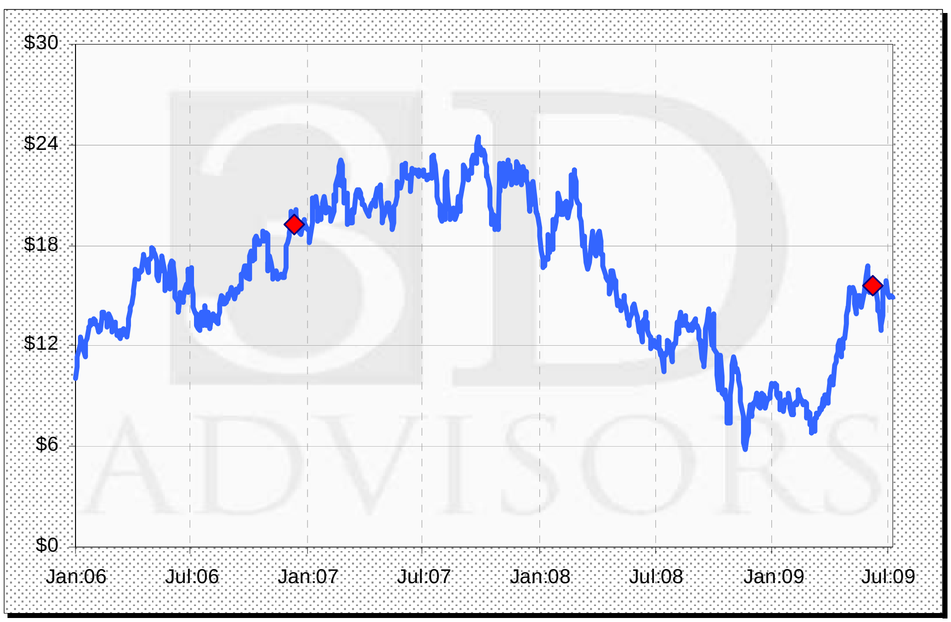
From the outset, we should mention that the insider trading profile at Iconix is neither one that features a large group of executives acting in a short time frame to sell shares nor one that highlights large holdings reductions. In fact, there are only three named executives that are Section 16 filers at the Company, and the recent trades involved holdings reductions of no greater than 33% for any one individual. Yet there are some elements to the recent activity that are quite telling to us, especially when considered in the context of the business model and balance sheet risks outlined above.

With regards to the recent insider trading activity, our focus is most significantly on the behavior, both current and past, of Chairman, CEO and President Neil Cole. As many are aware, Cole sold 650,000 shares in the Company's June 5th stock offering. The offering, which was priced at $15.00, covered 10 million shares; the Company sold 9.2 million shares and the insiders sold the other 800,000. Cole was a long-term buyer of ICON between December 2002 and June 2004, acquiring almost 500,000 shares during this span at an average price of $1.60. He turned a massive profit on these buys when he dropped 800,000 shares in the December 2006 stock offering priced at $18.75. He would sell again in March 2008, but these sales were all related to expiring options and in fact he retained some of the shares. Indeed, he went on a stock accumulation streak in the second half of 2008, first buying 20,000 shares on the open market in September at $10.75 each, then acquiring 238,000 shares in October when he exercised 660,000 options that were about to expire and turned in 421,000 to cover the acquisition costs and taxes. He would then resurface on February 25th of this year to buy another 10,000 shares on the open market when the shares dipped to $8.

This second purchase is very important because his recent sale in the June stock offering occurred less than six months from the February purchase date, which is a violation of the short-swing profit rule, which is clear under Rule 16b-3. We have looked over Cole's 13D amendment and the Company's documents filed since his sale and there is no mention of the violation. The penalty for the short-swing violation is the Company would be required to disgorge his profits from the sale of the 10,000 shares purchased in February, which amounts to $67,000 ($15 sale price minus $8.26 purchase price x 10,000 shares). A class-action suit could be filed on behalf of the shareholders if a company does not follow through with the disgorgement. But more important to us than the ramifications of the violation is Cole's determination to sell apparently outweighed the risk he assumed with the trading violation.

Taking a look at the shares he sold in the secondary, 361,759 of the 650,000 came from options exercised on the same day from three different series with expiration dates of February 2010, July 2010 and August 2010. This means he sold 288,241 from his common holdings. This number covers all but 10,000 of the 298,000 shares he acquired from exercising options and buying shares on the open market between March 2008 and February 2009. The shares sold in the stock offering accounted for 22% of his actionable ownership. One last reason the sale of all this common is interesting is because Cole's equity compensation has recently consisted solely of restricted stock which was all deferred by an amendment to his employment agreement (more on this later). It's just interesting to us that he would sell this much common with all of his stock awards no longer slated to be saleable.

Figure 2. ICON Daily Closing Price, 01/03/06 through 07/09/09. Red diamonds are the dates where CEO Neil Cole sold shares in stock offerings. Source: Reuters and ICON SEC Filings.



Also selling in the stock offering was Director **Steven Mendelow**, a board member since 1999 who serves as the Chairman of the Audit Committee and has a seat on the Compensation Committee. He was a board member at New Retail Concepts, where Neil Cole was the Chairman and CEO, when it was merged into Iconix in August 1998. Mendelow sold 100,000 shares on June 9th, which came from options exercised on the same day. The options, which were all deeply in the money, came from four different series with expiration dates between February 2010 and September 2013 and accounted for 33% of his actionable holdings. His last trade occurred in the December 2006 stock offering, when he sold 95,000 shares (25% of holdings) at $18.75. Also selling in the June stock offering was Director **Barry Emanuel**, another New Retail Concepts veteran, who sold 50,000 shares. Emmanuel's sale, which covered 20% of his ownership, involved the monetization of his September 2013 option series. This was his first trade since he sold 80,000 shares in late 2007 at 50% higher prices.

For anyone thinking the number of selling insiders in the secondary offering or otherwise is unimpressive, it is important to remember there are really only three named executive officers (Cole, CFO **Warren Clamen**, and General Counsel **Andrew Tarshis**). Tarshis had already disposed of a bunch of his actionable holdings in March. Plus, the executives and directors are now prohibited from trading for a period of 90 days from the June 9th stock offering (lock-up period), so it may be a little while before we get any further trading signals.

<u>Governance: CEO's employment agreement over-the-top generous</u>

CEO Neil Cole's employment agreement

CEO Cole's current employment agreement, entered into in January 2008 and later amended in December 2008, includes a number of very interesting items. As some clients may recall, we had recently highlighted the self-serving employment agreement of Julian Geiger, CEO of Aeropostale (NYSE:ARO) in some recent reports. While Cole's is not on the same level as Geiger's (few are), there are a number of liberal components that make it pretty clear Cole's allies on the board are taking good care of him. Here are some of the finer points:

- Five year term through 2012 (prior agreement was a three year term)
- Base salary increase from $600,000 to $1,000,000
- $500,000 signing bonus on top of his annual cash bonus
- A total of 1.7 million time-vested and performance restricted shares
- Last year the Company put through a new bonus plan for execs; Under this new plan Cole's potential annual bonus payout is considerably higher than it was under his prior employment agreement. He has the potential to earn up to 150% of his base salary.
- If Cole were to be fired without cause or resign for good reason under his last employment agreement, he would receive one year of base salary. Under the new agreement, he would receive two years of salary and base. This was amended in December 2008 to increase it to three years of base and bonus.

But here is where things get interesting. The stock awards included in Cole's employment agreement were so large that they actually covered more shares than the Company had remaining for issuance under its 2006 Equity Incentive Plan, which at the end of 2008 amounted to just 76,000 shares. Last year Iconix attempted to increase the number of shares available for issuance under the 2006 Plan by 1.5 million shares, but shareholders, in an uncommon move, rejected the proposal. The Company has since proposed a new equity plan (2009 Equity Incentive Plan), but in the interim, since they did not have the shares available to give him when the stock awards began vesting, they amended his employment agreement in December 2008 to defer delivery of 1.1 million restricted stock units until his retirement or a change in control. In meantime and in lieu of receiving vested restricted shares, Cole is to receive an extra bonus payment of $500,000 annually as long as a few performance criteria are met:

- ✓ The percentage determined by dividing the Company's EBITDA by its revenues for the calendar year in question places it in the top fifty percent (50%) of those companies contained in the Standard & Poor's SmallCap Retailing Index at the end of that calendar year; or

- ✓ The Company's annual revenue percentage growth for the calendar year in question when compared to the immediately preceding calendar year places it in the top 50% of those companies contained in the Standard & Poor's SmallCap Retailing Index at the end of that calendar year.

This did not sit right with us considering the fact that Iconix is really a brand management company that grows principally through acquisitions (as compared to most companies in the Retailing Index), but we were taken aback when we came across the following provision in his employment agreement related to the large restricted stock awards:

> **<u>Ownership Retention.</u>** The shares of Common Stock underlying the RSU's and PSU's shall only be saleable or otherwise transferable by the Executive prior to termination of his employment with the Company (i) as necessary to pay taxes on the distributed stock, (ii) to trusts or other entities established for the benefit of the Executive and/or his immediate family members, subject to such trusts or other entities agreeing in writing to retain such shares of Common Stock during the period of the Executive's employment with the Company, subject to sub-section (iii), (iii) if at the time of such sale or other transfer, the value of the Common Stock owned by the Executive and by trusts or other entities established for the benefit of the Executive and/or his immediate family members (and not subject to forfeiture conditions and not including options) shall, and would immediately after any sale or other transfer, exceed five million dollars ($5,000,000) in value, or (iv) as otherwise approved by the Board in its sole discretion.

In effect, the Company is paying Cole this extra $500,000 per year for deferring the delivery of these restricted shares which he was not even permitted to sell in the first place. This is just as egregious as Strayer Education paying its executives to hold their vested stock options. Not to mention, Iconix is offering this deal because it maxed out its equity plan after having put so many options and shares in its executives' hands. Finally, with regards to the proposed 2009 Equity Plan that will be voted on by the shareholders at the August Annual Meeting, 617,000 of the 3 million shares they are making available for awards have already been earmarked for awards made to the top three executives *last year*.

Odd departure of two Named Executives in past year

This area warrants further investigation, but we mention it here simply because the departure of individuals who have turned into competitors is an important element of the Iconix story. In August 2008 Executive V.P. and Named Executive Officer **David Conn** (41) ceased being an executive when his employment agreement ended. The Company gave him an agreement to employ him as a non-executive, part-time employee through February 2009, paying him $25,000 per month ($300,000 annually). Conn was VP of Marketing from 1995 to 2000, before he jumped ship to Columbia House (music) and later returned to Iconix in 2004. Then in February 2009, Senior V.P. of Business Affairs and Licensing and Named Executive Officer **Deborah Sorell Stehr** (46), who was the general counsel from 1998 to 2006, also resigned from her executive position when her employment agreement expired. It is disclosed that she now serves as a non-executive employee.

The circumstances surrounding these resignations are very suspicious, especially as the two are quite young and didn't renew their employment agreements but remained with the Company in lesser roles. Even more interesting to us is that the other named executives such as CFO **Warren Clamen** and General Counsel **Andrew Tarshis** were given new three-year employment agreements in November 2008 that increased their salaries, provided large restricted stock awards, and very favorable severance benefits. Not to mention, the new annual bonus plan is quite favorable for the officers compared to its predecessor program. We are very interested to find out why Conn and Stehr either were not offered or walked away from such a potentially high-paying offers that would have been much more lucrative than their past agreements.

Sloppy disclosure practices: omission or commission?

From time to time, Iconix disclosure practices seem less than perfect and it is unclear if the sloppiness is omission or commission. A perfect example involves a situation that took place in 2007 involving the Department of Justice (DOJ). The matter surfaced in the DOJ's review of the Company's 2007 Rocawear acquisition. In March of that year, Iconix and Rocawear filed the requisite Notification and Report Forms with the federal antitrust authorities. Though the DOJ had no concerns about anti-trust matters, it opened an investigation concerning the fact that the Company omitted certain communication between Iconix executives and its Board concerning the efficacy of the acquisition. On May 1 2007, the DOJ issued a civil investigative demand seeking these documents, their submission being required under the Hart-Scott-Rodino Act. On October 15, 2007, Iconix consented to the judgment being entered against it and agreed to a fine of $550,000.

We consider this somewhat significant since no mention of this investigation had ever been disclosed in any public documents submitted by Iconix. Whereas the $75,000 fine levied against Neil Cole (mentioned above) had been disclosed in such documents, the omission of the investigation and subsequent fine is somewhat telling to us especially given the fact that the Company's ability to acquire new brands is central to their strategy and one would think that any trouble with regulators in completing an expected acquisition would be promptly disclosed. The only reference to this matter appeared in a Company press-release upon the closure of the matter. Although the offense was, in reality, quite benign, the fine was large for a company of this size. This all served to make the failure to disclose the situation quite interesting to us from a behavioral standpoint.