

BLUEFLY INC
Form 10-Q
May 17, 2013

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 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 March 31, 2013

OR

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

For the transition period from _____ to _____

Commission File Number 001-14498

BLUEFLY, INC.

(Exact name of registrant as specified in its charter)

Delaware

*(State or other jurisdiction of
incorporation or organization)*

13-3612110

(I.R.S. Employer Identification Number)

42 West 39th Street, New York, NY 10018

(Address of principal executive offices) (Zip Code)

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Registrant's telephone number, including area code: (212) 944-8000

Indicate by check mark whether the registrant (1) 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 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 the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act:

Large accelerated filer Accelerated filer Non-accelerated filer Smaller reporting company
(Do not check if a smaller reporting company)

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

As of May 15, 2013, there were 28,598,933 shares of Common Stock, \$.01 par value, of the registrant outstanding.

BLUEFLY, INC.

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Part I – FINANCIAL INFORMATION

Item 1. – Financial Statements

BLUEFLY, INC.**CONSOLIDATED BALANCE SHEETS**

| | (Unaudited) March 31, 2013 | December 31, 2012 |
|---|----------------------------------|----------------------|
| Assets | | |
| Current assets: | | |
| Cash and cash equivalents | \$-- | \$1,283,000 |
| Restricted cash securing letters of credit | 4,635,000 | 4,635,000 |
| Accounts receivable, net | 1,695,000 | 2,433,000 |
| Inventories, net | 16,203,000 | 20,521,000 |
| Prepaid expenses and other current assets | 1,061,000 | 1,412,000 |
| Total current assets | 23,594,000 | 30,284,000 |
| Property and equipment, net | 5,235,000 | 5,714,000 |
| Other assets, net | 508,000 | 545,000 |
| Total assets | \$29,337,000 | \$36,543,000 |
| Liabilities and Stockholders' Equity | | |
| Current liabilities: | | |
| Revolving credit facility, expiring November 2015 | \$4,551,000 | \$5,311,000 |
| Accounts payable | 14,349,000 | 13,722,000 |
| Allowance for sales returns | 1,700,000 | 2,081,000 |
| Accrued expenses and other current liabilities | 1,606,000 | 2,720,000 |
| Deferred revenue | 2,850,000 | 4,381,000 |
| Embedded derivative financial liability to related party stockholders | 250,000 | 379,000 |
| Notes and interest payables to related party stockholders, net of discount | 2,861,000 | 2,599,000 |
| Total current liabilities | 28,167,000 | 31,193,000 |
| Deferred rent liability | 420,000 | 413,000 |
| Total liabilities | 28,587,000 | 31,606,000 |
| Commitments and contingencies (Note 8) | | |
| Stockholders' equity: | | |
| Bluefly, Inc. stockholders' equity: | | |
| Preferred stock - \$0.01 par value; 1,000,000 shares authorize and none issued or outstanding | -- | -- |

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| | | |
|---|---------------|---------------|
| Common stock— \$.01 par value; 50,000,000 shares authorized as of March 31, 2013 and December 31, 2012, respectively; 28,937,311 shares issued and 28,598,933 shares outstanding as of March 31, 2013 and December 31, 2012, respectively | 286,000 | 286,000 |
| Treasury stock | (1,824,000) | (1,824,000) |
| Additional paid-in capital | 193,827,000 | 193,574,000 |
| Accumulated deficit | (191,539,000) | (187,099,000) |
| Total stockholders' equity | 750,000 | 4,937,000 |
| Total liabilities and stockholders' equity | \$29,337,000 | \$36,543,000 |

The accompanying notes are an integral part of these unaudited consolidated financial statements.

BLUEFLY, INC.**CONSOLIDATED STATEMENTS OF OPERATIONS**

(Unaudited)

| | Three Months Ended March 31, | |
|---|---------------------------------|----------------|
| | 2013 | 2012 |
| Net sales | \$ 19,794,000 | \$ 24,266,000 |
| Cost of sales | 15,813,000 | 20,521,000 |
| Gross profit | 3,981,000 | 3,745,000 |
| Selling and fulfillment expenses | 4,708,000 | 5,458,000 |
| Marketing expenses | 1,231,000 | 2,578,000 |
| General and administrative expenses | 2,035,000 | 3,541,000 |
| Total operating expenses | 7,974,000 | 11,577,000 |
| Operating loss | (3,993,000) | (7,832,000) |
| Interest expense to related-party stockholders | (222,000) | -- |
| Other interest expense and other income, net | (225,000) | (72,000) |
| Net loss | (4,440,000) | (7,904,000) |
| Less: Net loss attributable to non-controlling interest in Eyefly LLC | -- | (34,000) |
| Net loss attributable to Bluefly, Inc. stockholders | \$(4,440,000) | \$(7,870,000) |
| Basic and diluted net loss per common share attributable to Bluefly, Inc. stockholders | \$(0.16) | \$(0.28) |
| Weighted average common shares outstanding (basic and diluted) | 28,576,612 | 28,523,237 |

The accompanying notes are an integral part of these unaudited consolidated financial statements.

BLUEFLY, INC.**CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY**

(Unaudited)

| | Common Stock \$.01 Par Value | | Treasury Stock | | Additional Paid-in Capital | Accumulated Deficit | Non- Interest | Total Stockholders' Equity |
|------------------------------|---------------------------------|-----------|------------------------|---------------|----------------------------------|------------------------|------------------|----------------------------------|
| | Number of Shares | Amount | Number of Shares | Amount | | | | |
| Balance at December 31, 2012 | 28,598,933 | \$286,000 | 338,398 | \$(1,824,000) | \$193,574,000 | \$(187,099,000) | \$- | \$4,933,000 |
| Stock-based compensation | - | - | - | - | 253,000 | - | - | 253,000 |
| Net loss | - | - | - | - | - | (4,440,000) | - | (4,440,000) |
| Balance at March 31, 2013 | 28,598,933 | \$286,000 | 338,398 | \$(1,824,000) | \$193,827,000 | \$(191,539,000) | \$- | \$750,000 |

The accompanying notes are an integral part of these unaudited consolidated financial statements.

BLUEFLY, INC.**CONSOLIDATED STATEMENTS OF CASH FLOWS**

(Unaudited)

| | Three Months Ended | |
|---|--------------------|---------------|
| | March 31, | |
| | 2013 | 2012 |
| Cash flows from operating activities: | | |
| Net loss | \$(4,440,000) | \$(7,904,000) |
| Adjustments to reconcile net loss to net cash used in operating activities: | | |
| Depreciation and amortization expenses | 820,000 | 667,000 |
| Provisions for returns | (381,000) | 381,000 |
| Bad debt expense | 96,000 | 129,000 |
| Reserve for inventory obsolescence | (300,000) | (562,000) |
| Stock-based compensation expense | 253,000 | 975,000 |
| Deferred rent expense | 7,000 | 12,000 |
| Amortization expense related to warrants issued to third-party | -- | 150,000 |
| Amortization of discount on notes payable to related-party stockholders | 212,000 | -- |
| Change in fair value of embedded derivative financial liability to related-party stockholders | (129,000) | -- |
| Change in operating assets and liabilities: | | |
| (Increase) decrease in: | | |
| Accounts receivable | 642,000 | 411,000 |
| Inventories | 4,618,000 | 5,186,000 |
| Prepaid expenses and other current assets | 319,000 | 1,562,000 |
| Other assets | -- | 220,000 |
| Increase (decrease) in: | -- | -- |
| Accounts payable | 627,000 | (68,000) |
| Accrued expenses and other current liabilities | (1,114,000) | (1,481,000) |
| Interest payable to related-party stockholders | 50,000 | -- |
| Deferred revenue | (1,531,000) | (405,000) |
| Net cash used in operating activities | (251,000) | (727,000) |
| Cash flows from investing activities: | | |
| Purchases of property and equipment | (272,000) | (1,166,000) |
| Net cash used in investing activities | (272,000) | (1,166,000) |
| Cash flows from financing activities: | | |
| Borrowings under revolving credit facility | 17,555,000 | -- |
| Repayments under revolving credit facility | (18,315,000) | -- |
| Net cash provided by financing activities | (760,000) | -- |
| Net decrease in cash and cash equivalents | (1,283,000) | (1,893,000) |
| Cash and cash equivalents – beginning of period | 1,283,000 | 4,413,000 |
| Cash and cash equivalents – end of period | \$-- | \$2,520,000 |

Supplemental disclosure of cash flow information:

| | | |
|--|-----------|-----------|
| Cash paid during the period for interest expense | \$171,000 | \$65,000 |
| Cash paid during the period for interest expense to related-party stockholders | \$58,000 | \$-- |
| Supplemental disclosure of non-cash financing disclosure of cash flow information: | | |
| Issuance of common stock for asset acquisition | \$-- | \$600,000 |

The accompanying notes are an integral part of these unaudited consolidated financial statements.

NOTE 1 – THE COMPANY

Bluefly, Inc., a Delaware corporation, (the “Company”), is a leading off-price Internet retailer of designer, contemporary and private-label apparel and accessories, providing its customers with unique access to in-season products at superior values. The Company’s e-commerce website, www.bluefly.com (“Bluefly.com”), was launched in September 1998. In December 2011, the Company expanded its website portfolio by launching its www.belleandclive.com website (“Belleandclive.com” and, collectively with Bluefly.com, the “Websites”), a members-only shopping destination that presents highly-curated selections of important brands via limited-time flash sale events.

In 2011, the Company and A + D Labs LLC (“A + D Labs”) entered into a limited liability company operating agreement in connection with the formation of Eyefly LLC (“Eyefly”), a Delaware limited liability company, which was initially owned 52% by the Company and 48% by A + D Labs. Eyefly was formed for the purposes of developing and operating an e-commerce website and related online and mobile applications focused on selling fashionable prescription eyewear directly to consumers. Eyefly launched its e-commerce website, www.eyefly.com (“Eyefly.com”), in June 2011. On October 25, 2012, the Company sold its entire 52% controlling membership interest in Eyefly to A + D Labs as discussed further in Note 3 – Summary of Significant Accounting Policies.

On January 3, 2012, the Company formed a new wholly-owned subsidiary EVT Acquisition Co., LLC, a New York limited liability company (“EVT”), in connection with the Company’s acquisition of assets. See Note 5 – Acquisition for additional information.

The Company operates in one business segment and has no operations outside the United States. International net sales for the period March 31, 2013 and 2012 represented 5.6% and 6.1%, respectively, of total net sales.

NOTE 2 – BASIS OF PRESENTATION, LIQUIDITY AND MANAGEMENT’S PLAN

These Consolidated Financial Statements (unaudited) have been prepared in accordance with accounting principles generally accepted in the United States (“GAAP”) for interim financial information. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements. In the opinion of management, all adjustments (consisting only of normal recurring adjustments) considered necessary for fair presentation of results for the interim periods have been reflected in these Consolidated Financial Statements (unaudited), and the presentations and disclosures herein are adequate when read in conjunction with the Audited Consolidated Financial Statements included in our Form 10-K for the year ended December 31, 2012 and Auditor’s Report, which included an explanatory paragraph reporting a going concern.

Operating results for the three months ended March 31, 2013 are not necessarily indicative of the results that may be expected for the entire year. The Unaudited Consolidated Financial Statements include the accounts and operations of Bluefly, Inc. and its subsidiaries. All intercompany accounts and transactions have been eliminated in consolidation.

The Consolidated Financial Statements contemplate continuation of the Company as a going concern. The Company has sustained cumulative net losses and negative cash flows from operations since inception. As of March 31, 2013, the Company had an accumulated deficit of \$191,539,000 and incurred a net loss attributable to Bluefly, Inc. stockholders of \$4,440,000 for the three months ended March 31, 2013.

The Company is currently in active discussions regarding a strategic transaction under the direction of a special committee consisting of independent members of the Board of Directors, together with the assistance of an independent financial advisor ("Proposed Strategic Transaction"). The Company expects that the consideration payable to shareholders of the Company will be minimal. We currently have sufficient funds from operations and from our Credit Facility to support our operations until the anticipated closing of the Proposed Strategic Transaction. Management believes that the Proposed Strategic Transaction, if and when consummated, will provide the necessary liquidity to support the working capital needs of the Company and eliminate the factors that resulted in the going concern uncertainty. There can be no assurance that the Proposed Strategic Transaction can be consummated.

If the Company is unable to complete the Proposed Strategic Transaction or an alternative strategic transaction, or to secure additional financing to fund our operations, the Company will not be able to sustain its operations. The Company has implemented certain cost containment measures, which includes reduction in workforce and overhead, and delaying payments to suppliers.

NOTE 3 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Use of estimates

The preparation of the consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosures of contingent assets and liabilities at the dates of the financial statements and the reported amounts of revenues and expenses during the reporting periods. Significant estimates and assumptions include the adequacy of the allowances for doubtful accounts and sales returns, recoverability of inventories, useful lives of property and equipment (including website development costs) and intangible assets, realization of deferred tax assets, and the calculations related to stock-based compensation expense. Actual results could differ from those estimates. The Company's success is largely dependent on its ability to anticipate, identify and respond to unexpected changes in fashion trends and to provide merchandise that satisfies consumer preferences and demand. The Company's failure to anticipate, identify or respond to unexpected changes in fashion trends and consumer preferences could adversely affect its financial condition and results of operations.

Revenue recognition

The Company recognizes revenue when the earnings process is completed, and revenue is measurable. Gross sales consist primarily of revenue from product sales and shipping and handling charges and are net of promotional discounts and sales-based taxes assessed by governmental authorities that are imposed on sales transactions. Net sales represent gross sales, less provisions for returns and credit card chargebacks.

Gross sales are recognized when all the following criteria are met (1) a customer executes an order, (2) the product price and the shipping and handling fee have been determined, (3) credit card authorization has occurred and collection is reasonably assured, and (4) the product has been shipped and received by the customer.

Deferred revenue (which consists primarily of goods shipped to customers, but not yet received, and customer credits) totaled approximately \$2,850,000 and \$4,381,000 as of March 31, 2013 and December 31, 2012, respectively, which are presented as Current liabilities in the Consolidated Balance Sheets.

Shipping and handling fees billed to customers are presented and included as part of gross sales, and freight costs incurred in connection with shipping customer orders are presented and included as part of Cost of sales in the Consolidated Statements of Operations.

Sales incentives

The Company frequently offers sales incentives to customers to receive a reduction in the sales price of merchandise. Sales incentives include, but are not limited to discounts, coupons, daily deal programs and e-mail promotions through online marketing programs. For sales incentives issued to customers in conjunction with the sale of merchandise, the Company recognizes the reduction in gross sales at the time of sale.

Provisions for sales returns and doubtful accounts

The Company generally permits returns for up to 40 days from the date of sale. The Company performs credit card authorizations and checks the verifications of its customers prior to shipment of the merchandise. Accordingly, the Company establishes a reserve for estimated future sales returns and allowance for doubtful accounts at the time of shipment based primarily on historical data. Accounts receivable (which represents billed credit card transactions in process to be collected and a trade receivable (discussed further below) is presented in the Consolidated Balance Sheets net of the allowance for doubtful accounts.

Stock-based compensation expenses

The Company's Board of Directors has adopted three stock-based employee compensation plans, one in April 2005, one in July 2000 (which expired in December 2012) and one in May 1997 (collectively, the "Plans"). The Plans, which provide for the granting of restricted stock awards, deferred stock unit awards, stock option awards, and other equity and cash awards, were adopted for the purpose of encouraging key employees, consultants and directors who are not employees to acquire a proprietary interest in the growth and performance of the Company, and are similar in nature. Vesting terms for restricted stock generally range from three months to one year, while deferred stock unit awards vest every three months over a period of one to three years. Stock option awards are granted in terms not to exceed ten years and become exercisable as specified when the option is granted and vesting terms range from immediately to a ratable vesting period of four years. As of March 31, 2013, the Plans have an aggregate balance of 1,153,103 shares available for future issuance.

Income taxes

Income taxes represent income taxes paid or payable (or received or receivable) for the current year and includes any changes in deferred taxes during the year. Deferred tax assets and liabilities are recognized for future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets, including tax loss and credit carry forwards, and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. Deferred income tax expense represents the change during the period in deferred tax assets and deferred tax liabilities. The components of the deferred tax assets and liabilities are individually classified as current and non-current based on their characteristics. Deferred tax assets are reduced by a valuation allowance when, in the opinion of management, it is more likely than not that some portion or all of the deferred tax assets will not be realized.

Basic and diluted net loss per common share attributable to Bluefly, Inc. stockholders

Basic net loss per common share attributable to Bluefly, Inc. stockholders excludes dilution and is computed by dividing net loss attributable to Bluefly, Inc. stockholders by the weighted average number of common shares outstanding for the period.

Diluted net loss per common share attributable to Bluefly, Inc. stockholders is computed by dividing net loss attributable to Bluefly, Inc. stockholders by the weighted average number of common shares outstanding for the period, adjusted to reflect potentially dilutive securities using the "treasury stock" method for stock option awards, warrants, restricted stock awards, deferred stock unit awards, and the "if-converted" method for the Rho Notes. Due to the Company's net losses for the periods presented, (i) stock option awards and warrants to purchase shares of Common Stock (ii) restricted stock awards that have not yet vested and (iii) Rho Notes convertible into shares of Common Stock were not included in the computation of diluted loss per common share attributable to Bluefly, Inc. stockholders, as the effects would be anti-dilutive.

Cash and cash equivalents

The Company considers all highly liquid investments with an original maturity of three months or less to be cash and cash equivalents. The Company's cash and cash equivalents are placed and maintained with financial institutions that it believes are of high credit quality. However, the Company's cash and cash equivalents are potentially exposed to concentration of credit risk in the event of default by financial institutions to the extent that cash balances with financial institutions are in excess of insured limits. At March 31, 2013, the Company reclassified overdraft amounts of

approximately \$26,000 to the Revolving Credit Facility.

Restricted cash

As of March 31, 2013, the Company had \$4,635,000 in restricted cash, which has been funded by and deducted against the availability of the Company's revolving Credit Facility that was held as cash collateral against the Company's outstanding letters of credit issued, and outstanding under its previous credit facility with Wells Fargo Retail Finance, LLC ("Wells Fargo").

Fair value of financial instruments

The Company's financial instruments consist of cash and cash equivalents, accounts receivable, other assets, accounts payable and accrued expenses. The carrying amounts of these financial instruments approximate fair value due to their short maturities.

Inventories, net

Inventories, which consist of finished goods, are stated at the lower of cost or market value. Cost is determined by the first-in, first-out ("FIFO") method. The Company reviews its inventory levels in order to identify slow-moving and unsellable merchandise and establishes a reserve for such merchandise. Inventory reserves are established based on historical data and management's best estimate. Inventory may be marked down below cost if management determines that the inventory stock will not sell at or above its cost. Inventory is presented net of reserves in the Consolidated Balance Sheets.

Property and equipment, net

Property and equipment are stated at cost net of accumulated depreciation and amortization expenses. Leasehold improvements are amortized over the shorter of their estimated useful lives or the remaining term of the lease. Lease amortization is included in depreciation expense. Equipment and software are depreciated on a straight-line basis over two to five years. Costs related to maintenance and repairs are expensed as incurred.

Website development costs

Website development costs, which consist primarily of external direct costs, relate to the Company's Websites. All costs incurred by the Company related to the development phase, including costs incurred for enhancements that are expected to result in additional new functionality, are capitalized. Such costs are amortized on a straight-line basis over 36 months. All costs related to the planning and post-implementation phase, including training and maintenance are expensed as incurred. Capitalized costs related to website development are included in Property and equipment, net in the Company's Consolidated Balance Sheets.

Long-lived assets

The Company's policy is to evaluate long-lived assets for possible impairment whenever events or changes in circumstances indicate that the carrying amount of such assets may not be recoverable. This evaluation is based on a number of factors, including expectations for future operating income and undiscounted cash flows that will result from the use of such assets. The Company has not identified any such impairment of its long-lived assets at March 31, 2013 and 2012.

Deferred rent liability

The Company recognizes and records rent expense related to its lease agreement, which includes scheduled rent increases, on a straight-line basis beginning on the commencement date over the life of the lease. The Company also recognizes and records rent concessions, in the form of reduced rent payments, on a straight-line basis over the life of the lease agreement. Differences between straight-line rent expense and actual rent payments are recorded as Deferred rent liability and presented as a long-term liability in the Consolidated Balance Sheets.

Treasury stock

Treasury stock represents Common Stock withheld by the Company to satisfy income tax withholding obligations of certain officers and employees of the Company in connection with the distribution of Common Stock in respect of deferred stock units held by such officers and employees.

Recently issued, but not yet effective, accounting pronouncements

The Company is not aware of any recently issued, but not yet effective, accounting pronouncements that would have a significant impact on the Company's consolidated financial position or results of operations.

NOTE 4 – FAIR VALUE

Authoritative guidance relating to fair value establishes a framework for measuring fair value and expands disclosure about fair value measurements except as it applies to non-financial assets and non-financial liabilities. The Company's financial instruments consist of cash and cash equivalents, accounts receivable, other assets, accounts payable and accrued expenses. The carrying amounts of these financial instruments approximate fair value due to their short maturities. The following is the fair value hierarchy for disclosure of fair value measurements:

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

Level 2 - Quoted prices for similar assets and liabilities in active markets or inputs that are observable

Level 3 - Inputs that are unobservable (for example cash flow modeling inputs based on assumptions)

In connection with the Embedded Derivative in the Rho Notes discussed below in Note 6 – 2012 Financing, the Company evaluates the fair value measurement of the Embedded Derivative on a recurring basis to determine the appropriate fair value level to classify the Embedded Derivative at each reporting period. This determination requires significant estimates and judgments by the Company. The following table sets forth the Company’s liabilities that were measured at fair value as of March 31, 2013, by level within the fair value hierarchy:

| | March 31, 2013 | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
|---|----------------|---|--|--|
| Liabilities: | | | | |
| Embedded derivative financial liability to related party stockholders | \$ 250,000 | \$ -- | \$ 250,000 | \$ -- |
| Total embedded derivative financial liability to related party stockholders | \$ 250,000 | \$ -- | \$ 250,000 | \$ -- |

NOTE 5 – ACQUISITION

On January 10, 2012, the Company, through a newly-formed wholly-owned subsidiary, EVT, entered into an asset purchase agreement with Moda for Friends LLC (the “Seller”) and purchased certain intangible assets that include a contractual-related agreement, purchased customer list, developed technologies and trademarks (the “Acquired Intangible Assets”) owned by the Seller for a total purchase price of \$600,000 plus transaction costs of \$11,000. The Company paid the purchase price through the issuance of 285,714 shares of its Common Stock, with each share being valued at \$2.10 (the closing price of the Common Stock on the day prior to the consummation of the transaction). The Company completed the asset acquisition because it would facilitate the launch and operation of its own flash sales business.

At December 31, 2012, the Acquired Intangible Assets were deemed to be impaired and the fair value was determined to be zero (Level 3 in the fair value hierarchy) due to the Company’s potential inability to meet its obligations under the terms and conditions of the contract given the Company’s current limited financial resources.

For the year ended December 31, 2012, the Company recorded \$383,000 of impairment loss in total amortization expense in the Consolidated Statement of Operations related to the Acquired Intangible Assets.

NOTE 6 – 2012 FINANCING

On August 13, 2012 (the “Closing Date”), the Company entered into a Note and Warrant Purchase Agreement (the “Purchase Agreement”) with Rho Ventures VI, L.P. (“Rho”) and Prentice Consumer Partners, LP (“Prentice”, and together with Rho, the “Purchasers”) pursuant to which the Company issued (i) \$1,500,000 aggregate principal amount of collateralized subordinated convertible promissory notes to Rho (the “Rho Notes”) and (ii) \$1,500,000 aggregate principal amount of collateralized subordinated promissory notes to Prentice (the “Prentice Notes” and together with the Rho Notes, the “Notes”).

The Rho Notes bear interest at 12% per annum, compounded annually, and interest is payable upon maturity or conversion. The Prentice Notes bear interest at 15% per annum, compounded annually, and interest is payable quarterly. Prentice received an origination fee on the Closing Date equal to two percent of the Prentice Notes.

The Rho Notes are convertible, at the holder's option, (a) into equity securities that the Company might issue in any subsequent round of financing that results in proceeds to the Company of at least \$7,500,000 (a “Qualified Financing”) at a price equal to the lowest price per share paid by any investor in such Qualified Financing or (b) into shares of the Company’s Common Stock at a price per share equal to \$1.05, which approximates the fair market value on the Closing Date (the “Rho Conversion Feature”).

The Notes have a one-year term but may become due prior to the end of such term in the event of a change of control or a Qualified Financing. The Notes are collateralized by second priority liens on all assets of the Company.

In connection with the issuance of the Notes, the Company also issued warrants, with a seven year term, to purchase 476,190 shares of the Company's Common Stock (the "Warrants") to each of Rho and Prentice at a price equal to \$1.05 per share, which approximates the fair market value of the Common Stock on the Closing Date.

The Notes contain a financial covenant in which the Company is to maintain current assets in excess of \$20,000,000 including cash and cash equivalents, accounts receivable, inventories (which includes prepaid inventory), prepaid expenses and other current assets (the "Financial Covenant"). In the event that the Company does not maintain this Financial Covenant, the outstanding principal and accrued interest expense of the Notes shall be accelerated and automatically become due and payable. In the event we are unable to complete the proposed strategic transaction; there can be no assurance that we will remain in compliance with the Financial Covenant.

In connection with the issuance of the Notes, the Company incurred approximately \$127,000 of debt issuance costs ("Deferred Financing Costs"), which primarily consisted of legal and other professional fees. These Deferred Financing Costs were deferred and are being amortized to interest expense to related party stockholders over the term of the Notes. The Deferred Financing Costs are recorded within Other Current Assets in the Company's Consolidated Balance Sheet.

As the Notes were issued with detachable Warrants, the Company has initially allocated the proceeds received from the issuance between the Notes and Warrants on a relative fair value basis. With respect to the Rho Notes, the Company then has evaluated the Rho Conversion Feature to determine whether this feature qualifies as a beneficial conversion feature or derivative instrument. The Company noted that the Rho Conversion Feature contains both a fixed conversion price and a contingently adjustable conversion price based on a future event. Based on the terms of the Rho Notes and authoritative guidance, the Company has concluded that the entire Rho Conversion Feature is an embedded derivative liability (the "Embedded Derivative"), which requires bifurcation and must be separately accounted for as a derivative instrument.

The Company measured the fair value of the Embedded Derivative using a Black-Scholes valuation model as of the Closing Date. Expected volatility is based on the historical volatility of the price of the Company's Common Stock, measured over the same period of time as the remaining maturity life of the Rho Notes. The risk free interest rate is based on the interest rate for U.S. Treasury Notes having a maturity period equal to the remaining maturity life of the Rho Notes. As a result of the bifurcation, the Company recognized an Embedded Derivative of approximately \$274,000 with a corresponding discount on the Rho Notes, which reduced the carrying value of the Rho Notes on the date of issuance. This discount represents additional non-cash interest expense that is to be amortized over the remaining life of the Rho Notes.

The Company also remeasures the fair value of the Embedded Derivative at each reporting date. Any change in fair value is recorded as part of interest expense to related party stockholders in the Company's Consolidated Statements of Operations.

The assumptions used at March 31, 2013 are as follows:

| | | |
|--------------------------|--------|---|
| Risk-free interest rate | 0.11 | % |
| Expected life (in years) | 0.37 | |
| Dividend yield | 0.00 | % |
| Expected volatility | 125.92 | % |

As of March 31, 2013, the Company's Notes and interest payable to related party stockholders, net consists of the following:

| | |
|---|-------------|
| Notes payable to related party stockholders | \$3,000,000 |
| Unamortized discount on notes payable to related party stockholders | (318,000) |
| Total notes payable to related party stockholders, net | 2,682,000 |
| Interest payable to related party stockholders | 180,000 |
| Total notes and interest payable to related party stockholders, net | \$2,862,000 |

For the three months ended March 31, 2013, the Company recognized interest expense in connection with the Notes, including changes in fair value of the Embedded Derivative and amortization of the debt discount, which were included in total interest expense to related party stockholders in the Consolidated Statements of Operations, as follows:

| | |
|---|-----------|
| Amortization of discount on notes payable to related party stockholders | \$212,000 |
| Appreciation in fair value of embedded derivative financial liability to related party stockholders | (129,000) |
| Interest expense to related party stockholders | 107,000 |
| Amortization expense of deferred financing costs | 32,000 |
| Total interest expense to related party stockholders | \$222,000 |

Costs incurred in connection with the Company's financing activities are deferred and amortized over the terms of the related agreements using the straight-line method. During 2012, we deferred approximately \$127,000 and \$432,000 relating to the August 2012 financing, and the new revolving credit facility with Wells Fargo Capital Finance, and Salus Capital Partners, LLC, respectively. Amortization of these costs, which is recognized in other interest expense and other income, net, in the accompanying consolidated statements of operations, totaled approximately \$32,000 for the three months ended March 31, 2013. Deferred financing costs, net of accumulated amortization, included in other assets, net, amounted to approximately \$47,000 as of March 31, 2013.

NOTE 7 – REVOLVING CREDIT FACILITY FINANCING AGREEMENT

On November 13, 2012, the Company entered into a new three-year revolving credit facility, expiring November 2015 (“Credit Facility”) with Salus Capital Partners, LLC (“Salus”) collateralized by all assets of the Company. The Credit Facility refinanced the Company’s previous credit facility with Wells Fargo. Pursuant to the terms of the Credit Facility, Salus provides the Company with a revolving credit facility and facilitates the issuance of letters of credit in favor of suppliers or factors.

Availability under the Credit Facility is determined by a formula that considers a specified percentage of the Company’s accounts receivable and a specified percentage of the Company’s inventory. The maximum availability is \$10 million, of which up to \$5 million is available for the issuance of letters of credit. Interest accrues under the Credit Facility at the prime rate plus 4.75%, subject to a minimum rate of 8.00%. Letters of credit issued to third parties are cash collateralized by amounts drawn under the Credit Facility. At closing, \$4,700,000 was drawn under the Credit Facility, which reduced the availability of the Credit Facility, to cash collateralize letters of credit issued by Wells Fargo, which were outstanding at such date. In addition, the Company paid financing costs of \$432,000 at closing, which were capitalized, and will pay a collateral monitoring fee of \$3,000 per month and will pay unused commitment fees of 0.75% of the remaining availability under the Credit Facility. A termination fee of \$75,000 was paid at closing to Wells Fargo, which was included in Other interest expense in the 2012 Consolidated Statement of Operations.

As of March 31, 2013, maximum total availability under the Credit Facility was approximately \$5.0 million, of which \$4.6 was outstanding, leaving approximately \$0.4 million available for further borrowings.

The terms of the Credit Facility contain a material adverse condition clause. This feature may limit the Company's ability to obtain additional borrowings or result in a default on current outstanding letters of credit. The terms of the Credit Facility contain a material adverse effect clause defined as a material adverse change in the ability of the Company to perform its obligations under the Credit Agreement or, upon the operations, business, properties, liabilities (actual or contingent) or condition (financial or otherwise), or impairment of the rights and remedies of the Agent or any lender under the Credit Facility, or upon the legality, validity, binding effect or enforceability against any party to the Credit Facility. This feature may limit our ability to obtain additional borrowings or result in a default on current outstanding letters of credit.

For the three months ended March 31, 2013, the Company paid approximately \$135,000 in interest expense and fees under the Credit Facility.

The Credit Facility was amended on April 11, 2013 to modify certain borrowing availability formulas for sixty days, which increased borrowing availability by up to \$650,000. The Company paid a \$100,000 fee in connection with the amendment. Salus also waived covenant violations caused by the late delivery of 2012 audited financial statements and the explanatory paragraph regarding a going concern uncertainty contained in the auditor's unqualified opinion for such financial statements.

NOTE 8 – COMMITMENTS AND CONTINGENCIES

The Company's commitment and contingencies associated with marketing contracts, lease obligations, and employment agreements did not change materially from that disclosed in the Form 10-K filing for the year ended December 31, 2012.

NOTE 9 – STOCK-BASED COMPENSATION

Authoritative guidance relating to stock-based compensation requires the Company to measure compensation cost for stock awards at fair value and recognize compensation over the service period for awards expected to vest. Total stock-based compensation expense recorded in the Consolidated Statements of Operations was \$253,000 and \$975,000 for the three months ended March 31, 2013 and 2012, respectively.

Stock Option Awards

The fair value of stock option awards granted is estimated on the date of grant using a Black-Scholes option pricing model. Expected volatilities are calculated based on the historical volatility of the price of the Company's Common Stock. Management monitors stock option exercise and employee termination patterns to estimate forfeiture rates within the valuation model. The expected holding period of stock options represents the period of time that stock options granted are expected to be outstanding. The risk-free interest rate for periods within the expected life of the stock option award is based on the interest rate of U.S. Treasury notes in effect on the date of the grant.

The following table summarizes the Company's stock option award activity:

| | Number of Shares | Weighted Average Exercise Price Per Share |
|------------------------------|---------------------|---|
| Balance at December 31, 2012 | 4,205,881 | \$ 2.11 |
| Options granted | 293,500 | \$ 0.75 |
| Options cancelled | (171,947) | \$ 1.80 |
| Options expired | (1,088,689) | \$ 3.27 |
| Options exercised | -- | \$ -- |
| Balance at March 31, 2013 | 3,238,745 | \$ 1.74 |

There were 293,500 stock option awards granted during the first quarter of 2013. At March 31, 2013, there was no aggregate intrinsic value of the fully vested stock option awards and the weighted average remaining contractual life of the stock option awards was approximately eight years. The Company did not capitalize any compensation cost, or modify any of its stock option awards during the first quarter of 2013. There were no stock option exercises and no cash was used to settle equity instruments granted under the Company's equity incentive plans during the first quarter of 2013.

For the three months ended March 31, 2013 and 2012, the Company recognized expense of approximately \$247,000 and \$975,000, respectively, in connection with these awards.

Stock Option 1997 and 2000 Plans

On May 1, 2013, the 750 stock option awards outstanding in the 1997 Plan contractually expired and there were no remaining shares in the 2000 Plan.

Restricted Stock Awards

The following table is a summary of activity related to restricted stock awards for key employees at March 31, 2013:

| | Restricted Stock Awards | Weighted Average Grant Date Fair Value (per share) |
|--|-------------------------------|---|
| Balance at December 31, 2012 | 22,321 | \$ 1.12 |
| Shares granted | -- | \$ -- |
| Shares forfeited | -- | \$ -- |
| Shares restriction lapses | -- | \$ -- |
| Balance at March 31, 2013 | 22,321 | \$ 1.12 |
| Aggregate grant date fair value | | \$ 25,000 |
| Vesting service period of shares granted | | 1 year |
| Number of shares vested during the three months ended March 31, 2013 | -- | |
| Number of shares non-vested at March 31, 2013 | 22,321 | |

For the three months ended March 31, 2013, the Company recognized expense of approximately \$6,000 related to restricted stock awards. There were no restricted stock awards issued during the three months ended March 31, 2012 or outstanding as of March 31, 2012 and, accordingly, the Company did not recognize any expense related to restricted stock awards.

NOTE 10 – NET LOSS PER SHARE ATTRIBUTABLE TO BLUEFLY, INC. STOCKHOLDERS

Basic net loss per common share attributable to Bluefly, Inc. stockholders excludes dilution and is computed by dividing net loss attributable to Bluefly, Inc. stockholders by the weighted average number of common shares outstanding for the period.

Diluted net loss per common share attributable to Bluefly, Inc. stockholders is computed by dividing net loss attributable to Bluefly, Inc. stockholders by the weighted average number of common shares outstanding for the period, adjusted to reflect potentially dilutive securities using the treasury stock method for stock option awards, warrants, restricted stock awards, deferred stock unit awards, and the if-converted method for the Rho Notes (as defined in Note 6 – 2012 Financing). Due to the Company's net loss, (i) stock option awards and warrants to purchase shares of Common Stock (ii) restricted stock awards that have not yet vested and (iii) Rho Notes convertible into shares of Common Stock were not included in the computation of diluted loss per common share attributable to Bluefly, Inc. stockholders, as the effects would be anti-dilutive. Accordingly, basic and diluted weighted average

shares outstanding are equal for the following periods presented:

| | Three Months Ended March 31, | |
|--|---------------------------------|----------------|
| | 2013 | 2012 |
| Net loss attributable to Bluefly, Inc. stockholders | \$(4,440,000) | \$(7,870,000) |
| Weighted average common shares outstanding (basic) | 28,576,612 | 28,523,237 |
| Weighted average common shares outstanding (diluted) | 28,576,612 | 28,523,237 |

NOTE 11 – NASDAQ COMPLIANCE

On February 15, 2013, the Company was notified by the Nasdaq Stock Market that it is not in compliance with the continued listing requirements for the Nasdaq Capital Market because shares of the Company's Common Stock had closed at a per share bid price of less than \$1.00 for at least 30 consecutive trading days. Under Nasdaq rules, the Company was given a 180-day grace period to regain compliance, which extends to August 14, 2013. In order to regain compliance, shares of the Company's Common Stock would need to close at a price of \$1.00 per share or more for at least ten consecutive trading days at any time prior to August 14, 2013. The Company may be granted an additional 180-day grace period to regain compliance, if, at that time, it meets the initial listing criteria of the Nasdaq Capital Market, other than the minimum bid price requirement. In the event that the Company does not regain compliance within the requisite time period, it would have the right to appeal any delisting. The failure to maintain listing on the Nasdaq Capital Market may have an adverse effect on the price and/or liquidity of the Company's Common Stock.

NOTE 12 – SUBSEQUENT EVENTS

Bonus Arrangement

On April 2, 2013, the special committee approved a bonus arrangement for Joseph Park, the Company's Chief Executive Officer that had been recommended by the Company's compensation committee. The bonus arrangement is intended to incentivize Mr. Park to secure the best possible price in any sale of the Company. Under the arrangement, Mr. Park will receive five per cent of the net proceeds, which would otherwise have been payable to the shareholders of the Company, of any transaction constituting a sale of the Company approved by the Board. The special committee reserved the right to make any determinations requiring the interpretation of the incentive, in its sole discretion.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

Recent Developments

The Company is currently in active discussions regarding a strategic transaction under the direction of a special committee consisting of independent members of the Board of Directors, together with the assistance of an independent financial advisor ("Proposed Strategic Transaction"). The Company expects that the consideration payable to shareholders of the Company will be minimal. We currently have sufficient funds to support our operations until the anticipated closing of the Proposed Strategic Transaction. Management believes that the Proposed Strategic Transaction, if and when consummated, will provide the necessary liquidity to support the working capital needs of the Company and eliminate the factors that resulted in the going concern uncertainty. There can be no assurance that the Proposed Strategic Transaction can be consummated.

If the Company is unable to complete the Proposed Strategic Transaction or an alternative strategic transaction, or to secure additional financing to fund our operations, the Company will not be able to sustain its operations.

Our revolving credit facility with Salus Capital Partners, LLC ("Salus") was amended on April 11, 2013 to modify certain borrowing availability formulas for sixty days. The amendment increased borrowing availability by up to \$650,000. The Company paid a \$100,000 fee in connection with the amendment. Salus waived covenant violations caused by the late delivery of 2012 audited financial statements and the going concern uncertainty paragraph contained in the Auditor's Report for such financial statements.

Overview

Bluefly, Inc. is a leading Internet retailer that sells over 350 brands of designer apparel and accessories at discounts of up to 75% off of retail value. We launched bluefly.com in September 1998 and expanded our portfolio of web sites in 2011 by launching Belle & Clive, a members-only shopping destination that presents highly-curated selections of important brands via limited-time sale events, and launching Eyefly, an online retailer of fashionable prescription glasses.

During 2012, we embarked upon a new strategy that focuses on lowering our customer acquisition costs, increasing the lifetime value of our customers and increasing our return on invested capital. To increase our return on invested capital, we have focused on improving our inventory turns by being more competitive with our pricing. Subject to appropriate levels of working capital, management believes that these initiatives will take several additional quarters to materialize. During the three months ended March 31, 2013, this shift in strategy positively impacted gross profit margin percentages as compared to prior year. We continued to deliberately reduce inventory receipts from March 31, 2012 to March 31, 2013. This reduction contributed to a decrease in net sales whereby net sales for the three months ended March 31, 2013 declined by 18.4%, as compared to the three months ended March 31, 2012. However, while our net sales declined, we had \$4.3 million less inventory than at December 31, 2012 and, therefore, we started seeing improvements in our returns on invested capital related to inventory.

Our net sales decreased by approximately 18.4% to \$19,794,000 for the three months ended March 31, 2013, from \$24,266,000 for the three months ended March 31, 2012. Our gross margin percentage increased to 20.1% for the three months ended March 31, 2013, from 15.4% for the three months ended March 31, 2012. Our gross profit increased by approximately 6.3% to \$3,981,000 for the three months ended March 31, 2013, from \$3,745,000 for the three months ended March 31, 2012. We

incurred an operating loss of \$3,993,000 for the three months ended March 31, 2013 as compared to an operating loss of \$7,832,000 for the three months ended March 31, 2012. The decrease in operating loss for the three months ended March 31, 2013, as compared to the three months ended March 31, 2012, was primarily a result of an increase in gross profit and a decrease in total operating expenses.

As a percentage of net sales, selling and fulfillment expenses increased to 23.8% or \$4,708,000 for the three months ended March 31, 2013, compared to 22.5% or \$5,458,000 for the three months ended March 31, 2012. General and administrative expenses decreased to 10.3% or \$2,035,000 for the three months ended March 31, 2013, compared to 14.6% or \$3,541,000 for the three months ended March 31, 2012.

Total marketing expenses (including staff related costs) as a percentage of net sales decreased to 6.2% or \$1,231,000 for the three months ended March 31, 2013, compared to 10.6% or \$2,578,000 for the three months ended March 31, 2012. Total marketing expenses (excluding staff related costs) decreased to \$1,231,000 for the three months ended March 31, 2013 from \$2,578,000 for the three months ended March 31, 2012. Marketing expenses (excluding staff related costs) decreased primarily as a result of a decrease in offline marketing expenditures related to television advertising and as a result of the reduction in certain online marketing expenditures.

Our reserve for returns and credit card chargebacks decreased to 33.4% of gross sales for the first quarter of 2013 compared to 35.3% for the first quarter of 2012. The decrease was primarily caused by a reduction in our return rate, however, there can be no assurance that this trend will continue in the future.

At March 31, 2013, we had an accumulated deficit of \$191,539,000. The net losses and accumulated deficit resulted primarily from operating losses including, but not limited to, the costs associated with the strategic change in our product mix and sales incentives, decreases in average order size, selling products at lower gross margin percentages, and to a lesser extent, the non-cash effects of equity-linked instruments previously issued.

Results Of Operations

For The Three Months Ended March 31, 2013 Compared To The Three Months Ended March 31, 2012.

The following table sets forth our Consolidated Statements of Operations data for the three months ended March 31. All data is in thousands except as indicated below:

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| | 2013 | | 2012 | |
|--|------------|------------------------------|------------|------------------------------|
| | | As a % of Net Sales | | As a % of Net Sales |
| Net sales | \$19,794 | 100.0 | \$24,266 | 100.0 |
| Cost of sales | 15,813 | 79.9 | 20,521 | 84.6 |
| Gross profit | 3,981 | 20.1 | 3,745 | 15.4 |
| Selling and fulfillment expenses | 4,708 | 23.8 | 5,458 | 22.5 |
| Marketing expenses | 1,231 | 6.2 | 2,578 | 10.6 |
| General and administrative expenses | 2,035 | 10.3 | 3,541 | 14.6 |
| Total operating expenses | 7,974 | 40.3 | 11,577 | 47.7 |
| Operating loss | (3,993) | (20.2) | (7,832) | (32.3) |
| Interest expense to related party stockholders | (222) | (1.1) | -- | -- |
| Other interest expense, net | (225) | (1.1) | (72) | (0.3) |
| Net loss | \$(4,440) | (22.4) | \$(7,904) | (32.6) |

We also measure and evaluate ourselves against certain other key operational metrics. The following table, which excludes Eyefly, sets forth our actual results based on these other metrics for the three months ended March 31, as indicated below:

| | 2013 | 2012 |
|--|----------|----------|
| Average order size (including shipping and handling) | \$244.97 | \$242.58 |
| New members added during the period* | 137,025 | 489,181 |

*Based on unique email addresses

In addition to the financial statement items and metrics listed, which are non-GAAP financial measurements above, we also report gross sales, another non-GAAP financial measure. We define gross sales as the total dollar amount of orders received by customers (including shipping and handling) net of customer credits, but before any reserves are taken for returns or bad debt. We believe that the presentation of gross sales is useful to investors because (a) it provides an alternative measure of the total demand for the products sold by us and (b) it provides a basis upon which to measure the percentage of total demand that is reserved for both returns and bad debt. Management uses the gross sales measure for these same reasons.

Net sales: Gross sales for the three months ended March 31, 2013 decreased by approximately 20.7% to \$29,716,000, from \$37,461,000 for the three months ended March 31, 2012. For the three months ended March 31, 2013, we recorded a provision for returns and credit card chargebacks of \$9,922,000, or approximately 33.4% of gross sales. For the three months ended March 31, 2012, the provision for returns and credit card chargebacks was \$13,195,000, or approximately 35.2% of gross sales. The decrease in this provision as a percentage of gross sales resulted from a decrease in sales, and a decrease in return rate to 33.1% at March 31, 2013 from 35.2% at March 31, 2012. There can be no assurance that this trend will continue.

After the necessary provisions for returns, credit card chargebacks, our net sales for the three months ended March 31, 2013 were \$19,794,000. This represents a decrease of approximately 18.4% compared to the three months ended March 31, 2012, in which net sales totaled \$24,266,000.

Cost of sales: Cost of sales consists of the cost of product sold to customers, in-bound and out-bound shipping costs, inventory reserves, commissions and packing materials. Cost of sales for the three months ended March 31, 2013 was \$15,813,000, resulting in a gross margin percentage of approximately 20.1%. Cost of sales for the three months ended March 31, 2012 was \$20,521,000 resulting in a gross margin percentage of approximately 15.4%. Gross profit increased by approximately 4.7% to \$3,981,000 for the three months ended March 31, 2013, compared to \$3,745,000 for the three months ended March 31, 2012. The increase in both gross profit and gross margin percentage is attributable to the deliberate shift in our strategy discussed above as we increased inventory turns by being more competitive with our pricing and selling merchandise at closer to cost. In addition, cost of product decreased primarily as a result of a reduction of sales, as well as an increase in product margin.

Selling and fulfillment expenses: Selling and fulfillment expenses decreased by approximately 13.7% for the three months ended March 31, 2013 compared to the three months ended March 31, 2012. Selling and fulfillment expenses

include a total of \$0 and \$105,000 of costs related to Eyefly for the three months ended March 31, 2013 and 2012, respectively. The decrease in Selling and fulfillment is primarily attributable to the following: (a) Fulfillment costs – lower order volume, lower fulfillment and credit card fees (b) Ecommerce - decrease in personnel costs/photo shoot/temporary help costs (c) Technology – increase in depreciation expense and software support during the three months ended March 31, 2013.

Marketing expenses: Marketing expenses (including staff related costs) decreased by approximately 52.2% to \$1,231,000 for the three months ended March 31, 2013, from \$2,578,000 for the three months ended March 31, 2012. The decrease is primarily attributable to decreased customer acquisition costs.

Marketing expenses include expenses related to (a) online marketing programs, which consist of social media programs, online integration partnerships, paid search, and fees paid to marketing affiliates and comparison engines, (b) offline marketing programs, which consist of direct mail campaigns, television advertising and production costs, as well as (c) staff related costs. As a percentage of net sales, our marketing expenses decreased to 6.2% for the three months ended March 31, 2013 from 10.6% for the three months ended March 31, 2012.

General and administrative expenses: General and administrative expenses include merchandising, finance and administrative salaries and related expenses, insurance costs, accounting and legal fees, depreciation and other office related expenses. General and administrative expenses for the three months ended March 31, 2013 decreased to \$2,035,000, as compared to \$3,541,000 for the three months ended March 31, 2012. The decrease in general and administrative expenses was primarily the result of a decrease in severance costs.

As a percentage of net sales, general and administrative expenses for the three months ended March 31, 2013 decreased to 10.3%, from 14.6% for the three months ended March 31, 2012.

Loss from operations: For the three months ended March 31, 2013, we incurred an operating loss of \$3,993,000, compared to an operating loss of \$7,832,000 for the three months ended March 31, 2012.

Interest expense to related party stockholders: Interest expense to related party stockholders for the three months ended March 31, 2013 was \$222,000. Interest expense to related party stockholders consists of non-cash amortization expense of the discount relating to our outstanding notes issued to certain related parties in connection with the recent financing, non-cash changes in fair value of the embedded derivative, accrued interest expense and amortization expense related to deferred financing charges.

Other interest expense, net: Interest expense for the three months ended March 31, 2013 increased to approximately \$225,000, compared to \$72,000 for the three months ended March 31, 2012. Interest expense consists primarily of fees paid in connection with our financing facilities (as described further below).

We earned less than \$1,000 in interest income for the three months ended March 31, 2013 and 2012. These amounts related primarily to interest income earned on our cash balances.

Net loss per share attributable to Bluefly, Inc. stockholders: Net loss per share attributable to Bluefly, Inc. stockholders decreased to \$0.16 per share for the three months ended March 31, 2013, compared to \$0.28 per share for the three months ended March 31, 2012. The decrease in net loss per share attributable to Bluefly, Inc. stockholders was primarily attributable to a decrease in our operating loss.

Liquidity And Capital Resources

General

At March 31, 2013, we had approximately zero in cash and cash equivalents compared to \$1.3 million and \$2.5 million at December 31, 2012 and March 31, 2012, respectively. As of March 31, 2013 we had availability under the Credit Facility of \$0.4 million. Subsequently, we amended the Credit Facility, which increased our overall availability. (See Note 7 - Revolving Credit Facility Financing Agreement.) Working capital, which is computed as

total current assets less total current liabilities and represents a measure of operating liquidity, at March 31, 2013 and December 31, 2012 was \$(4.6) million and \$(0.9) million, respectively. As of March 31, 2013, we had an accumulated deficit of approximately \$191.5 million. We have incurred negative cash flows and cumulative net losses since inception.

Working capital levels at any specific date are subject to variability based upon seasonality, inventory management and sales levels. These factors, in turn, affect the levels of accounts receivable and inventory.

Our needs for liquidity have been primarily to support operating losses, satisfy our working capital requirements, make capital expenditures, and make principal and interest payments on debt obligations. Historically, such requirements have been funded through normal operations and through the use of our financing arrangements and capital raising activities. During 2012, we embarked upon a new strategy that focuses on lowering our customer acquisition costs, increasing the lifetime value of our customers and increasing our return on invested capital. To increase our return on invested capital, we have focused on improving our inventory turns by being more competitive with our pricing and management believes that these initiatives will take several quarters to materialize.

The Company is currently in active discussions regarding a strategic transaction under the direction of a special committee consisting of independent members of the Board of Directors, together with the assistance of an independent financial advisor ("Proposed Strategic Transaction"). The Company expects that the consideration payable to shareholders of the Company will be minimal. We currently have sufficient funds from operations and under our Credit Facility to support our operations until the anticipated closing of the Proposed Strategic Transaction. Management believes that the Proposed Strategic Transaction, if and when consummated, will provide the necessary liquidity to support the working capital needs of the Company and eliminate the factors that resulted in the going concern uncertainty. There can be no assurance that the Proposed Strategic Transaction can be consummated.

If the Company is unable to complete the Proposed Strategic Transaction or an alternative strategic transaction, or to secure additional financing to fund our operations, the Company will not be able to sustain its operations. The Company has implemented certain cost containment measures, which includes reduction in workforce and overhead, and delaying payments to suppliers.

Credit Facility

On November 13, 2012, we entered into a new three-year revolving credit facility (“Credit Facility”) with Salus Capital Partners, LLC (“Salus”) secured by all of our assets. The Credit Facility refinanced our previous credit facility with Wells Fargo Retail Finance, LLC (“Wells Fargo”).

Pursuant to the terms of the Credit Facility, Salus provides us with a revolving credit facility and facilitates the issuance of letters of credit in favor of suppliers or factors. Availability under the Credit Facility is determined by a formula that considers a specified percentage of our accounts receivable and a specified percentage of our inventory. The maximum availability is \$10 million, of which up to \$5 million is available for the issuance of letters of credit. Interest accrues under the Credit Facility at the prime rate plus 4.75%, subject to a minimum rate of 8.00%. Letters of credit issued to third parties are cash collateralized by amounts drawn under the Credit Facility. At closing, \$4.7 million was drawn under the Credit Facility to cash collateralize letters of credit issued by Wells Fargo, which were outstanding at such date. In addition, we paid an origination fee of \$187,500 at closing, will pay a collateral monitoring fee of \$3,000 per month and will pay unused commitment fees of 0.75% of the remaining availability under the Credit Facility. A termination fee of \$75,000 was paid at closing to Wells Fargo.

As of March 31, 2013, maximum total availability under the Credit Facility was approximately \$5.0 million, of which \$4.6 was outstanding at March 31, 2013, leaving approximately \$0.4 million available for further borrowings.

The terms of the Credit Facility contain a material adverse effect clause defined as a material adverse change in the ability of the Company to perform its obligations under the Credit Agreement or, upon the operations, business, properties, liabilities (actual or contingent) or condition (financial or otherwise), or impairment of the rights and remedies of the Agent or any lender under the Credit Facility, or upon the legality, validity, binding effect or enforceability against any party to the Credit Facility. This feature may limit our ability to obtain additional borrowings or result in a default on current outstanding letters of credit.

Both availability under our Credit Facility and our operating cash flows are affected by the payment terms that we receive from suppliers and service providers, and the extent to which suppliers require us to provide credit support under our Credit Facility. In some instances, new vendors may require prepayments. We may make prepayments in order to open up these new relationships, or to gain access to inventory that would not otherwise be available to us. As of March 31, 2013, we had approximately \$0.3 million of prepaid inventory in our Consolidated Balance Sheet, compared to \$0.5 million as December 31, 2012.

The Credit Facility was amended on April 11, 2013 to modify certain borrowing availability formulas for a sixty day period. This amendment increased borrowing availability by up to \$650,000. The Company paid a \$100,000 fee in

connection with the amendment. The interest rate payable under the facility was increased by one percent for sixty days and thereafter the rate will be the greater of (i) the prime rate plus 8.75% and (ii) 12.00%. Salus also waived covenant violations caused by the late delivery of 2012 audited financial statements and the explanatory paragraph regarding a going concern uncertainty contained in the auditor's opinion for such financial statements. Salus has waived our going concern uncertainty at December 31, 2012 and increased our borrowing availability only through mid-June, 2013, after which we would need additional waivers and/or accommodations from Salus.

2012 Financing Transaction

On August 13, 2012 (the "Closing Date"), we entered into a Note and Warrant Purchase Agreement (the "Purchase Agreement") with Rho Ventures VI, L.P. ("Rho") and Prentice Consumer Partners, LP ("Prentice" and together with Rho, the "Purchasers") pursuant to which we issued (i) \$1,500,000 aggregate principal amount of collateralized subordinated convertible promissory notes to Rho (the "Rho Notes") and (ii) \$1,500,000 aggregate principal amount of collateralized subordinated promissory notes to Prentice (the "Prentice Notes" and together with the Rho Notes, the "Notes"). The Rho Notes bear interest at 12% per annum, compounded annually, and interest is payable upon maturity or conversion. The Prentice Notes bear interest at 15% per annum, compounded annually, and interest is payable quarterly. Prentice received an origination fee on the Closing Date equal to 2 percent of the Prentice Notes. The Rho Notes are convertible, at the holder's option, (a) into equity securities that we might issue in any subsequent round of financing that results in proceeds to us of at least \$7,500,000 (a "Qualified Financing") at a price equal to the lowest price per share paid by any investor in such Qualified Financing or (b) into shares of our Common Stock at a price per share equal to \$1.05, which represents the fair market value on the Closing Date.

The Notes have a one-year term but may become due prior to the end of such term in the event of a change of control or a Qualified Financing. The Notes are collateralized by second priority liens on all our assets.

In connection with the issuance of the Notes, we also issued warrants, with a seven year term, to purchase 476,190 shares of our common stock (the “Warrants”) to each of Rho and Prentice, respectively, at a price equal to \$1.05 per share, which represents the fair market value of the Common Stock on the Closing Date.

We incurred approximately \$127,000 of debt issuance costs (“Deferred Financing Costs”) related to the issuance of the Notes, which primarily consisted of legal and other professional fees. These Deferred Financing Costs were deferred and are being amortized to interest expense to related party stockholders over the term of the Notes.

Refer to the consolidated financial statements within Note 6 – 2012 Financing for further details.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

We are a smaller reporting Company as defined by regulation S-K and as such, are not required to provide this information.

Item 4. Controls and Procedures

As of the end of the period covered by this Form 10-Q (the “Evaluation Date”), we carried out an evaluation, under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)). Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that, as of the Evaluation Date, our disclosure controls and procedures were effective in ensuring that information required to be disclosed by us in the reports that we file or submit under the Exchange Act were recorded, processed, summarized and reported, within the time periods specified in the SEC’s rules and forms, and were effective to ensure that information required to be disclosed by us in the reports that we file or submit under the Exchange Act was accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, to allow timely decisions regarding required disclosure. There have been no changes in our internal control over financial reporting that occurred during our most recent fiscal quarter that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Special Note Regarding Forward Looking Statements

This report may include statements that constitute “forward-looking statements,” usually containing the words “believe,” “project,” “expect” or similar expressions. These statements are made pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. Forward-looking statements inherently involve risks and uncertainties that could cause actual results to differ materially from the forward-looking statements. The risks and uncertainties are detailed from time to time in reports filed by the Company with the Securities and Exchange Commission, including Forms 8-K, 10-Q and 10-K. These risks and uncertainties include, but are not limited to, the following: the Company’s need for additional capital and dependence upon consummation of a strategic transaction to resolve its liquidity constraints; the risk of default by us under our credit facility and the consequences that might arise from us having granted a lien on substantially all of our assets under that agreement; the Company’s history of losses and anticipated future losses; the Company’s ability to realize benefits from new initiatives such as its members-only web site Belle and Clive; risks associated with the Company’s shift in strategy to emphasize inventory turns over product margin; the risks that our reduction in spending on offline marketing in favor of online methods will continue to be successful; risks associated with the continuing difficulties in the unfavorable general economic environment; risks associated with affiliates of Rho Ventures, LP, affiliates of Soros Fund Management, private funds associated with Maverick Capital Ltd. and affiliates of Prentice Capital Management, LP each owning a significant portion of our stock; the potential failure to forecast revenues and/or to make adjustments to our operating plans necessary as a result of any failure to forecast accurately; unexpected changes in fashion trends; cyclical variations in the apparel and e-commerce markets; risks associated with our dependence on certain concentration of suppliers for a material portion of our inventory; risks of litigation related to the sale of unauthentic or damaged goods and litigation risks related to sales in foreign countries; our potential exposure to product liability claims in the event that products sold by us are defective; the dependence on third parties and certain relationships for certain services, including our dependence on UPS and USPS (and the risks of a mail slowdown due to terrorist activity) and our dependence on our third-party web hosting, fulfillment and customer service centers; online commerce security risks; our ability to raise additional capital, if needed, to support the growth of our business; risks related to brand owners’ efforts to limit our ability to purchase products indirectly; management of potential growth; the competitive nature of our business and the potential for competitors with greater resources to enter the business; the availability of merchandise; the need to further establish brand name recognition; risks associated with our ability to handle increased traffic and/or continued improvements to our Web Sites; rising return rates; dependence upon executive personnel who do not have

long-term employment agreements; the successful hiring and retaining of new personnel; risks associated with expanding our operations; risks associated with potential infringement of other's intellectual property; the potential inability to protect our intellectual property; government regulation and legal uncertainties; uncertainties relating to the imposition of sales tax on Internet sales and our ability to utilize our net operating losses.

Part II - OTHER INFORMATION

Item 5. Other Information

None noted.

Item 6. Exhibits

The following is a list of exhibits filed as part of this Report:

| <u>Exhibit Number</u> | <u>Description</u> |
|----------------------------------|---|
| 31.1 | Certification Pursuant to Rule 13a-14(a)/15d-14(a). |
| 31.2 | Certification Pursuant to Rule 13a-14(a)/15d-14(a). |
| 32.1 | Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |
| 32.2 | Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |
| 101.INS | XBRL Instance Document. |
| 101.SCH | XBRL Taxonomy Extension Schema. |
| 101.CAL | XBRL Taxonomy Extension Calculation Linkbase. |
| 101.DEF | XBRL Taxonomy Extension Definition Linkbase. |
| 101.LAB | XBRL Taxonomy Extension Label Linkbase. |
| 101.PRE | XBRL Taxonomy Extension Presentation Linkbase. |

SIGNATURES

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

BLUEFLY, INC.

By: /s/ Joseph C. Park
Joseph C. Park
Chief Executive Officer

By: /s/ James Gallagher
James Gallagher
Chief Financial Officer

May 17, 2013