

UNITED STATES DISTRICT COURT FOR THE EASTERN DISTRICT OF PENNSYLVANIA

IN RE: FAO, Inc. Securities Litigation

X  
: MASTER FILE NO. 03-CV-06596-MMB  
X

**NOTICE OF PENDENCY AND SETTLEMENT OF CLASS ACTION**

**If you bought FAO common stock between August 27, 2003 and November 7, 2003 (inclusive) (The “Class Period”), you could get a payment from a class action settlement.**

*A federal court authorized this notice. This is not a solicitation from a lawyer.*

- The settlement will provide \$1.75 million in cash, plus interest, to pay claims from investors who suffered damages from buying FAO common stock between August 27, 2003 and November 7, 2003 (inclusive). The settlement represents an average recovery of 77.4¢ per share. This average is an estimate and is before deduction of any Court approved fees and expenses. See Question 8 below for a more detailed explanation.
- Attorneys for the Lead Plaintiffs have expended considerable time and effort in the prosecution of this litigation on a contingent fee basis, and have advanced the expenses of the litigation, in the expectation that if they were successful in obtaining a recovery for the Class they would be paid from such recovery. Plaintiffs’ Attorneys intend to ask the Court to award them fees up to 33 $\frac{1}{3}$ % of the settlement, and reimbursement of litigation expenses not to exceed \$95,000. Collectively, the fees and expenses are estimated to average 30¢ per share. If approved by the Court, these amounts will be paid from the Settlement Fund. Therefore, the approximate recovery, after deduction of attorneys’ fees and expenses approved by the Court, is an average of 47.4¢ per share. This is an estimate. Your actual recovery, if any, may vary depending on the dates and prices of your FAO stock purchases or sales and the number of Proof of Claim forms that are filed. See Question 8 below for a more detailed explanation.
- The settlement resolves a lawsuit concerning whether two of FAO’s principal officers misled investors about the financial condition of FAO. Defendants deny the allegations in the lawsuit. The parties disagree on the liability and damage issues. See Question 4 below for a more detailed explanation.
- Your legal rights are affected whether you act, or don’t act. Read this notice carefully.

YOUR LEGAL RIGHTS AND OPTIONS IN THIS SETTLEMENT:	
<b>SUBMIT A CLAIM FORM</b>	The only way to get a payment.
<b>EXCLUDE YOURSELF</b>	Get no payment. This is the only option that allows you ever to be part of any other lawsuit against Defendants about the legal claims in this case.
<b>OBJECT BUT REMAIN IN THE SETTLEMENT</b>	Write to the Court about why you don’t like the Settlement.
<b>GO TO A HEARING</b>	The May 16, 2005 Hearing is open to the public. To speak in Court in support of any objection you may have filed, you will need to give advance written notice to the Court and the parties.
<b>DO NOTHING</b>	Get no payment. Give up rights.

- These rights and options—**and the deadlines to exercise them**—are explained in this notice.
- The Court in charge of this case still has to decide whether to approve the settlement. Payments will be made if the Court approves the Settlement and after appeals are resolved and claims are processed. Please be patient.
- Further information regarding this Settlement may be obtained by contacting Plaintiffs’ Lead Counsel: Sherrie R. Savett, Berger & Montague, P.C., 1622 Locust Street, Philadelphia, PA, 19103-6365, Telephone: 215-875-3000, or Kenneth J. Vianale, Vianale & Vianale LLP, The Plaza Suite 801, 5355 Town Center Road, Boca Raton, FL, 33486, Telephone: 561-391-4900.

**WHAT THIS NOTICE CONTAINS**

	<b>PAGE</b>
<b>BASIC INFORMATION</b> .....	PAGE 3
1. Why did I get this Notice package?	
2. What is this lawsuit about?	
3. Why is this a class action?	
4. Why is there a settlement?	
<b>WHO IS IN THE SETTLEMENT</b> .....	PAGE 4
5. How do I know if I am part of the settlement?	
6. Are there exceptions to being included?	
7. I’m still not sure if I am included.	
<b>THE SETTLEMENT BENEFITS — WHAT YOU GET</b> .....	PAGE 4
8. What does the settlement provide?	
<b>HOW YOU GET A PAYMENT — SUBMITTING A CLAIM FORM</b> .....	PAGE 5
9. How can I get a payment?	
10. When would I get my payment?	
11. What am I giving up to get a payment or stay in the Class?	
<b>EXCLUDING YOURSELF FROM THE SETTLEMENT</b> .....	PAGE 6
12. How do I get out of the settlement?	
13. If I do not exclude myself, can I sue Defendants for the same thing later?	
14. If I exclude myself, can I get money from this settlement?	
<b>THE LAWYERS REPRESENTING YOU</b> .....	PAGE 6
15. Do I have a lawyer in this case?	
16. How will the lawyers be paid?	
<b>OBJECTING TO THE SETTLEMENT</b> .....	PAGE 7
17. How do I tell the Court that I do not like the settlement?	
18. What is the difference between objecting and excluding?	
<b>THE COURT’S FAIRNESS HEARING</b> .....	PAGE 7
19. When and where will the Court decide whether to approve the settlement?	
20. Do I have to come to the hearing?	
21. May I speak at the hearing?	
<b>IF YOU DO NOTHING</b> .....	PAGE 8
22. What happens if I do nothing at all?	
<b>GETTING MORE INFORMATION</b> .....	PAGE 8
23. How do I get more information about the Settlement?	
24. How do I obtain more information about the separate settlement involving FAO shares purchased between March 26, 2002 and December 12, 2002?	
<b>UNDERSTANDING YOUR PAYMENT — THE PLAN OF ALLOCATION</b> .....	PAGE 9
<b>SPECIAL NOTICE TO SECURITIES BROKERS AND OTHER NOMINEES</b> .....	PAGE 10
<b>PROOF OF CLAIM AND RELEASE FORM</b> .....	PAGE 11

## BASIC INFORMATION

### 1. Why did I get this Notice package?

You or someone in your family may have purchased shares of FAO, Inc. common stock (“FAO stock”) between August 27, 2003 and November 7, 2003 (inclusive). The Court in charge of the case is the United States District Court for the Eastern District of Pennsylvania and the case is known as *In re FAO, Inc. Securities Litigation*, Master File No. 03-CV-06596-MMB. U.S. District Judge Michael M. Baylson is in charge of this class action. The people who sued are called Plaintiffs, and the individuals they sued — Jerry R. Welch and Jerome A. Kollar — are called Defendants. FAO, Inc. is not a defendant because it filed for bankruptcy.

The Court sent you this notice because you have a right to know about a proposed settlement of this class action lawsuit, and about all of your options, before the Court decides whether to approve the settlement. If the Court approves the settlement, and resolves any objections to the settlement submitted by Class Members, as explained below, or appeals, then an administrator appointed by the Court will process the claims received and distribute the payments to Class Members with valid claims. You can track the progress of the settlement by visiting: [www.hrsclaimsadministration.com](http://www.hrsclaimsadministration.com).

This package explains the lawsuit, the settlement, your legal rights, the benefits that are available, who is eligible for them, and how to obtain them.

### 2. What is this lawsuit about?

The lawsuit claims that Defendants misled investors by misrepresenting FAO’s financial condition. Specifically, the lawsuit claims that Defendants issued press releases and other statements that failed to disclose that the Company was experiencing a severe liquidity crunch and would not be able to continue to fund operations without an immediate infusion of cash. The lawsuit claims that as a result of these false and misleading statements, the value of FAO stock was inflated, and that investors who purchased FAO stock at these inflated prices were damaged. FAO filed for bankruptcy shortly after the end of the Class Period. Defendants deny they did anything wrong.

### 3. Why is this a class action?

In a class action, one or more persons or entities called Class Representatives sue on behalf of all persons and/or entities who have similar claims. All of these persons and/or entities are referred to as a Class, or individually, as Class Members. One court resolves all of the issues for all Class Members, except for those Class Members who exclude themselves from the Class.

### 4. Why is there a settlement?

The Court did not decide in favor of Plaintiffs or Defendants. Instead, Plaintiffs and Defendants have agreed to settle the lawsuit. Plaintiffs have agreed to settle the lawsuit based on the facts they have discovered during the litigation, the risks that will be involved in a trial, and their conclusions that the proposed settlement is fair, reasonable and adequate, and serves the best interests of the Class Members. Counsel for Plaintiffs have determined that by settling, they avoid the cost and risks of a trial, while at the same time providing substantial compensation to the Class. The Class Representatives and the Counsel for the Class believe that the settlement is best for all Class Members.

Lead Plaintiffs and Defendants do not agree regarding the merits of Plaintiffs’ allegations with respect to liability or the average amount of damages per share that would be recoverable if Lead Plaintiffs were to prevail on each claim asserted. The issues on which the parties disagree include: (1) whether Defendants made any false and misleading statements; (2) whether the statements made were false, material or otherwise actionable under the federal securities laws; (3) whether Defendants made the statements with the requisite intent; (4) the appropriate economic model for determining the amount by which FAO stock was allegedly artificially inflated (if at all) during the Class Period; (5) the extent to which the various matters that Lead Plaintiffs alleged were materially false or misleading (if at all) influenced and artificially inflated (if at all) the trading price of FAO stock at various times during the Class Period; and (6) the extent to which external factors, such as general market conditions, influenced the trading price of FAO stock at various times during the Class Period.

While Plaintiffs’ Counsel were prepared to go to trial, and were confident in the merits of their case, they recognize that a trial is a risky proposition and that Plaintiffs and the Class may not have prevailed on all of their claims. In addition, Plaintiffs’ Counsel believe that this Settlement provides a substantial recovery to the Class, and believe that they may not have obtained a greater recovery even if they had gone to trial. FAO, Inc. could not

be named a defendant because it has filed for bankruptcy. Throughout the settlement negotiations, Defendants continued to deny liability, and denied that Plaintiffs and the Class were damaged, asserting instead that the decline in the price of FAO stock was attributable to other factors. This dispute regarding damages would be subject to expert testimony, and therefore, it would be impossible to predict with certainty which side's arguments would find favor with the jury. As a result, in a trial, Plaintiffs could have recovered nothing or substantially less than the amount of the Settlement. Further, even assuming that Plaintiffs could have won at trial, any verdict would inevitably be the subject of appeal, and the Class' recovery would have remained uncertain and been further delayed. In this case, even if Plaintiffs had won a verdict greater than the settlement at trial, and that verdict had withstood Defendants' challenge on appeal, Plaintiffs may not have been able to collect the judgment.

## WHO IS IN THE SETTLEMENT

To see if you will get money from this settlement, you first have to decide if you are a Class Member.

### 5. How do I know if I am part of the Settlement?

Judge Baylson decided that everyone who fits the following description is a Class Member:

All persons who purchased FAO stock from August 27, 2003 through November 7, 2003 (inclusive) (the "Class Period").

### 6. Are there exceptions to being included?

You are not a Class Member if you are a Defendant in this lawsuit or Mr. Fred Kayne (a former defendant in this lawsuit). The Class also excludes members of the immediate family of each of the Defendants and Mr. Kayne, any entity in which any Defendant or Mr. Kayne has a controlling interest, and the heirs of any such excluded person. Also, if you exclude yourself from the Class, as described below, you are not a part of the Class. If one of your mutual funds owns FAO stock, that alone does not make you a Class Member. You are a Class Member only if you purchased FAO stock. Contact your broker to see if you own or held FAO stock.

To be a Class Member, you must have purchased FAO stock during the Class Period.

### 7. I'm still not sure if I am included.

If you are still not sure whether you are included in the Class, you can ask for free help, by calling 1-800-528-7199 for more information. Alternatively, you can fill out and return the claim form attached to this Notice to see if you qualify.

## THE SETTLEMENT BENEFITS—WHAT YOU GET

### 8. What does the settlement provide?

On March 31, 2004, the parties in the lawsuit arrived at a proposed settlement of the lawsuit and signed a Memorandum of Understanding that required authorization from the bankruptcy court before the settlement could be funded or a formal agreement prepared. This authorization was received in December 2004. The parties' agreement, by itself, is not sufficient for the settlement to be official – the proposed settlement requires the Judge's approval. The terms of the proposed settlement are summarized below, and the full settlement terms are contained in a Stipulation and Agreement of Settlement ("Stipulation") dated January 10, 2005. You can obtain a copy of the Stipulation by writing to Plaintiffs' Counsel: Sherrie R. Savett, Esquire, Berger & Montague, P.C., 1622 Locust Street, Philadelphia, PA 19103, or by visiting [www.hrsclaimsadministration.com](http://www.hrsclaimsadministration.com).

#### a. What is the Settlement Fund?

The proposed settlement calls for Defendants to create a settlement fund in the amount of \$1.75 million in cash. This \$1.75 million has been deposited into an interest bearing account, the "Gross Settlement Fund." It is estimated that approximately 2.26 million shares of FAO stock were damaged during the Class Period. Thus, Class Counsel estimate that the \$1.75 million recovery represents an average recovery of 77.4¢ per share. This average recovery is only an estimate and can vary as explained below. Subject to the Court's approval, a portion of the Gross Settlement Fund also will be used to pay Plaintiffs' attorneys' fees and reasonable litigation expenses. See Question 16 below for a more detailed explanation. A portion of the Gross Settlement Fund will also be used to pay taxes due on interest earned by the Gross Settlement Fund and any notice and claims administration expenses permitted by the Court or the Stipulation. After the foregoing deductions from the Gross Settlement Fund have been made, the amount remaining (the "Net Settlement Fund") will be distributed to Class Members who submit valid claims.

**b. What can you expect to receive under the proposed settlement?**

Your share of the Net Settlement Fund will depend on: (1) the number of claims filed; (2) when during the Class Period you purchased your FAO stock; (3) whether you sold your FAO stock during the Class Period, or held your FAO stock past the end of the Class Period; (4) the amount of administrative costs, including the costs of notice; and (5) the amount awarded by the Court for attorneys' fees, costs and expenses. By following the Plan of Allocation at the end of this notice, you can calculate your "Recognized Loss." The Claims Administrator will distribute the Net Settlement Fund, according to the Plan of Allocation, after the deadline for submission of Proof of Claim and Release forms has passed and all claims have been processed. The percentage of the Recognized Loss that is distributed will be determined by dividing the total Recognized Losses of all Authorized Claimants by the Net Settlement Fund. See Plan of Allocation below.

**HOW YOU GET A PAYMENT—SUBMITTING A CLAIM FORM**

**9. How can I get a payment?**

To qualify for payment, you must send in a Proof of Claim and Release form. This claim form is attached to this Notice. You may also download a claim form from [www.hrsclaimsadministration.com](http://www.hrsclaimsadministration.com). Read the instructions carefully, fill out the form, sign it in the two locations indicated, include all the documents the form asks for and mail the claim form and documentation, postmarked no later than June 10, 2005 to:

Claims Administrator  
FAO, Inc. Securities Litigation  
Heffler, Radetich & Saitta L.L.P.  
P.O. Box 58940  
Philadelphia, PA 19102-8940

The Claims Administrator will process your claim and advise you if you are an "Authorized Claimant" – meaning that your claim satisfies the requirements approved by the Court.

**10. When would I receive my payment?**

The Court will hold a hearing on May 16, 2005, to decide whether to approve the Settlement. Even if Judge Baylson approves the Settlement, there may be appeals that would delay the implementation of the Settlement. It's always uncertain whether these appeals can be resolved, and resolving them can take time, perhaps more than a year. After the approval, and the resolution of any appeals, the Claims Administrator must process all of the claim forms. Everyone who sends in a claim form will be informed of the approval or disapproval of their claim. Please be patient. You can also track the progress of the settlement by visiting: [www.hrsclaimsadministration.com](http://www.hrsclaimsadministration.com).

**11. What am I giving up to get a payment or stay in the Class?**

Unless you exclude yourself, you will remain in the Class. That means that if the settlement is approved, you and all Class Members will release (can't sue, continue to sue, or be part of any other lawsuit) all "Settled Claims" against Defendants and the "Released Parties." It also means that all of the Court's orders will apply to you and legally bind you. Please see the definitions of all of the terms that are in quotations below. If you sign the claim form, you are agreeing to a "Release of Claims," attached to the claim form, which describes exactly the legal claims that you give up if you receive settlement benefits.

"Released Parties" means the Defendants and FAO, their past or present subsidiaries, affiliates, parents, successors and predecessors, estates and assigns and the respective officers, directors, shareholders, agents, legal representatives, trustees, employees, attorneys, insurers, reinsurers, advisors, investment advisors, auditors, and accountants of the foregoing, and any person, firm, trust, corporation, officer, director or other individual or entity in which any Defendant or FAO has a controlling interest or which is related to or affiliated with any of the Defendants or FAO, and the legal representatives, heirs, successors in interest or assigns of the Defendants or FAO.

"Settled Claims" means any and all claims, debts, demands, rights or causes of action or liabilities whatsoever (including, but not limited to, any claims for damages, interest, attorneys' fees, expert or consulting fees, and any other costs, expenses or liability whatsoever), whether based on federal, state, local, statutory or common law or any other law, rule or regulation, whether fixed or contingent, accrued or unaccrued, liquidated or unliquidated, at law or in equity, matured or unmatured, whether class or individual in nature, including both known claims and Unknown Claims (as defined below), (i) that have been asserted in this Action by the Class Members or any of them against any of the Released Parties, or (ii) that could have been asserted in any forum by the Class

Members or any of them against any of the Released Parties which arise out of or relate in any way to the allegations, transactions, facts, matters or occurrences, representations or omissions involved, set forth, referred to or that could have been asserted in the Complaint. Settled Claims also means any and all claims arising out of, relating to, or in connection with the settlement or resolution of this Action, other than claims to enforce the Settlement or any of its terms.

“Unknown Claims” means any and all Settled Claims which any Lead Plaintiff or any Class Member does not know or suspect to exist in his, her or its favor at the time of the release of the Released Parties, and any Settled Defendants’ Claims which any Defendant or Fred Kayne does not know or suspect to exist in his, her or its favor, which if known by him, her or it might have affected his, her or its decision(s) with respect to the Settlement.

### **EXCLUDING YOURSELF FROM THE SETTLEMENT**

If you do not want to receive a payment from this settlement, and you want to keep the right to sue or continue to sue Defendants on your own about the legal issues in this case, then you must take steps to get out of the Settlement. This is called excluding yourself—or is sometimes referred to as opting out of the Class.

#### **12. How do I get out of the settlement?**

To exclude yourself from the settlement, you must send a letter by mail stating that you want to be excluded from *In Re FAO, Inc. Securities Litigation*, Master File No. 03-CV-06596-MMB. Be sure to include your name, address, telephone number, and your signature, along with your purchases or sales in FAO stock in order to indicate your membership in the Class. You must mail your exclusion request postmarked no later than May 2, 2005 to:

Claims Administrator  
FAO, Inc. Securities Litigation  
Heffler, Radetich & Saitta L.L.P.  
P.O. Box 58940  
Philadelphia, PA 19102-8940

You can’t exclude yourself on the phone or by e-mail. If you ask to be excluded, you will not receive a settlement payment, and you cannot object to the settlement. You will not be legally bound by anything that happens in this lawsuit. You may be able to sue (or continue to sue) Defendants in the future.

#### **13. If I do not exclude myself, can I sue Defendants for the same thing later?**

Unless you exclude yourself, you give up any right to sue Defendants or the Released Parties for the claims that this settlement resolves. If you have a pending lawsuit, speak to your lawyer in that case immediately. You must exclude yourself from *this* Class to continue your own lawsuit. Remember, the exclusion deadline is May 2, 2005.

#### **14. If I exclude myself, can I receive money from this settlement?**

No. If you exclude yourself, do not send in a claim form to ask for any money. But, you may sue, continue to sue, or be part of a different lawsuit against Defendants.

### **THE LAWYERS REPRESENTING YOU**

#### **15. Do I have a lawyer in this case?**

The Court approved the law firms of Berger & Montague, P.C. and Vianale & Vianale LLP to represent you and the other Class Members. The lawyers of these firms are called Plaintiffs’ Counsel or Class Counsel. You will not be charged for these lawyers. If you want to be represented by your own lawyer, you may hire one at your own expense.

#### **16. How will the lawyers be paid?**

Plaintiffs’ Counsel have expended considerable time litigating this Action on a contingent fee basis, and have advanced the expenses of litigation with the expectation that if they were successful in recovering money for the Class, they would receive fees and be reimbursed for their expenses from the Settlement Fund, as is customary in this type of litigation. Therefore, Plaintiffs’ Counsel will file a motion asking the Court at the Fairness Hearing (see Question 19 below) to make an award of attorneys’ fees in an amount not to exceed 33 $\frac{1}{3}$ % of the Gross Settlement Fund and for reimbursement of litigation expenses in an amount not to exceed \$95,000. The requested

fees and expenses are estimated to be an average of 30¢ per share. (These averages are estimates based on approximately 2.26 million shares of FAO stock that are estimated to have been purchased with damages during the Class Period.) The Court may award less than these amounts. Any amounts awarded by the Court will come out of the Gross Settlement Fund.

### OBJECTING TO THE SETTLEMENT

You can tell the Court that you do not agree with the settlement, any part of the settlement, or the motion for attorneys' fees.

#### 17. How do I tell the Court that I do not like the Settlement?

If you are a Class Member, you can object to the settlement if you do not like any part of it. You can state why you think the Court should not approve it. The Court will consider your views. To object, you must send a letter stating that you object to the Settlement in *In re FAO, Inc. Securities Litigation*, Master File No. 03-CV-06596-MMB. Be sure to include your name, address, telephone number, your signature, your purchases or sales of FAO stock in order to indicate your membership in the Class and all of the reasons for your objection to the settlement. Be sure to mail the objection to the four different places stated below, postmarked no later than May 2, 2005.

COURT	CLASS COUNSEL	DEFENDANTS' COUNSEL
Clerk of the Court United States District Court Eastern District of Pennsylvania 601 Market Street, Room 2609 Philadelphia, PA 19106	Sherrie R. Savett, Esquire Berger & Montague, P.C. 1622 Locust Street Philadelphia, PA 19103  and  Kenneth J. Vianale, Esquire Vianale & Vianale LLP The Plaza Suite 801 5355 Town Center Road Boca Raton, FL 33486	Marc J. Sonnenfeld, Esquire Morgan Lewis & Bockius LLP 1701 Market Street Philadelphia, PA 19103

#### 18. What is the difference between objecting and requesting exclusion?

Objecting is simply telling the Court that you do not like something about the settlement. You can object only if you stay in the Class. Excluding yourself is telling the Court that you do not want to be part of the Class. If you exclude yourself, you have no basis to object because the case no longer affects you.

### THE COURT'S FAIRNESS HEARING

The Court will hold a hearing to decide whether to approve the settlement. You may attend and you may ask to speak.

#### 19. When and where will the Court decide whether to approve the settlement?

The Court will hold a Fairness Hearing at 4:00 p.m. on May 16, 2005, in a courtroom to be posted on the Court's schedule at the United States District Court for the Eastern District of Pennsylvania, 601 Market Street, Philadelphia, PA 19106. At this hearing the Court will consider whether the settlement is fair, reasonable, and adequate. If there are objections, the Court will consider them. Judge Baylson will listen to people (or their counsel) who have submitted a written objection and written indication of their intent to appear and speak at the Hearing, post-marked no later than May 2, 2005, and mailed to the four different places listed in the chart following Question 17 above. The Court may also decide how much to pay Plaintiffs' Counsel for attorneys' fees and expenses. After the hearing, the Court will decide whether to approve the settlement. We do not know how long these decisions will take.

## 20. Do I have to come to the hearing?

No. Class Counsel will answer any questions Judge Baylson may have. But, you are welcome to come at your own expense. If you send an objection, you do not have to come to Court to talk about it. As long as you mailed your written objection on time, the Court will consider it. You may also attend or pay your own lawyer to attend to speak in support of any objection you may have filed, but it is not necessary. You may do so as long as you have followed the instructions set forth in the answer to question 21.

## 21. May I speak at the hearing?

If you have submitted a written objection to the settlement or the motion of Plaintiffs' Counsel for attorneys' fees and expenses, and follow the instructions set out in response to Questions 17 and 19 above, you (or your counsel) may speak at the Fairness Hearing in support of your objection. To do so, along with your written objection, you must send a letter saying that it is your "Notice of Intention to Appear in *In Re FAO, Inc. Securities Litigation*, Master File No. 03-CV-06596-MMB." Be sure to include your name, address, telephone number, and your signature. Your Notice of Intention to Appear must be postmarked no later than May 2, 2005, and be sent to the Clerk of the Court, Class Counsel, and Defense Counsel, at the addresses listed in question 17. You cannot speak at the hearing if you exclude yourself.

## IF YOU DO NOTHING

## 22. What happens if I do nothing at all?

If you do nothing, you will not receive any money from this settlement. But, unless you exclude yourself, you will not be able to start a lawsuit, continue with a lawsuit, or be part of any other lawsuit against Defendants or the Released Parties about the legal issues in this case, ever again.

## GETTING MORE INFORMATION

## 23. How do I obtain more information about the settlement?

You can: (1) call 1-800-528-7199 toll free; (2) write to Claims Administrator, FAO, Inc. Securities Litigation, Heffler, Radetich & Saitta L.L.P., P.O. Box 58940, Philadelphia, PA 19102-8940, or (3) visit the website at [www.hrsclaimsadministration.com](http://www.hrsclaimsadministration.com), where you will find answers to common questions about the settlement, a claim form, plus other information to help you determine whether you are a Class Member and whether you are eligible for a payment.

## 24. How do I obtain more information about the separate settlement involving FAO shares purchased between March 26, 2002 and December 12, 2002?

There is a separate and unrelated settlement involving shares of FAO stock purchased during the period from March 26, 2002 through December 12, 2002. To see if you qualify to receive a portion of the settlement fund created in that case or to obtain a claim form for this 2002 case, you should contact the claims administrator for the earlier case: Steele, et al. v. Welch, et al., c/o The Garden City Group, Inc., P.O. Box 9000 #6271, Merrick, NY 11566-9000; 1- 800-361-4160.

Please note that if you purchased shares of FAO stock during **both**: (1) the earlier March 26, 2002 through December 12, 2002 period as well as (2) the August 27, 2003 through November 7, 2003 Class Period covered by this settlement, you will have to **complete two separate claim forms**, one for each case, and mail them to the respective addresses indicated on each claim form.

## UNDERSTANDING YOUR PAYMENT – THE PLAN OF ALLOCATION

**(You do not need to make any of these calculations yourself. The Claims Administrator will make all of these calculations for you.)**

1. The Net Settlement Fund will be allocated among the Authorized Claimants in accordance with this “Plan of Allocation.” The amount so allocated to each Authorized Claimant constitutes and is referred to herein as the Authorized Claimant’s “Payable Claim.” The Plan of Allocation is based upon Plaintiffs’ Counsel’s assessment of the merits and the relative strengths and weaknesses, including recoverable damages, of the claims of the members of the Class. In developing this Plan of Allocation, Class Counsel has considered, among other things, the following:

(a) On November 7, 2003, FAO issued a press release announcing: (i) that sales had been disappointing and significantly below expectations and that FAO had not observed the improvement in sales it had anticipated from its initial holiday marketing efforts; (ii) that if this trend continued FAO believed it would not have adequate liquidity to operate its business normally; (iii) that FAO was asking certain of its vendors to reduce shipments and most vendors to extend payment dates to the first of the year; and (iv) that FAO requested an overadvance from its lenders which could lead to its lenders issuing a notice of default.

(b) Prior to the issuance of this press release trading in FAO stock was halted on the NASDAQ. When trading resumed, the price of FAO stock fell to close at \$1.73 per share on Friday, November 7, 2003 on unusually heavy volume of over 1.2 million shares. Although all trading in FAO stock on November 7, 2003 occurred after the issuance of this press release, it is not certain that the impact of this press release was absorbed completely by the market during the final 3 hours of trading on that day.

(c) On the following two trading days (Monday and Tuesday, November 10 - 11, 2003), the price of FAO stock closed at an average of \$1.23 per share on unusually high volume of over 3.3 million shares.

2. An Authorized Claimant’s recognized loss (“Recognized Loss”) is determined by the date(s) the Authorized Claimant purchased or sold any shares of FAO stock during the Class Period, as set forth below.

(a) Stock Purchased between August 27, 2003 and November 6, 2003: For shares of FAO’s stock that were purchased from August 27, 2003 through November 6, 2003, inclusive, the Recognized Loss is as follows:

- (i) For shares sold either at a profit or a loss during the same August 27, 2003 through November 6, 2003 time period, the Recognized Loss is zero;
- (ii) For shares sold at a loss on November 7, 2003, the Recognized Loss is the difference between: (a) the purchase price paid and (b) the sales price received; and
- (iii) For shares retained after the close of business on November 7, 2003, the Recognized Loss is the difference between: (a) the purchase price paid and (b) the \$1.23 average closing price on November 10 and 11, 2003.

(b) Stock Purchased on November 7, 2003: For shares of FAO’s stock that were purchased on November 7, 2003, the Recognized Loss is as follows:

- (i) For shares sold either at a profit or a loss on November 7, 2003, the Recognized Loss is zero; and
- (ii) For shares retained after the close of business on November 7, 2003, the Recognized Loss is \$0.25 per share.

(c) For purposes of determining which shares of FAO’s stock purchased during the Class Period either were sold at any time during the Class Period or were retained past November 7, 2003, purchases and sales of FAO’s stock will be matched, on a “first-in/first-out” (“FIFO”) basis, by matching the first shares sold against any closing position of shares held as of August 26, 2003 (prior to the start of the Class Period) and then on a FIFO basis against any additional shares of FAO stock purchased during the Class Period on the basis of the assumption that the first share purchased was the first share sold. The matching under FIFO will be applied irrespective of the different accounts in which the shares of FAO stock were purchased and sold unless the title or ownership of the accounts differed.

(d) The date of purchase or sale is the “contract” or “trade” date as distinguished from the “settlement date.” The purchase price paid for FAO stock includes commissions and fees; the sales price is net of commissions and fees.

(e) The restrictions on computing Recognized Losses set out in the 3 bullet points below apply to all claims. As a practical matter, however, they apply primarily to certain transactions engaged in by sophisticated traders or certain corporate or institutional Claimants:

- “Short” sales will not be recognized for any amount of loss on the cover or purchase transaction, and no Recognized Loss will be computed for any such covering purchase transaction.
- No Recognized Loss will be computed for any transactions in shares of FAO stock engaged in by market makers.
- No Recognized Loss will be computed for any option premium paid or received where the shares of FAO stock were purchased or sold by reason of having exercised or been assigned an option.

3. An Authorized Claimant’s “Payable Claim” represents a percentage of the Authorized Claimant’s total Recognized Loss. This percentage is determined by dividing the Net Settlement Fund by the total Recognized Loss sustained by all Authorized Claimants. The resulting fraction, or payout percentage, is then multiplied by each Authorized Claimant’s Recognized Loss to determine the amount of each Claimant’s Payable Claim, subject to the further limitations below.

4. In the interest of economy, no payment will be made to any Authorized Claimant whose Payable Claim would be less than \$10 based on the initial allocation of the Net Settlement Fund to the Authorized Claimants.

5. If you inherited or received a gift of FAO stock during the Class Period, that inheritance or gift is not considered a purchase of FAO stock unless your ancestor or donor was the actual purchaser of FAO stock during the Class Period. You, as a recipient of a gift or inheritance, and the original purchaser may not both file a claim with regard to the same shares of FAO stock. If both you and the donor (or you and your ancestor’s estate) make such a claim, only the claim filed by the recipient (or heir) will be honored.

6. Nothing in this Plan of Allocation represents an admission by any of the Defendants that there is liability or damage of any kind as a result of the allegations in the Complaint or that the dollar amounts set forth in this Plan of Allocation reflect actual or potential damages to the Class.

7. Payment in the manner set forth above will be deemed conclusive compliance with the Stipulation as to all Authorized Claimants. All Class Members who fail to submit valid and timely Proofs of Claim will be barred from participating in the distribution of the Net Settlement Fund but otherwise will be bound by all of the terms of the Stipulation, including the terms of any final orders or judgments entered and the releases given to Defendants and others.

8. No Authorized Claimant will have any claim against Plaintiffs, Plaintiffs’ Counsel or the Claims Administrator, or any other agent designated by Plaintiffs’ Counsel based on the distributions made substantially in accordance with the Stipulation, the Plan of Allocation, and further orders of Court. In addition, in the interest of achieving substantial justice, Plaintiffs’ Counsel will have the right, but not the obligation, to waive what they deem to be formal or technical defects in any Proofs of Claim filed.

### **SPECIAL NOTICE TO SECURITIES BROKERS AND OTHER NOMINEES**

If you purchased FAO common stock during the Class Period as nominee for a beneficial owner, then within ten (10) days after you receive this Notice, you must either: (a) send a copy of this Notice and the accompanying Proof of Claim and Release form by first-class mail to all such beneficial owners; or (b) provide a list, electronically if possible, of the names and addresses of such beneficial owners to the Claims Administrator:

Claims Administrator  
FAO, Inc. Securities Litigation  
Heffler, Radetich & Saitta, L.L.P.  
P.O. Box 58940  
Philadelphia, PA 19102-8940

If you chose option: (a) above, you may request enough forms from the Claims Administrator (at no charge) to complete your mailing. You may seek reimbursement of your reasonable expenses actually incurred in complying with these directives, subject to approval of Plaintiffs’ Counsel or the Court. All communications concerning this matter should be addressed to the Claims Administrator.

### **INQUIRIES**

All inquiries concerning this Notice, the Proof of Claim and Release form, or any other questions by Class Members should be directed to the Claims Administrator listed above.

### **PLEASE DO NOT CONTACT THE COURT REGARDING THIS NOTICE**

DATED: February 14, 2005

BY ORDER OF THE DISTRICT COURT:  
MICHAEL M. BAYLSON, JUDGE

UNITED STATES DISTRICT COURT FOR THE EASTERN DISTRICT OF PENNSYLVANIA

IN RE: FAO, Inc. Securities Litigation : MASTER FILE NO. 03-CV-06596-MMB

PROOF OF CLAIM AND RELEASE FORM

I. GENERAL INSTRUCTIONS

1. If you purchased shares of FAO, Inc. common stock ("FAO stock") during the period from August 27, 2003 through November 7, 2003, inclusive, (the "Class Period"), you are a "Class Member" and you may be entitled to share in the settlement proceeds. (See the accompanying Notice for a description of persons that are excluded from the Class.) If you are NOT a member of the Class, DO NOT submit a Proof of Claim and Release.

2. To recover on your claims in this Action, you must complete this Proof of Claim and Release and sign it on page 14. YOU MUST MAIL YOUR COMPLETED AND SIGNED PROOF OF CLAIM AND RELEASE, POSTMARKED ON OR BEFORE JUNE 10, 2005 ADDRESSED AS FOLLOWS:

Claims Administrator
FAO, Inc. Securities Litigation
Heffler Radetich & Saitta L.L.P.
P.O. Box 58940
Philadelphia, PA 19102-8940

3. If you fail to timely file a properly addressed Proof of Claim and Release, your claim may be rejected and you may be precluded from any recovery from the Settlement Fund created in connection with the proposed settlement of the Action. Submission of this Proof of Claim and Release, however, does not assure that you will share in the proceeds from the settlement in this Action.

4. If you are a member of the Class and you do not timely request exclusion, you are bound by the terms of any judgment entered in this Action, whether or not you submit a Proof of Claim and Release.

5. If you purchased FAO stock during the Class Period and held the certificate(s) in your name, you are the beneficial owner as well as the record owner. If, however, you purchased FAO stock and the certificate(s) were registered in the name of a third party, such as a nominee or brokerage firm, you are the beneficial owner and the third party is the record owner.

6. In paragraph 15 below, entitled "Claimant Identification," identify each record owner, if different from the beneficial owner of FAO stock which forms the basis of this claim. This Proof of Claim and Release must be filed by the actual beneficial owner(s), or the legal representative of such beneficial owner(s) of the FAO stock upon which the claim is based.

7. All joint beneficial owners must sign this Proof of Claim and Release. Executors, administrators, guardians, conservators and trustees must complete and sign this Proof of Claim and Release on behalf of persons represented by them and documentation evidencing their authority must accompany this claim and their titles or capacities must be stated. The Social Security (or employer identification) number and telephone number of the beneficial owner may be used in verifying the claim. Failure to provide the foregoing information could delay verification of your claim or result in rejection of the claim.

8. The date of covering a "short sale" is deemed to be the date of purchase of FAO stock. The date of a "short sale" is deemed to be the date of sale of FAO stock. "Short" sales will not be recognized for any amount of loss on the cover or purchase transaction, and no Recognized Loss will be computed for any such covering purchase transaction.

9. Copies of brokers' confirmations or other documentation of your transactions in FAO stock should be attached to your claim. Failure to provide this documentation could delay verification of your claim or result in rejection of your claim. Do not attach originals.

10. FAO stock "transferred into," "delivered into" or "received into" the claimant's account will NOT be considered as purchased FAO stock unless claimant submits documents supporting that the original purchase of the FAO stock occurred during the Class Period. Also, FAO stock purchased and subsequently "transferred out" or "delivered out" of claimant's account will NOT be considered part of claimant's claim, as the right to file for those FAO stock belongs to the person receiving the FAO stock.



**16. SCHEDULE OF TRANSACTIONS IN FAO COMMON STOCK**

A. Number of Shares of FAO Common Stock Held at the end of Trading on August 26, 2003: \_\_\_\_\_

B. Purchases of FAO Common Stock from August 27, 2003 through November 7, 2003 (inclusive):

Trade Date Month / Day / Year (List Chronologically)	Number of Shares Purchased	Price Per Share	Total Cost (Including Commissions/Fees)
-  -		\$ . .	\$ . .
-  -		\$ . .	\$ . .
-  -		\$ . .	\$ . .

C. Total Shares of FAO Common Stock Purchased \_\_\_\_\_.

D. Sales of FAO Common Stock from August 27, 2003 through November 7, 2003:

Trade Date Month / Day / Year (List Chronologically)	Number of Shares Sold	Price Per Share	Total Received (Net of Commissions/Fees)
-  -		\$ . .	\$ . .
-  -		\$ . .	\$ . .
-  -		\$ . .	\$ . .

E. Total Shares of FAO Common Stock Sold \_\_\_\_\_.

F. Number of shares of FAO Common Stock Held at the End of Trading on November 7, 2003: \_\_\_\_\_

If you require additional space, attach extra schedules in the same format as above. Sign and print your name on each additional page and check here .

**YOU MUST READ THE REMAINDER OF THIS FORM AND SIGN BELOW.**

17. I hereby warrant and represent that I have not assigned or transferred or purported to assign or transfer, voluntarily or involuntarily, any matter released pursuant to this release or any other part or portion thereof.

18. Upon the occurrence of the Effective Date (as defined in the Stipulation) my signature hereto will constitute a full and complete release, remise and discharge by me or, if I am submitting this Proof of Claim on behalf of a corporation, partnership, estate or one or more other persons, by it, him, her or them, and by my, its, his, her or their heirs, executors, administrators, successors, and assigns of each of the "Released Parties" of all "Settled Claims," as defined in the Notice.

(a) "Settled Claims" means any and all claims, debts, demands, rights or causes of action or liabilities whatsoever (including, but not limited to, any claims for damages, interest, attorneys' fees, expert or consulting fees, and any other costs, expenses or liability whatsoever), whether based on federal, state, local, statutory or common law or any other law, rule or regulation, whether fixed or contingent, accrued or unaccrued, liquidated or unliquidated, at law or in equity, matured or unmatured, whether class or individual in nature, including both known claims and Unknown Claims (as defined below), (i) that have been asserted in this Action by the Class Members or any of them against any of the Released Parties, or (ii) that could have been asserted in any forum by the Class Members or any of them against any of the Released Parties which arise out of or relate in any way to the allegations, transactions, facts, matters or occurrences, representations or omissions involved, set forth, referred to or that could have been asserted in the Complaint. Settled Claims also means any and all claims arising out of, relating to, or in connection with the settlement or resolution of this Action, other than claims to enforce the Settlement or any of its terms.

(b) "Released Parties" means the Defendants and FAO, their past or present subsidiaries, affiliates, parents, successors and predecessors, estates and assigns and the respective officers, directors, shareholders, agents, legal representatives, trustees, employees, attorneys, insurers, reinsurers, advisors, investment advisors, auditors, and accountants of the foregoing, and any person, firm, trust, corporation, officer, director or other individual or entity in which any Defendant or FAO has a controlling interest or which is related to or affiliated with any of the Defendants or FAO, and the legal representatives, heirs, successors in interest or assigns of the Defendants or FAO.



**ACCURATE CLAIMS PROCESSING  
TAKES A SIGNIFICANT AMOUNT OF TIME.  
THANK YOU FOR YOUR PATIENCE.**

**Reminder Checklist:**

1. Please sign the above Release and Certification.
2. Remember to attach copies of supporting documentation.
3. Do not send original or copies of stock certificates.
4. Keep a copy of your Proof of Claim form for your records.
5. If you desire an acknowledgement of receipt of your Proof of Claim form, please send it via Certified Mail, Return Receipt Requested.
6. If you move after submitting your Proof of Claim form, please send your new address to the Claims Administrator.

In Re FAO, Inc. Securities Litigation  
c/o Heffler, Radetich & Saitta L.L.P.  
Claims Administrator  
P.O. Box 58940  
Philadelphia, Pennsylvania 19102-8940

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**PLEASE FORWARD—IMPORTANT LEGAL NOTICE**