

SECURITIES AND EXCHANGE COMMISSION

FORM 8-K/A

Current report filing [amend]

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FILER

KRAUSES FURNITURE INC

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SIC: **2510** Household furniture

Mailing Address

*200 NORTH BERRY STREET
BREA CA 94588*

Business Address

*200 N BERRY ST
STE 109
BREA CA 92821-3903
7149903100*

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 8-K/A

(Amendment No. 1)

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

Date of Report: February 4, 2000

KRAUSE'S FURNITURE, INC.

(Exact Name of Registrant as Specified in its Charter)

Delaware
(State or Other Jurisdiction of
Incorporation or Organization)

0-17868
(Commission File Number)

77-0310773
(I.R.S. Employer
Identification No.)

200 North Berry Street, Brea, California
(Address of Principal Executive Offices) (Zip Code)

(714) 990-3100
(Registrant's telephone number,
including area code)

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ITEM 5. OTHER EVENTS

This Form 8-K/A (Amendment No. 1) is being filed solely to update Item 7, Exhibits 10.15, 10.17 and 10.20. Krause's no longer seeks confidential treatment of portions of Exhibit 10.15. Exhibit 10.15 also includes an exhibit to such exhibit previously omitted, Exhibit 10.17 includes a schedule to such exhibit previously omitted, and Exhibit 10.20 includes an exhibit to such exhibit previously omitted.

ITEM 7. FINANCIAL STATEMENTS AND EXHIBITS.

- (a) Not applicable.
- (b) Not applicable.
- (c) Exhibits.

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Exhibit
No.

Description

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10.15	Series A Convertible Preferred Stock Securities Purchase Agreement dated as of January 11, 2000. Exhibit A to this agreement is filed as Exhibit 10.17 to this Amendment No. 1 to Report on Form 8-K; Exhibit C to this Agreement was filed as Exhibit 10.16 to the Original Report on Form 8-K filed on February 4, 2000 (the "Original Report"); Exhibit D to this Agreement was filed as Exhibit 4.8 to the Original Report.
10.17	Amended and Restated Stockholders Agreement by and among Krause's Furniture, Inc. and the Stockholders Listed on the Signature Pages Thereof, dated as of January 14, 2000.
10.20	First Amendment to Amended and Restated Subordination Agreement, dated as of December 15, 1999, by and between Congress Financial Corporation (Western) and Krause's Furniture, Inc.

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

KRAUSE'S FURNITURE, INC.

/s/ Robert A. Burton

Date: July 19, 2000

Robert A. Burton
Executive Vice President and
Chief Financial Officer

KRAUSE'S FURNITURE, INC.
 SERIES A CONVERTIBLE PREFERRED STOCK
 SECURITIES PURCHASE AGREEMENT

Dated as of January 11, 2000

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- Exhibit A - Form of Amended and Restated Stockholders' Agreement
- Exhibit B - Form of Opinion of Morrison & Foerster LLP
- Exhibit C - Form of Amended and Restated Registration Rights Agreement
- Exhibit D - Form of Indebtedness Amendment

This Securities Purchase Agreement, dated as of January 11, 2000 (this "Agreement"), between Krause's Furniture, Inc., a Delaware corporation (including its predecessors, the "Company") and the purchasers listed on the signature pages hereto (each a "Purchaser", and collectively, the "Purchasers").

WHEREAS, the Purchasers wish to severally purchase from the Company, and the Company wishes to sell to the Purchasers, an aggregate of 380,000 shares of the Company's Series A Convertible Preferred Stock, par value \$.001 per share (the "Series A Preferred Stock"), at an aggregate purchase price of \$19,000,000.

WHEREAS, in connection with the purchase and sale of the Series A Preferred Stock, the Purchasers, the Company and the stockholders listed on the signature pages thereof, will enter into an amended and restated Stockholders Agreement, substantially in the form attached hereto as Exhibit A (the "Stockholders Agreement").

WHEREAS, the Purchasers and the Company desire to provide for such purchase and sale and to establish various rights and obligations in connection therewith.

NOW, THEREFORE, in consideration of the premises and the mutual covenants and agreements herein set forth, the parties hereto agree as follows:

SECTION 1. PURCHASE AND SALE OF THE SERIES A PREFERRED STOCK.

1.1 Authorization to Sell the Series A Preferred Stock. Subject to the terms and conditions of this Agreement, the Company has duly authorized the issuance and sale of the Series A Preferred Stock.

1.2 Closings. The transactions contemplated hereby will take place in two closings. The first closing shall be held on or prior to January 18, 2000 (the "First Closing") at the offices of Skadden, Arps, Slate, Meagher & Flom LLP ("SASM&F"), 300 South Grand Avenue, Suite 3400, Los Angeles, California 90071-3144 at 9:00 a.m., or at such place, date and time as shall be mutually agreed by the Company and the Initial Purchasers (the "First Closing Date"). The second closing shall be held on or prior to January 18, 2000 (the "Second Closing" and together with the First Closing, the "Closings") at SASM&F, 300 South Grand Avenue, Los Angeles, California 90071-3144, at 9:00 a.m, or such place, date and time as shall be

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mutually agreed by the Company and the Individual Purchasers (the "Second Closing Date" and together with the First Closing Date, the "Closing Dates").

1.3 Deliveries at Closings.

(a) At the First Closing:

(i) the Company shall execute and deliver an Amended and Restated Stockholders Agreement in the form of Exhibit A hereto;

(ii) Morrison & Foerster LLP, counsel to the Company, shall deliver to the Initial Purchasers an opinion dated the First Closing Date substantially in the form of Exhibit B hereto;

(iii) the Company shall execute and deliver an Amended and Restated Registration Rights Agreement substantially in the form of Exhibit C hereto (the "Registration Rights Agreement");

(iv) the Company shall deliver to each Initial Purchaser stock certificates representing the number of shares of Series A Preferred Stock to be purchased by such Initial Purchaser, as set forth under its signature on the signature pages hereto, registered in the name of such Initial Purchaser or its designee or nominee;

(v) each Initial Purchaser shall pay to the Company, by wire transfer of immediately available funds, the purchase price for the Series A Preferred Stock being purchased by such Initial Purchaser; and

(vi) the Company shall deliver evidence of the restructuring of certain indebtedness of the Company as described in Section 1.4 below in form and substance satisfactory to the Initial Purchasers.

(b) At the Second Closing:

(i) Morrison & Foerster LLP, counsel to the Company, shall deliver to the Individual Purchasers an opinion dated the Second Closing Date substantially in the form of Exhibit B hereto;

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(ii) the Company shall deliver to each Individual Purchaser stock certificates representing the number of shares of Series A Preferred Stock to be purchased by such Individual Purchaser, as set forth under its signature on the signature pages hereto, registered in the name of such Individual Purchaser or its designee or nominee; and

(iii) each Individual Purchaser shall pay to the Company, by wire transfer of immediately available funds, the purchase price for the Series A Preferred Stock being purchased by such Individual Purchaser.

1.4 Restructuring of Certain Indebtedness. On or before the First Closing Date, the Company shall execute and deliver an Amendment to the Note Agreement substantially in the form of Exhibit D hereto (the "Indebtedness Amendment").

1.5 Definitions. Certain capitalized terms used in this Agreement are defined in Section 8 hereof.

SECTION 2. REPRESENTATIONS AND WARRANTIES OF THE COMPANY.

The Company represents and warrants as follows:

2.1 Organization and Qualification. Each of the Company and its Subsidiaries is a corporation duly organized and existing in good standing under the laws of the jurisdiction in which it is incorporated and has the power to own its respective property and to carry on its respective business as now being conducted. Each of the Company and its Subsidiaries is duly qualified as a foreign corporation to do business and in good standing in every jurisdiction in which the nature of the respective business conducted or property owned by it makes such qualification necessary and where the failure so to qualify would be material to the Company or such Subsidiary, as the case may be.

2.2 Due Authorization. The execution and delivery of this Agreement, the Stockholders Agreement and the Registration Rights Agreement, and the issuance and sale of the Series A Preferred Stock by the Company and compliance by the Company with all the provisions of this Agreement, the Stockholders Agreement and the Registration Rights Agreement (i) are within the corporate power and authority of the Company; (ii) do not and will not require any approval or consent of the stockholders of the Company or any other Person, other than approvals and consents which have been duly obtained or which will be obtained pursuant to Section 4.14;

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and (iii) have been authorized by all requisite corporate proceedings on the part of the Company. This Agreement, the Stockholders Agreement and the Registration Rights Agreement have been duly executed and delivered by the Company and constitute valid and binding agreements of the Company, enforceable in accordance with their respective terms, except that (i) such enforcement may be subject to bankruptcy, insolvency, reorganization, moratorium or other similar laws now or hereafter in effect relating to creditors' rights, and (ii) the remedy of specific performance and injunctive and other forms of equitable relief may be subject to equitable defenses and to the discretion of the court before which any proceeding therefor may be brought. The Company has furnished to the Purchasers true and correct copies of the Company's Certificate of Incorporation and By-laws as in effect on the date of this Agreement.

2.3 Subsidiaries. The Subsidiaries of the Company, all of which are wholly owned by the Company, together with their jurisdiction of incorporation, are as set forth on Schedule 2.3 hereto.

2.4 SEC Reports. The Company and its predecessor have filed all proxy statements, reports and other documents required to be filed by it under the Exchange Act, since December 31, 1996; and the Company has furnished the Purchasers copies of its Annual Report on Form 10-K for the fiscal year ended January 31, 1999, and all proxy statements and reports under the Exchange Act filed by the Company after such date, each as filed with the Securities and Exchange Commission (the "Commission") (collectively, the "SEC Reports"). Each SEC Report was in compliance in all material respects with the requirements of its respective report form and did not on the date of filing contain any untrue

statement of a material fact or omit to state a material fact required to be stated therein or necessary to make the statements therein, in the light of the circumstances under which they were made, not misleading. As of the date hereof there is no fact not disclosed in the SEC Reports which is material to the Company.

2.5 Financial Statements. The financial statements (including any related schedules and/or notes) included in the SEC Reports have been prepared in accordance with generally accepted accounting principles consistently followed (except as indicated in the notes thereto) throughout the periods involved and fairly present the consolidated financial condition, results of operations, changes in stockholders' equity and cash flows of the Company and its Subsidiaries as of the dates thereof and for the periods ended on such dates (in each case subject, as to interim statements, to changes resulting from year-end adjustments, which in the aggregate will not be

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material in amount or effect). The Company and its Subsidiaries have no material liabilities, contingent or otherwise, not reflected in the Company's balance sheet as of January 31, 1999 that is included in the SEC Reports or otherwise referred to in the SEC Reports or otherwise disclosed to the Purchasers in writing prior to the date of this Agreement, other than any such liabilities incurred in the ordinary course of business, consistent with past practice, since January 31, 1999. Since January 31, 1999, the Company and its Subsidiaries have operated their respective businesses only in the ordinary course, consistent with past practice, and no event has occurred that has or is reasonably likely to have a material adverse effect on the business, financial condition, operations, results of operations, assets, liabilities or prospects of the Company or any of its Subsidiaries (a "Material Adverse Effect"), other than changes disclosed or referred to in the SEC Reports or otherwise disclosed to the Purchasers in writing prior to the date of this Agreement.

2.6 Actions Pending; Compliance with Laws. There is no action, suit, investigation or proceeding pending or, to the knowledge of the Company, threatened by any public official or governmental authority, against the Company or any of its Subsidiaries or any of their respective properties or assets by or before any court, arbitrator or governmental body, department, commission, board, bureau, agency or instrumentality, which questions the validity or enforceability of, or seeks to enjoin or invalidate this Agreement, the Stockholders Agreement, the Registration Rights Agreement or the Series A Preferred Stock or any action taken or to be taken pursuant hereto or thereto, or, except as set forth in the SEC Reports or as otherwise disclosed to the Purchasers in writing, which is reasonably likely to be material to the Company or any of its Subsidiaries, and neither the Company nor any of its Subsidiaries is in default in any material respect with respect to any judgment, order, writ, injunction, decree or award.

2.7 Title to Properties; Insurance. The Company and each of its Subsidiaries have good and valid title to, or, in the case of property leased by any of them as lessee, a valid and subsisting leasehold interest in, their

respective properties and assets, free of all liens and encumbrances other than those referred to in the financial statements of the Company (or the notes thereto) for the fiscal year ended January 31, 1999, included in the SEC Reports, except in each case for such defects in title and such other liens and encumbrances which are disclosed in the SEC Reports or which do not in the aggregate materially detract from the value to the Company and its Subsidiaries of their respective properties and assets. The Company and its Subsidiaries maintain insurance in such amounts (to the extent available in the public market), including self-insurance, retainage and deductible arrangements, and of such

a character as is reasonable for companies engaged in the same or similar business. All insurance policies of the Company and its Subsidiaries are disclosed on Schedule 2.7.

2.8 Governmental Consents, etc. The Company is not required to obtain any consent, approval or authorization of, or to make any declaration or filing with, any governmental authority or other Person as a condition to or in connection with the valid execution, delivery and performance of this Agreement, the Stockholders Agreement and the Registration Rights Agreement and the valid offer, issue, sale or delivery of the Series A Preferred Stock, or the performance by the Company of its obligations in respect thereof, except for any filings required to effect any registration pursuant to the Registration Rights Agreement and any filings required pursuant to state and federal securities laws which will be timely made after the applicable Closing hereunder.

2.9 Holding Company Act and Investment Company Act. Neither the Company nor any Subsidiary is: (i) a "public utility company" or a "holding company," or an "affiliate" or a "subsidiary company" of a "holding company," or an "affiliate" of such a "subsidiary company," as such terms are defined in the Public Utility Holding Company Act of 1935, as amended, or (ii) a "public utility," as defined in the Federal Power Act, as amended, or (iii) an "investment company" or an "affiliated person" thereof or an "affiliated person" of any such "affiliated person," as such terms are defined in the Investment Company Act of 1940, as amended.

2.10 Taxes. (a) The Company and each of its Subsidiaries have filed or caused to be filed all tax returns which are required to be filed by them, and all such tax returns are true, complete and correct in all material respects. The Company and each of its Subsidiaries have paid or caused to be paid all taxes that have become due, except taxes the validity or amount of which is being contested in good faith by appropriate proceedings and with respect to which adequate reserves have been set aside in accordance with generally accepted accounting principles. The federal income tax returns of the Company and its Subsidiaries have been examined and reported on by the Internal Revenue Service (or closed by applicable statutes) and all tax liabilities including additional assessments have been satisfied for all fiscal years prior to and including the fiscal year ended December 31, 1993 for the Company and its Subsidiaries. The Company and its Subsidiaries have paid or caused to be paid,

or have established reserves in accordance with generally accepted accounting principles that the Company reasonably believes are adequate, for all federal income tax liabilities and state income tax liabilities applicable to the Company or any of its

Subsidiaries for all fiscal years which have not been examined and reported on by the taxing authorities (or closed by applicable statutes).

(b) As of January 31, 1999, the Company did not have any accumulated "earnings and profits" as determined under section 312 of the Internal Revenue Code of 1986, as amended (the "Code"). To the best knowledge and belief of the Company, the Company does not anticipate having any material current earnings and profits, as determined under section 312 of the Code, for its current taxable year. As of the date hereof, the Company is not a "United States real property holding corporation" within the meaning of section 897(c)(2) of the Code. The Company shall not become a United States real property holding corporation.

2.11 Conflicting Agreements and Charter Provisions. Neither the Company nor any of its Subsidiaries is a party to any contract or agreement or subject to any charter or bylaw provision or judgment or decree which has or is reasonably likely to have a Material Adverse Effect. None of (i) the execution and delivery of this Agreement, the Shareholders Agreement and the Registration Rights Agreement and the issuance of the Series A Preferred Stock and (ii) the fulfillment of and compliance with the terms and provisions hereof and thereof and of the Series A Preferred Stock will conflict with or result in a breach of the terms, conditions or provisions of, or give rise to a right of termination under, or constitute a default under, or result in any violation of, the Certificate of Incorporation or By-laws of the Company or any Subsidiary or any mortgage, agreement, instrument, order, judgment, decree, statute, law, rule or regulation to which the Company or any Subsidiary or any of their respective properties is subject. Neither the Company nor any of its Subsidiaries (i) is in default under any outstanding indenture or other debt instrument or with respect to the payment of principal of or interest on any outstanding obligation for borrowed money, or (ii) is in default under any of their respective contracts or agreements, or under any instrument by which the Company or any of its Subsidiaries is bound which default, in the case of this clause (ii), individually or in the aggregate with all other such defaults, would be material to the Company or any of its Subsidiaries.

2.12 Capitalization. As of the date hereof, the authorized capital stock of the Company consists of: (a) 35,000,000 shares of Common Stock, par value \$0.001 per share (the "Common Stock" and, together with the Series A Preferred Stock, the "Stock"), of which 22,050,328 shares are validly issued and outstanding, fully paid and nonassessable; (b) warrants to purchase 2,712,045 shares of Common Stock which are validly issued and outstanding, fully paid and nonassessable; (c) options to

purchase 2,823,458 shares of Common Stock and deferred stock units representing the right to receive 85,225 shares of Common Stock, all of which are validly issued and outstanding, fully paid and nonassessable; and (d) 666,667 shares of Preferred Stock, par value \$.001 per share, of which no shares are outstanding, as of the date hereof, and 380,000 shares designated as Series A Convertible Preferred Stock will be issued and outstanding on the Second Closing Date after consummation of the transactions contemplated hereby. All of the outstanding shares of Common Stock have been validly issued and are fully paid and nonassessable. Except as set forth in the Stockholders Agreement, no class of capital stock of the Company is entitled to preemptive rights. Except for the options and warrants listed above, there are no outstanding options, warrants, scrip, rights to subscribe to, calls or commitments of any character whatsoever relating to, securities or rights convertible into, shares of any class of capital stock of the Company, or contracts, commitments, understandings, or arrangements by which the Company is or may become bound to issue additional shares of its capital stock or options, warrants or rights to purchase or acquire any shares of its capital stock. Since August 1, 1996, the Company has not changed the amount of its authorized capital stock or subdivided or otherwise changed any shares of any class of its capital stock, whether by way of reclassification, recapitalization, stock split or otherwise, or issued or reissued, or agreed to issue or reissue, any of its capital stock.

2.13 Issuance, Sale and Delivery of the Series A Preferred Stock. The shares of Series A Preferred Stock being issued to the Initial Purchasers at the First Closing and the shares of Series A Preferred Stock being issued to the Individual Purchasers at the Second Closing are duly authorized and when issued and delivered in accordance herewith will be, validly issued, fully paid and nonassessable. The 17,272,727 shares of Common Stock to be issued upon conversion of the Series A Preferred Stock, when issued and delivered upon such conversion in accordance with the terms of the Certificate of Designation, will be validly issued, fully paid and nonassessable. The Company will take all action necessary to increase its authorized but unissued shares of Common Stock to such number of shares as shall be sufficient to reserve shares of Common Stock for issuance upon conversion of the Series A Preferred Stock, including, without limitation, obtaining the requisite stockholder approval of any necessary amendment to the Company's Certificate of Incorporation.

2.14 Registration Under Exchange Act. The Company has not registered the Series A Preferred Stock as a class pursuant to Section 12 of the Exchange Act.

2.15 ERISA. No accumulated funding deficiency (as defined in Section 302 of ERISA and Section 412 of the Code), whether or not waived, exists with respect to any Pension Plan (as defined in Section 11) (other than a

Multiemployer Plan (as defined below)). No liability to the PBGC has been, or is reasonably likely to be, incurred with respect to any Pension Plan (other than a Multiemployer Plan) by the Company, any of its Subsidiaries or any ERISA Affiliate (as defined below) which is or would be materially adverse to the Company, its Subsidiaries and any ERISA Affiliate. Neither the Company nor any of its Subsidiaries and any ERISA Affiliate has incurred, or is reasonably likely to incur, any withdrawal liability under Title IV of ERISA with respect to any Multiemployer Plan which is or would be materially adverse to the Company, its Subsidiaries and its ERISA Affiliates and if the Company, its Subsidiaries and ERISA Affiliates, were to completely withdraw as of the date hereof from each Multiemployer Plan in which they participate, the Company, its Subsidiaries and its ERISA Affiliates would not incur any material withdrawal liability under Title IV of ERISA. Neither the Company nor any of its Subsidiaries has any obligation to provide post-retirement health benefits to any employee or former employee. No fiduciary of any employee benefit plan (as defined in Section 3(3) of ERISA) maintained or contributed to by the Company or any of its subsidiaries, for the benefit of their respective employees (each an "Employee Plan") has engaged or caused any Employee Plan to engage in any transaction prohibited by Section 4975 of the Code or Section 406 of ERISA which is reasonably likely to subject the Company or any Subsidiary or any entity the Company or any Subsidiary has an obligation to indemnify to any tax or penalty imposed under Section 4975 of the Code or Section 502 of ERISA. Each Employee Plan has been maintained and administered in compliance with all applicable law including ERISA and the Code in all material respects. An "ERISA Affiliate" for purposes of this Section is any trade or business, whether or not incorporated, which, together with the Company, is under common control, as described in Section 414(b) or (c) of the Code, and the term "Multiemployer Plan" shall mean any Pension Plan which is a "multiemployer plan" (as such term is defined in Section 4001(a)(3) of ERISA).

2.16 Possession of Franchises, Licenses, Etc. The Company and its Subsidiaries possess all franchises, certificates, licenses, permits and other authorizations from governmental or political subdivisions or regulatory authorities and all patents, trademarks, service marks, trade names, copyrights, licenses and other rights, free from burdensome restrictions, that are necessary in any material respect to the Company or any of its Subsidiaries for the ownership, maintenance and operation of their respective properties and assets, and neither the Company nor any of its Subsidiaries is in violation of any thereof in any material respect.

2.17 Environmental and Other Regulations. The Company and its Subsidiaries are in compliance with all applicable laws and regulations relating to protection of the environment and human health, and are in compliance in all material respects with all other applicable laws and regulations, including, without limitation, those relating to equal employment opportunity and employment safety. There are no claims, notices, civil, criminal or administrative actions, suits, hearings, investigations, inquiries or proceedings pending or, to the best knowledge of the Company, threatened against the Company or any Subsidiary that are based on or related to any environmental

matters, including any disposal of hazardous substances at any place, or the failure to have any required environmental permits, and there are no past or present conditions that are likely to give rise to any liability or other obligations of the Company or any Subsidiary under any environmental laws.

2.18 Patents and Trademarks. Set forth on Schedule 2.18 is a true and complete list of all patents, patent applications, trademarks, service marks, trademark and service mark applications, trade names, copyrights and licenses presently used by the Company or any Subsidiary or necessary for the conduct of the business of the Company and its Subsidiaries as conducted and as proposed to be conducted (the "Intellectual Property Rights"). The Company owns, or has the right to use under the agreements or upon the terms described on Schedule 2.18, all of the Intellectual Property Rights. To the best of the Company's knowledge, the business conducted or proposed to be conducted by the Company and its Subsidiaries does not infringe or violate any of the patents, trademarks, service marks, trade names, copyrights, licenses, trade secrets or other proprietary rights of any other Person. Except as set forth on Schedule 2.18, to the Company's knowledge, no other Person has any right to or interest in any inventions, improvements, discoveries or other confidential information utilized by the Company or any Subsidiary in its business.

2.19 Material Contracts and Obligations. Schedule 2.19 sets forth a list of the following agreements or commitments of any nature to which the Company or any Subsidiary is a party or by which it is bound: (a) any agreement relating to material Intellectual Property Rights, (b) all employment and consulting agreements, and all employee benefit, bonus, pension, profit-sharing, stock option, stock purchase and similar plans and arrangements (other than plans or arrangements providing for less than \$10,000 per employee), (c) all manufacturing, distributor and sales representative agreements and all agreements with suppliers or vendors if the value of the payments thereunder is in excess of \$100,000, (d) all agreements or commitments that materially restrict the ability of the Company or any Subsidiary or Affiliate to

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engage in any business or line of business in any location, (e) all agreements or commitments relating to indebtedness or guarantees of the Company or any Subsidiary if the value of the payments thereunder is in excess of \$100,000 and (f) any other agreement or commitment which requires future payments by or to the Company or any Subsidiary in excess of \$100,000 or which is otherwise material to the Company or any of its Subsidiaries. The Company has delivered or made available to the Purchasers copies of all of the foregoing agreements and commitments. To the best knowledge of the Company, all of such agreements and commitments are valid, binding and in full force and effect.

2.20 Books and Records. All the books, records and accounts of the Company and its Subsidiaries are in all material respects true and complete, are maintained in accordance with good business practice and all laws applicable to its business, and accurately present and reflect in all material respects all of the transactions therein described. The Company has previously delivered to the Purchasers true and complete texts of all of the minutes relating to meetings of

the stockholders, boards of directors and committees of the Company and each Subsidiary for the past five years.

2.21 Transactions with Related Parties. Schedule 2.21 sets forth a true and complete list of the amounts and other essential terms of any contract, arrangement or transaction currently in effect or effected during the past five years between the Company or any Subsidiary and any Related Party, other than (i) arrangements for the payment of salary, including bonuses, for services rendered to the Company, which arrangements have previously been disclosed to the Purchasers, (ii) other arrangements with any such Person which in the aggregate do not involve more than \$10,000 or (iii) as previously disclosed in the SEC Reports.

2.22 Brokers. Neither the Company nor any Subsidiary has engaged any finder, broker or investment adviser, and has no obligation to pay any fees, in connection with the transactions contemplated hereby.

2.23 Accuracy of Information. None of the representations and warranties of the Company contained herein or the information, documents or other materials (other than projections) which have been furnished in writing by the Company or any of its representatives to the Purchasers in connection with the transactions contemplated by this Agreement contains any material misstatement of fact, or omits any material fact necessary to make the statements herein and therein, in light of the circumstances under which they were made, not misleading. All projections fur-

nished in writing by the Company (i) have been prepared by management of the Company after a careful analysis of all material data, (ii) are based on reasonable assumptions by management of the Company and (iii) represent the best estimate by management of the Company, based upon current reasonable assumptions, as to the financial performance of the Company and its Subsidiaries for the periods indicated, but do not represent any guarantee or assurance of the future financial results of the Company and its Subsidiaries.

2.24 Offering of Series A Preferred Stock. Neither the Company nor any Person acting on its behalf has offered any of the Series A Preferred Stock or any similar securities of the Company for sale to, solicited any offers to buy any of the Series A Preferred Stock or any similar securities of the Company from or otherwise approached or negotiated with respect to the Company with any Person other than the Purchasers and other "Accredited Investors" (as defined in Rule 501(a) under the Securities Act). Neither the Company nor any Person acting on its behalf has taken or will take any action (including, without limitation, any offering of any securities of the Company under circumstances which would require the integration of such offering with the offering of any of the Series A Preferred Stock under the Securities Act and the rules and regulations of the Commission thereunder) which could reasonably be expected to subject the offering, issuance or sale of any of the Series A Preferred Stock to the registration requirements of Section 5 of the Securities Act.

SECTION 3. REPRESENTATIONS AND WARRANTIES OF THE PURCHASERS.

Each Purchaser represents and warrants as follows:

3.1 Organization and Qualification. Such Purchaser is either (a) (i) duly organized and existing in good standing under the laws of the jurisdiction of its formation and has the power to own its respective property and to carry on its respective business as now being conducted and (ii) duly qualified to do business and in good standing in every jurisdiction in which the nature of the respective business conducted or property owned by it makes such qualification necessary, except where the failure to so qualify would not prevent consummation of the transactions contemplated hereby or have a material adverse effect on such Purchaser's ability to perform its obligations hereunder or (b) a natural person with the capacity to enter into this Agreement and to consummate the transactions contemplated hereby.

3.2 Due Authorization. Such Purchaser has all right, power and authority to enter into this Agreement and to consummate the transactions contemplated

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hereby. The execution and delivery of this Agreement by the Purchaser and the consummation by such Purchaser of the transactions contemplated hereby have been duly authorized by all necessary action on behalf of such Purchaser. This Agreement has been duly executed and delivered by the Purchaser and constitutes a valid and binding agreement of the Purchaser enforceable in accordance with its terms, except that (i) such enforcement may be subject to bankruptcy, insolvency, reorganization, moratorium or other similar laws now or hereafter in effect relating to creditors, rights, and (ii) the remedy of specific performance and injunctive and other forms of equitable relief may be subject to equitable defenses and to the discretion of the court before which any proceeding therefor may be brought.

3.3 Conflicting Agreements and Other Matters. Neither the execution and delivery of this Agreement nor the performance by the Purchaser of its obligations hereunder will conflict with, result in a breach of the terms, conditions or provisions of, constitute a default under, or require any consent, approval or other action by or any notice to or filing with any court or administrative or governmental body pursuant to, the organizational documents or agreements of the Purchaser or any mortgage, agreement, instrument, order, judgment, decree, statute, law, rule or regulation to which the Purchaser or any of its respective properties are subject.

3.4 Acquisition for Investment. The Purchaser is acquiring the Series A Preferred Stock being purchased by it for its own account for the purpose of investment and not with a view to or for sale in connection with any distribution thereof, and the Purchaser has no present intention or plan to effect any distribution thereof. The Purchaser acknowledges that the Series A Preferred Stock has not been registered under the Securities Act and may be sold or disposed of in the absence of such registration only pursuant to an exemption from such registration.

3.5 Brokers or Finders. No agent, broker, investment banker or other firm or Person, including any of the foregoing that is an Affiliate of the Purchasers, is or will be entitled to any broker's fee or any other commission or similar fee from the Purchaser in connection with any of the transactions contemplated by this Agreement that the Company will be responsible for pursuant to Section 9.9.

3.6 Accredited Investor. The Purchaser is an "Accredited Investor" within the meaning of Rule 501 promulgated under the Securities Act.

SECTION 4. COVENANTS OF THE COMPANY.

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4.1 Limitation on Senior Equity Securities. Without the consent of the holders of a majority of the then outstanding shares of Series A Preferred Stock, the Company will not issue any equity securities or any rights, options, warrants or other securities which are exercisable for, exchangeable for or convertible into shares of any class of capital stock ranking pari passu or senior as to dividends or upon liquidation to the Series A Preferred Stock.

4.2 Compliance with Laws. The Company will, and will cause each Subsidiary to, comply with all applicable statutes, rules, regulations and orders of all governmental authorities, with respect to the conduct of its business and the ownership of its properties, including without limitation, those relating to protection of the environment and human health, equal employment opportunity, employee safety, ERISA and international trade laws and regulations, and apply for obtain and maintain all permits necessary for the conduct of its business and the ownership of its properties.

4.3 Preservation of Franchises and Existence. The Company will (i) maintain its corporate existence, rights and franchises in full force and effect, and (ii) cause the Subsidiaries to maintain their respective corporate existences, rights and franchises in full force and effect; provided that nothing in this Section 4.3 shall prevent the Company or any Subsidiary from discontinuing its operations in any particular state or at any particular location or locations within the state, or prevent the corporate existence, rights and franchises of any Subsidiary from being terminated if, in the opinion of the Board of Directors, the preservation thereof is no longer desirable in the conduct of the business of the Company and its Subsidiaries and the loss thereof is not disadvantageous in any material respect to the holders of Series A Preferred Stock.

4.4 Use of Proceeds. The Company will only use the Proceeds for Permitted Proceeds Uses; provided that, in the case of Retail Proceeds, the Company may, pending any Retail Proceeds Uses, use Retail Proceeds to pay down long-term indebtedness so long as the Company has the right to immediately reborrow such amounts.

4.5 Insurance. The Company will, and will cause each of the Subsidiaries to, maintain with insurers believed by the Company to be responsible such insurance, in such amounts and of such types as are customarily carried under similar circumstances by companies engaged in the same or a similar business or having similar properties similarly situated.

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4.6 Payment of Taxes and Other Charges. The Company will pay or discharge, and will cause each of the Subsidiaries to pay or discharge, before the same shall become delinquent, (i) all taxes, assessments and other governmental charges or levies imposed upon it or any of its properties or income (including, without limitation, such as may arise under Sections 4062, 4063, or 4064 of ERISA or any similar provision of law), and (ii) all claims or demands of materialmen, mechanics, carriers, warehousemen, landlords and other like Persons which, in the case of either clause (i) or clause (ii), if unpaid, might result in the creation of a material lien upon any of its properties, provided, however, that the Company shall not be required to pay or discharge or cause to be paid or discharged any such tax, assessment, charge or claim whose amount, applicability or validity is being contested in good faith pursuant to appropriate proceedings.

4.7 Effect of Breach. In addition to the rights of THLi under the Stockholders Agreement, upon the occurrence of an Event of Default and notification by THLi prior to the two-year anniversary of the First Closing Date of its desire to add directors in accordance with Section 6.2, then the Board of Directors shall take all necessary action to increase or decrease the size of the Board of Directors and to appoint to the Board of Directors a number of additional members (the "Additional Members") designated by THLi that, when added to any directors then in office designated solely by THLi, will result in directors designated by THLi constituting a majority of the entire Board of Directors. THLi shall be entitled to designate the Additional Members and, for so long as such Event of Default continues, at each subsequent annual meeting, THLi shall be entitled to propose (and the Board of Directors shall nominate and recommend) Persons reasonably acceptable to the Board of Directors as the Additional Members of the Board of Directors. In the event of any vacancy arising by reason of the resignation, death, removal or inability to serve of any Additional Member, THLi shall be entitled to designate a successor to fill such vacancy for the remaining term of such director. At such times as such Event of Default shall have been cured or waived, the rights of THLi under this Section 4.7 shall terminate (and THLi shall cause such Additional Directors to resign from the Board of Directors), subject to reversion in the event of each and every subsequent Event of Default.

4.8 ERISA. Neither the Company nor any Subsidiary shall incur any material liability with respect to retiree medical or death benefits or unfunded benefits payable after termination of employment. All employee benefit plans and arrangements maintained or contributed to by the Company, any Subsidiary or any

ERISA Affiliate shall be maintained in compliance in all material respects with all applicable law, including any reporting requirements. With respect to any plan maintained by or contributed to by the Company or any Subsidiary, neither the Company nor any Subsidiary will fail to make any contribution due from it under the terms of such plan or as required by law. Neither the Company nor any ERISA Affiliate will permit a Pension Plan to incur an accumulated funding deficiency (as such term is defined in Section 302 of ERISA or Section 412 of the Code), whether or not waived, cause a lien or a security interest to attach to any asset of the Company or any Subsidiary for the benefit of any Plan, or incur any liability which would be material to the Company or any of its Subsidiaries under Title IV of ERISA, including withdrawal liability (other than the payment of premiums, none of which are overdue). Neither the Company nor any Subsidiary, nor any other Person including any fiduciary, will engage in any transaction prohibited by Section 406 of ERISA or Section 4975 of the Code which is reasonably likely to subject the Company, any Subsidiary or any entity that the Company or any Subsidiary has an obligation to indemnify to any tax or penalty imposed under Section 4975 of the Code or Section 502 of ERISA.

4.9 Financial Statements and Other Reports.

(a) The Company will, as soon as practicable and in any event within 60 days after the end of each quarterly period (other than the last quarterly period) in each fiscal year, furnish to THLi statements of consolidated net income and cash flows and a statement of changes in consolidated stockholders' equity of the Company and its Subsidiaries for the period from the beginning of the then current fiscal year to the end of such quarterly period, and a consolidated balance sheet of the Company and its Subsidiaries as of the end of such quarterly period, setting forth in each case in comparative form figures for the corresponding period or date in the preceding fiscal year, all in reasonable detail and certified by an authorized financial officer of the Company, subject to changes resulting from year-end adjustments; provided, however, that delivery pursuant to clause (iii) below of a copy of the Quarterly Report on Form 10-Q of the Company for such quarterly period filed with the Commission shall be deemed to satisfy the requirements of this clause (i);

(b) The Company will, as soon as practicable and in any event within 100 days after the end of each fiscal year, furnish to THLi statements of consolidated net income and cash flows and a statement of changes in

consolidated stockholders' equity of the Company and its Subsidiaries for such year, and a consolidated balance sheet of the Company and its Subsidiaries as of the end of such year, setting forth in each case in comparative form the corresponding figures from the preceding fiscal year, all in reasonable detail and examined and reported on by independent public accountants of recognized national standing selected by the Company; provided, however, that delivery pursuant to clause (iii) below of a copy of the Annual Report on Form 10-K of the Company for such fiscal year filed with the Commission shall be deemed to satisfy the requirements of this clause (ii);

(c) The Company will, promptly upon transmission thereof, furnish to each Purchaser copies of all such financial statements, proxy statements, notices and reports as it shall send to its stockholders and copies of all such registration statements (without exhibits), other than registration statements relating to employee benefit or dividend reinvestment plans, and all such regular and periodic reports as it shall file with the Commission;

(d) The Company will, promptly after such package becomes available, furnish to THLi copies of all financial reporting packages prepared for management of the Company; and

(e) Until the two-year anniversary of the First Closing Date, the Company will, as soon as practicable, and in any event within 5 days after the end of each month, furnish to THLi and GECC detailed reports, and any other information THLi and GECC may reasonably request, relating to (i) the use of Proceeds by the Company and its Subsidiaries and (ii) the Company's compliance with the Retail Plan and the E-Commerce Plan;

(f) The Company will promptly furnish to THLi copies of any reports furnished to GECC pursuant to the Note Agreement; and

(g) The Company will promptly furnish to THLi copies of any compliance certificates furnished to lenders in respect of indebtedness of the Company and its Subsidiaries and, with reasonable promptness, furnish to each Purchaser such other financial and other data of the Company and its Subsidiaries as such Purchaser may reasonably request, including, but not limited to, operating financial information for each retail store owned or operated by the Company or any of its Subsidiaries.

4.10 Inspection of Property. The Company will permit representatives of THLi to visit and inspect, at THLi's expense, any of the properties of the Company and its Subsidiaries, to examine the corporate books and make copies or extracts therefrom and to discuss the affairs, finances and accounts of the Company and its Subsidiaries with the principal officers of the Company, all at

such reasonable times, upon reasonable notice and as often as such Purchaser may reasonably request.

4.11 Lost, Stolen, Damaged and Destroyed Stock Certificates. Upon receipt of evidence satisfactory to the Company of the loss, theft, destruction or mutilation of any certificate for shares of Series A Preferred Stock (or any certificate for the shares of Common Stock into which the Series A Preferred Stock is convertible) and in the case of loss, theft or destruction, upon delivery of an indemnity satisfactory to the Company (which, in the case of any Purchaser, may be an undertaking by such Purchaser so to indemnify the Company), or, in the case of mutilation, upon surrender and cancellation thereof, the Company will issue a new certificate of like tenor for a number of shares of Series A Preferred Stock (or, if applicable, shares of Common Stock into which the Series A Preferred Stock is convertible) equal to the number of shares of such stock represented by the certificate lost, stolen, destroyed or mutilated.

4.12 Related Party Transactions. The Company shall not, directly or indirectly, and shall not permit any of its Subsidiaries to, directly or indirectly, enter into, amend or terminate any contract, arrangement or transaction with a Related Party, other than (i) any action to terminate the Consumer Credit Card Agreement by and among Krause's Sofa Factory, Castro Convertible Corporation and Monogram Credit Bank of Georgia, dated as of April 27, 1997 and (ii) the payment of salary and benefits pursuant to employment agreements entered into in the ordinary course of business.

4.13 Operations in Accordance with Business Plan. The business and operations of the Company and its Subsidiaries shall be conducted in all material respects in accordance with the Company's annual business plan as approved by a majority of the Board of Directors, which majority must include the GECC Designee and the THLi Designees (each as defined in the Stockholders Agreement), except for such changes which shall have been approved in accordance with Section 2.2(u) of the Stockholders Agreement. The Company shall submit the E-Commerce Plan to the Board of Directors for approval no later than 90 days from the First Closing Date.

4.14 Reservation of Shares. From and after the 15th day following the first meeting of stockholders of the Company occurring on or after the First Closing Date, the Company shall at all times reserve and keep available out of its authorized but unissued shares of Common Stock solely for the purpose of effecting the conversion of the shares of the Series A Preferred Stock, such number of its shares of Common Stock as shall from time to time be sufficient to effect the conversion of all outstanding shares of the Series A Preferred Stock.

4.15 Notice of Breach. As promptly as practicable, and in any event not later than ten Business Days after senior management of the Company becomes

aware of any breach by the Company of any provision of this Agreement, including, without limitation, this Article 4, the Company shall provide the Purchasers with written notice specifying the nature of such breach and any actions proposed to be taken by the Company to cure such breach.

4.16 Limitation on Dividends. The Company shall not pay any dividends on Common Stock so long as any shares of Series A Preferred Stock remain outstanding.

4.17 Right of First Refusal. Subject to the terms and conditions specified in this Section 4.17, the Company hereby grants to THLi or any of its designees (collectively, the "First Refusal Stockholders") a right of first offer with respect to future sales by the Company of its Offered Shares (as hereinafter defined).

Each time the Company proposes to offer any shares of, or securities convertible into or exercisable or exchangeable for any shares of, any class of its capital stock ("Offered Shares"), the Company shall first make an offering of such Offered Shares to the First Refusal Stockholders in accordance with the following provisions:

(a) The Company shall deliver a notice in accordance with Section 9.5 of this Agreement ("Notice") to THLi stating (i) its bona fide intention to offer such Offered Shares, (ii) the number of such Offered Shares to be offered, and (iii) the price and terms, if any, upon which it proposes to offer such Offered Shares.

(b) Within 15 days after delivery of the Notice, the First Refusal Stockholders may elect to purchase or obtain, at the price and on the terms specified in the Notice, up to that portion of such Offered Shares that equals the proportion that the number of shares of Common Stock issued and held

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(or issuable upon conversion and exercise of all convertible or exercisable securities then held by THLi and its Affiliates) bears to the total number of shares of Common Stock then outstanding (assuming full conversion and exercise of all outstanding convertible or exercisable securities).

(c) The right of first offer in this Section 4 shall not be applicable to any issuance or sale of any of the following securities:

(i) Common Stock issued pursuant to any stock split, dividend or distribution payable in additional shares of Common Stock or other securities or rights convertible into, or entitling the holder thereof to receive directly or indirectly, additional shares of Common Stock without payment of any consideration by such holder, provided that all holders of capital stock of the Company and options or warrants or other

securities exercisable or exchangeable for or convertible into, capital stock of the Company receive their pro rata share (on a common equivalent basis) of such Common Stock,

(ii) Common Stock issuable or issued to employees, consultants or directors of the Company directly or pursuant to a stock option plan or restricted stock plan, or other similar arrangements related to compensation for services in effect on the date of this Agreement, or thereafter approved by a majority vote of THLi Designees;

(iii) capital stock issued upon conversion or exercise of warrants, options or other securities outstanding immediately following the First Closing; or

(iv) Common Stock issued in a bona fide firm commitment under written offering to the public.

SECTION 5. RESTRICTIONS ON TRANSFER. Neither the Purchasers or any of their respective Affiliates shall, directly or indirectly, sell, transfer, pledge, encumber or otherwise dispose of (collectively, a "Transfer") any of the Series A Preferred Stock or Common Stock received upon conversion of the Series A Preferred Stock, except for: (a) Transfers to or between Affiliates who agree to be bound by the provisions of this Agreement; (b) Transfers of Series A Preferred Stock or Common Stock received upon conversion of the Series A Preferred Stock pursuant to the exercise of the registration rights set forth in the Registration Rights Agreement; or (c) other Transfers that comply with the provisions of the Securities Act. The Company may

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require, in connection with any Transfer pursuant to the preceding clause (c), an opinion of counsel to the Purchaser that such Transfer complies with the provisions of the Securities Act.

SECTION 6. EVENT OF DEFAULT AND REMEDIES.

6.1 Event of Default. The occurrence of any of the events set forth on Schedule 6.1 prior to the two-year anniversary of the First Closing Date shall constitute an Event of Default under this Agreement.

6.2 Remedies. The Company shall notify the Purchasers immediately upon becoming aware of any Event of Default. If an Event of Default occurs and is continuing, then in every such case:

(a) THLi at its option, shall have the right to either:

(i) demand immediate redemption of up to its Maximum Number (as such term is defined in the Certificate of Designation) of shares of Series A Preferred Stock pursuant to paragraph 5(c) of the Certificate of Designation, or

(ii) nominate and designate additional members of the Board of Directors pursuant to Section 4.7 hereof; and

(b) without limiting the foregoing, any Purchaser may enforce its rights by suit in equity, by action at law, or by any other appropriate proceedings, whether for the specific performance (to the extent permitted by law) of any covenant or agreement contained in this Agreement or the Certificate of Incorporation or in aid of the exercise of any power granted in this Agreement or the Certificate of Incorporation.

If THLi elects to demand redemption pursuant to clause (a)(i) above, each other holder of Series A Preferred Stock shall also be entitled to demand immediate redemption of such shares of Series A Preferred Stock permitted under paragraph 5(c) of the Certificate of Designation.

6.3 Conduct No Waiver. No course of dealing on the part of any holder, nor any delay or failure on the part of any holder to exercise any of its rights, shall operate as a waiver of such right or otherwise prejudice such holder's rights, powers and remedies.

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6.4 Remedies Cumulative. No right or remedy conferred upon or reserved to the holders of Series A Preferred Stock under this Agreement is intended to be exclusive of any other right or remedy, and every right and remedy shall be cumulative and in addition to every other right and remedy given hereunder or now and hereafter existing under applicable law. Every right and remedy given by this Agreement or by applicable law to the holders of Series A Preferred Stock may be exercised from time to time and as often as may be deemed expedient by the holders.

SECTION 7. CONDITIONS.

7.1 Conditions to Each Party's Obligations to Effect the Transactions Contemplated Hereby. The respective obligations of each party to effect the transactions contemplated by this Agreement shall be subject to the fulfillment at or prior to the applicable Closing Date of the following conditions:

(a) No temporary restraining order, preliminary or permanent injunction or other order or decree by any court of competent jurisdiction which prevents the consummation of the transactions contemplated hereby or imposes material conditions with respect thereto shall have been issued and remain in effect (each party agreeing to use its reasonable efforts to have any such injunction, order or decree lifted).

(b) No action shall have been taken, and no statute, rule or regulation shall have been enacted, by any state or Federal government or governmental agency which would prevent the consummation of the

transactions contemplated by this Agreement or imposes material conditions with respect thereto.

(c) All consents and approvals of governmental entities legally required for the consummation of the transactions contemplated by this Agreement shall have been obtained and be in effect at the applicable Closing Date, except those for which failure to obtain such consents and approvals would not, individually or in the aggregate, have a Material Adverse Effect or materially impair the ability of any party to this Agreement to consummate the transactions contemplated by this Agreement.

7.2 Conditions to Purchasers' Obligations to Effect the Transactions Contemplated Hereby. The obligations of the Purchasers to effect the transactions

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contemplated by this Agreement shall be subject to the fulfillment at or prior to the applicable Closing Date of the following additional conditions:

(a) The Company shall have performed in all material respects all obligations required to be performed by it under this Agreement at or prior to the applicable Closing Date, and the representations and warranties of the Company contained in this Agreement shall be true and correct in all material respects (if not qualified by materiality) and true and correct (if so qualified) on and as of the date of this Agreement and at and as of the applicable Closing Date as if made at and as of the applicable Closing Date, except to the extent that any such representation or warranty expressly relates to another date (in which case, as of such date).

(b) The consent or approval of each third party whose consent or approval shall be required in connection with the transactions contemplated hereby shall have been obtained.

(c) The Company and the stockholders listed on the signature pages thereto shall have executed and delivered the Stockholders Agreement substantially in the form attached hereto as Exhibit A.

(d) Purchasers shall have received an opinion of Morrison & Foerster LLP, counsel to the Company, substantially in the form attached hereto as Exhibit B.

(e) The Company and the stockholders listed on the signature pages thereto shall have executed and delivered the Registration Rights Agreement substantially in the form attached hereto as Exhibit C.

(f) Since the date of this Agreement, there shall not have been any change or events which have resulted or would in reasonable probability result in a Material Adverse Effect.

(g) The Company, GECC and JOL shall have executed and delivered the Indebtedness Amendment substantially in the form attached hereto as Exhibit D.

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(h) The Company shall have filed the Certificate of Designation substantially in the form attached hereto as Exhibit E with the Delaware Secretary of State.

(i) Purchasers shall have completed their business, legal and financial due diligence review and the results of such review shall be satisfactory to Purchasers in their sole judgment.

SECTION 8. INTERPRETATION.

8.1 Definitions.

"Affiliate" and "Associate" shall have the respective meanings ascribed to such terms in Rule 12b-2 of the General Rules and Regulations under the Exchange Act.

"beneficially own" with respect to any Series A Preferred Stock shall mean having "beneficial ownership" of such Series A Preferred Stock (as determined pursuant to Rule 13d-3 under the Exchange Act), including pursuant to any agreement, arrangement or understanding, whether or not in writing.

"Board of Directors" shall mean the board of directors of the Company.

"Business Day" shall mean any day other than a Saturday, Sunday, or a day on which banking institutions in the State of New York are authorized or obligated by law or executive order to close.

"Certificate of Designation" shall mean the Certificate of Designation of Series A Convertible Preferred Stock of the Company substantially in the form attached hereto as Exhibit E.

"Code" shall mean the Internal Revenue Code of 1986, as amended.

"Consolidated" or "consolidated," when used with reference to any financial term in this Agreement (but not when used with respect to any tax return or tax liability), shall mean the aggregate for two or more Persons of the amounts signified by such term for all such Persons, with inter-company items eliminated and, with respect to earnings, after eliminating the portion of earnings properly attributable to minority interests, if any, in the capital stock of any such Person or attribut-

able to shares of preferred stock of any such Person not owned by any other such Person.

"E-Commerce Plan" shall mean a business plan setting forth the Company's planned business to business and E-commerce activities, including detailed information with respect to E-Commerce Proceed Uses, strategy, implementation of strategy, milestone targets and a timeline with respect thereto, as such business plan may be amended from time to time in accordance with Section 2.2(u) of the Stockholders Agreement.

"E-Commerce Proceed Uses" shall mean the use of Proceeds to build infrastructure and sales and marketing capabilities for (including the recruitment of appropriate talent associated with) business-to-business activities and e-commerce activities, including commerce related to transactions on the Internet and such further uses described in the E-Commerce Plan.

"ERISA" shall mean the Employee Retirement Income Security Act of 1974, as amended.

"Exchange Act" shall mean the Securities Exchange Act of 1934, as amended, or any successor Federal statute, and the rules and regulations of the Commission thereunder, all as the same shall be in effect at the time. Reference to a particular section of the Securities Exchange Act of 1934, as amended, shall include reference to the comparable section, if any, of any such successor Federal statute.

"GECC" shall mean, collectively, General Electric Capital Corporation, a New York corporation and GE Capital Equity Investments, Inc., a Delaware corporation.

"Individual Purchasers" shall mean the Purchasers other than THLi, GECC and Permal.

"Initial Purchasers" shall mean THLi, GECC and Permal.

"JOL" shall mean Japan Omnibus Ltd., an international business corporation incorporated in the British Virgin Islands.

"Note Agreement" shall mean, collectively, the Securities Purchase Agreement dated as of August 26, 1996 between the Company and GECC and the Supple-

mental Securities Purchase Agreement, dated as of August 14, 1997, among the Company GECC and JOL, in each case, as amended.

"PBGC" shall mean the Pension Benefit Guaranty Corporation, or any successor thereto.

"Pension Plan" shall mean any multiemployer plan or single employer plan, as defined in Section 4001 of ERISA, that is subject to Title IV of ERISA, that the Company, any Subsidiary or any ERISA Affiliate maintains or is or ever has been obligated to contribute to for the benefit of employees or former employees of the Company, any Subsidiary or any ERISA Affiliate.

"Permal" shall mean those entities and individuals constituting the Permal Group as set forth on Schedule C to the Stockholders Agreement.

"Permitted Proceeds Uses" shall mean Retail Proceed Uses or E-Commerce Proceed Uses.

"Person" shall mean any individual, firm, corporation, partnership or other entity, and shall include any successor (by merger or otherwise) of such entity.

"Proceeds" shall mean the proceeds from the sale of the Series A Preferred Stock pursuant to this Agreement.

"Related Party" shall mean any officer, director or beneficial holder of 3% or more of the outstanding shares of capital stock of the Company or any Subsidiary, any spouse, former spouse, child, parent, parent of a spouse, sibling or grandchild of any such officer, director or beneficial holder of the Company or any Subsidiary, and any Affiliate or Associate of any of the foregoing Persons; provided, however, that neither THLi nor GECC shall be deemed to be a Related Party.

"Retail Plan" shall mean a business plan setting forth the Company's planned retail activities, including detailed information with respect to Retail Proceed Uses, Strategy, implementation of Strategy, milestone targets and a time line with respect thereto, as such business plan may be amended from time to time in accordance with section 2.2(a) of the Stockholders Agreement.

"Retail Proceed Uses" shall mean the use of Proceeds to (i) repay the Loan and Security Agreement, dated as of January 20, 1995, as amended, by and between

Congress Financial Corporation (Western), Krause's Sofa Factory and Castro Convertible Corporation (the "Credit Agreement"), (ii) make capital expenditures related to the opening of new stores, (iii) for working capital purposes in connection with the Company's retail business and (iv) for such further uses described in the Retail Plan.

"Securities Act" shall mean the Securities Act of 1933, as amended, or any successor federal statute, and the rules and regulations of the Commission thereunder, all as the same shall be in effect at the time.

"Subsidiary" of any Person means any corporation or other entity of which a majority of the voting power or the Voting Securities or equity interest is owned, directly or indirectly, by such Person.

"THLi" shall mean, collectively, TH Lee.Putnam Internet Partners, L.P. and TH Lee.Putnam Internet Parallel Partners, L.P., together with their affiliates.

"Voting Securities" of any Person shall mean at any time shares of any class of capital stock of such Person which are then entitled to vote generally in the election of directors.

8.2 Accounting Principles. The character or amount of any asset, liability, capital account or reserve and of any item of income or expense required to be determined pursuant to this Agreement, and any consolidation or other accounting computation required to be made pursuant to this Agreement, and the construction of any definition in this Agreement containing a financial term, shall be determined or made, as the case may be, in accordance with generally accepted accounting principles, to the extent applicable, unless such principles are inconsistent with the express requirements of this Agreement. References in this Agreement to a fiscal year refer to the period ending on the last Sunday of January of the following calendar year as determined by the 52/53 retail fiscal year. (For example, 1998 fiscal year refers to the fiscal year ending January 31, 1999.)

SECTION 9. MISCELLANEOUS.

9.1 Severability. If any term, provision, covenant or restriction of this Agreement or any exhibit hereto is held by a court of competent jurisdiction to be invalid, void or unenforceable, the remainder of the terms, provisions, covenants and restrictions of this Agreement and such exhibits shall remain in full force and effect

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and shall in no way be affected, impaired or invalidated. It is hereby stipulated and declared to be the intention of the parties that they would have executed the remaining terms, provisions, covenants and restrictions without including any of such which may be hereafter declared invalid, void or unenforceable.

9.2 Specific Enforcement. Each Purchaser, on the one hand, and the Company, on the other, acknowledge and agree that irreparable damage would occur in the event that any of the provisions of this Agreement were not performed in accordance with their specific terms or were otherwise breached. It is

accordingly agreed that the parties shall be entitled to an injunction to prevent breaches of the provisions of this Agreement and to enforce specifically the terms and provisions hereof in any court of the United States or any state thereof having jurisdiction, this being in addition to any other remedy to which they may be entitled at law or equity.

9.3 Entire Agreement. This Agreement (including the documents set forth in the exhibits hereto) contains the entire understanding of the parties with respect to the transactions contemplated hereby.

9.4 Counterparts. This Agreement may be executed in one or more counterparts, all of which shall be considered one and the same agreement, and shall become effective when one or more of the counterparts have been signed by each party and delivered to the other parties, it being understood that all parties need not sign the same counterpart.

9.5 Notices and Other Communications. All notices, consents, requests, instructions, approvals, financial statements, proxy statements, reports and other communications provided for herein shall be in writing and shall be delivered personally, by facsimile or sent by prepaid overnight courier service, to:

The Company:

Krause's Furniture, Inc.
200 North Berry Street
Brea, CA 92821-3903
Facsimile #: (714) 990-3561
Attention: Philip M. Hawley

With a copy to:

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Krause's Furniture, Inc.
200 North Berry Street
Brea, CA 92821-3903
Facsimile #: (714) 990-3561
Attention: Judith O. Lasker, Esq.

and

Morrison & Foerster LLP
555 West 5th Street, Suite 3500
Los Angeles, CA 90013-1024
Facsimile #: (213) 892-5454
Attention: Charles Kaufman, Esq.

Each Purchaser:

At the address or facsimile number set forth on the signature pages hereto.

With a copy to:

Skadden, Arps, Slate, Meagher & Flom LLP
300 South Grand Avenue
Suite 3400
Los Angeles, California 90071
Facsimile #: (213) 687-5600
Attention: Michael A. Woronoff, Esq.

or to such other address as any party may, from time to time, designate in a written notice given in a like manner.

9.6 Amendments. This Agreement may be amended as to the Purchasers and their successors and assigns, and the Company may take any action herein prohibited, or omit to perform any act required to be performed by it, if the Company shall obtain (i) the written consent of the Purchasers and/or such successors and assigns who are the registered holders of not less than a majority of the outstanding shares of Series A Preferred Stock then held by the Purchasers and their successors or assigns and (ii) the written consent of THLi; provided, however, that without the consent of each holder affected, however, no amendment or waiver may (with

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respect to any shares of Series A Preferred Stock held by a nonconsenting holder of shares of Series A Preferred Stock):

(a) reduce the aggregate number of shares of Series A Preferred Stock whose holders must consent to an amendment or waiver of any provision of this Agreement; or

(b) make any change in the foregoing amendment and waiver provisions.

This Agreement may not be waived, changed, modified, or discharged orally, but only by an agreement in writing signed by the party or parties against whom enforcement of any waiver, change, modification or discharge is sought or by parties with the right to consent to such waiver, change, modification or discharge on behalf of such party.

9.7 Cooperation. Each Purchaser and the Company agree to take, or cause to be taken, all such further or other actions as shall reasonably be necessary to make effective and consummate the transactions contemplated by this Agreement.

9.8 Successors and Assigns. All covenants and agreements contained herein shall bind and inure to the benefit of the parties hereto and their

respective successors and assigns. Any Purchaser may (but shall not be required to) assign any or all of its rights under this Agreement to any transferee of any Series A Preferred Stock; provided that THLi may only assign its rights under Section 4 to a transferee of at least 30% of the Stock held by THLi as of the date of this Agreement (calculated as if all shares of Series A Preferred Stock had been converted into shares of Common Stock as of the date of such calculation). If THLi assigns any or all of its rights under Section 4, such rights shall only be exercised by holders of more than 50% of the Stock held by THLi as of the date of this Agreement (calculated as if all shares of Series A Preferred Stock had been converted into shares of Common Stock as of the date of such calculation). This Agreement may not be assigned by the Company.

9.9 Expenses and Remedies.

(a) The Company agrees to pay THLi for all reasonable outside legal and consulting fees of THLi in connection with this Agreement and the consummation of all transactions contemplated hereby, which costs shall not

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exceed \$50,000, and all costs and expenses relating to any future amendment or supplement to this Agreement or the Series A Preferred Stock (or any proposal by the Company for such amendment or supplement) whether or not consummated or any waiver or consent with respect thereto (or any proposal for such waiver or consent) whether or not consummated, and all costs and expenses of THLi relating to the enforcement of this Agreement, the Registration Rights Agreement or the Series A Preferred Stock.

(b) The Company further agrees to indemnify and save harmless each Purchaser and each Purchaser's officers, directors, partners, employees, trustees and agents, each Person who controls such Purchaser within the meaning of the Securities Act or the Exchange Act, from and against any and all costs, expenses, damages or other liabilities resulting from any breach of this Agreement by the Company or any legal, administrative or other proceedings arising out of the transactions contemplated hereby (other than such costs, expenses, damages or other liabilities resulting, directly or indirectly, (i) from the breach by such Purchaser of any of its representations, warranties or other agreements contained herein, (ii) from the gross negligence or willful misconduct of such Purchaser or any of its officers, directors, partners, employees or agents, or any Person who controls such Purchaser within the meaning of the Securities Act or the Exchange Act or (iii) from an ERISA violation resulting from any action or inaction by such Purchaser, other than an ERISA violation resulting from a breach by the Company of this Agreement); provided, however, that, if and to the extent that such indemnification is unenforceable for any reason, the Company shall make the maximum contribution to the payment and satisfaction of such indemnified liability which shall be permissible

under applicable laws.

(c) The indemnified party under this Section 9.9 will, promptly after the receipt of notice of the commencement of any action against such indemnified party in respect of which indemnity may be sought from the Company on account of an indemnity agreement contained in this Section 9.9 notify the Company in writing of the commencement thereof. The omission of any indemnified party so to notify the Company of any such action shall not relieve the Company from any liability which it may have to such indemnified party except to the extent the Company shall have been prejudiced by the omission of such indemnified party so to notify the Company, pursuant to this Section 9.9. In case any such action shall be brought against any indemnified party and it shall notify the Company of the commencement thereof,

the Company shall be entitled to participate therein and, to the extent that it may wish, to assume the defense thereof, with counsel reasonably satisfactory to such indemnified party, and after notice from the Company to such indemnified party of its election so to assume the defense thereof, the Company will not be liable to such indemnified party under this Section 9.9 for any legal or other expense subsequently incurred by such indemnified party in connection with the defense thereof nor for any settlement thereof entered into without the consent of the Company; provided, however, that (i) if the Company shall elect not to assume the defense of such claim or action or (ii) if the indemnified party reasonably determines (x) that there may be a conflict between the positions of the Company and of the indemnified party in defending such claim or action or (y) that there may be legal defenses available to such indemnified party different from or in addition to those available to the Company, then separate counsel for the indemnified party shall be entitled to participate in and conduct the defense, in the case of (i) and (ii) (x), or such different defenses, in the case of (ii) (y), and the Company shall be liable for any reasonable legal or other expenses incurred by the indemnified party in connection with the defense. The obligations of the Company to each indemnified party hereunder shall be separate obligations, and the Company's liability to any such indemnified party hereunder shall not be extinguished solely because any other indemnified party is not entitled to indemnity hereunder. The obligations of the Company under this Section 9.9 shall survive the redemption or purchase by the Company of the shares of Series A Preferred Stock purchased by any Purchaser, any transfer of the Series A Preferred Stock by any Purchaser and the termination of this Agreement, the Series A Preferred Stock, the Stockholders Agreement and any of the other documents executed in connection herewith.

9.10 Survival of Representations and Warranties. All representations and warranties contained herein or made in writing by any party in connection herewith shall survive the execution and delivery of this Agreement and the

issuance and delivery of the Series A Preferred Stock, regardless of any investigation made by or on behalf of any party.

9.11 Transfer of Series A Preferred Stock. (a) Each Purchaser understands and agrees that the Series A Preferred Stock has not been registered under the Securities Act or the securities laws of any state and that they may be sold or otherwise disposed of only in one or more transactions registered under the Securities Act and, where applicable, such laws or transactions as to which an exemption

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from the registration requirements of the Securities Act and, where applicable, such laws are available. Each Purchaser acknowledges that, except as provided in the Registration Rights Agreement, such Purchaser has no right to require the Company to register the Series A Preferred Stock. Each Purchaser understands and agrees that each certificate representing the Series A Preferred Stock shall bear legends substantially in the form as follows:

"THE SECURITIES REPRESENTED BY THIS CERTIFICATE HAVE NOT BEEN REGISTERED UNDER THE SECURITIES ACT OF 1933, AS AMENDED (THE "ACT") OR THE SECURITIES LAWS OF ANY STATE AND MAY NOT BE SOLD OR OTHERWISE DISPOSED OF EXCEPT PURSUANT TO AN EFFECTIVE REGISTRATION STATEMENT UNDER SUCH ACT AND APPLICABLE STATE SECURITIES LAWS OR AN APPLICABLE EXEMPTION TO THE REGISTRATION REQUIREMENTS OF SUCH ACT OR SUCH LAWS."

"THE TRANSFER OF THE SECURITIES REPRESENTED BY THIS CERTIFICATE IS RESTRICTED BY A STOCKHOLDERS AGREEMENT BY AND AMONG KRAUSE'S FURNITURE, INC. (THE "COMPANY") AND THE STOCKHOLDERS PARTIES THERETO (THE "STOCKHOLDERS AGREEMENT"), A COPY OF WHICH IS ON FILE AT THE OFFICES OF THE COMPANY."

"IN ADDITION TO THE RESTRICTIONS SET FORTH IN THE STOCKHOLDERS AGREEMENT, THE SECURITIES REPRESENTED BY THIS CERTIFICATE ARE SUBJECT TO THE RESTRICTIONS SET FORTH IN A SECURITIES PURCHASE AGREEMENT BY AND AMONG THE COMPANY AND THE PURCHASERS LISTED ON THE SIGNATURE PAGES THERETO, A COPY OF EACH OF WHICH IS ON FILE AT THE OFFICES OF THE COMPANY."

9.12 Governing Law; Consent to Jurisdiction. This Agreement shall be governed by and construed in accordance with the laws of the State of New York, including, without limitation, Sections 5-1401 and 5-1402 of the New York General Obligations Law and New York Civil Practice Laws and Rules 327(b). Each of the parties hereto hereby irrevocably and unconditionally consents to submit to the exclusive jurisdiction of the courts of the State of New York and of the United States of America, in each case located in the County of New York, for any action, proceeding or investigation in any court or before any governmental authority ("litigation") arising out of or relating to this Agreement and the transactions contemplated hereby (and agrees not to commence any litigation relating thereto except in such courts), and further agrees that service of any

Registered Mail to its respective address set forth in this Agreement shall be effective service of process for any litigation brought against it in any such court. Each of the parties hereto hereby irrevocably and unconditionally waives any objection to the laying of venue of any litigation arising out of this Agreement or the transactions contemplated hereby in the courts of the State of New York or the United States of America, in each case located in the County of New York, and hereby further irrevocably and unconditionally waives and agrees not to plead or claim in any such court that any such litigation brought in any such court has been brought in an inconvenient forum. Each of the parties irrevocably and unconditionally waives, to the fullest extent permitted by applicable law, any and all rights to trial by jury in connection with any litigation arising out of or relating to this Agreement or the transactions contemplated hereby.

9.13 Publicity. Each of the parties hereto agrees that it will make no statement regarding the transactions contemplated hereby which is inconsistent with the press release agreed to by the parties hereto. Notwithstanding the foregoing, each of the parties hereto may, in document required to be filed by it with the Commission or other regulatory bodies, make such statements with respect to the transactions contemplated hereby as each may be advised is legally necessary upon advice of its counsel.

9.14 Signatures. This Agreement shall be effective upon delivery of original signature pages or facsimile copies thereof executed by each of the parties hereto.

IN WITNESS WHEREOF, the Company and the Purchasers have caused this agreement to be executed and delivered by their respective officers thereunto duly authorized.

KRAUSE'S FURNITURE, INC.

By:

Name: Robert A. Burton

Title: Executive Vice President/CFO

TH LEE.PUTNAM INTERNET PARTNERS, L.P.

By: TH LEE.PUTNAM INTERNET FUND
ADVISORS, L.P., its General Partner

By: TH LEE.PUTNAM INTERNET FUND
ADVISORS, LLC, its General Partner

By: _____
Name: Christine Kim
Title: Vice President

Address: 200 Madison Avenue, Suite 2225
New York, New York 10016
Facsimile #: (212) 951-8655
Attention: Christine Kim

Number of Shares: 134,000

Purchase Price: \$6,700,000

TH LEE.PUTNAM INTERNET PARALLEL
PARTNERS, L.P.

By: TH LEE.PUTNAM INTERNET FUND
ADVISORS, L.P., its General Partner

By: TH LEE.PUTNAM INTERNET FUND
ADVISORS, LLC, its General Partner

By: _____
Name: Christine Kim
Title: Vice President

Address: 200 Madison Avenue, Suite 2225
New York, New York 10016

Number of Shares: 126,000

Purchase Price: \$6,300,000

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GE CAPITAL EQUITY INVESTMENTS, INC.

By: _____
Name: George L. Hashbarger, Jr.
Title: Senior Vice President

Address: 260 Long Ridge Road
Stamford, Connecticut 06927
Facsimile #: (203)
Attention:

Number of Shares: 20,000

Purchase Price: \$1,000,000

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ASCEND PARTNERS, L.P.

By: _____
Name: Malcom Fairbairn
Title: Managing Member, Ascend Capital, LLC
(General Partner for Ascend Partners, LP)

Address: One Valley High
Lafayette, California 94549
Facsimile #:
Attention: Malcolm Fairbairn, c/o Emily Wang

Number of Shares: 6,500

Purchase Price: \$325,000

ATCO DEVELOPMENT, INC.

By:

Name: Kamal Abdelnour
Title: President and CEO

Address: 11777 Katy Freeway, Suite 175
Houston, Texas 77079
Facsimile #:
Attention: Kamal Abdelnour

Number of Shares: 5,000

Purchase Price: \$250,000

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BANK INSINGER De BEAUFORT

By:

Name: Frans Kee J.J. Human
Its: Director

Address: 11777 San Vicente Boulevard, Suite 702
Los Angeles, California 90049
Facsimile #:
Attention: Diana Deryez

Number of Shares: 3,750

Purchase Price: \$187,500

LARRY BLACK

By: _____

Address: c/o Black and Company
One SW Columbia Street
Portland, Oregon 97258
Facsimile #:

Number of Shares: 1,000

Purchase Price: \$50,000

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BRANAGH REVOCABLE TRUST

Authorized Investment Advisor:

By:

Name: Peter W. Branagh
Title: Trustee

By:

Name: Ramona Y. Branagh
Title: Trustee

Address: c/o Apex Capital, LLC
Pine Grove
4 Orinda Way, Suite 240-B
Orinda, California 94563
Facsimile #:
Attention: Sanford J. Colen

Number of Shares: 300

Purchase Price: \$15,000

MATTHEW WILLIAM CLARKE

By:

Name:
Title:

Address: 314 Edgar Gooch Rd.
Hazel Green, AL 35750

Number of Shares: 2,000

Purchase Price: \$100,000

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SANFORD J. COLEN

By:

Sanford J. Colen

Address: Apex Capital, LLC
Pine Grove
4 Orinda Way, Suite 240-B
Orinda, California 94563
Facsimile #:
Attention: Sanford J. Colen

Number of Shares: 900

Purchase Price: \$45,000

AARON J. COLEN, UTMA, CA

By:

Name: Sanford J. Colen
Title: Custodian

Address: Apex Capital, LLC
Pine Grove
4 Orinda Way, Suite 240-B
Orinda, California 94563
Facsimile #:
Attention: Sanford J. Colen

Number of Shares: 250

Purchase Price: \$12,500

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ELYSE L. COLEN, UTMA, CA

By:

Name: Sanford J. Colen
Title: Custodian

Address: Apex Capital, LLC
Pine Grove
4 Orinda Way, Suite 240-B
Orinda, California 94563
Facsimile #:
Attention: Sanford J. Colen

Number of Shares: 250

Purchase Price: \$12,500

SARAH KESSLER COX

By:

Address: 101 South Las Palmas Avenue
Los Angeles, California 90004
Facsimile #:

Number of Shares: 500

Purchase Price: \$25,000

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JOHN DAVIES

By:

Address: c/o Tyler Runnels
1999 Avenue of the Stars, Suite 2530
Los Angeles, California 90067
Facsimile #:

Number of Shares: 1,250

Purchase Price: \$62,500

DIAMOND A. PARTNERS, L.P.

By:

Name:
Title:

Address: Lawndale Capital Management, L.L.C.
One Sansome Street, Suite 3900
San Francisco, California 94104
Facsimile #: 415-288-2323
Attention: Andrew E. Shapiro

Number of Shares: 2,625

Purchase Price: \$131,250

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J. STEVEN EMERSON

By:

Address: Emerson Investment Group
10506 Ilona Avenue, Suite 1410
Los Angeles, California 90064
Facsimile #:
Attention: J. Steven Emerson

Number of Shares: 6,250

Purchase Price: \$312,500

EMILY FAIRBAIRN - IRA

By:

Name:

Title:

Address: One Valley High
Lafayette, California 94549
Facsimile #:
Attention: Emily Wang

Number of Shares: 4,500

Purchase Price: \$225,000

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MALCOLM FAIRBAIRN - IRA

By:

Name:

Title:

Address: One Valley High
Lafayette, California 94549
Facsimile #:
Attention: Emily Wang

Number of Shares: 1,500

Purchase Price: \$75,000

WILLIAM T. AND KATHLEEN P. GIBSON

By:

Name: William T. Gibson

By:

Name: Kathleen P. Gibson

Address: 109 La Plata
Santa Barbara, California 93109
Facsimile #:

Number of Shares: 500

Purchase Price: \$25,000

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JONATHAN & NANCY GLASER FAMILY TRUST

By:

Name: Jonathan M. Glaser
Title: Trustee

By:

Name: Nancy Ellen Glaser
Title: Trustee

Address: 1999 Avenue of the Stars, Suite 2530
Los Angeles, California 90067
Facsimile #:
Attention:

Number of Shares: 2,000

Purchase Price: \$100,000

EDWARD M. HAWLEY

By:

Address: 129 North Van Ness
Los Angeles, California 90004
Facsimile #:

Number of Shares: 200

Purchase Price: \$10,000

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GEORGE P. HAWLEY

By:

Address: 116 North Citrus Avenue
Los Angeles, California 90036
Facsimile #: 323-939-9555

Number of Shares: 200

Purchase Price: \$10,000

ALLISON BOOTH HAWLEY TRUST I

By:

Name: John F. Hawley
Title: Trustee

Address: 238 South Lorraine
Los Angeles, California 90004
Facsimile #:
Attention: John F. Hawley

Number of Shares: 2,500

Purchase Price: \$125,000

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CAITLIN HALE HAWLEY TRUST I

By:

Name: John F. Hawley
Title: Trustee

Address: 238 South Lorraine
Los Angeles, California 90004
Facsimile #:
Attention: John F. Hawley

Number of Shares: 2,500

Purchase Price: \$125,000

HAWLEY FAMILY TRUST

By:

Name: John F. Hawley
Title: Trustee

Address: 238 South Lorraine
Los Angeles, California 90004
Facsimile #:
Attention: John F. Hawley

Number of Shares: 2,500

Purchase Price: \$125,000

MAUREEN ERIN HAWLEY TRUST I

By:

Name: John F. Hawley
Title: Trustee

Address: 238 South Lorraine
Los Angeles, California 90004
Facsimile #:
Attention: John F. Hawley

Number of Shares: 2,500

Purchase Price: \$125,000

SHANNON FOLLEN HAWLEY TRUST I

By:

Name: John F. Hawley
Title: Trustee

Address: 238 South Lorraine
Los Angeles, California 90004
Facsimile #:
Attention: John F. Hawley

Number of Shares: 2,500

Purchase Price: \$125,000

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DR. PHILIP HAWLEY, JR.

By:

Address: 165 South Las Palmas
Los Angeles, California 90004-1085
Facsimile #:

Number of Shares: 1,250

Purchase Price: \$62,500

VICTOR F. HAWLEY

By:

Address: 122 South Plymouth Boulevard
Los Angeles, California 90005
Facsimile #: 323-931-2052

Number of Shares: 200

Purchase Price: \$10,000

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RICHARD HICKS

By:

Address: 21 Tanfield Road
Tiburon, California 94920
Facsimile #:

Number of Shares: 6,000

Purchase Price: \$300,000

IAN JACK

By:

Address: 630 South Lucerne
Los Angeles, CA 90005

Number of Shares: 2,000

Purchase Price: \$100,000

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KATHRYN JERGENS TRUST

By:

Name:
Title:

Address: 1999 Avenue of the Stars, Suite 2530
Los Angeles, California 90067
Facsimile #: 310-201-2712
Attention: Kathryn Jergens

Number of Shares: 250

Purchase Price: \$12,500

DIANE JOHNSON

By:

Address: 9901 Manassas Place
Tucson, Arizona 85748
Facsimile #:

Number of Shares: 200

Purchase Price: \$10,000

RICHARD M. KELLER

By: _____

Address: 101 South Las Palmas Avenue
Los Angeles, California 90004
Facsimile #:

Number of Shares: 500

Purchase Price: \$25,000

STEPHEN M. KELLER

By: _____

Address: 30 East 81st Street, Apt. 7E
New York, New York 10028
Facsimile #:
Attention: Elizabeth Hughes

Number of Shares: 500

Purchase Price: \$25,000

STEPHEN F. KELLER PROFESSIONAL
CORPORATION DEFINED BENEFIT
PLAN

By:

Name:

Title: Trustee

Address: 101 S. Las Palmas Avenue
Los Angeles, California 90004
Facsimile #:
Attention: Stephen F. Keller

Number of Shares: 1,500

Purchase Price: \$75,000

SIDNEY KIMMEL

Authorized Investment Advisor:

By:

Address: Apex Capital, LLC
Pine Grove
4 Orinda Way, Suite 240-B
Orinda, California 94563
Facsimile #:
Attention: Sanford J. Colen

Number of Shares: 125

Purchase Price: \$6,250

KONOPIOSOS FAMILY TRUST DATED 12/15/80

By:

Name: Theodore D. Konopisos
Title: Trustee

By:

Name: Jeri L. Konopisos
Title: Trustee

Address: 17291 Irvine Boulevard, Suite 254
Tustin, California 92780
Facsimile #:
Attention: Elizabeth Hughes

Number of Shares: 1,250

Purchase Price: \$62,500

PETER LAMM

By:

Address: 1655 El Camino Real
Palo Alto, California 94306
Facsimile #:

Number of Shares: 2,000

Purchase Price: \$100,000

ROBERT LONDON

By:

Address: Cruttenden Roth
809 Presidio Avenue, Suite B
Santa Barbara, California 93101
Facsimile #:
Attention: Robert London

Number of Shares: 6,000

Purchase Price: \$300,000

JEFFREY S. MORGAN

By:

Address: 27 Horseshoe Lane
Rolling Hills Estates, CA
90274
Facsimile #: 310-516-2310
Attention: Jeffrey S. Morgan

Number of Shares: 200

Purchase Price: \$10,000

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JEFFREY S. MORGAN BSSC MASTER DEFINED CONTRIBUTION
PENSION PLAN

By:

Name:

Its:

Address: Bear Stearns Corp. Custodian
One Metrotech Center North

Brooklyn, New York
11201
Facsimile #: 310-516-2310
Attention: Jeffrey S. Morgan

Number of Shares: 425

Purchase Price: \$21,250

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THE MUHL FAMILY TRUST

By:

Name: Phillip E. Muhl
Title: Trustee

By:

Name: Kristin A. Muhl
Title: Trustee

Address: 500 South Buena Vista
Burbank, California 91521-0312
Facsimile #:
Attention: Phillip E. Muhl or Kristin A.
Muhl

Number of Shares: 625

Purchase Price: \$31,250

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PACIFIC SECURITY GROUP, INC.

By:

Name:
Title:

Address: 2224 Walsh Tarlton, Suite 200
Austin, Texas 78746
Facsimile #:

Number of Shares: 500

Purchase Price: \$25,000

PERMAL U.S. OPPORTUNITIES LTD.

Authorized Investment Advisor:

By:

Name:
Title:

Address: Apex Capital, LLC
Pine Grove
4 Orinda Way, Suite 240-B
Orinda, California 94563
Facsimile #:
Attention: Sanford J. Colen

Number of Shares: 1,000

Purchase Price: \$50,000

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PILOT HOLDINGS, L.P.

By: SHED INVESTMENTS, LLC, its General Partner

By:

Name: Thomas M. DeLitto
Title: Managing Member

Address: 177 Post Road West
Westport, Connecticut 96880

Number of Shares: 5,000

Purchase Price: \$250,000

POINTE INVESTMENTS CAPITAL, LTD.

By:

Name:

Title:

Address: 638 N. Faring
Los Angeles, California 90077
Facsimile #:
Attention: Mohamed Hadid

Number of Shares: 2,000

Purchase Price: \$100,000

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POLLAT, EVANS & CO., INC.

Authorized Investment Advisor:

By:

Name:

Title:

Address: Apex Capital, LLC
Pine Grove
4 Orinda Way, Suite 240-B
Orinda, California 94563
Facsimile #:
Attention: Sanford J. Colen

Number of Shares: 175

Purchase Price: \$8,750

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KEVIN AND ERIN PRZYBOCKI

By: _____
Name: Kevin Przybocki

By: _____
Name: Erin Przybocki

Address: 1104 Vancouver Avenue
Burlingame, California 94010
Facsimile #:

Number of Shares: 200

Purchase Price: \$10,000

CHARLES B. RUNNELS, JR.

By: _____

Address: 2029 Avenue of the Stars, Suite 2530
Los Angeles, California 90067
Facsimile #:
Attention: Tyler Runnels

Number of Shares: 625

Purchase Price: \$31,250

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CHARLES B. RUNNELS, III

By: -----

Address: 10095 East Charter Oak
Scottsdale, Arizona 85260
Facsimile #:

Number of Shares: 625

Purchase Price: \$31,250

G. TYLER RUNNELS

By: -----

Address: 1999 Avenue of the Stars, Suite 2530
Los Angeles, California 90067
Facsimile #: 310-201-2712

Number of Shares: 5,600

Purchase Price: \$280,000

30

69

LORD ROBIN RUSSELL

By: -----

Address: Park House
Woburn Park
Woburn
Milton Keynes
MK17 9PQ England

Facsimile #:

Number of Shares: 250

Purchase Price: \$12,500

TIMOTHY MICHAEL WALLACE

By: _____

Address: 116 S. McCadden Place
Los Angeles, California 90004
Facsimile #:
Attention: Tyler Runnels

Number of Shares: 2,500

Purchase Price: \$125,000

31

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WAVE ENTERPRISES, INC.

By: _____

Name: Mike E. O'Neal
Title: President

Address: 24255 Pacific Coast Highway
Malibu, California 90263-4458
Facsimile #:
Attention: Mike E. O'Neal

Number of Shares: 250

Purchase Price: \$12,500

IRA WEINGARTEN

By: _____

Address: Equity Communications
1512 Grand Avenue, Suite 200
Santa Barbara, California 93103
Facsimile #:
Attention: Ira Weingarten

Number of Shares: 625

Purchase Price: \$31,250

32

71

DAVID WEINSTEIN

By: _____

Address: 5523 Ashpon Court
Boca Raton
Florida 33486
Facsimile #: 561-988-7913

Number of Shares: 400

Purchase Price: \$20,000

J.D. YATES

By: _____

Address: 1235 Lane 30 1/4
Pueblo, Colorado 81006
Facsimile #:

Number of Shares: 250

Purchase Price: \$12,500

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ZAXIS PARTNERS, L.P.

By:

Name:

Title:

Address: Apex Capital, LLC
Pine Grove
4 Orinda Way, Suite 240-B
Orinda, California 94563
Facsimile #:
Attention: Sanford J. Colen

Number of Shares: 5,000

Purchase Price: \$250,000

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EXHIBIT A

FORM OF AMENDED AND RESTATED STOCKHOLDERS AGREEMENT

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EXHIBIT B

FORM OF MORRISON & FOERSTER OPINION

January [], 2000

[Initial Purchasers]

[Individual Purchaser]

Re: Issuance of 380,000 Shares of Series A
Convertible Preferred Stock of
Krause's Furniture, Inc.

Ladies and Gentlemen:

We have acted as special counsel for Krause's Furniture, Inc., a Delaware corporation (the "Company"), in connection with the transactions contemplated by the Series A Convertible Preferred Stock Securities Purchase Agreement, dated as of January [], 2000 (the "Securities Purchase Agreement"), among the Company and the purchasers listed on the signature pages thereto (the "Purchasers"). This opinion is furnished to you pursuant to Section 7.2(d) of the Securities Purchase Agreement. Unless otherwise defined herein, terms defined in the Securities Purchase Agreement shall have the same meanings herein.

We have examined originals or copies of the following documents (each a "Document" and collectively, the "Documents"):

- the Securities Purchase Agreement;
- the Amended and Restated Stockholders Agreement, dated as of January [], 2000, by and among the Company and the stockholders of the Company listed on the signature pages thereto;
- the Amended and Restated Registration Rights Agreement, dated as of January [], 2000, by and among the Company and the stockholders of the Company listed on the signature pages thereto;

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[Initial Purchasers]

[Individual Purchaser]

January [], 2000

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- the Agreement Amending the Supplemental Securities Purchase Agreement, dated as of January [], 2000, by and among the Company, General Electric Capital Corporation and Japan Omnibus Ltd.; and
- the Certificate of Designation of Series A Convertible Preferred Stock of the Company filed with the Delaware Secretary of State as of January 12, 2000.

In addition, we have examined such records, documents, certificates of public officials and of the Company, made such inquiries of officials of the Company, and considered such questions of law as we have deemed necessary for the purpose of rendering the opinions set forth herein. We have also examined a form of certificate of the Series A Preferred Stock.

We have assumed the genuineness of all signatures and the authenticity of all items submitted to us as originals and the conformity with originals of all items submitted to us as copies. In making our examination of the Documents, we have assumed that each party to one or more of the Documents other than the Company has the power and authority (and with respect to parties that are individuals, the capacity) to execute and deliver, and to perform and observe the provisions of the Documents, and has duly authorized, executed and delivered such Documents, and that such Documents constitute the legal, valid and binding obligations of such party.

Our opinion in paragraph (a) below as to the qualification and good standing of the Company and its Subsidiaries is based solely upon certificates of public officials in the states referred to in that paragraph. In addition, with your consent, we have relied upon the certificate of Robert Burton, the senior vice president and chief financial officer of the Company, and Judith O. Lasker, the secretary and general counsel of the Company (the "Officers' Certificate") attached hereto as Exhibit A, with respect to certain factual matters. Our opinion in paragraph (h) below is based solely upon the Officers' Certificate and our review of the agreements and orders described therein. We have made no independent investigation as to whether those certificates are accurate or complete, but we have no knowledge of any such inaccuracy or incompleteness. In rendering our opinions in paragraphs (f), (i) and (j) below, we have assumed that the representations and warranties of the Purchasers contained in the Securities Purchase Agreement are true and correct as of when made and as of the date hereof, including that each Purchaser is an "accredited investor" within the meaning of Regulation D under the Securities

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[Initial Purchasers]
[Individual Purchaser]
January [], 2000
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Act and that each Purchaser is acquiring the Series A Preferred Stock being purchased by such person under the Securities Purchase Agreement for investment purposes only and not with a view to distribution thereof.

Our opinion in paragraph (j) below is based on a review of those statutes and regulations which, in our experience, are normally applicable to transactions of the type contemplated by the Documents.

Whenever our opinion herein with respect to the existence or absence of facts is indicated to be based on our knowledge, it is intended to signify that, in connection with the matter described in the first paragraph hereof, none of Charles Kaufman, Timothy Scott, Kathryn Johnstone, Michael J. Connell, Allen Weingarten, Joseph Cuomo or Raj Tanden has acquired actual knowledge of the existence or absence of such facts. Please be advised that the above-named persons are the only attorneys of this firm who have been actively engaged in the representation of the Company in connection with that matter (although other attorneys of the firm have represented and continue to represent the Company on other matters). We have not undertaken any independent investigation to determine the existence or absence of such facts, and no

inference as to our knowledge of the existence or absence of such facts should be drawn from the fact of our representation of the Company.

We express no opinion herein relating to state securities or blue sky laws. We express no opinion herein as to the Supplemental Securities Purchase Agreement, dated as of August 14, 1997.

The opinions hereinafter expressed are subject to the following further qualifications and exceptions:

- (1) The effect of bankruptcy, insolvency, reorganization, arrangement, moratorium or other similar laws relating to or affecting the rights of creditors generally, including, without limitation, laws relating to fraudulent transfers or conveyances, preferences and equitable subordination;
- (2) Limitations imposed by general principles of equity upon the availability of equitable remedies or the enforcement of provisions of the Documents, and the effect of judicial decisions which have held that certain provisions are unenforceable where their enforcement would violate the implied covenant of good faith and fair dealing, or would be commercially unreasonable or where a default under the Documents is not material;

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[Individual Purchaser]
January [], 2000
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- (3) The effect of judicial decisions which may permit the introduction of extrinsic evidence to supplement the terms of the Documents or to aid in the interpretation of the Documents;
- (4) We express no opinion as to the effect on the opinions expressed herein of (i) the compliance or non-compliance of any party to the Documents other than the Company with any laws or regulations applicable to it, or (ii) the legal or regulatory status or the nature of the business of any such party;
- (5) We express no opinion as to the enforceability of provisions of the Documents providing for indemnification or contribution, to the extent such indemnification or contribution is against public policy;
- (6) We express no opinion as to the enforceability of the provisions of Section 4.7 of the Securities Purchase Agreement insofar as such provisions are required to be stated in the Certificate of Incorporation of the Company to be valid and binding obligations of the Company; and
- (7) We express no opinion as to the enforceability of any provisions

of the Documents providing that claims arising under the Documents are to be determined by a particular court or particular courts.

Based upon and subject to the foregoing, we are of the opinion that:

(a) The Company is a corporation duly organized, validly existing and in good standing under the laws of the State of Delaware and is duly qualified and in good standing in the State of California. Each of Keegan Management Co., Krause's Custom Crafted Furniture, Castro Convertible Corp. and Brea Holdings, Inc. (the "Subsidiaries") is a corporation duly incorporated, validly existing and in good standing under the laws of the jurisdiction in which it is incorporated.

(b) The Company has the corporate power and authority to execute and deliver, and to perform and observe the provisions of, the Documents.

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[Individual Purchaser]
January [], 2000
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(c) The Documents have each been duly authorized, executed and delivered by the Company. The Documents constitute valid and binding obligations of the Company enforceable against the Company in accordance with their respective terms.

(d) The shares of Series A Preferred Stock have been duly authorized and are validly issued, fully paid and nonassessable.

(e) Following receipt of the requisite approval of the Company's stockholders and the filing with the Delaware Secretary of State of an amendment to the Company's Certificate of Incorporation effecting the requisite increase in the Company's authorized shares of Common Stock, the shares of Common Stock issuable upon conversion of the Series A Preferred Stock, when issued and delivered upon conversion in accordance with the terms of the Certificate of Designation, will be validly issued, fully paid and nonassessable.

(f) No registration with, consent or approval of, notice to, or other action by, any governmental entity is required on the part of the Company for the execution, delivery or performance by the Company of the Documents, or if required, such registration has been made, such consent or approval has been obtained, such notice has been given or such other appropriate action has been taken, except for any filings required pursuant to state and federal securities laws which will be timely if made after the Closing Date.

(g) The execution, delivery and performance of the Documents by the Company are not in violation of its Certificate of Incorporation or Bylaws.

(h) The execution, delivery and performance of the Documents by

the Company will not violate or result in a material breach of any of the terms of or constitute a material default under or (except as contemplated in the Documents) result in the creation of any lien, charge or encumbrance on any property or assets of the Company, pursuant to the terms of any indenture, mortgage, deed of trust or other agreement or order described in the Officers' Certificate. As to agreements which by their terms are or may be governed by the laws of a jurisdiction other than California or New York, we assume that such agreements are governed by the law of California for purposes of the opinion expressed in this paragraph. In addition, we exclude from the scope of such opinion any potential violation of financial covenants contained in such agreements.

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[Individual Purchaser]
January [], 2000
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(i) It is not necessary to register under the Securities Act of 1933, as amended, the offer, sale or delivery by the Company to the Purchasers of the Series A Convertible preferred Stock, or the issuance to the holders of the Series A Convertible Preferred Stock of the Common Stock to be issued upon the conversion thereof in the manner contemplated by the Securities Purchase Agreement and the Certificate of Designation.

(j) The sale and issuance of the shares of Series A Convertible Preferred Stock in accordance with the terms of the Securities Purchase Agreement will not violate any federal, New York or California statute applicable to the Company, or the General Corporation Law of the State of Delaware.

We express no opinion as to matters governed by any laws other than the substantive laws of the States of New York (including its applicable choice-of-law rules) and California, the General Corporation Law of the State of Delaware and the federal laws of the United States, in each case which are in effect on the date hereof.

We note that each Document other than the Certificate of Designation contains a New York choice-of-law provision. We have assumed, with your permission, that any provision of the Documents excepting New York choice or conflicts of law rules from any New York choice-of-law provision would not be interpreted to include Section 5-1401 of the General Obligations Law of the State of New York ("NYGOL"). We express no opinion as to the New York choice-of-law provision in each of the Documents to the extent that Section 1-105 of the Uniform Commercial Code of the State of New York requires the application of the law of another jurisdiction. For purposes of this opinion, we have assumed that Section 5-1401 of NYGOL would be given effect in accordance with its terms. We have assumed that no provision of the Documents violates the public policy of any jurisdiction other than the State of New York having a substantial relationship to the transaction contemplated by the Documents, and that no provision of the law of the State of New York applicable to the Documents violates the public policy of any such other jurisdiction. We express

no opinion as to the effect of the laws of any jurisdiction other than the State of New York on the opinions expressed herein regarding the enforceability of New York choice-of-law provisions.

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[Individual Purchaser]
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This opinion is solely for your benefit and may not be relied upon by, nor may copies be delivered to, any other person without our prior written consent.

Very truly yours,

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Exhibit A to Opinion

OFFICERS' CERTIFICATE
Krause's Furniture, Inc.

IN CONNECTION WITH the execution and delivery by KRAUSE'S FURNITURE, INC., a Delaware corporation (the "COMPANY"), of a Series A Convertible Preferred Stock Securities Purchase Agreement dated as of January ___, 2000 (the "SECURITIES PURCHASE AGREEMENT") among the Company and the purchasers listed on the signature pages thereto (collectively, the "PURCHASERS"), Morrison & Foerster, LLP has been asked to render its opinion with respect to various matters (the "OPINION LETTER").

In support of the Opinion Letter and with the knowledge that Morrison & Foerster, LLP is relying on the matters hereby certified in rendering certain portions of the Opinion Letter, the undersigned hereby certify that the undersigned are the duly elected and acting Chief Financial Officer and Secretary of the Company and, as of the date hereof:

1. Attached hereto as EXHIBIT A is a true and correct copy of the Certificate of Incorporation of the Company, as on file with the Secretary of State of the State of Delaware (the "CERTIFICATE"). Except as reflected in EXHIBIT A, the Certificate has not been modified, amended or superseded, and remains in full force and effect.

2. Attached hereto as EXHIBIT B is a true, correct and complete copy of the Bylaws of the Company as modified or amended through and including the date hereof, and such Bylaws have not otherwise been modified, amended or superseded, and the Bylaws remain in full force and effect.

3. Attached hereto as EXHIBIT C is a true, correct and complete copy of the resolutions duly adopted by the Board of Directors of the Company at a

meeting duly noticed and held on December 29, 1999. All such resolutions are in full force and effect on the date hereof and in the form in which adopted and no other resolutions have been adopted by the Board of Directors of the Company or any committee thereof relating to the transaction referred to in such resolutions or with respect to any amendment or modification to the Certificate or the Bylaws of the Company.

4. Attached hereto as EXHIBIT D is a schedule of material contracts and obligations of the Company as of the date hereof for purposes of the Opinion Letter.

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5. The following named individuals are elected officers of the Company, each holding the office of the Company set forth opposite their respective name. The signature written opposite the name and title of each such officer is in each case such person's genuine signature.

<TABLE>

<CAPTION>

Name	Office	Signature
----	-----	-----
<S>	<C>	<C>
Philip M. Hawley	Chairman of the Board and Chief Executive Officer	
Robert A. Burton	Senior Vice President and Chief Financial Officer	
Judith Olson Lasker	Secretary and General Counsel	

</TABLE>

6. No certificate relating to the voluntary or involuntary dissolution of the Company, and no certificate of merger of the Company, has been or is being held for subsequent filing with the Secretary of State of Delaware. Further, no event leading to any dissolution or merger of the Company has occurred and the Company is validly existing and in good standing under the laws of the State of Delaware.

7. The Company has no permit, authorization, concession, franchise or license that is important to the conduct of the business of the Company which is not of a type commonly obtained by businesses generally or by businesses in a similar line of business.

8. As used herein, "BANKRUPTCY CODE" shall mean the Bankruptcy Code of 1978, 11 U.S.C. 101 et seq., as amended and now in effect and as hereafter amended. The Company has not: (i) filed a voluntary petition or answer seeking liquidation, reorganization, arrangement, readjustment of its debts, or for any other relief under the Bankruptcy Code, or under any other act or law pertaining to insolvency or debtor relief, whether state, Federal, or foreign; (ii) entered into any agreement indicating its consent to, approval of, or acquiescence in,

any such petition or proceeding; (iii) applied for, or acquiesced in any application for, the appointment of a receiver, custodian or trustee for the Company or for all or a substantial part of its property; (iv) made an assignment for the benefit of creditors, or admitted any inability or failure generally to pay its debts as such debts become due.

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9. The Company has not received any notice of: (i) any filing of an involuntary petition against the Company seeking liquidation, reorganization, arrangement or readjustment of its debts, or for any other relief under the Bankruptcy Code, or under any other act or law pertaining to insolvency or debtor relief, whether state, Federal or foreign; (ii) the involuntary appointment of a receiver, custodian or trustee of the Company or for all or a substantial part of the Company's property; or (iii) the entry of a material judgment or the issuance of a writ of attachment, execution or similar process against any substantial part of the property of the Company, or the entry of an order for relief under the Bankruptcy Code or any other applicable act or law, in any such case or proceeding.

10. Neither the Company nor its assets is subject to any order, writ, judgment, injunction, decree, determination or award of any court or of any governmental agency or instrumentality (whether federal, state, local or foreign) that affects the Company's business operations, restricts its business or restricts its freedom to contract. To our knowledge, no authorization, approval, consent or other order of, or registration, qualification, declaration or filing with, any governmental agency, court or any other entity is required for the authorization, execution, delivery or performance by the Company of the Securities Purchase Agreement or any instrument or agreement to be executed or delivered by the Company as contemplated therein, and the Company is not required to notify any governmental authority or agency of the United States or the State of Delaware, including any court of law, of any transactions or agreements that it enters into or obligations it undertakes.

11. To our knowledge, the execution, delivery and performance by the Company of the Securities Purchase Agreement and any instrument or agreement to be executed or delivered by the Company as contemplated therein, will not violate or result in a material breach of any of the terms of or constitute a material default under or (except as contemplated in the Documents) result in the creation of any lien, charge or encumbrance on any property or assets of the Company pursuant to the terms of any indenture, mortgage, deed of trust or other agreement or order described in EXHIBIT D attached hereto.

12. The Company has not offered the Series A Preferred Stock to any person who is not an "accredited investor," as defined in Regulation D under the Securities Act of 1933, as amended.

[the next page is the signature page]

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IN WITNESS WHEREOF, the undersigned have executed this Officer's

ROBERT A. BURTON,
Senior Vice President and Chief
Financial Officer

JUDITH OLSON LASKER,
Secretary and General Counsel

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EXHIBIT C
FORM OF AMENDED AND RESTATED REGISTRATION
RIGHTS AGREEMENT

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EXHIBIT D
FORM OF INDEBTEDNESS AMENDMENT

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SCHEDULE 6.1
EVENTS OF DEFAULT

(a) the Company's breach of the covenant contained in the last sentence of Section 4.13 of the Agreement;

(b) the failure of the Company to receive approval of the E-Commerce Plan in accordance with Section 2.2(u) of the Stockholders Agreement within 120 days from the First Closing Date;

(c) failure to use at least \$10,000,000 of the Proceeds for E-Commerce Proceed Uses during the term of the E-Commerce Plan; and

(d) the Company's material variance (positive or negative) from the aggregate projected expenditures contained in the E-Commerce Plan for any calendar month and the continuance of a material variance for the period beginning on the first day of such month and ending 60 days after written notice is given to the Company by THLi.

THLi shall be deemed to waive any Event of Default pursuant to clause (c) or (d) above unless THLi has notified the Company in writing of such Event of Default within 15 days of the later of (i) THLi's becoming aware of such Event of Default and (ii) THLi's receipt of the monthly report required by Section 4.9(e) of the Agreement. In addition, THLi may approve deviations from the E-Commerce Plan (and such deviations will not be deemed to be Events of Default) or waive any of the defaults listed above, in each case by executing a written instrument specifying such waiver.

Schedule 6.1 - 1

AMENDED AND RESTATED STOCKHOLDERS AGREEMENT

by and among

KRAUSE'S FURNITURE, INC.

and

THE STOCKHOLDERS LISTED ON

THE SIGNATURE PAGES HEREOF

Dated as of January 14, 2000

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AMENDED AND RESTATED STOCKHOLDERS AGREEMENT

This Amended and Restated Stockholders Agreement (this "Agreement") is made as of January 14, 2000 by and among Krause's Furniture, Inc., a Delaware corporation (the "Company") and each of the stockholders of the Company listed on the signature pages hereof (each, a "Signatory Stockholder" and collectively, the "Signatory Stockholders").

W I T N E S S E T H :

WHEREAS, pursuant to a Securities Purchase Agreement between the Company and General Electric Capital Corporation (collectively, with GE Capital Equity Investments, Inc., "GECC") dated August 26, 1996 (the "1996 Securities Purchase

Agreement"), GECC purchased from the Company 5,000,000 shares of the Company's common stock, par value \$.001 per share (the "Common Stock"), for an aggregate purchase price of \$5,000,000, the Company's 10% Subordinated Pay-in-Kind Notes due August 31, 2001, as described in the Securities Purchase Agreement (the "Notes"), in the initial principal amount of \$5,000,000, and, in connection with the Notes, a warrant (the "First Warrant") to purchase 1,400,000 shares of Common Stock;

WHEREAS, concurrently with such purchase by GECC, (i) Hawley Group purchased 1,000,000 shares of Common Stock for an aggregate purchase price of \$1,000,000, (ii) certain other investors purchased 3,000,000 shares of Common Stock for an aggregate purchase price of \$3,000,000 and (iii) Japan Omnibus Ltd. (formerly named Edson Investments Inc.) and certain other holders of indebtedness of the Company exchanged such indebtedness for shares of Common Stock, as more fully described in the Securities Purchase Agreement;

WHEREAS, in connection with the 1996 Securities Purchase Agreement, the Company entered into a Stockholders Agreement with certain stockholders dated August 26, 1996 (the "Prior Stockholders Agreement");

WHEREAS, pursuant to a Supplemental Securities Purchase Agreement between the Company, GECC and Japan Omnibus LTD. ("JOL"), dated August 14, 1997, (i) the Company and GECC amended and restated the provisions of the Notes, (ii) GECC and JOL purchased certain additional notes, (iii) in connection with the Notes, GECC and JOL received warrants (the "Second Warrants") to purchase 1,300,000 shares of Common Stock and (iv) GECC and JOL received an additional

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warrant (the "Performance Warrant," and collectively with the First Warrant and the Second Warrants, the "Warrants") to purchase 1,000,000 shares of Common Stock;

WHEREAS, pursuant to a Securities Purchase Agreement among the Company, TH Lee.Putnam Internet Partners, L.P. and TH Lee.Putnam Internet Parallel Partners, L.P. (collectively with their Affiliates, "THLi"), and the purchasers listed on the signature pages thereto (collectively, the "Purchasers"), dated the date hereof (the "2000 Securities Purchase Agreement," and, together with the 1996 Securities Purchase Agreement, the "Securities Purchase Agreements"), the Purchasers are purchasing from the Company 380,000 shares of the Company's Series A Convertible Preferred Stock, par value \$.001 per share (the "Series A Preferred Stock"), for an aggregate purchase price of \$19,000,000;

WHEREAS, pursuant to the 2000 Securities Purchase Agreement, the Company will restructure the Notes, as more fully described in the 2000 Securities Purchase Agreement; and

WHEREAS, it is a condition to the consummation of the foregoing transactions that the parties hereto enter into this Agreement to amend, restate

and supersede the Prior Stockholders Agreement in accordance with Section 11 of the Prior Stockholders Agreement, and the parties hereto deem it to be in their best interests to enter into this Agreement establishing and setting forth their agreement with respect to certain rights and obligations associated with ownership of shares of capital stock of the Company.

SECTION 1. DEFINITIONS. As used herein, the following terms shall have the following meanings (capitalized terms used herein and not defined herein shall have the meanings assigned to such terms in the 2000 Securities Purchase Agreement):

"Affiliate" and "Associate" have the meanings ascribed to such terms in Rule 12b-2 of the General Rules and Regulations under the Exchange Act.

"Beneficially Own" with respect to any securities shall mean having "beneficial ownership" of such securities (as determined pursuant to Rule 13d-3 under the Exchange Act), including pursuant to any agreement, arrangement or understanding, whether or not in writing.

"Board" has the meaning assigned to it in Section 2.1.

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"By-laws" means the By-laws of the Company as in effect on the date hereof, as they may be amended from time to time hereafter.

"Capitalized Lease" shall mean, with respect to any person, any lease or any other agreement for the use of property which, in accordance with generally accepted accounting principals, should be capitalized on the lessee's or user's balance sheet.

"Capitalized Lease Obligation" of any person shall mean and include, as of any date as of which the amount thereof is to be determined, the amount of the liability capitalized or disclosed (or which should be disclosed) in a balance sheet of such person in respect of a Capitalized Lease of such person.

"Certificate" means the Certificate of Incorporation of the Company as in effect on the date stated hereof, as it may be amended from time to time hereafter.

"Common Stock Equivalents" means rights, options, scrip, warrants or other securities convertible into, or exchangeable or exercisable for, shares of Common Stock.

"Company" has the meaning assigned to it in the first paragraph hereof.

"Current Market Price", when used with reference to shares of Common Stock for any given date, shall mean the closing price per share of Common Stock on such date. The closing price for each day shall be the last quoted sale price or, if not so quoted, the average of the high bid and low asked prices in the

over-the-counter market, as reported by the National Association of Securities Dealers, Inc. Automated Quotation System or such other system then in use, or, if on any such date the Common Stock or such other securities are not quoted by any such organization, the average of the closing bid and asked prices as furnished by a professional market maker making a market in the Common Stock or such other securities selected by the Board of Directors of the Company. If the Common Stock is listed or admitted to trading on a national securities exchange, the closing price shall be the last sale price, regular way, or, in case no such sale takes place on such day, the average of the closing bid and asked prices, regular way, in either case as reported in the principal consolidated transaction reporting system with respect to securities listed or admitted to trading on the New York Stock Exchange or, if the Common Stock or such other securities are not listed or admitted to trading on the New York Stock Exchange, as reported in the principal consolidated transaction reporting system with respect to

securities listed on the principal national securities exchange on which the Common Stock or such other securities are listed or admitted to trading.

"E-Commerce Activities" shall mean business-to-business and e-commerce activities, including commerce related to transactions on the Internet, related to the E-Commerce Proceed Uses.

"Employment Agreement" shall mean the Employment Agreement dated as of August 26, 1996, as amended, between the Company and Philip M. Hawley ("Hawley").

"Exchange Act" shall mean the Securities Exchange Act of 1934, as amended, or any successor Federal statute, and the rules and regulations of the omission thereunder, all as the same shall be in effect at the time. Reference to a particular section of the Securities Exchange Act of 1934, as amended, shall include reference to the comparable section, if any, of any such successor Federal statute.

"Fully Diluted" shall mean, when used with reference to the Common Stock, at any date as of which the number of shares thereof is to be determined, (i) all shares of Common Stock outstanding at such date and (ii) all shares of Common Stock issuable in respect of vested options or warrants to purchase, or securities convertible into, exercisable for or exchangeable for, shares of Common Stock outstanding on such date, the conversion, exercise or exchange price of which is less than the Current Market Price.

"Group" has the meaning assigned such term for purposes of Rule 13d-5 under the Exchange Act.

"Guarantee" by any Person shall mean all obligations (other than endorsements in the ordinary course of business of negotiable instruments for deposit or collection) of any Person guaranteeing, or in effect guaranteeing,

any Indebtedness, dividend or other obligation of any other Person (the "Primary Obligor") in any manner, whether directly or indirectly, including, without limitation, all obligations incurred through an agreement, contingent or otherwise, by such Person: (i) to purchase such Indebtedness or obligation or any property or assets constituting security therefor, (ii) to advance or supply funds (x) for the purchase or payment of such Indebtedness or obligation, (y) to maintain working capital or other balance sheet condition or otherwise to advance or make available funds for the purchase or payment of such Indebtedness or obligation, (iii) to lease property or to purchase

securities or other property or services primarily for the purpose of assuring the owner of such Indebtedness or obligation of the ability of the primary obligor to make payment of such Indebtedness or obligation, or (iv) otherwise to assure the owner of the Indebtedness or obligation of the primary obligor against loss in respect thereof. For the purposes of any computations made under this Agreement, a Guarantee in respect of any Indebtedness for borrowed money shall be deemed to be Indebtedness equal to the principal amount of the Indebtedness for borrowed money which has been guaranteed, and a Guarantee in respect of any other obligation or liability or any dividend shall be deemed to be Indebtedness equal to the maximum aggregate amount of such obligation, liability or dividend.

"Hawley Group" shall mean those Persons listed on Schedule A attached hereto.

"Hawley Trusts" shall mean the Hawley Group other than Philip M. Hawley and Dr. Philip M. Hawley, Jr.

"Indebtedness" shall mean, with respect to any person, (i) all obligations of such person for borrowed money, or with respect to deposits or advances of any kind, (ii) all obligations of such person evidenced by bonds, debentures, notes or similar instruments, (iii) all obligations of such person under conditional sale or other title retention agreements relating to property purchased by such person, (iv) all obligations of such person issued or assumed as the deferred purchase price of property or services (other than accounts payable to suppliers and similar accrued liabilities incurred in the ordinary course of business and paid in a manner consistent with industry practice), (v) all Indebtedness of others secured by (or for which the holder of such Indebtedness has an existing right, contingent or otherwise, to be secured by) any lien or security interest on property owned or acquired by such person whether or not the obligations secured thereby have been assumed, but only to the extent of such security, if such obligations have not been assumed, (vi) all Capitalized Lease Obligations of such person, (vii) all Guarantees of such person, (viii) all obligations (including but not limited to reimbursement obligations) relating to the issuance of letters of credit for the account of such person, (ix) all obligations arising out of foreign exchange contracts, and (x) all obligations arising out of interest rate and currency swap agreements, cap, floor and collar agreements, interest rate insurance, currency spot and

forward contracts and other agreements or arrangements designed to provide protection against fluctuations in interest or currency exchange rates.

"Permal Group" shall mean those Persons listed on Schedule C attached hereto.

"Permitted Transfer" shall mean any Transfer (i) by an individual Stockholder to such Stockholder's spouse, former spouse, child, parent, parent of a spouse, sibling or grandchild (collectively, "Relatives") or to or among a trust of which there are no principal beneficiaries other than one or more Relatives of such Stockholder; (ii) from a Relative of an individual Stockholder to another Relative of that individual Stockholder or to that individual Stockholder; (iii) by any Stockholder to any of its Affiliates or partners; or (iv) by an Individual Stockholder pursuant to laws of descent or survivorship.

"Person" means any individual, corporation, limited liability company, limited or general partnership, joint venture, association, joint-stock company, trust, unincorporated organization or government or any agency or political subdivisions thereof.

"Proportionate Share" means, with respect to each Stockholder, a number of shares of Common Stock which bears the same ratio to the number of shares of Common Stock beneficially owned by such Stockholder on a Fully Diluted basis as the Tag-Along Number bears to the number of shares of Common Stock beneficially owned by the Selling Stockholders on a Fully Diluted basis.

"Registration Rights Agreement" means the Registration Rights Agreement, dated as of the date hereof, between the Company and the stockholders listed on the signature page thereto as it may be amended from time to time.

"Related Party" shall mean any officer, director or beneficial holder of 3% or more of the outstanding shares of capital stock of the Company or any Subsidiary, any Relative of any such officer, director or beneficial holder of the Company or any Subsidiary, and any Affiliate or Associate of any of the foregoing persons.

"Securities Act" shall mean the Securities Act of 1933, as amended, or any successor federal statute, and the rules and regulations of the Commission thereunder, all as the same shall be in effect at the time.

"Sell" as to any Stock, shall mean to sell, or in any other way directly or indirectly transfer (including by operation of law, by merger or consolidation, or sale of securities of a holding company), assign, distribute or otherwise dispose of, such

Stock; and the terms "Sale" and "Sold" shall have meanings correlative to the foregoing. A Permitted Transfer shall not constitute a Sale for purposes of this Agreement.

"Stock" means (i) any shares of Common Stock and (ii) any Common Stock Equivalents (including, without limitation, the Common Stock issuable upon conversion, exercise or exchange thereof), in each case, whether owned on the date hereof or acquired hereafter.

"Stockholder" and "Stockholders" shall mean the stockholders listed on Schedule B hereto; provided that any transferee of Stock pursuant to a Permitted Transfer shall be treated as a Stockholder for purposes of this Agreement and shall be entitled to the benefits of, and shall be bound by, the provisions of this Agreement.

"Stockholder's Group" shall mean, with respect to any Stockholder who is a member of the Hawley Group or the Permal Group, either the Hawley Group or the Permal Group, as the case may be.

"Subsidiary" means with respect to any Person, (i) any corporation, partnership or other entity of which shares of capital stock or other ownership interests having ordinary voting power to elect a majority of the board of directors or other similar managing body of such corporation, partnership or other entity are at the time owned by such Person, or (ii) the management of which is otherwise controlled, directly or indirectly, through one or more intermediaries by such Person.

"Transfer" as to any Stock, means to Sell, or in any other way directly or indirectly transfer, assign, distribute, pledge, encumber or otherwise dispose of, either voluntarily or involuntarily, and whether or not for value.

"Voting Shares" means shares of any class of capital stock of the Company the holders of which are generally entitled to vote in the election of members of the Board.

SECTION 2. CORPORATE GOVERNANCE.

2.1 BOARD OF DIRECTORS.

(a) Members. Subject to the provisions of Section 6.10 of the 1996 Securities Purchase Agreement and Section 4.7 of the 2000 Securities Purchase Agreement, the Board of Directors of the Company (the "Board") shall

consist of nine members, of whom:

(i) one shall be designated by GECC (such person so designated, and any successor thereto, being referred to herein as the "GECC Designee");

(ii) one shall be designated by Permal Group (such person so designated, and any successor thereto, being referred to herein as the "Permal Designee");

(iii) one shall be Hawley, or, in the event of death or incapacity of Hawley, shall be John Hawley, or, if John Hawley is unavailable to serve as director or ceases to serve as director, then an individual nominated by the trustee(s) of the Hawley Trusts, having qualifications similar to those of John Hawley or any other director of the Company shall serve as director under the same terms that would have applied to John Hawley hereunder (the "Hawley Designee").

(iv) an E-commerce and/or business to business expert shall be designated by THLi (the "THLi Internet Designee") and one additional member shall be designated by THLi (the "THLi Fund Designee" and, together with the THLi Internet Designee and any successors to either of them, being referred to herein as the "THLi Designees");

(v) one shall be unanimously designated by GECC and THLi (such person so designated, and any successor thereto, being referred to herein as the "GECC/THLi Designee"); and

(vi) three shall be selected by the vote of the GECC Designee, the Permal Designee, the THLi Fund Designee and the Hawley Designee (such persons so designated, any successors thereto, being referred to herein as the "Joint Designees" and, together with the GECC Designee, the Permal Designee, the Hawley Designee, the THLi Designees and the GECC/THLi Designee, the "Designees").

At each meeting of the stockholders of the Company held for the purpose of electing directors, the Stockholders (other than the Hawley Trusts) shall take such

action as shall be necessary to cause the Designees (or any successor to any such person designated in accordance with paragraph (b) of this Section) to be elected as directors (including, in the case of GECC, Permal Group and THLi, causing their respective designees on the Board to nominate, and recommend to the stockholders of the Company the election of, the Designees to the Board and opposing, and causing their respective designees on the Board to oppose, any proposal to remove any Designee at each meeting of the stockholders of the Company at which the election or removal of members of the Board is on the agenda), and shall take no action which would diminish the prospects of any

Designee being elected to the Board or increase the prospects of any Designee being removed from the Board. The Company shall take all necessary action to reduce the size of the Board to the extent required by the first sentence of this paragraph and shall cause the current members of the Board to resign from office as necessary to implement the provisions of the first sentence of this paragraph.

(b) Vacancies. Each of the GECC Designee, the Permal Designee, the THLi Designees and the GECC/THLi Designee shall hold office until his death, resignation or removal or until his successor shall have been duly elected and qualified. If any GECC Designee shall cease to serve as a director of the Company for any reason, the vacancy resulting thereby shall be filled by another person designated by GECC. If any Permal Designee shall cease to serve as a director of the Company for any reason, the vacancy resulting thereby shall be filled by another person designated by Permal Group. If any of the THLi Designees shall cease to serve as a director of the Company for any reason, the vacancy resulting thereby shall be filled by another person designated by THLi. If any GECC/THLi Designee shall cease to serve as a director of the Company for any reason, the vacancy resulting thereby shall be filled by another person unanimously designated by GECC and THLi. If the Hawley Designee shall cease to serve as a director of the Company for any reason, the vacancy resulting thereby shall be filled by another person unanimously designated by the Hawley Group. In the event that at any time there exist vacancies on the Board such that there is either no GECC Designee, no Permal Designee, no GECC/THLi Designee or less than two THLi Designees, no action may be taken by the Board until such vacancy is filled. GECC, Permal Group, the Hawley Group and THLi agree to use their best efforts to designate successors to fill any such vacancies as promptly as practicable.

(c) Removal. No GECC Designee may be removed from office except by GECC, no Permal Designee may be removed from office except by Permal Group, no THLi Designee may be removed from office except by THLi, no Hawley

Designee may be removed from office except by the Hawley Group; provided that such limitation shall not apply to the removal of Hawley as Chairman so long as Hawley remains a Director, no GECC/THLi Designee may be removed from office except unanimously by GECC and THLi. GECC shall have the right to remove any GECC Designee, Permal Group shall have the right to remove any Permal Designee, THLi shall have the right to remove any THLi Designee, the Hawley Group shall have the right to remove any Hawley Designee and GECC and THLi shall unanimously have the right to remove any GECC/THLi Designee, with or without cause, at any time.

(d) Quorum Requirements. Subject to Section 2.2, the quorum which shall be required for action to be taken by the Board (other than an adjournment of any meeting of the Board) shall be the GECC Designee, the Permal Designee, the THLi Fund Designee and the Hawley Designee. Directors participating by telephone conference in any meeting of the Board shall be considered in

determining whether a quorum of directors is present.

(e) Committees. The Company shall cause the GECC Designee, the Permal Designee and at least one THLi Designee to be appointed to each of the committees of the Board as may be requested at any time or from time to time by GECC, Permal Group or THLi, as the case may be.

(f) Chairman of the Board. Hawley shall serve as Chairman of the Board for as long as he is Chief Executive Officer. GECC, Permal Group and THLi presently intend to continue to nominate Hawley to serve as a director and Chairman of the Board after Hawley retires as Chief Executive Officer, provided that Hawley shall not be obligated to accept such nomination.

(g) Board and Committee Meetings. The Company shall hold regular meetings of its Board on at least a quarterly basis. The Company agrees, and shall cause its By-laws to be amended to the extent necessary to provide, that the GECC Designee, any THLi Designee and the GECC/THLi Designee shall have the right, upon reasonable notice, to call meetings of the Board and of each committee of the Board on which he or she is a member.

(h) Duration. The right of each of GECC, Permal Group and THLi to designate directors pursuant to this Section shall continue only for so long as GECC and its Affiliates, Permal Group, or THLi and its Affiliates, as the case may be, beneficially owns at least 2,000,000 shares of Common Stock on a Fully Diluted

Basis, as adjusted for stock splits, combinations or similar transactions. The right of the Hawley Group to designate directors pursuant to this Section 2.1(h) shall continue only for so long as the Hawley Group beneficially owns at least 1,000,000 shares of Common Stock on a Fully Diluted Basis, as adjusted for stock splits, combinations or similar transactions.

(i) Observation. In addition to THLi's right to designate members of the Board pursuant to Section 2.1(a), so long as THLi is the owner of any Stock, it shall have the right to designate an observer to attend meetings of the Board, but such observer shall not have a vote with respect to any matter presented to the Board of Directors for action thereon. In connection with such observer's right, THLi shall receive all notices and information provided to Board members.

2.2 CERTAIN ACTIONS REQUIRING CONSENT OF THE GECC DESIGNEE AND THE THLI FUND DESIGNEE. Notwithstanding any other provision of this Agreement, without the approval, at a meeting of the Board or a committee thereof duly called and held, (1) for so long as GECC is entitled to designate the GECC Designee, of the GECC Designee and (2) for so long as THLi is entitled to designate the THLi Fund Designee, of the THLi Fund Designee, the Company shall not, directly or indirectly, and shall not permit any of its Subsidiaries to, directly or indirectly, take any of the following actions (except to the extent any such

action is specifically authorized under this Agreement, the Securities Purchase Agreements, the Registration Rights Agreement or an annual business plan previously approved by the GECC Designee and the THLi Fund Designee in accordance with this Section):

(a) merge with or into or consolidate with any other Person;

(b) voluntarily liquidate, dissolve or wind up or file any voluntary petition in bankruptcy or for receivership or make any assignment for the benefit of creditors;

(c) in any transaction or series of transactions, acquire (including pursuant to a merger or consolidation) all or any substantial portion of the business or assets of any Person;

(d) enter or commit to enter into any joint venture or partnership or establish any non-wholly-owned subsidiaries or otherwise make any debt or equity investment in any Person (other than extensions of credit in the ordinary course of business);

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(e) expand into new lines of business (it being understood that "new lines of business" do not include (i) geographic expansion of the retail operations conducted by the Company and its Subsidiaries as of the date of this Agreement and (ii) E-Commerce Activities);

(f) assign to any other Person any rights of the Company under this Agreement, the Registration Rights Agreement or the Securities Purchase Agreements;

(g) in any transaction or series of transactions, sell, lease or exchange any assets of the Company and/or any Subsidiary, except for (i) sales of inventory in the ordinary course of business, (ii) subleasing of vacant retail space on arm's-length terms and (iii) entering into or terminating leases in the ordinary course of business pursuant to a procedure adopted by the Board of Directors and approved by the GECC Designee and the THLi Fund Designee;

(h) adopt or change any material accounting policy of the Company or any of its Subsidiaries, except as required by generally accepted accounting principles;

(i) create, incur, assume or suffer to exist any Indebtedness other than (a) Indebtedness in existence as of the date of this Agreement and interest thereon, reduced to the extent such amounts are repaid or retired, and any refinancing of such Indebtedness, (b) Indebtedness under the Loan and Security Agreement dated as of January 20, 1995 between the Company and Congress Financial Corporation (Western), as amended to the date of this Agreement, including premium (if any), and interest thereon, (c) Indebtedness already approved in accordance with this subsection, reduced to the extent such amounts

are repaid, refinanced or retired, and (d) other Indebtedness not to exceed in the aggregate \$200,000 at any time outstanding;

(j) mortgage, encumber, create, incur or suffer to exist, liens on its assets (other than liens on assets under Indebtedness outstanding as of the date hereof and materialmen's, mechanics' and other similar liens arising for work performed in the ordinary course of business which are not overdue for more than 30 days);

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(k) pay, declare or set aside any sums for the payment of, any dividends, or make any distribution on, any shares of its capital stock or redeem, repurchase or otherwise acquire any outstanding shares of its capital stock or any other of its outstanding securities or Indebtedness (except for Indebtedness (other than indebtedness to any Related Party, excluding indebtedness for expenses incurred in the ordinary course of business on behalf of the Company and its Subsidiaries) to the extent it becomes due in accordance with its terms);

(l) make or commit to make (with respect to the Company and all of its Subsidiaries taken together) during (i) the calendar year ended December 31, 2000, any capital expenditure or capital expenditures in an amount in excess of \$8,000,000 with respect to the Company's retail business and \$100,000 with respect to the Company's E-commerce business and (ii) any other calendar year any capital expenditure or capital expenditures in an amount in excess of \$100,000;

(m) issue or sell any shares of capital stock or rights, options, warrants or other securities exercisable for, exchangeable for or convertible into shares of capital stock of the Company or any of the Company's Subsidiaries, other than upon the exercise of options or warrants outstanding on the date of this Agreement or previously approved in accordance with this Section, or grant, amend or terminate any stock appreciation right or other stock-based award;

(n) enter into, adopt, amend or terminate any employment or consulting agreement, or hire or retain any person who will report directly to the Chief Executive Officer or to whom the Company shall pay total compensation (including, without limitation, compensation in the form of benefits) in excess of \$150,000 per year, or enter into, adopt, amend or terminate any employee benefit plan, policy or arrangement, except as required by law or generally accepted accounting principles; provided that the renewal by the Company in the ordinary course of its business of benefit plans applicable to employees of the Company, generally, shall not require consent pursuant to this subparagraph (n);

(o) amend its Certificate or By-laws, including, without limitation, any change in the number of directors comprising its Board of Directors, or adopt, amend, redeem or terminate any shareholder rights plan or

similar plan or arrangement;

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(p) amend, modify or waive an provision of this Agreement, the Securities Purchase Agreements, the Registration Rights Agreement or the agreements ancillary thereto, or become a party to any agreement which by its terms restricts the Company's or any of its Subsidiaries', or any Stockholder's, performance of the terms of any of such agreements;

(q) change its independent certified accountants or actuaries;

(r) register any securities under the Securities Act or grant any registration rights therefor;

(s) enter into, amend or terminate, or waive any material rights of the Company and its Subsidiaries under, any contract, arrangement or transaction involving consideration in excess of \$100,000 or which is otherwise material to the Company or any of its Subsidiaries;

(t) enter into, amend or terminate any contract, arrangement or transaction with a Related Party, other than (i) any action to terminate the Consumer Credit Card Agreement by and among Krause's Sofa Factory, Castro Convertible Corporation and Monogram Credit Bank of Georgia, dated as of April 27, 1997, and (ii) the payment of salary and benefits pursuant to employment arrangements entered into in the ordinary course of business in compliance with this Agreement;

(u) enter into, adopt, amend (whether by agreement or by conduct of the business), except as required by law or generally accepted accounting principles, or terminate any annual business plan;

(v) take any action required by law to be approved by the Board;
or

(w) agree or otherwise commit to take any of the actions set forth in the foregoing subparagraphs (a) through (v).

2.3 MANAGEMENT.

(a) Chief Executive Officer. Subject to the provisions of this Agreement and the Employment Agreement, Hawley shall be the Chief Executive Officer of the Company. In the event of the death, resignation, removal or other termination of Hawley's services as Chief Executive Officer, any successor Chief Executive Officer (and any successor(s) thereto) shall be selected by a majority of

the Board; provided that no such person shall be selected without the unanimous approval of the GECC Designee and the THLi Fund Designee.

(b) Appointment of Management. Subject to Section 2.2 hereof, all members of management of the Company (other than the Chief Executive Officer) shall be designated by, their compensation shall be determined by, and they may be removed, promoted or demoted by, the Chief Executive Officer of the Company; provided, however, that the designation of, setting of compensation for, or removal, promotion or demotion of, any person who will report directly to the Chief Executive Officer or earn total compensation (including benefits) from the Company and its Subsidiaries of \$150,000 or more per year shall be subject to the prior approval of the Board.

2.4 DIRECTORS' INDEMNIFICATION.

(a) The Company shall obtain and cause to be maintained in effect, with financially sound insurers, a policy of directors' and officers' liability insurance covering the Designees (and their respective successors) in an amount of at least \$15,000,000 or such other amount the Board shall specify (as such amount shall be increased from time to time at the request of GECC or THLi).

(b) The Certificate, By-laws and other organizational documents of the Company and each of its Subsidiaries shall at all times, to the fullest extent permitted by law, provide for indemnification of, advancement of expenses to, and limitation of the personal liability of, the members of the Board and the members of the boards of directors or other similar managing bodies of each of the Company's Subsidiaries and such other persons, if any, who, pursuant to a provision of such Certificates, By-laws or other organizational documents, exercise or perform any of the powers or duties otherwise conferred or imposed upon members of the Board or the boards of directors or other similar managing bodies of each of the Company's Subsidiaries. Such provisions may not be amended, repealed or otherwise modified in any manner adverse to any member of the Board or any member of the boards of directors or other similar managing bodies of any of the Company's Subsidiaries, until at least six years following the termination of this Agreement.

(c) Each of the Designees is intended to be a third-party beneficiary of the obligations of the Company pursuant to this Section 2.4, and the obligations of the Company pursuant to this Section 2.4 shall be enforceable by the Designees.

2.5 EXPENSES. The Company shall pay the reasonable out-of-pocket expenses incurred by each of the GECC designee, the Permal Designee, the THLi Designees, the GECC/THLi Designees and the Joint Designees in connection with performing his or her duties, including without limitation the reasonable out-of-pocket expenses incurred by such person attending meetings of the Board or any committee thereof or meetings of any board of directors or other similar managing body (and any committee thereof) of any subsidiary of the Company.

2.6 COOPERATION. Each Stockholder (other than the Hawley Trusts) shall vote all of its voting shares and shall take all other necessary or desirable actions within its control (including, without limitation, attending all meetings in person or by proxy for purposes of obtaining a quorum, executing all written consents in lieu of meetings and voting to remove members of the Board or to amend the Certificate, as applicable), and the Company shall take all necessary and desirable actions within its control (including, without limitation, calling special Board and stockholder meetings and voting to remove members of the Board or to amend the Certificate, as applicable), to (a) effectuate the provisions of Section 2.1 and (b) cause the Company to have a sufficient number of authorized and unissued shares of Company Stock reserved for issuance solely for the purpose of effecting conversion of outstanding Series A Preferred Stock.

SECTION 3. RESTRICTIONS ON TRANSFERS OF STOCK.

(a) Notwithstanding anything to the contrary contained herein, no Stockholder shall Transfer any Stock, except for Sales in bona fide transactions for value complying with the provisions of this Section 3 and Permitted Transfers. The Company shall not reflect on its books any Sale of Stock, unless (a) the Sale is pursuant to an effective registration statement under the Securities Act and under any applicable state securities or blue sky laws, or (b) the Selling Stockholder shall have furnished the Company with evidence reasonably satisfactory to the Company that no such registration is required because of the availability of an exemption from registration under the Securities Act and under applicable state securities or blue sky laws. A written opinion of counsel of recognized standing to the effect set forth in clause (b) of the preceding sentence shall satisfy the requirements of such clause.

(b) Any Transfer or attempted Transfer of Stock in violation of any provision of this Agreement shall be void, and the Company shall not record such Transfer on its books or treat any purported transferee of such Stock as the owner of such Stock for any purpose.

SECTION 4. RIGHTS OF FIRST OFFER.

(a) If any Stockholder (other than the Hawley Trusts) intends to Sell any Stock (other than (1) Sales pursuant to a registered public offering or (2) Sales on a national securities exchange which, when aggregated with all other Sales under this clause (2) by such Stockholder or, if such Stockholder is

a member of a Stockholder Group, all other Sales under this clause (2) by the members of such Stockholder Group from and after the date of this Agreement, would represent, in the aggregate, not more than 1,000,000 shares of Common Stock on a Fully Diluted Basis, as adjusted for stock splits, combinations or similar transactions):

(i) The Stockholder intending to transfer such Stock (the "Proposing Seller") shall give each other Stockholder (each an "Offeree") written notice of its intent to Sell such Stock, specifying the number of securities to be sold and the minimum price and terms and conditions of such sale and offering to Sell to such Offeree, at such minimum price and on such terms and conditions, its pro rata share of such Stock (based on the number of shares of Common Stock beneficially owned by each Offeree on a Fully Diluted basis); provided that any Offeree may, by written notice to the Proposing Seller, elect to purchase, in addition to its pro rata share of such Stock, all or any portion of the Stock (if any) with respect to which any other Offeree fails to exercise its right of first offer under this Section 4, and such additional Stock shall be pro-rated among such Offerees in the manner described above to the extent such additional Stock is oversubscribed;

(ii) if any Offeree shall not, within 15 days after receipt of the notice given pursuant to clause (i) above, accept such offer in writing with respect to the Stock specified in such notice, then the Proposing Seller shall be free to Sell the Stock specified in the notice to such Offeree (but only those securities covered by the notice of intention to Sell which no other Offeree shall have agreed to purchase) at a price equal to or above the minimum price and on other terms and conditions no less favorable to the Proposing Seller than those specified in such notice, at any time within 90 days of the expiration of such 15-day period;

(iii) if the Proposing Seller shall not have consummated the proposed Sale within 90 days after the expiration of the 15-day period referred to in

clause (ii) above, then the Proposing Seller may not thereafter Sell such Stock without complying with the provisions of this Section 4; and

(iv) if any Offeree shall accept such offer within 15 days after the notice given pursuant to clause (i) above, then such Offeree shall purchase the Stock specified in such notice as promptly as is reasonably practicable, but in any event within 45 days after the notice given pursuant to clause (i) above or such later date as the Proposing Seller may designate within the 90-day period referred to in clause (iii) above.

(b) THLi, GECC and each of the members of the Hawley Group, each in favor of the others, covenants that if any of them (for purposes of this Section, a "Permal Offeree") has the opportunity to purchase any Common Stock ("Offered Shares") owned by any member of the Permal Group, whether by offer to the Permal Offeree from a member of the Permal Group or due to a solicitation by the Permal Offeree, or otherwise, the Permal Offeree shall promptly notify the parties subject to (and entitled to the benefits of) this Section 4(b)(v) of the opportunity and shall allow them the right to participate in such purchase and acquire Offered Shares. The number of Offered Shares that may be purchased by each of them, respectively, shall be (i) as among GECC, THLi and all of the members of the Hawley Group together, in proportion to the number of shares of Common Stock owned by GECC, THLi or the Hawley Group, respectively, as a percentage of the aggregate number of shares of Common Stock then owned by GECC, THLi and all members of the Hawley Group together, and (ii) as among the members of the Hawley Group, in proportion to the number of shares of Common Stock owned by such member as a percentage of the number of shares of Common Stock then owned by all Hawley Group members electing to purchase Common Stock hereunder. The rights in this Section 4(b) are in addition to and subordinate to the other provisions of this Stockholders Agreement. Any failure to exercise the rights in the Section within 15 days of receipt of notice shall be deemed a waiver of such rights.

SECTION 4A. HAWLEY TRUST STOCK RIGHTS OF FIRST OFFER. If any of the Hawley Trusts intends to sell any Stock (other than (1) Sales pursuant to a registered public offering or (2) Sales on a national securities exchange which, when aggregated with all other Sales under this clause (2) by the Hawley Group from and after the date of this Agreement, would represent, in the aggregate, not more than 1,000,000 shares of Common Stock on a Fully Diluted Basis, as adjusted for stock splits, combinations or similar transactions):

(i) the Hawley Trust intending to transfer such Stock (the "Hawley Trust Seller") shall give the Company, GECC, THLi and the Permal Group written notice (the "Hawley Trust Seller Notice") of its intent to Sell such Stock, specifying the number of securities to be sold and the minimum price and terms and conditions of such sale, and offering to Sell to the Company, GECC, THLi and the Permal Group, at such minimum price and on such terms and conditions. The Company shall provide a copy of any Hawley Trust Seller Notice to each Stockholder within two days after receipt by it of the Hawley Trust Seller Notice. The Company shall have the right to purchase all or any part of such Stock by giving written notice to the Hawley Trust Seller, GECC, THLi and the Permal Group within two days after receipt by it of the Hawley Trust Seller Notice, specifying the number of shares of such Stock to be so purchased by the Company. If the Company elects to purchase none of, or less than all, the Stock that is the subject of the proposed Transfer by the Hawley Trust Seller, then GECC, THLi and the Permal Group shall have the right to purchase their pro rata share of any or all of the available

Stock (and, if either elects not to purchase its full pro rata share, the Stock not so purchased) by giving written notice to the Hawley Trust Seller and the Company within seven days after receipt by it of the Hawley Trust Seller Notice (the "Notice Period"); provided that any other Stockholder (each, an "Electing Stockholder") may, by written notice to GECC, THLi and the Permal Group prior to the expiration of the Notice Period elect to purchase its pro rata share of the available Stock, and any such Electing Stockholder may elect to purchase, in addition to its pro rata share of the available Stock, all or any portion of the Stock (if any) with respect to which GECC, THLi, the Permal Group or any other Stockholder fails to exercise its right under this Section 4A, and such additional Stock shall be pro-rated among such Electing Stockholders in the manner described above to the extent such additional Stock is oversubscribed;

(ii) GECC shall act as agent for the Electing Stockholders in connection with any exercise by an Electing Stockholder of its rights under this Section and the Hawley Trust Seller shall not be obligated to deal with any Stockholder other than GECC in connection with any purchase and sale under this Section 4A; provided that GECC shall have no liability to the Hawley Trust Seller if GECC fails to purchase any Stock which GECC disclosed in writing to the Hawley Trust Seller at the time of delivery of GECC's election to purchase was being purchased by GECC solely as agent for one or more

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Electing Stockholders; and GECC shall have no liability to any other Stockholder for any act or omission by GECC under this Section 4A;

(iii) if the Company, GECC, THLi and the Permal Group fail to elect to purchase all the Stock specified in the Hawley Trust Seller Notice, then the Hawley Trust Seller shall be free to sell, pursuant to a Shelf Registration Statement, the portion of such Stock as to which no election to purchase has been made by the Company, GECC, THLi or the Permal Group at a price equal to or above the minimum price and on other terms and conditions no less favorable to the Hawley Trust Seller than those specified in the Hawley Trust Seller Notice, at any time within 90 days of the expiration of the seven-day period referred to in clause (i) above;

(iv) if the Hawley Trust Seller shall not have consummated the proposed Transfer within 90 days after the expiration of the seven-day period referred to in clause (ii) above, then the Hawley Trust Seller may not thereafter Transfer such Stock without complying with the provisions of this Section 4A;

(v) any Electing Stockholder shall provide to GECC all funds required, and shall execute and deliver to GECC all documents reasonably requested by GECC, in connection with the purchase by GECC of any Stock

as agent for such Electing Stockholder, and GECC shall deliver certificates representing the Stock acquire by such Electing Stockholder to such Stockholder promptly following the consummation of any purchase under this Section 4A and the satisfaction by such Electing Stockholder of his obligations under this clause (v).

SECTION 5. TAG-ALONG RIGHTS.

(a) If GECC, any member of Permal Group, or THLi whether acting alone or in concert with any other Stockholder (collectively, the "Selling Stockholders") pursuant to a common plan, understanding or arrangement, shall enter into an agreement to Sell or otherwise propose to Sell to any Person or Group (other than pursuant to a registered public offering) (such Person or Group, the "Tag-along Transferee"), in one transaction or a series of related transactions, any Stock, such that immediately following the consummation of such Sale, the Selling Stockholders would have Sold to such Person or Group in the aggregate Stock representing in excess of 3,000,000 shares of Common Stock on a Fully Diluted Basis, as adjusted

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for stock splits, combinations or similar transactions (a "Tag-along Sale") (such number of shares of Stock being referred to herein as the "Tag-along Number"), then each of the other Stockholders (each a "Tag-along Offeree") shall have the right to participate in such Tag-Along Sale by selling a number of shares of Common Stock equal to such Stockholder's Proportionate Share, as part of the Tag-Along Sale by the Selling Stockholders, on the same terms as those applicable to the Tag-Along Sale (except that, if the Tag-Along Sale involves Common Stock Equivalents, the economic terms of such Sale shall be appropriately adjusted to reflect that the Tag-Along Offerees are selling Common Stock).

(b) The Selling Stockholders shall provide to each Tag-Along Offeree written notice of any Tag-Along Sale (the "Tag-along Notice"), not more than 45 and not less than 15 days prior to the Tag-Along Sale, setting forth the terms of the Tag-Along Sale and specifically identifying the Tag-Along Transferee of the Stock, and shall give each Tag-Along Offeree at least 10 days after delivery of the Tag-Along Notice within which to exercise its rights contained in this Section 5, by written notice thereof to the Selling Stockholder.

SECTION 6. CONFLICTING AGREEMENTS. Each Stockholder represents and warrants that such Stockholder has not granted and is not a party to any proxy, voting trust or other agreement which is inconsistent with or conflicts with any provision of this Agreement, and no holder of Stock shall grant any proxy or become party to any voting trust or other agreement which is inconsistent with or conflicts with any provision of this Agreement.

SECTION 7. LEGEND. (a) Each Stockholder and the Company shall take all such action necessary (including exchanging with the Company certificates representing shares of Stock issued prior to the date hereof) to cause each

certificate representing outstanding shares of Stock (other than shares which have been registered under the Securities Act, to which the first paragraph of such legends shall not apply) to bear legends substantially in the form as follows:

"THE SECURITIES REPRESENTED BY THIS CERTIFICATE HAVE NOT BEEN REGISTERED UNDER THE SECURITIES ACT OF 1933, AS AMENDED (THE "ACT") OR THE SECURITIES LAWS OF ANY STATE AND MAY NOT BE SOLD OR OTHERWISE DISPOSED OF EXCEPT PURSUANT TO AN EFFECTIVE REGISTRATION STATEMENT UNDER SUCH ACT AND APPLICABLE STATE SECURITIES LAWS OR AN APPLICABLE EXEMPTION TO THE REGISTRATION REQUIREMENTS OF SUCH ACT OR SUCH LAWS."

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"THE TRANSFER OF THE SECURITIES REPRESENTED BY THIS CERTIFICATE IS RESTRICTED BY A STOCKHOLDERS AGREEMENT BY AND AMONG KRAUSE'S FURNITURE, INC. (THE "COMPANY") AND THE STOCKHOLDERS PARTIES THERETO (THE "STOCKHOLDERS AGREEMENT"), A COPY OF WHICH IS ON FILE AT THE OFFICES OF THE COMPANY."

"IN ADDITION TO THE RESTRICTIONS SET FORTH IN THE STOCKHOLDERS AGREEMENT, THE SECURITIES REPRESENTED BY THIS CERTIFICATE ARE SUBJECT TO THE RESTRICTIONS SET FORTH IN A SECURITIES PURCHASE AGREEMENT BETWEEN THE COMPANY AND GENERAL ELECTRIC CAPITAL CORPORATION AND A SECURITIES PURCHASE AGREEMENT BY AND AMONG THE COMPANY AND THE PURCHASERS LISTED ON THE SIGNATURE PAGES THERETO, A COPY OF EACH OF WHICH IS ON FILE AT THE OFFICES OF THE COMPANY."

The first paragraph of the legends shall be removed from certificates for shares transferred pursuant to Rule 144 under the Securities Act or when such shares are transferred in any other transaction, in each case if the seller delivers to the Company an opinion of its counsel, which counsel and opinion shall be reasonably satisfactory to the Company, or a "no-action" letter from the staff of the Securities and Exchange Commission, in either case to the effect that such legend is no longer necessary in order to protect the Company against a violation by it of the Securities Act upon any Sale or other disposition of such shares without registration thereunder. The requirement that the above legend regarding this Agreement be placed upon certificates evidencing shares of Stock shall cease and terminate upon the Sale of such shares, other than pursuant to a Permitted Transfer. Upon the consummation of any event requiring the removal of a legend hereunder, the Company, upon the surrender of certificates containing such legend, shall, at its own expense, deliver to the holder of any such shares as to which the requirement for such legend shall have terminated, one or more new certificates evidencing such shares not bearing such legend.

(b) Any provision herein to the contrary notwithstanding, certificates for up to 1,000,000 shares of Common Stock held by the Hawley Trusts shall not be required to bear legends required by this Agreement so long as such shares may sold under Rule 144(k) under the Securities Act or are not "restricted securities" within the meaning of Rule 144 under the Securities Act.

SECTION 8. REPRESENTATIONS AND WARRANTIES.

(a) Each party hereto represents and warrants to the other parties hereto as follows:

(i) it has full power and authority to execute, deliver and perform its obligations under this Agreement;

(ii) this agreement has been duly and validly authorized, executed and delivered by it, and constitutes a valid and binding obligation of it, enforceable against it in accordance with its terms except to the extent that enforceability may be limited by bankruptcy, insolvency or other similar laws affecting creditors' rights generally;

(iii) the execution, delivery and performance of this Agreement by it does not (x) violate, conflict with, or constitute a breach of or default under its organizational documents, if any, or any agreement to which it is a party or by which it is bound or (y) violate any law, regulation, order, writ, judgment, injunction or decree applicable to it;

(iv) no consent or approval of, or filing with, any governmental or regulatory body is required to be obtained or made by it in connection with the transactions contemplated hereby; and

(v) it is not a party to any agreement which is inconsistent with the rights of any party hereunder or otherwise conflicts with the provisions hereof.

(b) each Signatory Stockholder severally represents and warrants to GECC and THLi with respect only to GECC and THLi and not any other Stockholder as follows:

(i) Schedule B hereto sets forth a list of all securities of the Company (including, without limitation, shares of capital stock, convertible securities, debentures, etc.) held of record or beneficially owned by it immediately after the date hereof; and

(ii) except as set forth on Schedule B hereto and other than this

Agreement and the Registration Rights Agreement, it is not a party to any contract or agreement, written or oral, with respect to the voting or transfer of securities of the Company (including, without limitation, any voting agreement, voting trust, stockholder's agreement, registration rights agreement, etc.).

SECTION 9. DURATION OF AGREEMENT. Subject to the last sentence of this Section, the rights and obligations of a Stockholder under this Agreement shall terminate at such time as such Stockholder no longer is the beneficial owner of any shares of Stock. As to any of GECC's rights or obligations under this Agreement, this Agreement shall terminate at such time as GECC no longer is the beneficial owner of 2,000,000 or more of the outstanding shares of Common Stock on a Fully Diluted Basis, subject to adjustment for stock splits, combinations or similar transactions, or at such earlier time as may be agreed by GECC, Permal Group and THLi (or, if applicable, THLi's transferee pursuant to Section 14(ii)).

As to any of THLi's rights or obligations under this Agreement, this Agreement shall terminate at such time as THLi (and any transferee's assigned rights under this Agreement pursuant to Section 14) no longer beneficially owns 2,000,000 or more of the outstanding shares of Common Stock on a Fully Diluted Basis, subject to adjustment for stock splits, combinations or similar transactions, or at such earlier time as may be agreed by GECC, Permal Group and THLi (or such transferee, if applicable).

This Agreement (other than Section 4A), shall terminate as to any member of the Hawley Group six months after Hawley ceases to be a Director of the Company.

Any provision herein to the contrary notwithstanding, the provisions of Sections 3, 4, 4A, 5 and 7 of this Agreement shall not be applicable to any shares of Stock first acquired by any member of the Hawley Group after August 26, 1996 or by any member of the Permal Group, GECC or THLi after the date hereof.

SECTION 10. FURTHER ASSURANCES. At any time or from time to time after the date hereof, the parties agree to cooperate with each other, and at the request of any other party, to execute and deliver any further instruments or documents and to take all such further action as the other party may reasonably request in order to evidence or effectuate the consummation of the transactions contemplated hereby and to otherwise carry out the intent of the parties hereunder.

SECTION 11. AMENDMENT AND WAIVER. Except as otherwise provided herein, no modification, amendment or waiver of any provision of this Agreement shall be effective against the Company or any Stockholder unless such modification, amendment or waiver is approved in writing by the Company, Stockholders holding at least a majority of the Common Stock, and, so long as it holds any shares of Stock, by GECC or THLi. The failure of any party to enforce any of the

provisions of this Agreement shall in no way be construed as a waiver of such provisions and shall not affect the right of such party thereafter to enforce each and every provision of this Agreement in accordance with its terms.

SECTION 12. SEVERABILITY. Whenever possible, each provision of this Agreement shall be interpreted in such manner as to be effective and valid under applicable law, but if any provision of this Agreement is held to be invalid, illegal or unenforceable in any respect under any applicable law or rule in any jurisdiction, such invalidity, illegality or unenforceability shall not affect any other provision or any other jurisdiction, but this Agreement shall be reformed, construed and enforced in such jurisdiction as if such invalid, illegal or unenforceable provision had never been contained herein.

SECTION 13. ENTIRE AGREEMENT. Except as otherwise expressly set forth herein, this document and the other documents dated the date hereof executed in connection herewith embody the complete agreement and understanding among the parties hereto with respect to the subject matter hereof and supersedes and preempts any prior understandings, agreements or representations by or among the parties, written or oral, which may have related to the subject matter hereof in any way.

SECTION 14. SUCCESSORS AND ASSIGNS. Except as otherwise provided herein, this Agreement shall bind and inure to the benefit of and be enforceable by the Company and its successors and assigns and each Stockholder and their respective successors, assigns, heirs and personal representatives, so long as they hold Stock. No Stockholder shall have the right to assign its rights and obligations under this Agreement, except pursuant to (i) a Permitted Transfer or (ii) a transfer by THLi of more than 50% of the Stock (calculated as if all shares of Series A Preferred Stock had been converted into shares of Common Stock as of the date of such calculation) held by THLi as of the date of this Agreement (in which case the transferee shall be entitled to exercise all rights, and shall be bound by all obligations, of its transferor under this Agreement).

SECTION 15. COUNTERPARTS. This Agreement may be executed in separate counterparts each of which shall be an original and all of which taken together shall constitute one and the same agreement.

SECTION 16. REMEDIES. Each Stockholder shall be entitled to enforce its rights under this Agreement specifically to recover damages by reason of any breach of any provision of this Agreement and to exercise all other rights existing in their favor. The parties hereto agree and acknowledge that money damages may not be an adequate remedy for any breach of the provisions of this Agreement and that each party may in its sole discretion apply to any court of law or equity of competent jurisdiction for specific performance and/or injunctive relief (without posting a bond or other security) in order to enforce or prevent any violation of the provisions of this Agreement.

SECTION 17. NOTICES AND OTHER COMMUNICATIONS. All notices, consents, requests, instructions, approvals, financial statements, proxy statements, reports and other communications provided for herein shall be in writing and shall be delivered personally, by facsimile or sent by prepaid overnight courier service, to the Company and to each Stockholder as set forth below and to any subsequent holder of Stock subject to this Agreement at such address as indicated by the Company's records, or at such address or to the attention of such other person as the recipient party has specified by written notice to the sending party:

The Company:

Krause's Furniture, Inc.
200 North Berry Street
Brea, CA 92821-3903
Facsimile #: (714) 990-3561
Attention: Philip M. Hawley

with copies to:

Krause's Furniture, Inc.
200 North Berry Street
Brea, CA 92821-3903
Facsimile #: (714) 990-3561
Attention: Judith O. Lasker, Esq.

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and

Morrison & Foerster LLP
555 West 5th Street, Suite 3500
Los Angeles, CA 90013-1024
Facsimile #: (213) 892-5454
Attention: Charles Kaufman, Esq.

To each Stockholder:

At the address for such Stockholder set forth on Schedule
B attached hereto.

with a copy to:

Fried, Frank, Harris, Shriver & Jacobson
One New York Plaza
New York, New York 10004
Facsimile #: (212) 859-4000
Attention: Warren de Wied, Esq.

and

Stroock & Stroock & Lavan LLP
7 Hanover Square
New York, New York 10004
Facsimile #: (212) 806-6006
Attention: David Kaufman, Esq.

and

Skadden, Arps, Slate, Meagher & Flom LLP
300 South Grand Avenue
Suite 3400
Los Angeles, California 90071
Facsimile #: (213) 687-5600
Attention: Michael A. Woronoff, Esq.

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SECTION 18. GOVERNING LAW; CONSENT TO JURISDICTION. This Agreement shall be governed by and construed in accordance with the laws of the State of New York, including, without limitation, Sections 5-1401 and 5-1402 of the New York General Obligations Law and New York Civil Practice Laws and Rules 327(b). Each of the parties hereto hereby irrevocably and unconditionally consents to submit to the exclusive jurisdiction of the courts of the State of New York and of the United States of America, in each case located in the County of New York, for any action, proceeding or investigation in any court or before any governmental authority ("litigation") arising out of or relating to this Agreement and the transactions contemplated hereby (and agrees not to commence any litigation relating thereto except in such courts), and further agrees that service of any process, summons, notice or document by U.S. Registered Mail to its respective address set forth in this Agreement shall be effective service of process for any litigation brought against it in any such court. Each of the parties hereto hereby irrevocably and unconditionally waives any objection to the laying of venue of any litigation arising out of this Agreement or the transactions contemplated hereby in the courts of the State of New York or the United States of America, in each case located in the County of New York, and hereby further irrevocably and unconditionally waives and agrees not to plead or claim in any such court that any such litigation brought in any such court has been brought in an inconvenient forum. Each of the parties irrevocably and unconditionally waives, to the fullest extent permitted by applicable law, any and all rights to trial by jury in connection with any litigation arising out of or relating to this Agreement or the transactions contemplated hereby.

SECTION 19. DESCRIPTIVE HEADINGS. The descriptive headings of this Agreement are inserted for convenience only and do not constitute a part of this Agreement.

SECTION 20. CONSTRUCTION. Where specific language is used to clarify by example a general statement contained herein, such specific language shall not be deemed to modify, limit or restrict in any manner the construction of the general statement to which it relates. The language used in this Agreement shall be deemed to be the language chosen by the parties hereto to express their mutual intent, and no rule of strict construction shall be applied against any party.

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IN WITNESS WHEREOF, the parties hereto have executed this Stockholders Agreement on the day and year first above written.

KRAUSE'S FURNITURE, INC.

By:

Name: Robert A. Burton
Title: Executive Vice President/CFO

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GE CAPITAL EQUITY INVESTMENTS, INC.

By:

Name: George L. Hashbarger, Jr.
Title: Senior Vice President

GENERAL ELECTRIC CAPITAL CORPORATION

By:

Name: George L. Hashbarger, Jr.
Title: Department Operations Manager

PERMAL CAPITAL MANAGEMENT, INC.

By: _____
Name:
Title:

PERMAL SERVICES, INC.

By: _____
Name:
Title:

PERMAL CAPITAL PARTNERS, L.P.

By: PERMAL MANAGEMENT CORPORATION,
its Investment Manager

By: _____
Name:
Title:

PERMAL ASSET MANAGEMENT

By: _____
Name:
Title:

PERMAL SPECIAL OPPORTUNITIES, LTD.

By: _____
Name:

Title:
JAPAN OMNIBUS LTD.

By: _____
Name:

Title:

JEAN R. PERRETTE

By: _____

ISAAC ROBERT SOUEDE

By: _____

THOMAS M. DELITTO

By: _____

THOMAS M. AND DONNA S. DELITTO

By: _____
Name: Thomas M. DeLitto

By: _____
Name: Donna S. DeLitto

UNITED GULF BANK (B.S.C.) E.C.

By: _____
Name:
Title:

KUWAIT INVESTMENT PROJECTS COMPANY

By: _____
Name:
Title:

ATCO HOLDINGS, LTD.

By: _____

Name:

Title:

ATCO DEVELOPMENT, INC.

By: _____

Name:

Title:

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PILOT HOLDINGS, L.P.

By: SHED INVESTMENTS, LLC,
its General Partner

By: _____

Name: Thomas M. DeLitto

Title: Managing Member

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ALLISON BOOTH HAWLEY TRUST I

By: _____

Name:

Title:

CAITLIN HALE HAWLEY TRUST I

By: _____

Name:

Title:

MAUREEN ERIN HAWLEY TRUST I

By: _____

Name:

Title:

SHANNON FOLLEN HAWLEY TRUST I

By: _____
Name:
Title:

HAWLEY FAMILY TRUST

By: _____
Name:
Title:

39

DR. PHILIP M. HAWLEY, JR.

By: _____

PHILIP M. HAWLEY

By: _____

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TH LEE.PUTNAM INTERNET PARTNERS, L.P.

By: TH LEE.PUTNAM INTERNET FUND
ADVISORS, L.P., its General Partner

By: TH LEE.PUTNAM INTERNET FUND
ADVISORS, LLC, its General Partner

By: _____
Name: Christine Kim
Title: Vice President

TH LEE.PUTNAM INTERNET PARALLEL

PARTNERS, L.P.

By: TH LEE.PUTNAM INTERNET FUND
ADVISORS, L.P., its General Partner

By: TH LEE.PUTNAM INTERNET FUND
ADVISORS, LLC,
its General Partner

By: _____
Name: Christine Kim
Title: Vice President

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ASCEND PARTNERS, L.P.

By: _____
Name:
Title:

LARRY BLACK

By: _____

BRANAGH REVOCABLE TRUST

By: _____
Name: Peter W. Branagh
Title: Trustee

By: _____
Name: Ramona Y. Branagh
Title: Trustee

MATTHEW WILLIAM CLARKE - IRA

By: _____
Name:
Title:

SANFORD J. COLEN

By: _____

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AARON J. COLEN, UTMA, CA

By: _____

Name: Sanford J. Colen

Title: Custodian

ELYSE L. COLEN, UTMA, CA

By: _____

Name: Sanford J. Colen

Title: Custodian

SARA K. COX

By: _____

JOHN DAVIES

By: _____

DIAMOND A. PARTNERS, L.P.

By: _____

Name:

Title:

J. STEVEN EMERSON

By: _____

EMILY FAIRBAIRN - IRA

By: _____

Name:

Title:

MALCOLM FAIRBAIRN - IRA

By: _____

Name:

Title:

WILLIAM T. AND KATHLEEN P. GIBSON

By: _____

Name: William T. Gibson

By: _____

Name: Kathleen P. Gibson

JONATHAN & NANCY GLASER
FAMILY TRUST

By: _____

Name: Jonathan M. Glaser

Title: Trustee

By: _____

Name: Nancy Ellen Glaser

Title: Trustee

EDWARD M. HAWLEY

By: _____

GEORGE P. HAWLEY

By: _____

VICTOR F. HAWLEY

By: _____

RICHARD HICKS

By: _____

KATHRYN JERGENS TRUST

By: _____

Name:

Title:

DIANE JOHNSON

By: _____

RICHARD M. KELLER

By: _____

STEPHEN M. KELLER

By: _____

STEPHEN F. KELLER PROFESSIONAL
CORPORATION DEFINED BENEFIT

PLAN

By: _____
Name:
Title:

PAUL KESSLER

By: _____

SIDNEY KIMMEL

By: _____

THEODORE D. KONOPISOS

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By: _____

PETER LAMM

By: _____

ROBERT LONDON

By: _____

JEFFREY S. MORGAN

By: _____

THE MUHL FAMILY TRUST

By: _____
Name: Phillip E. Muhl
Title: Trustee

By: _____
Name: Kristin A. Muhl
Title: Trustee

PACIFIC SECURITY GROUP, INC.

By: _____

By: _____
Name:
Title:

POINTE INVESTMENTS CAPITAL, LTD.

By: _____
Name:
Title:

POLLAT, EVANS & CO., INC.

By: _____
Name:
Title:

KEVIN AND ERIN PRZYBOCKI

By: _____
Name: Kevin Przybocki

By: _____
Name: Erin Przybocki

CHARLES B. RUNNELS, JR.

By: _____

By: _____

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G. TYLER RUNNELS.

By: _____

LORD ROBIN RUSSELL

By: _____

TIMOTHY MICHAEL WALLACE

By: _____

WAVE ENTERPRISES, INC.

By: _____

Name:

Title:

IRA WEINGARTEN

By: _____

J.D. YATES

By: _____

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By: _____
 Name:
 Title:

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SCHEDULE A

HAWLEY GROUP CONSISTS OF:

Allison Booth Hawley Trust I
 Caitlin Hale Hawley Trust I
 Maureen Erin Hawley Trust I
 Shannon Follen Hawley Trust I
 Hawley Family Trust
 Dr. Philip M. Hawley, Jr.
 Philip M. Hawley

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SCHEDULE B

STOCKHOLDER INFORMATION

<TABLE>
 <CAPTION>

	SHARES OF SERIES A CONVERTIBLE PREF. STOCK PURCHASED -----	SHARES OF COMMON STOCK OWNED -----
<S>	<C>	<C>
Th Lee.Putnam Internet Partners, L.P. 200 Madison Avenue, Suite 2225 New York, New York 10016 Facsimile #: (212) 951-8655 Attention: Christine Kim	134,000	0
Th Lee.Putnam Internet Partners, L.P. 200 Madison Avenue, Suite 2225 New York, New York 10016 Facsimile #: (212) 951-8655	126,000	0

Attention: Christine Kim

GE Capital Equity Investments, Inc. 260 Long Ridge Road Stamford, Connecticut 06927	20,000	7,400,000 (1)
ATCO Holdings, Ltd c/o ATCO Development Inc. 1177 Katy Freeway, Suite 175 Houston, TX 77079-1772	0	832,322 (2)
Isaac Robert Souede 30 Dupont Avenue White Plains, NY 10605-3536	0	523,798 (2)
Jean R. Perrette 14 E. 90th Street, #9A New York, NY 10128-0671	0	655,854 (2)
ATCO Development, Inc. 1177 Katy Freeway, Suite 175N Houston, TX 77079-1772	5,000	253,167 (2)

</TABLE>

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<TABLE>
<CAPTION>

	SHARES OF SERIES A CONVERTIBLE PREF. STOCK PURCHASED -----	SHARES OF COMMON STOCK OWNED -----
<S> Permal Noscals, Ltd. c/o Apex Capital LLC Pine Grove 4 Orinda Way, Suite 240-B Orinda, CA 94563-2584	<C> 0	<C> 405,000 (2)
Fairmont Services Ltd. Attn: John Watts P.O. Box N3918 Nassau Bahamas	0	429,009 (2)
Ascend Partners, L.P. One Valley High Lafayette, California 94549 Attention: Malcolm Fairbairn, c/o Emily Wang	6,500	0 (2)

Emmanuel Bagdjian P.O. Box 644 1211 Geneva 4 Switzerland		75,000 (2)
Bank Insinger De Beaufort 11777 San Vicente Blvd, Suite 702 Los Angeles, California 90049 Attention: Diana Deryez	3,750	0 (2)
Larry Black c/o Black and Company One SW Columbia Street Portland, Oregon 97258	1,000	0 (2)
Branagh Revocable Trust Apex Capital, LLC Pine Grove 4 Orinda Way, Suite 240-B Orinda, California 94563 Attention: Sanford J. Colen	300	6,710 (2)

</TABLE>

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<TABLE>
<CAPTION>

	SHARES OF SERIES A CONVERTIBLE PREF. STOCK PURCHASED -----	SHARES OF COMMON STOCK OWNED -----
<S>	<C>	<C>
Carlton Securities NV Attn: John Watts P.O. Box N3918 Nassau Bahamas		108,822 (2)
Matthew William Clarke 314 Edgar Gooch Road Hazel Green, AL 35750	2,000	0 (2)
Sanford J. Colen Apex Capital, LLC Pine Grove 4 Orinda Way, Suite 240-B Orinda, California 94563 Attention: Sanford J. Colen	900	20,000 (2)
Aaron J. Colen, UTMA, CA	250	0 (2)

Apex Capital, LLC
Pine Grove
4 Orinda Way, Suite 240-B
Orinda, California 94563
Attention: Sanford J. Colen

Elyse L. Colen, UTMA, CA Apex Capital, LLC Pine Grove 4 Orinda Way, Suite 240-B Orinda, California 94563 Attention: Sanford J. Colen	250	0 (2)
---	-----	-------

Sarah K. Cox 101 South Las Palmas Avenue Los Angeles, CA 90004	500	0 (2)
--	-----	-------

John Davies c/o Tyler Runnels 1999 Avenue of the Stars, Suite 2530 Los Angeles, California 90067	1,250	0 (2)
--	-------	-------

</TABLE>

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<TABLE>
<CAPTION>

	SHARES OF SERIES A CONVERTIBLE PREF. STOCK PURCHASED -----	SHARES OF COMMON STOCK OWNED -----
<S>	<C>	<C>
Thomas M. DeLitto 38 Edinburg Lane Trumbull, CT 06611-1065		25,528 (2)

Diamond A. Partners, L.P. Lawndale Capital Management, L.L.C. One Sansome Street, Suite 3900 San Francisco, California 94104 Facsimile #: 415-288-2323 Attention: Andrew E. Shapiro	2,625	0 (2)
---	-------	-------

J. Steven Emerson, Roth I.R.A. Bear Stearns Custodian Emerson Investment Group 10506 Ilona Avenue, Suite 1410 Los Angeles, California 90064 Attention: J. Steven Emerson	6,250	0 (2)
---	-------	-------

Emily Fairbairn - IRA One Valley High Lafayette, California 94549 Attention: Emily Wang	4,500	0 (2)
Malcolm Fairbairn - IRA One Valley High Lafayette, California 94549 Attention: Emily Wang	1,500	0 (2)
William T. And Kathleen P. Gibson 109 La Plata Santa Barbara, California 93109	500	0 (2)
Jonathan & Nancy Glaser Family Trust 1999 Avenue of the Stars, Suite 2530 Los Angeles, California 90067	2,000	0 (2)
Edward M. Hawley 129 North Van Ness Los Angeles, California 90004	200	0 (2)

</TABLE>

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<TABLE>
<CAPTION>

	SHARES OF SERIES A CONVERTIBLE PREF. STOCK PURCHASED -----	SHARES OF COMMON STOCK OWNED -----
<S>	<C>	<C>
George P. Hawley 116 North Citrus Avenue Los Angeles, California 90036 Facsimile #: (323) 939-9555	200	0 (2)
Allison Booth Hawley Trust I 238 South Lorraine Los Angeles, California 90004 Attention: John F. Hawley	2,500	112,500
Caitlin Hale Hawley Trust I 238 South Lorraine Los Angeles, California 90004 Attention: John F. Hawley	2,500	112,500
Hawley Family Trust	2,500	500,000

238 South Lorraine
 Los Angeles, California 90004
 Attention: John F. Hawley

Maureen Erin Hawley Trust I 238 South Lorraine Los Angeles, California 90004 Attention: John F. Hawley	2,500	112,500
Shannon Follen Hawley Trust I 238 South Lorraine Los Angeles, California 90004 Attention: John F. Hawley	2,500	112,500
Dr. Philip Hawley, Jr. 165 South Las Palmas Los Angeles, California 90004-1085	1,250	20,000 (2)
Victor F. Hawley 122 South Plymouth Boulevard Los Angeles, California 90005 Facsimile #: (323) 931-2052	200	0 (2)
Richard Hicks 21 Tanfield Road Tiburon, California 94920	6,000	0 (2)

</TABLE>

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<TABLE>
 <CAPTION>

	SHARES OF SERIES A CONVERTIBLE PREF. STOCK PURCHASED -----	SHARES OF COMMON STOCK OWNED -----
<S>	<C>	<C>
Ian Jack 630 South Lucerne Los Angeles, CA 90005	2,000	0 (2)
Kathryn Jergens Trust 1999 Avenue of the Stars, Suite 2530 Los Angeles, California 90067 Facsimile #: (310) 201-2712 Attention: Kathryn Jergens	250	0 (2)
Diane Johnson 9901 Manassas Place Tucson, Arizona 85748	200	0 (2)

Richard M. Keller 101 South Las Palmas Avenue Los Angeles, California 90004	500	0 (2)
Stephen M. Keller 30 East 81st Street, Apt. 7E New York, New York 10028 Attention: Elizabeth Hughes	500	0 (2)
Stephen F. Keller Professional Corporation Defined Benefit Plan 101 South Las Palmas Avenue Los Angeles, California 90004 Attention: Stephen F. Keller	1,500	0 (2)
Sidney Kimmel Apex Capital, LLC Pine Grove 4 Orinda Way, Suite 240-B Orinda, California 94563 Attention: Sanford J. Colen	125	55,130 (2)
Konopisos Family Trust Dated 12/15/80 17291 Irvine Boulevard, Suite 254 Tustin, California 92780 Attention: Elizabeth Hughes	1,250	0 (2)

</TABLE>

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<TABLE>
<CAPTION>

	SHARES OF SERIES A CONVERTIBLE PREF. STOCK PURCHASED	SHARES OF COMMON STOCK OWNED
	-----	-----
<S>	<C>	<C>
Peter Lamm 1655 El Camino Real Palo Alto, California 94306	2,000	0 (2)
Robert London Cruttenden Roth 809 Presidio Avenue, Suite B Santa Barbara, California 93101 Attention: Robert London	6,000	0 (2)
Jeffrey S. Morgan 27 Horseshoe Lane Rolling Hills Estates, CA 90274	200	0 (2)

Facsimile #: (310) 516-2310
Attention: Jeffrey S. Morgan

Jeffrey S. Morgan BSSC Master Defined Contribution Pension Plan Bear Stearns Corp. Custodian One Metrotech Center North Brooklyn, New York 11201 Facsimile #: (310) 516-2310 Attention: Jeffrey S. Morgan	425	0 (2)
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The Muhl Family Trust 500 South Buena Vista Burbank, California 91521-0312 Attention: Phillip E. Muhl or Kristen A. Muhl	625	0 (2)
--	-----	-------

Pacific Security Group, Inc. 2224 Walsh Tarlton, Suite 200 Austin, Texas 78746	500	0 (2)
--	-----	-------

Permal U. S. Opportunities, Ltd. Apex Capital, LLC Pine Grove 4 Orinda Way, Suite 240-B Orinda, California 94563 Attention: Sanford J. Cole	1,000	0 (2)
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</TABLE>

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<TABLE>
<CAPTION>

	SHARES OF SERIES A CONVERTIBLE PREF. STOCK PURCHASED	SHARES OF COMMON STOCK OWNED
	-----	-----
<S>	<C>	<C>
Pilot Holdings, L.P. 177 Post Road West Westport, Connecticut 96880 Facsimile: (203) 222-7187 Attention; Thomas M. DeLitto	5,000	0 (2)
Pointe Investments Capital, Ltd. 638 North Faring Los Angeles, California 90077 Attention: Mohamed Hadid	2,000	0 (2)
Pollat, Evans & Co., Inc. Apex Capital, LLC	175	17,737 (2)

Pine Grove
 4 Orinda Way, Suite 240-B
 Orinda, California 94563
 Attention: Sanford J. Cole

Kevin and Erin Przybocki 1104 Vancouver Avenue Burlingame, California 94010	200	0 (2)
---	-----	-------

Quadra Appreciation Fund Inc. c/o Apex Capital LLC Pine Grove 4 Orinda Way, Suite 240-B Orinda, CA 94563-2584		5,000 (2)
---	--	-----------

Charles B. Runnels, Jr. 2029 Avenue of the Stars, Suite 2530 Los Angeles, California 90067 Attention: Tyler Runnels	625	0 (2)
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Charles B. Runnels, III 10095 East Charter Oak Scottsdale, Arizona 85260	625	0 (2)
--	-----	-------

G. Tyler Runnels 1999 Avenue of the Stars, Suite 2530 Los Angeles, California 90067 Facsimile: (310) 201-2712	5,600	0 (2)
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</TABLE>

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<TABLE>
 <CAPTION>

	SHARES OF SERIES A CONVERTIBLE PREF. STOCK PURCHASED -----	SHARES OF COMMON STOCK OWNED -----
<S>	<C>	<C>
Lord Robin Russell Park House Woburn Park Woburn Milton Keynes MK17 9PQ England	250	0 (2)
Timothy Michael Wallace 116 South McCadden Place Los Angeles, California 90004	2,500	0 (2)

Attention: Tyler Runnels

United Gulf Bank (B.S.C.) E.C. P.O. Box 5964 Manama Bahrain		201,098 (2)
Wave Enterprises, Inc. 24255 Pacific Coast Highway Malibu, California 90263-4458 Attention: Mike E. O'Neal	250	0 (2)
Ira Weingarten Equity Communications 1512 Grand Avenue, Suite 200 Santa Barbara, California 93103 Attention: Ira Weingarten	625	0 (2)
David Weinstein 5523 Asphon Court Boca Raton, Florida 33486 Facsimile #: (561) 988-7913	400	0 (2)
J. D. Yates 1235 Lane 30-1/4 Pueblo, Colorado 81006	250	0 (2)

</TABLE>

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Zaxis Partners, L.P. c/o Apex Capital, LLC Pine Grove 4 Orinda Way, Suite 240-B Orinda, California 94563		210,000 (2)
--	--	-------------

- (1) Indicates shares beneficially owned within the meaning of Rule 13D under the Securities Exchange Act of 1934.
- (2) Based on Shareholder List prepared by Equiserve Shareholder Services.

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SCHEDULE C

PERMAL GROUP CONSISTS OF:

Permal Capital Management, Inc.
Permal Services, Inc.
Permal Capital Partners, L.P.
Permal Asset Management
Permal Special Opportunities, Ltd.
Japan Omnibus Ltd.
Jean R. Perrette
Isaac Robert Souede
Thomas M. DeLitto
Thomas M. & Donna S. DeLitto
United Gulf Bank (B.S.C.) E.C.
Kuwait Investment Projects
ATCO Holdings Ltd.
ATCO Development, Inc.

C-1

FIRST AMENDMENT TO AMENDED
AND RESTATED SUBORDINATION AGREEMENT

THIS FIRST AMENDMENT TO AMENDED AND RESTATED SUBORDINATION AGREEMENT (this "Amendment"), dated as of December 15, 1999, is entered into by and between CONGRESS FINANCIAL CORPORATION (WESTERN), a California corporation ("Senior Lender"), and KRAUSE'S FURNITURE, INC., a Delaware corporation ("Subordinating Lender").

RECITALS

A. Subordinating Lender and Senior Lender have previously entered into that certain Amended and Restated Subordination Agreement dated as of August 26, 1996 (the "Subordination Agreement"). Terms used herein without definition shall have the meanings ascribed to them in the Subordination Agreement.

B. Subordinating Lender and Borrower have informed Senior Lender that they intend to amend, restate and replace all existing Junior Debt Documents with a new promissory note. In accordance with the terms of the Subordination Agreement, Subordinating Lender and Borrower hereby requests that Senior Lender (i) consent to the issuance of such new promissory note to replace the existing Junior Debt Documents and (ii) amend the Subordination Agreement to reflect certain terms of such new promissory note.

C. Senior Lender is willing to agree to give such consent and make such amendments to the Subordination Agreement under the terms and conditions set forth in this Amendment. Subordinating Lender is entering into this Amendment with the understanding and agreement that none of Senior Lender's rights or remedies as set forth in the Subordination Agreement is being waived or modified by the terms of this Amendment.

NOW, THEREFORE, in consideration of the foregoing and the mutual covenants herein contained, and for other good and valuable consideration, the receipt and sufficiency of which are hereby acknowledged, the parties hereby agree as follows:

1. Amendments to Subordination Agreement.

(a) The definition of "Junior Debt" set forth in Section 1 of the Subordination Agreement is hereby amended and restated in its entirety to read as follows:

"'Junior Debt' means all present and future indebtedness and other obligations (direct and indirect) owing by Borrower to Subordinating Lender including, but not limited to, indebtedness owed under the Junior Debt Documents."

(b) The definition of "Junior Debt Documents" set forth in Section 1 of the Subordination Agreement is hereby amended and restated in its entirety to read as follows:

"`Junior Debt Documents' means all instruments and agreements evidencing the Junior Debt, including, but not limited to, that certain Subordinated Promissory Note, dated December 15, 1999 in the original principal amount of Forty One Million One Hundred Forty One Thousand Eight Hundred Thirty Five Dollars (\$41,141,835) executed by Borrower to the order of Subordinating Lender, a copy of which is attached hereto as Exhibit A and incorporated herein by this reference."

(c) Section 3(b) of the Subordination Agreement (entitled "Payments to Subordinating Lender") is hereby amended and restated in its entirety to read as follows:

"b. Payments to Subordinating Lender. If no default or event of default by Borrower under any present or future instrument or agreement (including the Senior Loan Agreement) between Borrower and Senior Lender shall have occurred, Borrower may make the following payments against the Junior Debt:

(i) quarterly payments of interest at a rate per annum equal to one percent (1.0%) in excess of the rate announced publicly from time to time by Bank of America National Trust and Savings Association at its San Francisco executive offices as its "prime rate", but in any event not to exceed a maximum rate of ten percent (10%) per annum; and

(ii) semi-annual payments of principal, in an amount not to exceed fifty percent (50%) of Excess Cash Flow for the applicable semi-annual period, if any (for the purposes of this Section 3(b)(ii), `Excess Cash Flow' shall mean, for any applicable semi-annual period, net income after taxes of Borrower, exclusive of extraordinary gains, plus depreciation and any other non-cash items to the extent deducted from the revenues of Borrower in the calculation of net income or loss, and less any capital expenditures that are actually made and not financed during such period); provided however, that (A) principal payments shall not be permitted, unless, notwithstanding the availability of Excess Cash Flow, after giving effect to such principal payment, Borrower has a minimum of One Million Dollars (\$1,000,000) of Excess Availability (as defined under the Senior Loan Agreement) as of the last day of the applicable semi-annual period and (B) Borrower shall only be permitted to pay the semi-annual principal payments upon receipt and review by Lender of Borrower's financial statements for the semi-annual period to which the requested payment relates, which financial statements shall be prepared in accordance with GAAP consistently applied subject to normal year-end audit adjustments and shall show sufficient Excess Cash Flow to permit the principal payment and the required minimum Excess Availability;

provided further however, that after giving effect to any such payment to Subordinating Lender, no default or event of default by Borrower under any present or future instrument or agreement

(including the Senior Loan Agreement between Borrower and Senior Lender) shall have occurred and prior to such payment, Borrower and Subordinating Lender shall have provided notice to Senior Lender of such intended payment or any demand for such payment. Except as provided in this Agreement, Borrower and Subordinating Lender agree and (Subordinating Lender acknowledges such agreement) that Borrower shall neither: (i) make any payments to Subordinating Lender in respect of the Junior Debt; nor (ii) without Senior Lender's prior written consent, execute or deliver any negotiable instruments as evidence of the Junior Debt."

(d) The addresses set forth in Section 12 of the Loan Agreement to which notices are to be delivered to Senior Lender are hereby changed to the following:

Senior Lender: CONGRESS FINANCIAL CORPORATION (WESTERN)
251 South Lake Avenue, Suite 900
Pasadena, California 91101
Attention: Account Executive

With a copy to: KELLEY DRYE & WARREN LLP
777 South Figueroa Street, Suite 2700
Los Angeles, California 90017
Attention: Marshall C. Stoddard, Jr., Esq.

2. New Exhibit A. The existing Exhibit A to the Subordination Agreement is hereby replaced in its entirety with the Exhibit A attached hereto.

3. Consent to New Junior Debt Documents. Subject to the terms and conditions set forth herein, Senior Lender hereby consents to the issuance of a new promissory note by Borrower to the order of Subordinating Lender to replace all existing Junior Debt Documents; provided that, such new promissory note shall be in form and substance satisfactory to Senior Lender.

4. Effectiveness of this Amendment. Senior Lender must have received the following items, in form and substance acceptable to Senior Lender, or evidence of the occurrence thereof, before this Amendment is effective.

(a) Amendment. This Amendment fully executed in a sufficient number of counterparts for distribution to Senior Lender and Subordinating Lender.

(b) Authorizations. Evidence that the execution, delivery and performance by Subordinating Lender of this Amendment and any instrument or agreement required under this Amendment have been duly authorized.

(c) Representations and Warranties. The representations and warranties of Subordinating Lender set forth herein must be true and correct.

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(d) Eighth Amendment to Senior Loan Agreement. The Eighth Amendment to the Senior Loan Agreement duly executed by Borrower.

(e) Other Required Documentation. All other documents and legal matters in connection with the transactions contemplated by this Amendment shall have been delivered or executed or recorded and shall be in form and substance satisfactory to Senior Lender.

5. Representations and Warranties. Subordinating Lender and Borrower represent and warrant (jointly and severally) to Senior Lender that:

(a) Amount of Junior Debt. As of the date of this Amendment, the aggregate outstanding principal balance (principal plus interest) of this Junior Debt is Forty One Million One Hundred Forty One Thousand Eight Hundred Thirty Five Dollars (\$41,141,835).

(b) No Default. After giving effect to the transactions contemplated by this Amendment, Borrower is not in default under any Junior Debt Document.

6. Choice of Law. The validity of this Amendment, its construction, interpretation and enforcement, and the rights of the parties hereunder, shall be determined under, governed by, and construed in accordance with the laws of the State of California governing contracts wholly to be performed in that State.

7. Counterparts. This Amendment may be executed in any number of counterparts and by different parties on separate counterparts, each of which when so executed and delivered, shall be deemed an original, and all of which, when taken together, shall constitute but one and the same instrument.

8. Due Execution. The execution, delivery and performance of this Amendment are within the powers of the Subordinating Lender, have been duly authorized by all necessary corporate action, have received all necessary governmental approval, if any, and do not contravene any law or any contractual restrictions binding on Subordinating Lender.

9. Otherwise Not Affected. In the event of any conflict or inconsistency between the Subordination Agreement and the provisions of this Amendment, the provisions of this Amendment shall govern. Except to the extent set forth herein, the Subordination Agreement shall remain in full force and effect.

10. Ratification. Subordinating Lender hereby restates, ratifies and reaffirms each and every term and condition set forth in the Subordination Agreement, as amended hereby, effective as of the date hereof.

11. Estoppel. To induce Senior Lender to enter into this Amendment and to continue to make advances to Borrower under the Senior Loan Agreement, Subordinating Lender hereby acknowledges and agrees that, after giving effect to this Amendment, as of the date hereof, there exists no default by Subordinating Lender and no right of offset, defense, counterclaim or objection in favor of Subordinating Lender as against Senior Lender with respect to the obligations of Subordinating Lender under the Subordination Agreement.

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IN WITNESS WHEREOF, the parties hereto have executed this Amendment as of the day and year first above written.

KRAUSE'S FURNITURE, INC.,
a Delaware corporation

By: _____
Name: _____
Title: _____

CONGRESS FINANCIAL
CORPORATION (WESTERN),
a California corporation

By: _____
Name: _____
Title: _____

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ACKNOWLEDGMENT

The undersigned Borrower hereby approves of, and agrees and consents to the foregoing Amendment. Borrower further agrees to be bound by the Subordination Agreement, as amended by such Amendment. Although Senior Lender and Subordinating Lender have informed Borrower of such Amendment and the matters set forth above, and Borrower has acknowledged the same, Borrower understands and agrees that neither Senior Lender nor Subordinating Lender has a duty under the Subordination Agreement, the Senior Loan Agreement or any other agreement with Borrower, to so notify Borrower or to seek such an acknowledgment, for such Amendment to be effective, and nothing contained herein is intended to or shall create such a duty as to any amendments hereafter.

Dated: December 15, 1999

KRAUSE'S CUSTOM CRAFTED
FURNITURE CORP.,
a California corporation

By: _____
Name: _____
Title: _____

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EXHIBIT A

SUBORDINATED PROMISSORY NOTE

\$41,141,835

December 15, 1999
Brea, California

FOR VALUE RECEIVED, KRAUSE'S CUSTOM CRAFTED FURNITURE CORP., a California corporation (the "Borrower"), promises to pay to the order of KRAUSE'S FURNITURE, INC., a Delaware corporation (the "Lender"), at 200 N. Berry St., Brea, California 92821 (or at such other place as the Lender may designate in writing), on the date thirteen (13) months after written demand therefor, or, if no demand is made before November 30, 2004, then on December 31, 2005 (which date may be extended from time to time by mutual written agreement of Borrower

and Lender) the principal sum of forty-one million, one hundred forty-one thousand, eight hundred thirty-five dollars (\$41,141,835), together with interest on the outstanding unpaid principal amount from the date hereof to maturity at a rate per annum equal to one percentage point in excess of the rate announced publicly from time to time by Bank of America National Trust and Savings Association at its San Francisco executive offices as its "prime rate," up to a maximum rate of 10% per annum.

It is the intent of Borrower and Lender that this Note shall supercede and replace the outstanding notes of Borrower listed on Schedule A hereto, that this Note include in its principal amount the principal and accrued interest on each of such notes, and that such notes shall be canceled on the execution and delivery of this Note.

If interest accruing in any year remains unpaid on December 31 of the same year, then the aggregate unpaid interest of that year shall be added to the principal amount of this Note on the following January 1. All payments on this Note shall be applied first in payment of accrued and unpaid interest and any remainder in payment of principal.

Principal and interest shall be payable in lawful money of the United States of America.

If any default occurs in any payment due under this Note, Borrower and all guarantors and endorsers hereof, and their successors and assigns, promise to pay all costs and expenses, including attorneys' fees, incurred by each holder hereof in collecting or attempting to collect the indebtedness under this Note, whether or not any action or proceeding is commenced, and hereby waive the right to plead any and all statutes of limitation as a defense to a demand hereunder to the full extent permitted by law.

Borrower, for itself, its representatives, successors and assigns, waives presentment, protest and notice of dishonor and waives any right to be released by reason of any extension of time or change in terms of payment. Any forbearance by the holder hereof in exercising any right or remedy hereunder, or otherwise afforded by applicable law, shall not be a waiver or preclude the exercise of any such right or remedy. The

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holder's subsequent acceptance of any payment hereunder shall not be deemed a waiver of any default by Borrower. No waiver of the holder of any right, payment or charge hereunder shall be effective unless in writing.

It is the intent of Borrower and holder to conform strictly to the usury laws now or hereafter in force in the State of California. Any interest payable under this Note shall be subject to reduction to the amount not in excess of the maximum non-usurious amount allowed under the laws of the State of California as now or hereafter construed by the courts having jurisdiction over such matters. The aggregate of all interest contracted for, chargeable or receivable under this Note shall under no circumstances exceed the maximum legal rate upon the balance of this Note remaining unpaid from time to time. If such interest does exceed the maximum legal rate, it shall be cancelled automatically and if theretofore paid, credited on the principal amount of this Note or, if a portion of this Note has been prepaid, then such excess shall be rebated to Borrower.

Notwithstanding anything contained herein to the contrary, this Note and the principal and interest payments and other obligations of Borrower due hereunder are subject to that certain Amended and Restated Subordination Agreement dated as of August 16, 1996, between Lender and Congress Financial Corporation (Western), as the foregoing may be amended or modified from time to time. Borrower shall not prepay all or any portion of the principal amount of

this note without the prior written consent of Senior Lender.

Subject to any limitations imposed by Senior Lender, Borrower may prepay this Note in whole or in part without premium or penalty at any time;.

In the event action is taken to collect amounts due under this Note, the holder shall be entitled to reasonable attorneys' fees, costs of court and all other expenses of collection incurred by holder.

This Note is not intended to be a negotiable instrument and may not be transferred without the written consent of the Borrower.

This Note shall be construed in accordance with the laws of the State of California.

"Borrower"

KRAUSE'S CUSTOM CRAFTED FURNITURE CORP.

By: _____
Robert A. Burton
Executive Vice President and
Chief Financial Officer

SCHEDULE A

<TABLE>
<CAPTION>

<S>	Date <C>	Principal Amount <C>	Accrued Interest <C>	Principal Plus Accrued Interest <C>	Due Date <C>
1.	January 20, 1995	2,700,000	1,306,153	4,006,153	
2.	January 20, 1995	1,000,000	483,760	1,483,760	December 31, 1998
3.	September 22, 1995	500,000	206,983	706,983	January 18, 1998
4.	May 3, 1996	500,000	176,315	676,315	January 18, 1998
5.	May 22, 1996	750,000	260,666	1,010,666	January 18, 1998
6.	August 26, 1996	5,000,000	1,609,555	6,609,555	January 20, 2000
7.	September 27, 1996	1,000,000	313,363	1,313,363	January 20, 2000
8.	October 18, 1996	1,500,000	461,630	1,961,630	January 20, 2000
9.	November 26, 1996	2,500,000	743,339	3,243,339	January 20, 2000
10.	January 10, 1997	1,500,000	427,973	1,927,973	January 20, 2000
11.	April 3, 1997	500,000	124,801	624,801	January 20, 2000
12.	May 14, 1997	200,000	47,786	247,786	January 20, 2000
13.	August 11, 1997	100,000	21,577	121,577	January 20, 2000
14.	August 15, 1997	3,000,000	644,178	3,644,178	January 20, 2000
15.	December 31, 1997	3,500,000	625,829	4,125,829	January 20, 2000
16.	April 3, 1998	6,189,617	1,009,416	7,199,033	January 20, 2000
17.	April 7, 1998	1,801,800	291,867	2,093,667	January 20, 2000
18.	July 16, 1998	128,000	17,227	145,227	January 20, 2000
		-----	-----	-----	
		32,369,417	8,772,418	41,141,835	

</TABLE>