SHELLS SEAFOOD RESTAURANTS INC
Form 10-K
March 28, 2008

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-K

(Mark One)

x **Annual Report Pursuant to Section 13 of 15(d) of the Securities Exchange Act of 1934**
For the fiscal year ended: **December 30, 2007**
Or

o **Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**
For the transition period from ______ to ______

Commission file number: 0-28258

SHELLS SEAFOOD RESTAURANTS, INC.
(Exact name of registrant as specified in its charter)

DELAWARE	**65-0427966**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
16313 North Dale Mabry Highway, Suite 100, Tampa, Florida	**33618**
(Address of principal executive offices)	(Zip Code)

(813) 961-0944
(Registrant's telephone number, including area code)

Securities registered pursuant to Section 12(b) of the Act:

[	Title of each class	Name of each exchange on which registered	]
[	Common Stock, $0.01 par value per share	OTC Bulletin Board	]

Securities registered pursuant to Section 12(g) of the Act:
Common Stock, $0.01 par value per share.

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.
Yes o No x

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Exchange Act.
Yes o No x

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. o

---

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of “large accelerated filer”, “accelerated filer” and “smaller reporting company” in Rule 12b-2 of the Exchange Act (Check one): Large Accelerated Filer o
Accelerated Filer o Non-accelerated filer o Smaller Reporting Company x

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).
Yes o &#1 60; No x

As of July 1, 2007 (the last business day of the registrant’s most recently completed second fiscal quarter), the aggregate market value of the registrant’s common stock held by non-affiliates of the registrant (which for these purposes excludes directors, executive officers, and ten-percent holders of stock) was $1,364,000 based on the closing sale price as reported on the Over-the-Counter Bulletin Board.

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

Class	Outstanding at February 26, 2008
Common Stock, $0.01 par value per share	23,537,948 shares

DOCUMENTS INCORPORATED BY REFERENCE

Document	Parts Into Which Incorporated
Annual Report to Stockholders for the Fiscal Year Ended December 30, 2007 (Annual Report)	Parts I, II, and IV
Proxy Statement for the Annual Meeting of Stockholders scheduled to be filed with the SEC within 120 days after the end of the fiscal year ended December 30, 2007 (Proxy Statement)	Part III

FORWARD LOOKING STATEMENTS

When used in this Annual Report on Form 10-K, the words "believes", “intends”, "anticipates", "expects", and similar expressions are intended to identify forward-looking statements. These statements are subject to certain risks and uncertainties, which could cause actual results to differ materially from those projected.

In addition to seasonal fluctuations, the Company’s quarterly and annual operating results are affected by a wide variety of other factors that could materially and adversely affect revenues and profitability, including changes in consumer preferences, tastes and eating habits; increases in food, labor and other operating costs; the availability of food acceptable to our quality standards at acceptable prices; the availability of qualified labor; national, regional and local economic and weather conditions; international economic, cultural and political conditions; promotional timings and seasonality; demographic trends and traffic patterns; changes in travel and tourism tendencies, particularly in light of world events; competition from other restaurants and food service establishments; availability of third party financing to fund capital or operating activities, if required; changes in personnel, including senior management; and the timing, costs and charges relating to restaurant openings, closings and remodelings. As a result of these and other factors, the Company may experience material fluctuations in future operating results on a quarterly or annual basis, which could materially and adversely affect its business, financial condition and stock price. Furthermore, this document and other documents filed by the Company with the Securities and Exchange Commission (“SEC”) contain certain forward-looking statements with respect to the business of the Company and the industry in which it operates. These forward-looking statements are subject to certain risks and uncertainties, including those mentioned above, which may cause results to differ significantly from these forward-looking statements. The Company undertakes no obligation to update these forward looking statements on a regular basis. An investment in the Company involves various risks, including those mentioned above and those that are detailed from time-to-time in the Company’s SEC filings.

Any forward-looking statements included in this Annual Report reflect our beliefs only as of the date of this document. We do not undertake any obligation to publicly release the results of any revisions to these forward-looking statements which may be made to reflect events or circumstances after the date of this document or to reflect the occurrence of unanticipated events, unless we are required to do so by law.

SHELLS SEAFOOD RESTAURANTS, INC.

INDEX TO ANNUAL REPORT ON FORM 10-K
For the Fiscal Year Ended December 30, 2007

TABLE OF CONTENTS

PART I

ITEM 1. BUSINESS

Shells Seafood Restaurants, Inc. was incorporated under the laws of the State of Florida in April 1993 and was reincorporated under the laws of the State of Delaware in April 1996. Effective December 1994, Shells, Inc., a company incorporated under the laws of the State of Florida, was merged with and into our company and became our wholly-owned subsidiary.

Concept and Strategy

Shells is a full-service, casual dining seafood concept designed to appeal to a broad range of customers by providing generous portions of high-quality seafood at reasonable prices, warm, friendly service, and a relaxed, appealing atmosphere. Shells restaurants feature a wide selection of seafood items, including shrimp, oysters, clams, scallops, crawfish, mussels, lobster, crab and daily fresh fish specials, cooked to order in a variety of ways: steamed, sautéed, grilled, blackened and fried. In addition, our restaurants offer a wide selection of signature pasta dishes, appetizers, salads, and desserts and full bar service. All Shells restaurants are open for lunch and dinner.

As of December 30, 2007, our fiscal year end, we owned 19 Shells restaurants, owned a 51% ownership interest in one Shells restaurant and managed three additional licensee-owned Shells restaurants pursuant to contractual arrangements. All of our restaurants are located in Florida.

We believe that the seafood segment of the restaurant industry in which Shells operates has greater growth opportunities than other, more crowded casual dining segments. While there have been additional competitors entering this market in recent years, the number of regional and national chains serving this market is still relatively small. We believe that seafood consumption will continue to increase given that seafood's healthful aspects are regularly touted by scientific studies and subsequent media coverage.

The original Shells model of serving low-price seafood in a no-frills atmosphere began to face difficulties in the late '90s with heightened consumer demands for flavor, quality, variety and atmosphere. New competitors entered the market to meet these demands and Shells did not keep pace. In addition, our company finances were weakened by a difficult Midwest expansion and the physical condition of several restaurants began to deteriorate.

Since late 2003, we worked to update and strategically reposition the Shells concept by elevating the freshness, quality and variety of our food, improving our service levels and significantly enhancing our atmosphere through remodeling our restaurants. We implemented a two-tier pricing strategy that was intended to expand our ability to profitably build check average and sales. We continue to adapt our menu to maintain the price to value relationship, which Shells is known for, primarily through our seafood pastas and fried entrees. We have re-engineered our product sourcing, menu offerings and seasonal promotions to allow us to also deliver fresher, higher-quality seafood combinations and premiere menu items, such as lobster, at competitive prices. We leverage the quality, freshness and variety attributes through our marketing efforts.

Enhancing our ability to execute these concept improvements, we recruited new operations talent into our company and continuously focus on maintaining high operating standards throughout our restaurants.

Generating sales through improvements in guest traffic is critical to our future success. Since the fourth quarter of 2006, we have encountered an increasing erosion in guest traffic and sales as economic conditions in the state of Florida have worsened. Our initiatives throughout 2007 have focused on creating greater value in the food that we serve, reducing unnecessary costs within the company and redirecting our marketing strategies to better ensure effectiveness.

We are continuing to execute our turnaround strategy in a very challenging economic environment. We believe significant opportunities exist to both improve sales and profits, and ultimately to opportunistically expand our brand further.

In 2007, we sold the Shells service marks and system in certain middle eastern countries to Food and Entertainment Company, LTD. in a 10-nation development agreement. This arrangement not only provides us with ongoing revenue from a related consulting and services agreement, but also builds our brand internationally and opens the door for future international development opportunities.

Restaurant Locations

Our managed and operated restaurants are located in the following Florida markets and cities/neighborhoods:

Tampa/Sarasota	**Orlando**	**South Florida**
Brandon	Daytona Beach	Kendall
Clearwater Beach	Kissimmee	Pembroke Pines
Holmes Beach	New Smyrna Beach	Sunrise
Redington Shores	Ocala	
St. Pete Beach	Orlando	
St. Petersburg	Winter Park	
Winter Haven	Melbourne	
North Tampa		
Sarasota		
South Tampa		

West Palm Beach	**Fort Myers**
Stuart	Fort Myers
West Palm Beach	

During 2007, we closed two under-performing restaurants. We continuously review the performance of each restaurant's unit economics and location, and regularly evaluate new real estate sites in Florida for potential expansion or relocation.

Restaurant Operations

Management and Employees. We currently employ three area directors. Each area director is responsible for the management of several restaurants, including management development, recruiting, training, quality of operations and unit profitability. The staff of a typical restaurant consists of one general manager, two or three assistant managers and approximately 60 other employees. Restaurant management and area directors participate in a bonus program based upon the financial results of their particular restaurant or restaurants.

Recruitment and Training. We believe that attaining continuously high service standards will better allow us to achieve long-term and sustainable success. We make substantial investments in the training and development of our managers, recognizing the direct relationship between this and strong restaurant-level performance. We generally recruit managers with significant experience in the full-service sector of the restaurant industry.

During their training, managers are taught all aspects of the quality of our products and service. We focus on food safety and food handling procedures, hospitality, our operating standards, and cost management methods. In addition, we provide week-long workshops for our managers with additional training in employee relations, guest satisfaction, operating systems and career development.

Our recruiting efforts focus on identifying and hiring individuals with a strong service and teamwork orientation. Our restaurant staffs are trained in each location by certified trainers in both the front and back of the house. We work diligently to retain our managers and employees, recognizing that greater tenure has positive benefits on the service we provide to guests, as well as managing quality and costs effectively.

Restaurant Reporting. We maintain financial and accounting controls for each restaurant through a central accounting system. Our financial systems and controls allow us to access each restaurant's sales, inventory costs and other financial data on a real-time basis, enabling both store-level management and senior management to quickly react to changing sales trends, to effectively manage food, beverage and labor costs, to minimize theft, and to improve the quality and efficiency of accounting and audit procedures. Store level management performs weekly inventories and manages weekly operating results versus budget.

Purchasing. Obtaining a reliable supply of quality ingredients with a primary focus on seafood at competitive prices is critical to our success. We have formed long-term relationships with several suppliers, manufacturers and harvesters of seafood. We purchase in bulk both fresh and frozen seafood and certain other supplies used in restaurant operations. In addition, Shells' menu has been designed to feature seafood varieties with stable sources of supply, as well as to provide flexibility to adjust to shortages and to take advantage of occasional purchasing opportunities. We believe our diverse menu selection helps minimize the effects of shortages of most seafood products. We generally have been able to anticipate and react to fluctuations in food costs through selected menu price adjustments, purchasing seafood directly from numerous suppliers and promoting certain alternative menu selections in response to availability and price of supply.

Performance Food Group of Florida has been our primary distributor since October 2002. Performance Food Group purchases and takes delivery of the products that we contract for purchase, according to our specifications and subject to our quality assurance inspections. Based on purchase orders initiated by our restaurants, Performance Food Group then sells the food products to us on a cost plus basis, and distributes the food products directly to our restaurants. From time-to-time, at our direction to facilitate a forward purchase opportunity, Performance Food Group acquires inventory in excess of normal recurring restaurant delivery and re-supply, which approximates 30 days supply. We pay interest on inventory holdings above 60-day supply levels, at a fixed interest rate of 7.8% per annum. In addition, Performance Food Group procures, on our behalf, many of our operating supplies, and distributes and sells these products to the individual restaurants at agreed upon price mark-ups.

6

Quality Control. We maintain a continuous quality assurance inspection program for all of our seafood and protein purchases. Each shipment of frozen seafood or other protein is inspected through statistical sampling methods upon receipt at Performance Food Group's distribution center for quality and conformity to our written specifications, prior to delivery to the restaurants. Fresh fish and produce are also inspected on a random basis by our quality control inspector. Randomly, we also inspect the facilities and vehicles in which these products are processed, stored, or shipped to our restaurants. In addition, fresh fish purchased by our individual restaurants must be purchased from one of our approved suppliers and is inspected by a restaurant manager at the time of delivery. As part of our training program, restaurant employees are educated as to the correct handling and proper physical characteristics of each product.

Our area directors, general managers and assistant managers are all responsible for properly training hourly employees and for ensuring that Shells restaurants are operated in accordance with strict health, quality and food safety standards. Compliance with our quality standards is monitored by on-site visits and formal inspections by the area directors. We believe that our inspection procedures and employee training practices help to maintain high standards of quality and safety of the food and service we provide.

Advertising and Marketing

Our marketing efforts leverage the use of billboard, newspaper, radio and television advertising to raise awareness of the Shells brand and to inform new and existing customers about our promotions. The fact that our restaurants are generally clustered in particular media markets helps us obtain cost-effective advertising. We also stage in-store promotions and various local marketing efforts to help our restaurants partner with their communities.

Across most major markets, our broad scale marketing initiatives included network television, radio, outdoor signage, newspaper, concentrated internet and direct mail campaigns. The 2007 marketing initiatives focused on value offerings with the Florida economy slowing down. Using several forms of media, the value message was driven by radio, TV, print and email marketing programs. We also continued our local store marketing program, providing all of our restaurants with resources to take advantage of an array of sales-building initiatives. This included couponing initiatives targeted at increasing guest traffic, to go sales, price point discount offers and local school and community events.

Based upon the positive impact on sales from the use of radio in 2006, we continued with radio advertising in 2007 in all markets, adding the Ft. Myers and West Palm Beach markets in the first quarter and part of the second quarter of the 2007. The message was delivered via DJ endorsements and personal spokespersons in each market. The radio was coupled with in restaurant events including live broadcasts and giveaways.

The marketing medium was changed in the second quarter of 2007, when sales continued to decline. With a limited budget we were able to create a new television commercial that associated our brand with images of plated food and images of the restaurant full of people. The commercials included a $9.99 offering, which targeted the value driven guest. We supported the on-air advertising with in-store point-of-purchase promotions.

We continue to use Dunn and Company as our advertising agency. Dunn and Company is responsible for all creative and media buying services for Shells. The agency assists us with various branding elements, including menu and store point-of-purchase promotion materials.

Joint Venture and Third-Party Owned Restaurants

The Shells restaurant system currently consists of (i) 19 restaurants that are wholly owned by us; (ii) one restaurant, in Melbourne, Florida, in which we have a 51% ownership interest, and (iii) three restaurants that we manage and operate, but do not own. In addition to the equity interest in the Melbourne restaurant, we receive a management and licensing fee of 6% of the restaurant sales.

Two of the managed restaurants are managed and operated by us pursuant to agreements, originally entered into in July 1993. Pursuant to these agreements, we provide management services and license proprietary information required to operate these restaurants in return for a percentage of each restaurant's sales. The agreements, as amended in October 2001, provide for a 4% management fee until such time as sales return to near 1999 levels, and then increasing to a 6% fee. Of the total management fee received, 2% of sales is placed in escrow and disbursed to a third party to satisfy each managed restaurants’ requirement to make third party royalty payments. The management agreements generally grant us authority to determine the programs and policies affecting the day-to-day operations of each of these managed restaurants, have a remaining term of approximately 17 years, and provide that the third-party owners are responsible for funding all restaurant expenses, including food and beverage costs, staffing, training, recruiting, inventory, working capital, and capital investment.

We operate the third managed restaurant pursuant to an oral agreement requiring that the restaurant is operated in conformity with the policies and procedures established by us for Shells restaurants. Consistent with the amended management agreement for our other managed restaurants, beginning in October 2001, we receive a net management fee of 2% of the restaurant's sales.

In the past, the enforceability of these management and license agreements has been questioned by certain of the licensees. Although we believe the agreements are enforceable, there can be no assurance that the agreements will not be challenged in the future, and, if challenged, that the agreements will be determined to be enforceable.

International Restaurants

In December 2007, we entered into an agreement to sell our marks and system in certain middle eastern countries to Food and Entertainment Co., LTD, an entity owned by the Alhokair Group, a company domiciled in the Kingdom of Saudi Arabia. We sold the development rights to Food and Entertainment to open 10 restaurants over a 10-year period, solely within a territory to initially consist of the Kingdom of Saudi Arabia, Egypt, Jordan, Qatar, Oman, Bahrain, United Arab Emirates, Kuwait, Pakistan, India and based on additional performance criteria, Tunisia and Morocco.

In conjunction with such sale of our marks and system, we also entered into an agreement to provide technical consulting and support services to Food and Entertainment for a 10-year period, with two options to renew, at the election of Food and Entertainment, for additional five year periods. The technical and support services to be provided under such agreements include restaurant design, operations, training, product sourcing and menu engineering for which we receive a fee of 1% of Food and Entertainment’s gross sales of its Shells restaurants in operation, payable monthly. The first international restaurant is under development and is scheduled to open in 2008.

Competition

The restaurant industry is intensely competitive with respect to price, service, location, food quality and variety, and there are many well-established competitors with substantially greater financial and other resources. These competitors include national, regional and local full-service casual dining chains, some of which specialize in or offer seafood products. We also face competition from a broad range of other restaurants and foodservice establishments, including full-service and quick service restaurants, which specialize in a variety of cuisines. Some of our competitors have been in existence for substantially longer periods than we have, and may be better established in the markets where we have our restaurants. In addition, we believe that the full-service casual dining segment is likely to attract a significant number of new entrants, some offering seafood products. We believe Shells is competitively positioned within the industry due to our relative value proposition and points of differentiation, as discussed previously.

Government Regulation

We are subject to extensive federal, state and local government regulation by various governmental agencies, including state and local licensing, zoning, land use, construction and environmental regulations and various regulations relating to the sale of food and alcoholic beverages, sanitation, disposal of refuse and waste products, public health, safety and fire standards. Our restaurants are subject to periodic inspections by governmental agencies to ensure conformity with these regulations. Difficulties or failure in obtaining required licensing or other regulatory approvals could delay or prevent the opening of a new restaurant, and the suspension of, or inability to renew, a license at an existing restaurant could adversely affect our operations. Restaurant operating costs are also affected by other government actions beyond our control, including annual increases in minimum hourly wage requirements, such as those that were implemented in Florida beginning in 2005. Other measures largely beyond our control that can impact operating costs include workers compensation and property insurance rates, health care insurance costs and unemployment and other taxes.

Approximately 14% of our revenue is attributable to the sale of alcoholic beverages. Alcoholic beverage control regulations require each of our restaurants to apply to a state authority and, in certain locations, county or municipal authorities for a license or a permit to sell alcoholic beverages on the premises. Typically, licenses must be renewed annually and may be revoked or suspended for cause at any time. Alcoholic beverage control regulations relate to numerous aspects of daily operations of our restaurants, including minimum age of patrons and employees, hours of operation, wholesale purchasing, inventory control and handling, storage and dispensing of alcoholic beverages. The failure of a restaurant to obtain or retain liquor or food service licenses would adversely affect the restaurant’s operations.

We are also subject to "dram-shop" statutes, which generally provide a person injured by an intoxicated person the right to recover damages from an establishment that wrongfully served alcoholic beverages to the intoxicated person. We carry liquor liability insurance coverage as part of our existing comprehensive general liability insurance.

Our restaurants are subject to federal and state minimum wage laws governing such matters as working conditions, overtime and tip credits. A significant number of our restaurant personnel are paid at rates related to the state minimum wage which exceeds the federal rate and, accordingly, further increases in Florida's minimum wage rate could increase our labor costs.

The Americans with Disabilities Act prohibits discrimination in employment and public accommodations on the basis of disability. Under the Act, including in situations where we elect to acquire or purchase a restaurant, we could be required to expend funds to modify our restaurants to better provide service to, or make reasonable accommodations for the employment of, disabled persons.

Service Marks and Proprietary Information

We have registered the service mark "Shells" with the Secretary of the State of Florida and the "Shells" service mark and "jumping fish" logo with the United States Patent and Trademark Office. In addition, Food and Entertainment Co., LTD is in the process of registering the "Shells" service mark in the Kingdom of Saudi Arabia. We believe that our service marks have significant value and are essential to our ability to create demand for, and brand awareness of, our restaurants. There can be no assurance, however, that our service marks do not or will not violate the proprietary rights of others, that they would be upheld if challenged or that we would not be prevented, in such an event, from using our service marks, any of which could have a material adverse affect on us. Although there can be no assurance that we will have the financial resources necessary to enforce or defend our service marks, we have vigorously opposed, and intend to continue to oppose vigorously, any infringement of our service marks.

We also rely on trade secrets and proprietary knowledge and employ various methods to protect our concepts and recipes. These methods may not afford complete protection, and there can be no assurance that others will not independently develop similar knowledge or obtain access to our knowledge, concepts and recipes.

Employees

As of December 30, 2007, we employed approximately 850 persons, of whom approximately 120 were management or administrative personnel employed on a salaried basis and 730 were employed in non-management restaurant positions on an hourly basis. Approximately 370 employees are employed on a full-time basis. We consider our employee relations to be good. No employees are covered by a collective bargaining agreement.

Our Executive Officers

Our executive officers are:

Name	Age	Position
Guy C. Kathman	51	Vice President of Operations
Warren R. Nelson	56	Interim President, Chief Financial Officer, Treasurer and Secretary

Guy C. Kathman has been our Vice-President of Operations since joining Shells in September 2003. From 2001 to 2003, Mr. Kathman was employed by Posados Café as a General Manager. From 1997 to 2001, Mr. Kathman was employed by Brinker International, On the Border Restaurants, as a Regional Director of Operations.

Warren R. Nelson currently serves as our interim President to which he was appointed on February 29, 2008. Mr. Nelson has served as Executive Vice-President of Finance, Chief Financial Officer, Treasurer, and Secretary, since June 1993. Mr. Nelson is also Treasurer and a member of the Board of Trustees for a non-profit, the Florida Chapter of the ALS Association.

Our board of directors has adopted a Code of Business Conduct and Ethics that applies to our board members, as well as our principal executive officer and principal financial officer, and our other officers and employees. This Code of Business Conduct and Ethics is available on our web site, at www.shellsseafood.com. We intend to satisfy the amendment and waiver disclosure requirements under applicable securities regulations by posting any amendments of, or waivers to, the Code of Business Conduct and Ethics on our web site. A copy of our Code of Business Conduct and Ethics will be sent without charge upon request in writing addressed to us at: 16313 N. Dale Mabry Hwy, Suite 100, Tampa, Florida 33618, c/o Secretary.

Item 1A. Risk Factors

The risks and uncertainties described below are not the only risks we face. In addition to the following risk factors, we refer you to those risk factors described elsewhere in this Annual Report on Form 10K and in various of our publicly reported documents. Further risks and uncertainties not presently known to us, or that we currently believe are immaterial, could also impair our business operations.

Keep these risk factors in mind when you read "forward-looking" statements elsewhere in this Form 10K. These are statements that relate to our expectations for future events and time periods. Generally, the words "anticipate," ”believe,” "expect," "intend" and similar expressions identify forward-looking statements. Forward-looking statements involve risks and uncertainties. Future events and circumstances could differ significantly from those associated with the forward-looking statements.

We have continuing capital requirements and a history of losses. Historically, our cash requirements have exceeded our cash flow from operations. This has been due to costs associated with developing and opening restaurants, as well as the operating performance of certain restaurants. We have experienced operating and net losses during the majority of the recent prior years. As of December 30, 2007, we had a working capital deficiency of $4,712,000 and a cash balance of $458,000. In 2007, we incurred a net loss of $4,400,000, and we invested $439,000 in property and equipment. As of December 31, 2006, we had a working capital deficiency of $4,446,000 and a cash balance of $734,000. In 2006, we incurred a net loss of $3,002,000, and we invested $1,774,000 in property and equipment. In addition, in 2007, we experienced a significant decline in sales and customer traffic. There are no assurances that our strategies will reverse the recent trend in sales and customer traffic declines as necessary to meet our contemplated cash flow requirements. There can be no assurances that further losses will not be experienced in the future.

Our independent registered public accounting firm has indicated substantial doubt about our ability to continue as a “going concern.” Our current independent registered public accounting firm, in their report with respect to our financial statements as of December 30, 2007 includes a “going concern” opinion. As discussed in Note 1 to the audited financial statements, we have incurred significant losses for the years ended December 30, 2007, December 31, 2006 and January 1, 2006, have an accumulated deficit, and have a secured promissory note which is due in May 2008. Sufficient liquidity to satisfy working capital requirements, make the scheduled debt reduction under the promissory note if the maturity date is not extended, and repay other debt obligations; is dependent primarily on the realization of cash flow from operations and obtaining alternative financing sources. There can be no assurances that these initiatives will be successful. Because of these conditions, our independent registered public accounting firm has raised substantial doubt about our ability to continue as a going concern.

Operating expenses may increase. Since 2005, we have incurred annual increases in labor costs due to the Florida minimum wage rate increase. Many of our commodity and operating costs have increased in 2007, generally stemming from escalating fuel costs. The cost of utilities continues to rise due to increasing energy costs. Insurance expenses increased mostly as a result of the hurricanes in 2004 and 2005. However, we have seen recent moderation in insurance costs, to include reductions in costs in 2008. Due to the significant increase in real estate market values throughout Florida, we also have incurred significant increases in real estate taxes generally over the past several years. We have seen a moderation in recent real estate tax trends, as the real estate market in Florida has significantly weakened relative to the state’s economy. In addition, certain of our leases are coming up for renewal or expiring over the next several years. Increases in rent expense may occur as a result of renewing current leases or negotiating new lease terms. There can be no assurances that any future increases in menu pricing or guest traffic will be adequate to compensate for these and any other operating cost increases.

We may be unable to repay certain of our debts when they mature. Certain of our investors have funded a $1,440,000 line of credit which matures in May 2008. In March 2007, the maturity date of the line of credit was extended from May 23, 2007 to May 23, 2008 at a fee of 7% of the $1,440,000 borrowed. There are no assurances that such investors will continue to extend the maturity date on this note or that adequate financing options will be available to us when necessary or at terms that we find acceptable.

We have a promissory note outstanding through Colonial Bank, for the financing of our joint venture restaurant, located in Melbourne, Florida. As of December 30, 2007, we owed $607,000 on the principal balance of this note, which matures in September 2012. Additionally, on January 16, 2008, we entered into a line of credit agreement with Colonial Bank, pursuant to which we have borrowed $140,000 of the $350,000 available under the credit line. The line of credit facility matures on September 19, 2008 and is secured by a $1,050,000 letter of credit with Food and Entertainment Co., LTD.

Each of the notes relating to the restaurant property, the $1,440,000 line of credit, and the $350,000 line of credit are secured by certain of our assets. Any failure by us to pay these debts as they mature would allow holders of these debts to seize and sell certain of our assets to satisfy the amounts owed to them.

Our ability to use net operating loss carryforwards and general business credits to reduce future tax payments may be further limited if there are additional changes in ownership of Shells. As of December 30, 2007, for federal income tax purposes, we had approximately $12,317,000 of net operating loss carryforwards, or NOLs, available to reduce taxable income in future years and approximately $3,969,000 of general business credits to carry forward. We believe that a substantial amount of these NOLs and credits are currently subject to an annual limitation under sections 382 and 383 of the Internal Revenue Code of 1986, as amended, as a result of ownership changes in 2002 and our sale of additional equity in 2005 to persons previously unassociated with our company. We estimate the limit to NOLs and credit carryforwards that may be used against taxable income to be approximately $75,000 per year for NOLs occurring prior to the 2002 ownership change, and $665,000 per year for NOLs occurring prior to the 2005 ownership change. Any portion of the annual limitation amounts not utilized in any year will carry forward to the following year, subject to a 15 to 20 year limitation. Any additional sale of equity may result in further restricting our ability to utilize NOLs or credit carryforwards.

Substantial dilution to our stockholders is possible. As of March 10, 2008, there were outstanding 23,538,000 shares of common stock, and warrants, options or other convertible securities outstanding to purchase an additional 12,434,000 shares of common stock, including options and warrants representing 10,570,000 shares of common stock at an average exercise price of $1.04 per share.

Over the last five years, we raised $11.3 million through issuing securities, including warrants and preferred stock convertible as of March 10, 2008 into 7,614,000 shares of our common stock. As of March 10, 2008, 18,493,000 shares of our common stock have been issued relating to these warrants and preferred stock. Many of these securities have anti-dilution protection provisions, which will become operative upon our issuance of additional securities at below specified dollar amounts.

In March 2005, we amended our certificate of incorporation to increase the total number of authorized shares of our common stock from 20,000,000 shares to 40,000,000 shares. Subsequently, in June 2005, our stockholders approved a further increase of the total number of authorized shares of our common stock from 40,000,000 shares to 58,000,000 shares. We may require additional financing in 2008. Certain forms of capital raising may result in substantial additional dilution to our existing stockholders. In addition, we expect to issue a substantial number of shares of our common stock or stock options to any person hired as our new Chief Executive Officer.

Control is concentrated among a few individuals. Frederick R. Adler, James Adler, Bruce Galloway and Trinad Capital, significant stockholders, together with members of our board of directors and executive management team, are beneficial owners of record, in the aggregate, of approximately 62.9% of our outstanding voting shares, consisting of Common Stock and Series B Convertible Preferred Stock, as of March 10, 2008 and are able to control the business and affairs of our company, including the election of our directors and decisions regarding any proposed dissolution, merger or sale of our assets.

We depend on key personnel. Our success is largely dependent upon our executive management and other key personnel. The loss of the services of one of our executives or other key personnel could materially adversely affect us. Our success may also depend on our ability to attract and retain qualified management restaurant industry personnel.

Operating results may require the closure of additional restaurants. If we experience prolonged periods of unfavorable operating results at any existing restaurants, view the prospects for a restaurant to be less than satisfactory, or do not renew a restaurant lease due to its operating results, we may elect to close or relocate restaurants. The lack of success or closing of any of our restaurants could have an adverse effect upon our financial condition and results of operations. We closed 16 restaurants during 2001, of which 14 were located in the Midwest and two were located in Florida. We closed one restaurant in 2002, three restaurants in 2004 and one restaurant in 2005. Additionally, in 2005, we relocated one restaurant to a higher volume location and opened two new restaurants. In 2007, we closed two restaurants. We continually monitor the operations and financial performance with respect to certain of our other existing restaurants. Many of our costs are fixed, and a reduction in the number of units open for operation results in decreased sales leverage.

Our operating results fluctuate seasonally because of our geographic concentration in Florida. We experience significant fluctuations in our quarter-to-quarter operating results because of factors including the seasonal nature of our business and weather conditions in Florida, which may be severe periodically and may include damaging hurricanes.

Our restaurants are all located in Florida and can be affected by the health of Florida’s economy in general, and of the tourism industry in particular, which can further be affected by anticipated world events, as well as economic trends. In addition, while the majority of our restaurants are located primarily in residential areas in Florida, many of our restaurants are located in seasonal tourist areas.

Our restaurant sales generally increase from January through April and June through August, the peaks of the Florida tourism season, and generally decrease from September through mid-December. In addition, because of our present geographic concentration, adverse publicity relating to our restaurants or adverse weather conditions could have a more pronounced adverse affect on our operating results than if our restaurants were more geographically dispersed. Adverse weather conditions or a decline in tourism in Florida, or in general economic conditions, which would likely affect the Florida economy or tourism industry, particularly during the time of peak sales, could materially adversely affect our operations and prospects. Because of the seasonality of our business, our results for any quarter are not necessarily indicative of the results that may be achieved for a full year.

Future hurricanes may be a risk to us. In recent years, the effects of hurricanes on the local economies in Florida and other states in the Gulf of Mexico region have been significant. During the third and fourth quarters of 2004 and the fourth quarter of 2005, we incurred substantial business and property losses as a result of several hurricanes that struck Florida. Property damage or interruption of operations from any future hurricanes may have a material adverse effect on our business and profitability.

Revenue from international operations may not be realized. In December 2007, we entered into an agreement to sell our marks and system in certain middle eastern countries to Food and Entertainment Co., LTD. Concurrent with the sale of our service marks, we entered into a ten year technical consulting and services agreement with Food and Entertainment Co., LTD for which we are to receive 1% of gross sales from the Shells restaurants operated by Food and Entertainment Co. While we require that Food and Entertainment Co. maintain a non-revocable letter of credit sufficient to protect our ability to collect, we cannot assure you that the amounts provided under the letter of credit will be adequate to fully compensate us under certain conditions of default, if incurred. We can not assure you that international cultural, economic or political conditions will not interrupt the operations of Shells international locations or affect the enforceability of the technical consulting and services agreement.

The supply and quality of our seafood may fluctuate. In recent years, the availability of certain types of seafood has fluctuated. This has resulted in a corresponding fluctuation in prices. We maintain both long and short-term contracts with the majority of our suppliers. We contract products direct with the manufacturer, where appropriate. In addition, we have an agreement which expires on October 31, 2008 with Performance Food Group to warehouse and distribute, on a cost plus agreement, the majority of our seafood supplies and to procure, distribute and store other supplies for us. We believe that our relationships with Performance Food Group and our other suppliers are satisfactory and that alternative sources are readily available. However, the loss of our relationship with Performance Food Group or other suppliers could materially adversely affect us. Additionally, there can be no assurance that we will be able to reach an agreement upon contract renegotiation with Performance Food Group on terms that are acceptable to us, or at all.

Some species of seafood have become subject to adverse publicity because of claims of contamination by lead, mercury or other chemicals that may exist in the ocean or in an aquaculture environment. This can adversely affect both market demand and supply for these food products. Customer demand may also be negatively impacted by reports of medical or other risks resulting from eating particular types of seafood. We maintain a continuous quality assurance inspection program for all of our seafood and protein purchases. However, we cannot assure you that seafood contamination or consumer perception of inadequate seafood quality, in the industry in general or as to us specifically, will not have a material adverse affect on us. Our failure to obtain adequate supplies of seafood, which meet our quality specifications at acceptable prices or problems or difficulties resulting from the contamination of seafood, in general, or at any of our restaurants in particular, will have a material adverse effect on our operations and profitability.

Food borne illness may occur in the market place, or to us specifically. Even though we maintain a strict quality assurance inspection program, we cannot assure you that these procedures will successfully detect food contamination. We can also not assure you that a food borne illness occurring anywhere else in the market place will not have a material adverse affect on our business and profitability. Historically, seafood may be particularly susceptible to these kinds of food-borne illnesses.

Our expenses for food commodity costs fluctuate. Our profitability depends, in part, on our ability to anticipate and to react to increases in food costs. We have limited control over these costs, many of which have increased in 2007 due to rising costs of manufacturing and transportation. Specifically, our dependence on frequent deliveries of seafood, produce, dairy and other products means we are at greater risk of shortages or interruptions in supply because of adverse weather or other conditions. This could adversely affect the availability and cost of these items. Also, substantial price increases imposed by our suppliers in the absence of alternative sources of supply in a timely manner, could have a material adverse affect on us.

We have been able to anticipate and react to fluctuations in food costs by:

- adjusting selected menu prices;
- purchasing seafood directly from numerous suppliers; and
- promoting alternative menu selections in response to price and availability of supply.

However, we cannot assure you that we will be able to continue to anticipate and respond to supply and price fluctuations, or that we will not be subject to significantly increased costs. A shortage of available seafood at prices that are acceptable to us could cause our cost of sales to increase. Because of our value oriented pricing structure, this could materially adversely affect our operations and profitability. In addition, seafood suppliers and processors are subject to a program of inspection by the Food and Drug Administration. Government tariffs may also be applied to certain imported products. These programs may increase our seafood costs and / or decrease availability as seafood suppliers' and processors' delivered costs in complying with these programs may increase.

Our industry is highly competitive. The restaurant industry, particularly the full-service casual dining segment, is highly competitive. We compete in the areas of:

- price;
- service;
- food quality, including taste, freshness, healthfulness and nutritional value;
- location; and
- atmosphere.

We have numerous well-established competitors, some of which dominate the industry. These competitors possess substantially greater financial, marketing, personnel and other resources than we do. Many of our competitors have achieved significant brand name and product recognition. They also engage in extensive advertising and promotional programs, both generally and in response to efforts by additional competitors to enter new markets or introduce new products. Our competitors include national, regional and local full-service casual dining chains, many of which specialize in or offer seafood products.

We believe that the full-service casual dining segment is likely to attract a significant number of new entrants, some offering seafood products. We also expect to face competition from a broad range of other restaurants and food service establishments. These include full-service, quick-service and fast casual food restaurants, which specialize in a variety of menu offerings. In addition, the full-service restaurant industry is characterized by the frequent introduction of new food products, which are accompanied by substantial promotional campaigns. In recent years, numerous companies in the full-service restaurant industry have introduced products, including seafood, intended to capitalize on growing consumer preference for food products that are, or are perceived to be, healthy, nutritious, and low in calories, carbohydrates or fat content. We expect that we will be subject to increasing competition from companies whose products or marketing strategies address these consumer preferences. While we believe that we offer a broad variety of quality seafood products, we cannot assure that:

- consumers will be able to distinguish our products from competitive products;
- substantially equivalent food products will not be introduced by our competitors; or
- we will be able to compete successfully.

Many factors affect our industry. We must respond to various factors affecting the restaurant industry, including:

- changes in consumer preferences, tastes and eating habits;
- demographic trends and traffic patterns;
- increases in food, labor and other operating costs;
- inflation; and
- national, regional and local economic conditions and the affect of world events, in general, and the tourism industry in particular.

Our insurance coverage may not be adequate. We maintain insurance, including insurance relating to personal injury, in amounts, which we currently consider adequate. Nevertheless, a partially or completely uninsured claim against us, if successful, could materially adversely affect us. Additionally, the insurance market in Florida, particularly property and business interruption, had sustained significant losses during 2005 and 2004 hurricane seasons. Adequate insurance coverage has become more difficult to acquire and the costs associated with such coverage may become economically prohibitive. If we are unable to obtain adequate insurance coverage, or if we do not have sufficient cash or financing available to pay the insurance premiums, it could cause us to be uninsured for certain perils which could materially affect us.

We face risks associated with government regulation. We are subject to extensive state and local government regulation by various agencies, including:

- state and local licensing, zoning, land use, construction and environmental regulations;
- various regulations relating to the sale of food and alcoholic beverages;
- regulations relating to sanitation, disposal of refuse and waste products;
- regulations relating to public health; and
- safety and fire standards.

Our restaurants are inspected periodically by governmental agencies to ensure conformity with these regulations. The suspension of, or inability to renew a license at an existing restaurant would adversely affect our operations. A significant percentage of our revenue and operating income comes from sales of alcoholic beverages. State and local regulation of the sale of alcoholic beverages require us to obtain a license or permit for each of our restaurants. The failure of a restaurant to obtain or retain a license to serve liquor could materially adversely affect our operations. In addition, our failure or difficulty in obtaining required licensing or other regulatory approvals could delay or prevent new restaurant openings.

Restaurant operating costs are also affected by other government actions, which are beyond our control, including increases in:

- minimum hourly wage requirements;
- workers compensation insurance rates;
- health care insurance costs;
- other insurance costs, including general liability and property; and
- unemployment and other taxes.

In May 2005, the minimum wage rate in Florida increased by $1.00 per hour. Tipped employees also received the $1.00 per hour wage increase under this new law. In January 2006, 2007 and 2008, the minimum wage rate in Florida increased another $0.25, $0.27 and $0.12 per hour, respectively, with tipped employees also receiving the full wage increase. At the beginning of each year, the minimum wage in Florida will increase further based on the U.S. Department of Labor, Bureau of Labor Statistics cost of living index. Such payroll cost increases can have a significantly adverse affect on our company. Menu price increases and other actions have been and are required to negate the affect of these wage increases. There can be no assurances that such measures expected to be taken by our company will be successful to adequately offset these additional payroll costs, or will be accepted without adverse reaction by our customers.

Furthermore, the Americans with Disabilities Act may require us to make certain modifications to certain of our restaurants to meet specified access and use requirements. These and other initiatives could adversely affect our results of operations.

We may have liability for sales of alcoholic beverages. We are also subject to “dram-shop” statutes. These statutes generally provide a person injured by an intoxicated person the right to recover damages from an establishment that wrongfully served alcoholic beverages to the intoxicated person. In certain states, statutes also provide that a vendor of alcoholic beverages may be held liable in a civil cause of action for injury or damage caused by or resulting from the intoxication of a minor under certain conditions. In addition, significant national attention is currently focused on the problem of drunk driving, which could result in the adoption of additional legislation. This could increase our potential liability for damage or injury caused by our customers.

We may not be able to protect our service marks and proprietary information. We own two United States registrations for the service marks that we use, including the name *“Shells.”* We believe that our service marks have significant value and are essential to our ability to create demand for and awareness of our restaurants. We cannot assure you, however, that our service marks:

- do not or will not violate the proprietary rights of others;
- would be upheld if challenged; or
- that we would not be prevented from using our service marks.

Any of these occurrences could materially adversely affect us. In addition, we cannot assure you that we will have the financial resources necessary to enforce or defend our service marks. We believe that we own all of our intellectual property and that the management and license agreements to which we are a party are enforceable. In the past, the enforceability of these management and license agreements has been questioned by certain of the licensees. Although we believe the agreements are enforceable, there can be no assurance that the agreements will not be challenged in the future, and, if challenged, that the agreements will be determined to be enforceable and the managed restaurants will be restricted from using the Shells service marks independent of us.

We also rely on trade secrets and proprietary knowledge. We employ various methods to protect our concepts and recipes. However, these methods may not completely protect us. We cannot assure you that others will not independently develop similar knowledge or obtain access to our knowledge, concepts and recipes. Although we generally enter into confidentiality agreements with our executives and managers, we cannot assure you that these agreements will adequately protect our trade secrets. We also may incur additional risks that may be associated with the registration of our service marks in the Kingdom of Saudi Arabia and other foreign countries by Food and Entertainment Co., LTD.

Absence of Dividends. We have never paid cash dividends on our common or preferred stock and do not anticipate paying any cash dividends in the foreseeable future. In addition, our debt financings prohibit the payment of cash dividends and any future financing agreements may also prohibit the payment of cash dividends.

Provisions with Potential Anti-Takeover Effect. Our certificate of incorporation provides that we may issue up to 2,000,000 shares of preferred stock from time-to-time in one or more series. The board of directors is authorized to determine the rights, preferences, privileges and restrictions granted to and imposed upon any wholly unissued series of preferred stock. The board is authorized to fix the number of shares of any series of preferred stock and the designation of any such series, without any vote or action by our stockholders. The board may authorize and issue preferred stock with voting, dividend, liquidation, conversion or other rights that could adversely affect the voting power or other rights of the holders of our common stock. In addition, the potential issuance of preferred stock may have the effect of delaying, deferring or preventing a change in control, may discourage bids for our common stock at a premium over the market price of the common stock and may adversely affect the market price of the common stock.

On October 24, 2001, we issued 66,862 shares of Series A 5% Convertible Preferred Stock, par value $0.01 per share, pursuant to an exemption from registration under Section 4(6) of the Securities Act of 1933, as amended, in consideration for the cancellation of $669,000 of trade indebtedness by trade creditors of our company. As of March 10, 2008, we had 22,694 shares of Series A Preferred Stock outstanding.

On May 24, 2005, we issued 461,954 units in a private placement. Each unit consisted of (i) one share of our Series B Convertible Preferred Stock convertible into 20 shares of our common stock, subject to adjustment under certain circumstances, and (ii) a warrant to purchase 10 shares of our common stock at an exercise price of $1.30 per share. In addition, we issued a warrant to purchase 37,651 units (consisting of 37,651 shares of our Series B Convertible Preferred Stock and warrants to purchase 376,510 shares of our common stock) at a purchase price of $15.00 per unit to the placement agent in our May 2005 financing. As of March 10, 2008, we had 87,552 shares of Series B Preferred Stock outstanding. The Series B Convertible Preferred Stock contains voting and anti-dilutive rights. The Series B Preferred Stock votes together with our common stock on an “as-converted” basis as a single class on all actions to be taken by our stockholders. Without the consent of a majority of the outstanding Series B Preferred Stock, we cannot alter or change adversely the powers, preferences or rights given to the Series B Preferred Stock, authorize or create any class of stock ranking as to a distribution of assets upon a liquidation event senior to or pari passu with the Series B Preferred Stock, issue any additional shares of the Series A Preferred Stock, or alter or change the powers, preferences or rights given to the Series A Preferred Stock. Upon any dissolution, liquidation, merger, consolidation, reorganization or other series of transactions, under certain conditions, the holders of Series B Preferred Stock are entitled to be paid out of our assets legally available for distribution to our stockholders, before any payment is made to the holders of our common stock.

ITEM 1B. UNRESOLVED STAFF COMMENTS

None

ITEM 2. PROPERTIES

We lease 6,800 square feet of space in Tampa, Florida for our executive offices. The annual rent payable under the lease, which expires October 31, 2008, is approximately $102,000. We have agreed with the landlord to renew this lease at a reduced square footage through at least October 31, 2009.

All but one of our existing restaurants in operation are leased properties. In the future, we intend to lease most of our properties but may from time-to-time acquire restaurant locations based on individual site evaluations. Each of our leases provides for a minimum annual rent and certain of these leases require additional rental payments to the extent sales volumes exceed specified amounts. Generally, we are required to pay the cost of insurance, taxes and a portion of the landlord's operating costs to maintain common areas. Restaurant leases have initial terms averaging 12 years and renewal options averaging 16 years, and rents averaging $21.00 per square foot.

ITEM 3. LEGAL PROCEEDINGS

On August 1, 2006, we were advised by our subtenant, Famous Dave’s RIBS-U, Inc., that they discontinued operations of the restaurant located in Streamwood, Illinois and have ceased remitting rent payments required by the sublease. The subtenant has requested discussions on settlement for a lease termination. Such restaurant closure is a condition of default under the sublease as well as the master lease between Shells and the ultimate landlord, 948 Barrington Road Partnership. The parties are continuing efforts to seek a suitable tenant replacement. The financial implications to Shells are undetermined at this time. If necessary, we intend to pursue our rights against Famous Dave’s RIBS-U, Inc., as appropriate to protect our interest.

On March 13, 2007 and on July 16, 2007, summons were served from the circuit court in Kane County, Illinois, naming the Spring Hill Mall, L.L.C., the primary landlord, as plaintiff. The suit relates to a restaurant lease in Carpentersville, Illinois. Under this lease, we are a sub-tenant to Chi-Chi’s, Inc., who filed bankruptcy in 2003 and subsequently rejected the lease. Since 2000, we have been further subleasing this property to Famous Dave’s RIBS-U, Inc. Under such terms, we partially subsidize lease payments. Since 2003, we have been negotiating with Spring Hill Mall for a buyout of our obligations under the various subleases. Under the suit, Spring Hill Mall sought payment of rent, occupancy, and related charges totaling $147,000 with the addition of interest and fees related to the suit. In February 2008, Spring Hill Mall and Shells jointly agreed to a settlement plan, whereby we will pay monthly to Spring Hill Mall amounts aggregating $177,840, which include amounts due in arrears as well as future amounts due from us through the term of the lease ending December 2010. Under the settlement agreement, we will maintain responsibility for leasehold obligations until December 2010.

On January 31, 2008, a summons was served from the Supreme Court of the State of New York, County of New York, naming 320 West 13th Street, LLC as plaintiff. This suit was brought against, among others, Jay A. Wolf, a member of our Board of Directors, and various entities allegedly controlled by Mr. Wolf, including Shells Seafood Restaurants, Inc. We believe we were wrongly named in this suit and are seeking to have our company removed as a defendant.

On February 27, 2008, a summons was served from the circuit court in Volusia County, Florida, naming Coconuts of Daytona Beach, Inc. as plaintiff. The suit relates to a lease with our subsidiary, Shells of Daytona Beach, Inc. (currently known as America’s Favorite Seafood, Inc.), of furniture, fixtures and equipment assigned on July 12, 1989. The plaintiff alleges that we have breached the agreement, as we discontinued making payments under the contract at or about April 2007. We believe the case is without merit and will defend it vigorously.

In the ordinary course of business, we are and may be a party to various legal proceedings, the outcomes of which, singly or in the aggregate, are not currently expected to be material to our financial position, results of operations or cash flows.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SHAREHOLDERS

None.

PART II

ITEM 5. MARKET FOR THE REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

Our common stock is traded on the over-the-counter bulletin board under the symbol “SHLL”. The following table sets forth the closing high and low price per share of our common stock as reported by the OTC bulletin board, for the periods presented.

These over-the-counter market quotations reflect inter-dealer prices, without retail markup, mark-down or commission and may not necessarily represent actual individual transactions.

Fiscal 2006				
First quarter	$	1.01	$	0.86
Second quarter	$	0.90	$	0.70
Third quarter	$	0.82	$	0.58
Fourth quarter	$	0.75	$	0.51
Fiscal 2007				
First quarter	$	0.75	$	0.45
Second quarter	$	0.47	$	0.15
Third quarter	$	0.23	$	0.11
Fourth quarter	$	0.19	$	0.08

Our authorized capital stock consists of 58,000,000 shares of common stock, par value $0.01 per share, and 2,000,000 shares of preferred stock, par value $0.01 per share. The number of stockholders of record of our common stock on March 20, 2008 was approximately 235. Our stock price as of March 20, 2008 was $0.11.

Dividend Policy

We have never declared or paid any cash dividends on our common or preferred stock. All future earnings are expected to be retained by us for the operation and development of our business. Accordingly, we do not anticipate paying cash dividends on the common or preferred stock in the foreseeable future.

During fiscal 2005, we recorded a non-cash charge of $1,735,000 to recognize as a deemed dividend the warrants and beneficial conversion feature of our Series B Convertible Preferred Stock issued in May 2005.

22

Equity Compensation Plans

Securities authorized for issuance under equity compensation plans as of December 30, 2007 were as follows:

Plan category	Number of securities to be issued upon exercise of outstanding options, warrants, and rights [a]	Weighted-average exercise price of outstanding options, warrants and rights [b]	Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column [a]) [c]
Equity compensation plans approved by security holders (1)	9,666,152	$ 1.06	136,375
Equity compensation plans not approved by security holders (2)	903,528	$ 0.85	-
Total	10,569,680		136,375

(1) Consists of (i) stock options issued under the Stock Option Plan for Non-Employee Directors, 1995 Employee Stock Option Plan, 1996 Employee Stock Option Plan and the 2002 Equity Incentive Plan, (ii) warrants to purchase 4,619,540 shares of common stock, exercisable through May 24, 2010, issued on May 24, 2005 in connection with the Series B Preferred Stock offering, at an exercise price of $1.30 per share, and (iii) warrants to purchase 1,129,530 shares of common stock granted to the placement agent in our May 2005 private financing as a portion of their fees in the form of a warrant to purchase 37,651 units (consisting of 37,651 shares of our Series B Convertible Preferred Stock and warrants to purchase 376,510 shares of our common stock) at a purchase price of $15.00 per unit.

(2) Consists of a stock option grant to purchase 903,528 shares of common stock pursuant to a Stock Option Agreement dated November 14, 2005 by and between Leslie J. Christon, our former President and Chief Executive Officer, and the Company. Ms. Christon ceased to be employed by Shells on February 29, 2008. In accordance with the terms of such option agreement, the option remains exerciseable until May 29, 2008.

The number of securities and type of plans available for future issuance of stock options as of December 30, 2007 was:

	Options for Common Shares:				
Plan Name	Authorized	Exercised	Outstanding	Expired	Available
Stock Option Plan for Non-Employee Directors	150,000	0	30,000	120,000	0
1995 Employee Stock Option Plan	840,000	11,000	98,500	730,500	0
1996 Employee Stock Option Plan	101,000	11,001	58,007	31,992	0
2002 Equity Incentive Plan	4,096,472	229,522	3,730,575	0	136,575
Total stock options	5,187,472	251,523	3,917,082	882,492	136,575

Our board of directors decreased the authorized shares under our 2002 Equity Incentive Plan by 903,528 shares effective November 14, 2005, concurrent with the stock option to purchase 903,528 shares granted outside the Plan to Leslie J. Christon, our former President and Chief Executive Officer.

Stock options exercised consist of (i) 1,000 shares of common stock issued from options exercised in 2007 by employees, (ii) 9,466 shares of common stock issued from options exercised in 2006 by employees, (iii) 26,600 shares of common stock issued from options exercised in 2005 by employees, (iv) 42,666 shares of common stock issued from options exercised in 2004 by employees, (v) 160,790 shares of common stock issued in 2003 to key employees pursuant to our fiscal year 2002 management bonus plan, and (vi) 11,001 shares of common stock issued from options exercised by employees prior to 2001.

The 1995 Employee Stock Option Plan expired in September 2005 on its tenth anniversary as provided in the plan document. Options to purchase 98,500 shares of common stock remain outstanding under this plan, and expire on the tenth anniversary of their issuance, the last of which options expire in May 2011, if not previously exercised.

The 1996 Employee Stock Option Plan expired in 2006 on its tenth anniversary as provided in the plan document. Options to purchase 58,007 shares of common stock remain outstanding under this plan, and expire on July 1, 2012, if not previously exercised.

STOCK PRICE PERFORMANCE

The following Stock Price Performance Graph shall not be deemed incorporated by reference by any general statement incorporating by reference this proxy statement into any filing under the Securities Act of 1933 or under the Securities Exchange Act of 1934, except to the extent Shells specifically incorporates this information by reference, and shall not otherwise be deemed filed under such Acts.

The following graph compares cumulative total return of our common stock with the cumulative total return of (i) the Russell 2000 Index and (ii) the Nations Restaurant News Stock Index (the "Peer Index"). The graph assumes (a) $100 was invested on December 29, 2002 (the first day of our fiscal 2003) in each of our common stock, the stocks comprising the Russell 2000 Index and the stocks comprising the Peer Index, and (b) the reinvestment of dividends, if any.

COMPARISON OF CUMULATIVE TOTAL RETURN AMONG SHELLS SEAFOOD RESTAURANTS, INC., RUSSELL 2000 INDEX, AND NATIONS RESTAURANT NEWS STOCK INDEX

ITEM 6. SELECTED FINANCIAL DATA

The following table sets forth selected historical consolidated financial data for Shells. This consolidated financial data should be read in conjunction with "Management's Discussion and Analysis of Financial Condition and Results of Operations" and the Consolidated Financial Statements and Notes thereto included elsewhere in this Form 10-K. (The amounts are presented in thousands, except earnings per share, shares outstanding, number of restaurants data, and percentage information).

	Year (52 Weeks) Ended			Year (53 Weeks) Ended	Year (52 Weeks) Ended
	December 30, 2007	December 31, 2006	January 1, 2006	January 2, 2005	December 28, 2003
Statement of Operations Data:					
REVENUES					
Restaurant sales	$ 41,305	$ 47,673	$ 44,335	$ 41,393	$ 43,881
Management fees	139	156	152	171	165
International fees	15	-	-	-	-
Total revenues	41,459	47,829	44,487	41,564	44,046
RESTAURANT OPERATING COSTS:					
Food and beverage	13,469	15,363	14,671	14,051	14,467
Labor	12,938	14,722	13,757	12,935	13,845
Other	12,373	12,948	11,374	10,123	11,117
Depreciation and amortization	1,789	2,199	1,499	1,058	1,077
Pre-opening expenses	-	-	758	-	-
Provision for impairment of assets	1,270	1,242	-	105	360
Total restaurant operating costs	41,839	46,474	42,059	38,272	40,866
RESTAURANT OPERATING (LOSS) INCOME	(380)	1,355	2,428	3,292	3,180
General and administrative expenses	3,560	3,821	4,015	3,249	3,387
(LOSS) INCOME FROM OPERATIONS	(3,940)	(2,466)	(1,587)	43	(207)
OTHER (EXPENSE) INCOME:					
Lease buy-out	-	212	600	-	-
Provision for impairment of assets due to lease buy-out	-	-	(211)	-	-
Interest expense, net	(296)	(332)	(413)	(1,154)	(463)
Other (expense) income, net	(5)	(173)	30	33	(100)

Total other (expense) income, net	(301)	(293)	6	(1,121)	(563)
LOSS BEFORE ELIMINATION OF MINORITY PARTNER INTEREST AND INCOME TAXES	(4,241)	(2,759)	(1,581)	(1,078)	(770)
ELIMINATION OF MINORITY PARTNER INTEREST	(159)	(243)	(271)	(266)	(264)
LOSS BEFORE INCOME TAX BENEFIT	(4,400)	(3,002)	(1,852)	(1,344)	(1,034)
Income tax benefit (1)	-	-	-	-	-
NET LOSS BEFORE PREFERRED STOCK DIVIDEND	(4,400)	(3,002)	(1,852)	(1,344)	(1,034)
Deemed dividend associated with warrants and beneficial conversion feature of preferred stock	-	-	(1,735)	-	-
NET LOSS APPLICABLE TO COMMON STOCK	$ (4,400)	$ (3,002)	$ (3,587)	$ (1,344)	$ (1,034)

26

	Fiscal Years Ended December 30, 2007	December 31, 2006	January 1, 2006
Earnings per Share Data:			
Basic and diluted net loss per share	$ (0.21)	$ (0.18)	$ (0.24)
Shares Outstanding Data:			
Basic and diluted weighted average	20,920	16,665	14,796
Operating Data:			
Number of restaurants (at end of period):			
Company-owned restaurants (2)	20	22	22
Licensed restaurants	3	3	3
	23	25	25
Average annual sales per Company-owned and joint venture restaurant open for full period (3)	$ 2,025	$ 2,167	$ 1,998
(Decrease) increase in Company-owned and joint venture restaurant same store sales (3)	-11.4%	3.8%	7.0%

	December 30, 2007	December 31, 2006	January 1, 2006	January 2, 2005	December 28, 2003
Balance Sheet Data:					
Working capital (deficiency)	$ (4,712)	$ (4,446)	$ (4,842)	$ (4,639)	$ (3,606)
Total assets	11,479	13,837	17,438	13,519	11,616
Long-term debt, less current portion	658	172	1,001	2,239	1,558
Long-term debt, related party, less current portion	-	1,527	809	1,495	2,267
Minority partner interest	539	522	472	442	466
Preferred stock	1	4	5	-	1
Stockholders' equity	361	4,339	7,190	502	1,183

(1)

The effective tax rates for fiscal years 2007, 2006, 2005, 2004 and 2003 include the effects of recognizing valuation allowance adjustments relating to tax benefits. There was no benefit or provision for income taxes in 2007, 2006, 2005, 2004 or 2003. The valuation allowance in 2007, 2006, 2005, 2004 and 2003 was increased by $1,777, $2,821, $252, $210 and $596, respectively, in each such year reserving for all tax assets that were deemed non-realizable.

(2) Includes one joint venture restaurant in which we own a 51% equity interest. Two locations were closed in 2007, and two locations were opened, one was relocated and one was closed in 2005.

(3) Includes only restaurants open during the full fiscal year reported and also open for a full comparable fiscal year and at least the full six months prior thereto. Sales data for closed stores is included through the end of the month prior to closing. Sales data is temporarily excluded if a store is closed for at least 30 days. Same store sales are calculated on a comparable calendar period basis for the periods compared.

ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

General

In fiscal year 2007, Shells experienced an increasingly difficult operating environment. Declining economic conditions in Florida, the state where all of our restaurants are located, have been most challenging for casual dining restaurants in general. As the economy has continued to soften, consumers have responded in tightening their discretionary spending patterns. The collapse of the housing market in Florida, one of the worst hit states in the United States, has dramatically weighed in on consumer sentiment. The price of fuel has increased sharply, adversely affecting dining out decisions, as well as travel and tourism. Many areas of commodity and operating costs have risen sharply in the latter part of 2007, due to the trickle down affect of escalating fuel costs. Another increase in the state minimum wage also pushed labor costs higher for the third consecutive year. Insurance, property tax and utilities costs, after reaching historic plateaus in 2006, have generally remained constant at these levels through 2007, with only minimal relief.

The decline in same store sales was a cumulative -11.4% for fiscal 2007. We recognize that our guests are being affected themselves by this difficult economic climate, and that they are now, more than ever, highly selective with their dining dollars. Restaurants that are able to offer high-quality menu offerings that are relevant to consumers, at a compelling value, will win the guest’s business and their loyalty. We continue to focus on initiatives to improve every aspect of the dining experiences of our guests. We always take great pride in the freshness and quality of the seafood that we serve. We have repositioned our menu offerings to drive those items that provide the greatest value proposition. We have taken measures to reduce costs by better attaining delivery and preparation efficiencies, without affecting either the quality of our products served or our operating standards.

Throughout 2007, we continued to seek to remove those elements of cost within the organization that were non-essential to our mission of building guest traffic. With a limited marketing budget, we continued to fine-tune our marketing strategies to seek the optimal, most cost effective means of delivering our message to a targeted audience.

Despite the many challenges facing Shells, we are greatly committed to our turnaround strategy. Our primary objective is to reverse the trend in negative customer traffic, by attracting new and former guests to experience our great quality seafood at more favorable price points. In addition, we are committed to achieving further cost reductions, offsetting those external influences caused by the economy. We will continue to aggressively address both our top and bottom line pressures. We will also seek both traditional and non-traditional means to fund our cash flow requirements.

In 2007, we sold the rights for the Shells brand for certain middle eastern countries to Food and Entertainment Co., LTD. in a 10-nation development agreement within the Middle East. This arrangement not only provides us with ongoing revenue from the consulting and services agreement, but also builds our brand internationally and opens the door for future international development opportunities.

There are no assurances that our strategies will drive improvements in sales and customer traffic needed to meet anticipated cash flow requirements and restore our profitability. It is also uncertain whether future financing options, which may be needed to execute our strategies, will be available, on terms that would be acceptable to us, or at all.

The following table sets forth, for the periods indicated, the percentages that the items in our Consolidated Statements of Operations bear to total revenues or, where indicated, restaurant sales.

	Fiscal Years Ended		
	December 30, 2007	December 31, 2006	January 1, 2006
REVENUES			
Restaurant sales	99.7%	99.7%	99.7%
Management fees	0.3%	0.3%	0.3%
International fees	0.0%	0.0%	0.0%
Total revenues	100.0%	100.0%	100.0%
RESTAURANT OPERATING COSTS			
Cost of sales (1)	32.6%	32.2%	33.1%
Labor and other related expenses (1)	31.3%	30.9%	31.0%
Other restaurant operating expenses(1)	30.0%	27.2%	25.7%
Depreciation and amortization (1)	4.3%	4.6%	3.4%
Pre-opening expenses (1)	0.0%	0.0%	1.7%
Provision for impairment of assets (1)	3.1%	2.6%	0.0%
Total restaurant costs (1)	101.3%	97.5%	94.9%
Restaurant operating (loss) income (1)	-0.9%	2.8%	5.5%
General and administrative expenses	8.6%	8.0%	9.0%
LOSS FROM OPERATIONS	-9.5%	-5.2%	-3.6%
Lease buy-out	0.0%	0.4%	1.3%
Provision for impairment of assets due to lease buy-out	0.0%	0.0%	-0.5%
Interest expense, net	-0.7%	-0.7%	-0.9%
Other (expense) income, net	0.0%	-0.4%	0.1%
Total other (expense) income	-0.7%	-0.7%	-0.0%
Loss before elimination of minority interests	-10.2%	-5.8%	-3.6%
Elimination of minority partner interest	-0.4%	-0.5%	-0.6%
Net loss before preferred stock dividend	-10.6%	-6.3%	-4.2%
Deemed dividend associated with warrants and beneficial conversion feature of preferred stock	0.0%	0.0%	-3.9%
Net loss applicable to common stock	-10.6%	-6.3%	-8.1%

(1) as a percentage of restaurant sales

Results of Operations
Fiscal Year 2007 versus Fiscal Year 2006

Total revenues for the fiscal year 2007 were $41,459,000 as compared to $47,829,000 for fiscal year 2006. The $6,370,000 or 13.3% decrease in revenues was primarily due to an 11.4% decrease in comparable store sales and the loss of weeks of operations due to the closure and disposition of two restaurants in 2007. Our revenues consisted of restaurant sales of our company-owned restaurants; management and licensing fees on sales at the managed restaurants; and international fees related to the sale of Shells marks and system in certain middle eastern countries. The decrease in same store sales was the result of a decline in customer traffic of 14.5% partially offset by a 3.6% increase in average customer check, which was affected by menu price increases and changes in menu mix. Our food sales and liquor sales accounted for 86% and 14% of revenues for 2007 and 87% and 13% of revenues for 2006, we believe, due in part to the increased emphasis and additional menu items promoted in the wine and liquor categories. Comparisons of same store sales includes only restaurants open during the full fiscal year shown and open for a full comparable fiscal year and at least the full six months prior thereto. Sales data for closed stores is included through the end of the month prior to closing. Sales data is temporarily excluded if a store is closed for at least 30 days. Same store sales are calculated on a comparable calendar period basis.

The cost of restaurant sales as a percentage of restaurant sales increased to 32.6% for 2007 from 32.2% for 2006. This 0.4% increase in cost of sales as a percentage of sales primarily related to enhancing many of our menu items in the first quarter of 2007 and higher dairy and other commodity costs, partially offset by an increase in liquor sales as a percentage of total sales. The cost of restaurant sales generally consists of the cost of food, beverages, freight, and paper and plastic goods used in food preparation and carry-out orders.

Labor and other related expenses as a percentage of restaurant sales increased to 31.3% in 2007 as compared to 30.9% in 2006. We benefited from non-recurring reductions in benefits and taxes relating to workers compensation insurance reserve reductions, and corresponding refunds from prior years' experiences of $20,000 and $107,000 in 2007 and 2006, respectively, of which $20,000 and $96,000 were allocated to restaurant labor costs. Exclusive of the non-recurring items, labor and other related expenses as a percentage of restaurant sales were 31.4 % and 31.1% for 2007 and 2006, respectively. This increase of 0.3% as a percentage of sales primarily was due to the decrease of operating leverage as reflected by the reduction in sales volume and the impact of the annual increase in the Florida minimum wage. Labor and other related expenses generally consist of restaurant hourly and management payroll, benefits, taxes and workers' compensation insurance.

Other restaurant operating expenses were $12,373,000 or 30.0% of restaurant sales for 2007 as compared with $12,948,000, or 27.2% of restaurant sales for 2006. This unfavorable variance of 2.8% as a percentage of restaurant sales was primarily due to the decrease in operating leverage as reflected by the reduction of sales volume, and to a lesser extent, utilities and insurance costs. Other restaurant operating expenses generally consist of advertising, costs associated with area directors, non-food supplies, repairs and maintenance, rent and other occupancy costs, insurance and utilities.

Depreciation and amortization expense was $1,789,000 or 4.3% as a percentage of restaurant sales for 2007 and $2,199,000 or 4.6% as a percentage of restaurant sales for 2006. The 0.3% decrease as a percentage of restaurant sales was due to the impairment of assets in the fourth quarter of 2006 and the second quarter of 2007, as well as the sale of a restaurant property in the fourth quarter of 2006 and closures of two restaurants in the second and fourth quarters of 2007.

In 2007, we recorded a provision in operating expenses for the impairment of assets totaling $1,270,000 or 3.1% of restaurant sales relating to the write-down of assets at one restaurant to their estimated fair value in accordance with Financial Accounting Standards Board Statement No. 144. The write-down was necessitated by the then current period operating losses and the projected deficiency of cash flow of the restaurant. In 2006, we recorded a provision in operating expenses for the impairment of assets totaling $1,242,000 or 2.6% of restaurant sales.

General and administrative expenses were $3,560,000 or 8.6% of revenues and $3,821,000 or 8.0% of revenues in 2007 and 2006, respectively. The $261,000 decrease from the prior year is primarily related to a decrease in administrative salary expense of $401,000, partially offset by an increase in stock option expense of $197,000. General and administrative expenses relate to the operations of all Shells restaurants owned by us and management services that we provide to the managed restaurants.

Net interest expense was $296,000 in 2007 compared to $332,000 in 2006. The $36,000 decrease in net interest expense in 2007 from 2006 was generally due to the retirement of debt in October 2006 in conjunction with the completion of a sale of a restaurant property, partially offset by additions in interest expense on the line of credit with related parties and an increase in the amount financed on the Melbourne property.

Other expense, net, in 2007 was $5,000, compared to other expense, net, in 2006 of $173,000. Exclusive of non-recurring items, other expense was $27,000 in 2007 and $111,000 in 2006. In 2007, we recognized a gain of $85,000 from the VisaCheck/MasterMoney Antitrust Settlement and a $6,000 gain on the disposal of assets related to the sale of the leasehold interest in two locations, partially offset by a lease renewal cost of $39,000 and $30,000 in closed store expenses. In 2006, we recognized a loss on disposal of assets of $39,000 from the write-down of fixed assets replaced during remodeling and $23,000 related to the settlement of lease obligations on a closed location.

As a result of the factors discussed above, the loss from operations for 2007 was $3,940,000 as compared to a loss from operations of $2,466,000 for 2006. Exclusive of non-recurring items, our loss from operations was $2,672,000 for 2007 compared to $1,331,000 for 2006. Net loss applicable to common stock for 2007 was $4,400,000 compared to $3,002,000 for 2006. Exclusive of non-recurring items, the net loss in 2007 was $3,154,000 compared to a net loss in 2006 of $2,017,000.

Fiscal Year 2006 versus Fiscal Year 2005

Total revenues for the fiscal year 2006 were $47,829,000 as compared to $44,487,000 for fiscal year 2005. The $3,342,000 or 7.5% increase in revenues was primarily due to a 3.8% increase in comparable store sales and the net additional weeks of operations in 2006 of two restaurants opened and one restaurant closed in 2005, partially offset by one fewer restaurant under management in fiscal 2005. Our revenues consisted of restaurant sales of our company-owned restaurants and management and licensing fees on sales at the managed restaurants. The increase in same store sales was the result of a 6.7% increase in average customer check, which was affected by menu price increases and changes in menu mix. Customer traffic declined by 2.7% in 2006 compared to 2005, which was affected by unfavorable trends in the fourth quarter. Our food sales and liquor sales accounted for 87% and 13% of revenues for 2006 and 88% and 12% of revenues for 2005, we believe, due in part, to the increased emphasis and additional menu items promoted in the wine and liquor categories. In 2005, we incurred estimated sales losses of $204,000, due to hurricane-related business interruption. Adjusting for estimated hurricane-related sales losses in 2005, same store sales in 2006 would have increased by 3.3% over the prior year.

The cost of restaurant sales as a percentage of restaurant sales decreased to 32.2% for 2006 from 33.1% for 2005. This 0.9% improvement in cost of sales as a percentage of sales primarily related to higher menu pricing implemented to offset the effect of the Florida minimum wage increases, an increase in liquor sales as a percentage of total sales, and gains derived from better operational controls over food and beverage costs.

Labor and other related expenses as a percentage of restaurant sales decreased to 30.9% in 2006 as compared to 31.0% in 2005. We benefited from non-recurring reductions in benefits and taxes relating to workers compensation insurance reserve reductions, and corresponding refunds from prior years' experiences of $107,000 and $344,000 in 2006 and 2005, respectively, of which $96,000 and $330,000 were allocated to restaurant labor costs. Exclusive of the non-recurring items, labor and other related expenses as a percentage of restaurant sales were 31.1% and 31.8% for 2006 and 2005, respectively. This improvement of 0.7% as a percentage of restaurant sales primarily related to a reduction in workers' compensation insurance premiums and unemployment taxes and a decrease in restaurant labor expense due to improved operational efficiencies, offset partially by minimum wage increases.

Other restaurant operating expenses were $12,948,000, or 27.2% of restaurant sales for 2006, as compared with $11,374,000, or 25.7% of restaurant sales for 2005. This unfavorable variance of 1.5% as a percentage of restaurant sales was primarily due to increased utilities, insurance and occupancy costs, as affected by property taxes, partially offset by a decrease in advertising costs.

Depreciation and amortization expense was $2,199,000 or 4.6% as a percentage of restaurant sales, for 2006 and $1,499,000, or 3.4% as a percentage of restaurant sales, for 2005. The 1.2% increase as a percentage of restaurant sales was due to additional restaurant remodels and new and relocated restaurants, subsequent to the third quarter of 2005.

There were no pre-opening expenses in 2006 compared to $758,000, or 1.7% of restaurant sales in 2005, related to new locations in Clearwater Beach and St. Petersburg and the relocation of our Stuart restaurant to a higher volume site. Pre-opening expenses relate to the costs incurred prior to opening a new restaurant location primarily for training, advertising, occupancy and legal costs.

In 2006, we recorded a provision in operating expenses for the impairment of assets totaling $1,242,000 or 2.6% of restaurant sales relating to the write-down of assets at one restaurant to their estimated fair value in accordance with Financial Accounting Standards Board Statement No. 144. The write-down was necessitated by the then current period operating losses and the projected deficiency of cash flow of the restaurant. There was no provision recorded in operating expenses in 2005 relating to the impairment of assets.

General and administrative expenses were $3,821,000 or 8.0% of revenues and $4,015,000 or 9.0% of revenues in 2006 and 2005, respectively. The decrease from the prior year is primarily related to decreases in manager training expenses, legal expenses, and recruiting, partially offset by increases in stock option expense. General and administrative expenses relate to the operations of all Shells restaurants owned by us and management services that we provide to the managed restaurants.

In April 2006, we recognized $212,000 of net cash proceeds in a non-recurring transaction related to the sale of an option embedded in the Ocala restaurant lease agreement to a new landlord. In January 2005, we entered into an agreement with our landlord in St. Pete Beach, Florida, whereby the landlord paid $600,000 to us for an option to buy-out the lease upon 60 days notice to us. To-date, no termination notice has been received from the landlord. We recorded a pre-tax charge of $211,000 relating to the write-down of impaired assets to their estimated fair value in accordance with Financial Accounting Standards Board Statement No. 144 relating to the expected shortened lease period as potentially affected by the lease buy-out option.

Net interest expense was $332,000 in 2006 compared to $413,000 in 2005. The $81,000 decrease in net interest expense in 2006 from 2005, was generally due to the retirement of debt in May 2005 in conjunction with our then private financing transaction and the retirement of debt in October 2006 in conjunction with the completion of a sale of a restaurant property, partially offset by additions in interest on the line of credit with related parties and the bank credit facility.

Other expense, net, in 2006 was $173,000, compared to other income, net, in 2005 of $30,000. In 2006, exclusive of non-recurring items, other expense was $111,000 in 2006 and $13,000 in 2005. In 2006, we recognized a loss on disposal of assets of $39,000 from the write-down of fixed assets replaced during remodeling and $23,000 related to the settlement of lease obligations on a closed location. In 2005, we recognized a non-recurring gain of $793,000 on a property sale, partially offset by non-recurring expenses of (i) $472,000 in losses on disposal of assets primarily related to restaurant remodeling, (ii) $100,000 lease termination fee for the early termination of a lease in Stuart, Florida, (iii) $98,000 in hurricane-related expenses, net of insurance recoveries, and (iv) $80,000 in financing costs related to a line of credit fee paid to our investors.

As a result of the factors discussed above, the loss from operations for 2006 was $2,466,000 as compared to a loss from operations of $1,587,000 for 2005. Exclusive of non-recurring items, our loss from operations was $1,331,000 for 2006 compared to $1,168,000 for 2005. Net loss before preferred stock dividend for 2006 was $3,002,000 compared to $1,852,000 for 2005. Exclusive of non-recurring items, the net loss in 2006 was $2,017,000 compared to $1,865,000 for 2005.

The deemed dividend in 2005 associated with warrants and beneficial conversion feature of our Series B Convertible Preferred Stock of $1,735,000 related to the May 2005 private placement financing transaction when we issued Series B Convertible Preferred Stock and warrants to purchase common stock. This one-time implied preferred stock dividend was recorded through accumulated deficit.

Liquidity and Capital Resources

In 2007, we incurred a significant loss from operations due to a sharp decrease in sales in our existing restaurants, coupled with rising commodity, operating and labor costs and already existing historically high utility rates, property taxes and insurance costs. We recorded a provision of $1,270,000 for impairments of assets recognized in the second and fourth quarters of 2007. Similarly in 2006, we recorded a provision of $1,242,000 for asset impairments. Given the external challenges we continued to face in 2007, which increased our costs as a percentage of revenues, we took measures to reduce expenses and improve efficiencies in those areas of costs that were within our control, such as cost of sales, labor and general and administrative expenses.

In March 2005, certain of our investors provided us a $1,600,000 revolving line of credit, which was originally due to mature on the earlier of March 31, 2006 or the closing of a financing providing us not less than $1,600,000 of net proceeds. The investors received a fee of $80,000 for establishing the credit line. Amounts drawn under the line of credit bear interest at the rate of 15% per annum, payable 8% monthly in arrears and 7% deferred until the maturity date. Upon completion of the financing in May 2005 described below, the maturity date was extended to May 23, 2007. In March 2007, the maturity date was further extended to May 23, 2008 for an extension fee equal to 7% of the outstanding line of credit which was paid with 224,000 shares of our common stock, with a recognized transaction cost of $101,000. At the time of the extension, the amount available to be drawn under the revolving line of credit was reduced to the then current amount borrowed of $1,440,000. In October 2005, we utilized $800,000 of the line of credit to fund the acquisition and opening costs of two new restaurant locations. In June 2006, we utilized an additional $640,000 of the revolving line of credit to fund remaining remodeling costs and working capital requirements.

In December 2005, we secured a six-month, $500,000 bank credit facility for which the full amount was immediately drawn on to fund remodeling. In April 2006, we recognized $212,000 in net cash proceeds related to the sale of an option embedded in the lease agreement of our restaurant property in Ocala, Florida. In October 2006, we completed a sale and simultaneous leaseback of our restaurant property in New Smyrna Beach, Florida, at a sales price of $1,333,000 in which we received net cash proceeds of $885,000, after transaction costs and retirement of a $324,000 note on the property. We also simultaneously retired the $500,000 bank credit facility, which had at that time been extended in anticipation of the New Smyrna transaction being completed.

In December 2007, we entered into an agreement to sell our marks and system in certain middle eastern countries to Food and Entertainment Co., LTD, an entity owned by the Alhokair Group, a company domiciled in the Kingdom of Saudi Arabia. We sold the development rights to Food and Entertainment to open 10 restaurants over a 10-year period, solely within a territory to initially consist of the Kingdom of Saudi Arabia, Egypt, Jordan, Qatar, Oman, Bahrain, United Arab Emirates, Kuwait, Pakistan, India and based on additional performance criteria, Tunisia and Morocco. The purchase price for such rights was $1,750,000. We received $700,000 upon the execution of the agreement and $350,000 in January 2008, and will receive an additional $350,000 in each of April 2008 and July 2008. The purchase price is supported by an irrevocable letter of credit in the amount of $1,050,000, which expires in October 2008.

In conjunction with such sale of our marks and system, we also entered into an agreement to provide technical consulting and support services to Food and Entertainment for a 10-year period, with two additional five-year options at the election of Food and Entertainment. Technical and support services to be provided under the agreement include restaurant design, operations, training, product sourcing and menu engineering for which we receive a fee of 1% of Food and Entertainment's gross sales of its Shells restaurants in operation, payable monthly. Upon expiration of the initial $1,050,000 letter of credit, and continuing for the duration of the technical consulting and support services agreement, Food and Entertainment has agreed to provide us with a $500,000 irrevocable letter of credit.

The following table presents a summary of our cash flows for the last three fiscal years (in thousands):

	2007	2006	2005
Net cash (used in) provided by operating activities	$ (275)	$ 38	$ 1,477
Net cash provided by (used in) investing activities	54	(278)	(5,518)
Net cash (used in) provided by financing activities	(55)	(387)	3,052
Net decrease in cash	$ (276)	$ (627)	$ (989)

As of December 30, 2007, our current liabilities of $7,122,000 exceeded our current assets of $2,410,000, resulting in a working capital deficiency of $4,712,000. In comparison, as of December 31, 2006, our working capital deficiency was $4,446,000. Our operating leverage decreased slightly, primarily due to an $981,000 increase in current liabilities and a $276,000 lower cash balance than last year, mostly offset by a $1,073,000 increase in other current assets reflecting the receivable outstanding from the transaction with Food and Entertainment. The increase in current liabilities, in large part, related to the reclassification of $1,627,000 in related party notes and deferred interest payable, which is scheduled to mature on May 23, 2008. As a partial offset, current maturities of long-term debt decreased by $400,000 due to the refinancing of the Melbourne note. Additionally, accrued expenses and accounts payable decreased by $257,000 and $102,000 from the prior year, respectively. Historically, we have generally operated with negative working capital as a result of investing current assets into non-current property and equipment, as well as the turnover of restaurant inventory relative to more favorable vendor terms in accounts payable.

Our year-end cash position decreased $276,000, from $734,000 as of December 31, 2006 to $458,000 as of December 30, 2007. The decrease in cash mostly related to cash used in operating activities of $275,000, resulting from the operating loss in 2007. Cash provided by investing activities of $54,000, reflected $493,000 in proceeds from the sale of assets relating to the dispositions of the Coral Springs and Davie restaurants, mostly offset by capital expenditures of $439,000. Cash used in financing activities of $56,000 reflected $1,682,000 in debt repayment and $142,000 in minority partner distributions, mostly offset by $1,768,000 in proceeds from the issuance of debt related primarily to short-term insurance premium financing and the refinancing of the Melbourne note.

On December 7, 2004, we completed a financing to include $2,375,000 principal amount of debentures and warrants to purchase 1,187,500 shares of our common stock. We received net proceeds of $2,010,000 from the financing. We paid interest at 12% and late payment penalties through May 23, 2005 when the debentures were retired by repayment in cash or conversion into our Series B Preferred Stock. Repayments in cash consisted of principal of $2,055,000, plus interest and penalties of $177,000. Debentures converted into our Series B Preferred Stock consisted of $320,000 principal plus interest and penalties of $28,000. The warrants were exercisable until December 7, 2007 at an exercise price of $0.60 per share. These warrants have expired without being exercised. As compensation for their services as placement agent in the debenture offering and future consulting services to us, the placement agent received cash fees and warrants with terms substantially identical to those received by the investors. The placement agent warrants have also expired without being exercised.

In October 2002, we refinanced through Colonial Bank two of our restaurant locations, Melbourne and Winter Haven, with notes of $635,000 and $667,000, respectively, both notes maturing in October 2007 with 15-year principal amortization schedules. In September 2005, we completed a sale and leaseback transaction of the Winter Haven location, providing net cash proceeds of $981,000, after repayment of the bank note mortgage and a second secured note. Upon repayment of the Winter Haven note, we ceased to be subject to the prior bank loan covenant provisions. In September 2007, we refinanced the $407,000 outstanding balance of the promissory note securing the Melbourne property. Additionally, the note was increased to $607,000, of which $200,000 funded a significant portion of the Melbourne restaurant remodeling.

We have incurred significant losses from operations, an accumulated deficit, and secured promissory notes which are scheduled to mature in May 2008, that raise substantial doubt about our ability to continue as a going concern. Sufficient liquidity to satisfy the debt obligations under these promissory notes if the maturity dates are not further extended, coupled with meeting other debt obligations; is dependent primarily on the realization of cash flow from operations, additional scheduled payments to be received from the transaction with Food and Entertainment and obtaining alternative financing sources. There can be no assurances that these initiatives will be successful. Our independent registered public accounting firm has included an explanatory paragraph in their report on our financial statements, stating that these statements have been prepared assuming that we will continue as a going concern and that our recurring losses from operations and net working capital deficiency raise substantial doubt about our ability to continue as a going concern.

Contractual Obligations

As of December 30, 2007, our contractual obligations were:

	Payments due by period				
	Total	< 1 yr	1 - 3 yrs	4 - 5 yrs	> 5yrs
Long-term debt (1)	$ 881,629	$ 223,340	$ 119,153	$ 539,136	$ -
Capital lease obligations	-	-	-	-	-
Operating lease obligations (2)	23,146,571	2,753,128	5,145,869	4,407,784	10,839,790
Purchase obligations	-	-	-	-	-
Other debt obligations reflected on the balance sheet under GAAP (3)	1,626,504	1,626,504	-	-	-
Total	$ 25,654,704	$ 4,602,972	$ 5,265,022	$ 4,946,920	$ 10,839,790

(1) Consists of long-term debt as reported in Note 7 of the Notes to Consolidated Financial Statements.
(2) Consists of operating leases primarily for real estate.
(3) Consists of related party debt due in 2008.

Quarterly Fluctuation of Financial Results

The restaurant industry in general is seasonal, depending on restaurant location and the type of food served. We have experienced fluctuations in our quarter-to-quarter operating results due, in large measure, to our concentration of restaurants in Florida. Business in Florida is influenced by seasonality due to various factors, which include but are not limited to weather conditions in Florida relative to other areas of the U.S., the health of Florida's economy and the effect of world events in general, and the tourism industry in particular. Our restaurant sales are generally highest from January through April and June through August, the peaks of the Florida tourism season, and generally lower from September through mid-December. Many of our restaurant locations are in coastal cities, where sales are significantly dependent on tourism and its seasonality patterns.

In addition, quarterly results have been substantially affected by the timing of restaurant closings, openings and remodelings. Because of the seasonality of our business and the impact of restaurant closings, openings and remodelings, results for any quarter are not generally indicative of the results that may be achieved for a full fiscal year on an annualized basis and cannot be used to indicate financial performance for the entire year.

New Accounting Pronouncements

In December 2007, the Financial Accounting Standards Board (“FASB”) issued SFAS No. 141 (revised 2007), Business Combinations (“SFAS 141R”). SFAS 141R establishes principles and requirements for an acquiring entity to recognize and measure in its financial statements the identifiable assets acquired, the liabilities assumed, any noncontrolling interest in the acquiree and the goodwill acquired. SFAS 141R expands on required disclosures to improve the statement users’ abilities to evaluate the nature and financial effects of business combinations. SFAS 141R is effective for fiscal years beginning after December 15, 2008. We are currently evaluating the potential impact, if any, of the adoption of SFAS 141R on our Consolidated Financial Statements.

In December 2007, the FASB issued SFAS No. 160, Noncontrolling Interests in Consolidated Financial Statements—an amendment of ARB No. 51 (“SFAS 160”). SFAS 160 requires that a noncontrolling interest in a subsidiary be reported within equity and the amount of consolidated net income attributable to the noncontrolling interest be identified in the consolidated financial statements. SFAS 160 calls for consistency in the manner of reporting changes in the parent's ownership interest and requires fair value measurement of any noncontrolling equity investment retained in a deconsolidation. SFAS No. 160 also establishes disclosure requirements that clearly identify and distinguish between the interests of the parent and the interests of the noncontrolling owners. SFAS No. 160 is effective for fiscal years beginning after December 15, 2008. We are currently evaluating the potential impact, if any, of the adoption of SFAS 160 on our Consolidated Financial Statements.

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities ("SFAS 159"), which gives entities the option to measure eligible financial assets, and financial liabilities at fair value on an instrument by instrument basis, that are otherwise not permitted to be accounted for at fair value under other accounting standards. The election to use the fair value option is available when an entity first recognizes a financial asset or financial liability. Subsequent changes in fair value must be recorded in earnings. This statement is effective as of the beginning of a company's first fiscal year after November 15, 2007. The adoption of this Statement is not expected to have a material effect on our Consolidated Financial Statements.

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements ("SFAS 157"). SFAS 157 defines fair value, establishes a framework for measuring fair value in accordance with generally accepted accounting principles, and expands disclosures about fair value measurements. SFAS 157 is effective for fiscal years beginning after November 15, 2007. The adoption of this Statement is not expected to have a material effect on our Consolidated Financial Statements.

Impact of Inflation and Price Changes

We have not operated in a highly inflationary period and management does not believe that inflation has had a material affect on sales or expenses through 2007. As expenses increase, such as the annual increases in the minimum wage rate in Florida and the recent significant increases in commodity costs, utilities, occupancy costs, and insurance, we expect to recover increased costs by increasing prices, to the extent permitted by competition, or by operating our business more efficiently and modifying our menu and promoting other less cost sensitive products. Many food products purchased by us are affected by commodity pricing and are, therefore, subject to unpredictable price volatility. Extreme changes in commodity prices and/or long-term changes, including operating expenses, could affect us adversely. From time-to-time, competitive circumstances could limit menu price flexibility, and in those cases margins would be negatively impacted by increased commodity prices.

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

We have limited exposure to market risk from changes in interest rates on debt and changes in commodity prices. Our exposure to interest rate risk is limited due to the fixed interest rates on our current debt instruments.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

INDEX TO CONSOLIDATED FINANCIAL STATEMENTS

REPORT OF IDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders
Shells Seafood Restaurants, Inc. and Subsidiaries
Tampa, Florida

We have audited the accompanying consolidated balance sheets of Shells Seafood Restaurants, Inc. and Subsidiaries (the "Company") as of December 30, 2007 and December 31, 2006 and the related consolidated statements of operations, stockholders' equity and cash flows for the fiscal years ended December 30, 2007 (52 weeks), December 31, 2006 (52 weeks) and January 1, 2006 (52 weeks). These consolidated financial statements are the responsibility of company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. The company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of the Company as of December 30, 2007 and December 31, 2006 and the results of its operations and cash flows for the fiscal years ended December 30, 2007 (52 weeks), December 31, 2006 (52 weeks) and January 1, 2006 (52 weeks) in conformity with accounting principles generally accepted in the United States of America.

The accompanying consolidated financial statements have been prepared assuming the Company will continue as a going concern. As more fully described in Note 1, the Company has incurred recurring losses from operations, has an accumulated deficit and has a secured promissory note due in fiscal 2008. These conditions raise substantial doubt about the Company's ability to continue as a going concern. Management's plans in regard to these matters are also described in Note 1. The consolidated financial statements do not include any adjustments to reflect the possible effects on the recoverability and classification of assets or the amounts and classification of liabilities that may result from the outcome of this uncertainty.

/s/ Kirkland, Russ, Murphy & Tapp P.A.
Clearwater, Florida
March 28, 2008

SHELLS SEAFOOD RESTAURANTS, INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS

	December 30, 2007	December 31, 2006
ASSETS		
Cash	$ 457,754	$ 734,122
Inventories	446,521	543,183
Other current assets	1,456,965	383,598
Receivables from related parties, net	48,780	34,305
Total current assets	2,410,020	1,695,208
Property and equipment, net	6,073,218	9,170,821
Goodwill	2,474,407	2,474,407
Other assets	509,164	481,641
Prepaid rent	12,009	14,629
TOTAL ASSETS	$ 11,478,818	$ 13,836,706
LIABILITIES AND STOCKHOLDERS’ EQUITY		
Accounts payable	$ 3,145,797	$ 3,248,031
Accrued expenses	1,786,675	2,043,678
Sales tax payable	164,188	225,639
Current portion of unearned revenue	174,996	-
Notes and deferred interest payable to related parties	1,626,504	-
Current portion of long-term debt	223,340	623,526
Total current liabilities	7,121,500	6,140,874
Notes and deferred interest payable to related parties	-	1,527,453
Long-term debt, less current portion	658,289	171,847
Unearned revenue, less current portion	1,560,421	-
Deferred rent	1,238,121	1,135,873
Total liabilities	10,578,331	8,976,047
Minority partner interest	539,020	521,876
STOCKHOLDERS’ EQUITY:		
Preferred stock, $0.01 par value; authorized 2,000,000 shares;		
Series A - 22,694 shares issued and outstanding	227	