INFOUSA INC
Form 10-Q
November 13, 2003

Table of Contents

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

x **Quarterly Report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**

For the quarterly period ended September 30, 2003 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 0-19598

infoUSA INC.

(exact name of registrant specified in its charter)

DELAWARE	47-0751545
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification Number)
5711 SOUTH 86TH CIRCLE, OMAHA, NEBRASKA	68127
(Address of principal executive offices)	(Zip Code)

Registrant s telephone number, including area code (402) 593-4500

N/A

(Former name, former address and former fiscal year, if changed since last report)

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 at least the past 90 days.

Yes x No o

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule12b-2 of the Act). Yes x No o

APPLICABLE ONLY TO CORPORATE ISSUERS:

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

52,242,941 shares of Common Stock at November 6, 2003

TABLE OF CONTENTS

Table of Contents

infoUSA INC.

INDEX

Table of Contents

infoUSA INC.

FORM 10-Q

FOR THE QUARTER ENDED

September 30, 2003

PART I

FINANCIAL INFORMATION

3

Table of Contents

ITEM 1. FINANCIAL STATEMENTS

infoUSA INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
(in thousands, except share and per share amounts)

	September 30, 2003	December 31, 2002
	(UNAUDITED)	
ASSETS		
Current assets:		
Cash and cash equivalents	$ 3,141	$ 6,285
Marketable securities	1,007	887
Trade accounts receivable, net of allowances of $2,829 and $3,673, respectively	34,152	39,352
Officer note receivable	510	510
List brokerage trade accounts receivable	12,621	16,635
Income taxes receivable	1,439	
Prepaid expenses	6,832	4,515
Deferred marketing costs	3,599	1,746
Total current assets	63,301	69,930
Property and equipment, net	43,480	45,756
Intangible assets, net	263,982	273,246
Other assets	4,990	4,454
	$ 375,753	$ 393,386
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Current portion of long-term debt	$ 16,910	$ 26,312
Accounts payable	13,704	13,303
List brokerage trade accounts payable	8,721	12,745
Accrued payroll expenses	11,990	11,410
Accrued expenses	1,884	1,827
Income taxes payable		3,287
Deferred income taxes	7,476	515
Deferred revenues	15,399	13,821
Total current liabilities	76,084	83,220
Long-term debt, net of current portion	136,477	164,116
Deferred income taxes	18,836	21,722
Other liabilities	4,554	6,000
Stockholders equity:		
Common stock, $.0025 par value. Authorized 295,000,000 shares; 52,799,107 shares issued and 52,218,561 outstanding at September 30, 2003 and 51,869,816 shares issued and 51,111,014 outstanding at December 31, 2002	132	130
Paid-in capital	98,237	92,205
Retained earnings	47,449	32,237
Treasury stock, at cost, 580,546 shares held at September 30, 2003 and 758,802 held at December 31, 2002	(3,494)	(4,538)

Notes receivable from officers	(337)	(834)
Accumulated other comprehensive loss	(2,185)	(872)
Total stockholders equity	139,802	118,328
	$ 375,753	$ 393,386

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

Table of Contents

infoUSA INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS
(in thousands, except per share amounts)

	THREE MONTHS ENDED September 30,		NINE MONTHS ENDED September 30,	
	2003	**2002**	**2003**	**2002**
	(UNAUDITED)		**(UNAUDITED)**	
Net sales	$77,379	$77,171	$232,290	$227,936
Costs and expenses:				
Database and production costs	21,416	20,618	64,556	63,191
Selling, general and administrative (excluding non-cash stock option compensation expense of $76 and $8 for the three months and $145 and $35 for the nine months ended September 30, 2003 and 2002, respectively)	36,827	34,711	103,825	98,558
Depreciation and amortization	7,006	6,805	21,214	21,058
Non-cash stock option compensation	76	8	145	35
Restructuring charges	645	804	1,630	1,616
Litigation settlement charge	1,667	110	1,667	417
Acquisition costs		2	54	175
Total operating costs and expenses	67,637	63,058	193,091	185,050
Operating income	9,742	14,113	39,199	42,886
Other income (expense):				
Investment income	394	35	1,222	133
Other charges	(2,240)	(115)	(6,385)	(5,355)
Interest expense	(2,243)	(3,404)	(9,500)	(12,562)
Income before income taxes	5,653	10,629	24,536	25,102
Income taxes	2,021	4,225	9,324	9,606
Net income	$ 3,632	$ 6,404	$ 15,212	$ 15,496
Basic earnings per share:	$ 0.07	$ 0.12	$ 0.30	$ 0.30
Diluted earnings per share:	$ 0.07	$ 0.12	$ 0.30	$ 0.30

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

Table of Contents

infoUSA INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)

	NINE MONTHS ENDED September 30, 2003	2002
	(UNAUDITED)	
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$ 15,212	$ 15,496
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	21,214	21,058
Amortization of deferred financing costs	539	620
Deferred income taxes	4,304	(2,164)
Non-cash stock option compensation expense	145	35
Non-cash 401(k) contribution in common stock	1,028	649
Gain on sale of assets	(860)	
Non-cash impairment of assets		2,978
Non-cash other charges	2,482	1,264
Changes in assets and liabilities, net of effect of acquisitions:		
Trade accounts receivable	6,727	3,020
List brokerage trade accounts receivable	4,014	(825)
Prepaid expenses and other assets	(5,185)	2,649
Deferred marketing costs	(1,853)	(429)
Accounts payable	(533)	3,117
List brokerage trade accounts payable	(4,179)	541
Income taxes receivable and payable, net	(4,726)	(1,480)
Accrued expenses and other liabilities	(785)	(10,900)
Net cash provided by operating activities	37,544	35,629
CASH FLOWS FROM INVESTING ACTIVITIES:		
Sale of other investments	1,628	
Purchase of other investments	(626)	(32)
Purchases of property and equipment	(4,657)	(2,453)
Acquisitions of businesses, net of cash acquired	(5,494)	(6,453)
Software and database development costs	(743)	(1,820)
Net cash used in investing activities	(9,892)	(10,758)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Repayment of long-term debt	(137,041)	(27,233)
Proceeds of long-term debt	100,000	
Deferred financing costs paid	(141)	(1,030)
Proceeds for repayment of officer loan	496	
Proceeds from exercise of stock options	5,890	569
Net cash used in financing activities	(30,796)	(27,694)
Net decrease in cash and cash equivalents	(3,144)	(2,823)
Cash and cash equivalents, beginning	6,285	4,382

Cash and cash equivalents, ending	$ 3,141	$ 1,559
Supplemental cash flow information:		
Interest paid	$ 8,390	$ 9,884
Income taxes paid	$ 9,904	$ 13,630

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

Table of Contents

infoUSA INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. GENERAL

The accompanying unaudited consolidated financial statements have been prepared on the same basis as the audited consolidated financial statements and, in the opinion of management, contain all adjustments, consisting of normal recurring adjustments, necessary to fairly present the financial information included therein. The consolidated financial statements have been prepared in accordance with the instructions to Form 10-Q and do not include all the information and footnotes required by accounting principles generally accepted in the United States of America for complete financial statements.

The Company suggests that this financial data be read in conjunction with the audited consolidated financial statements and notes thereto for the year ended December 31, 2002 included in the Company s 2002 Annual Report on Form 10-K, filed with the Securities and Exchange Commission. Results for the interim period presented are not necessarily indicative of results to be expected for the entire year.

Reclassifications. In April 2002, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 145, Rescission of FASB Statements No. 4, 44 and 64, Amendment of FASB Statement No. 13 and Technical Corrections. SFAS No. 145, among other things, rescinds SFAS No. 4 which required all gains and losses from the extinguishments of debt to be classified as an extraordinary item and amends SFAS No. 13 to require that certain lease modification that have economic effect similar to sale-leaseback transactions be accounted for in the same manner as sale-leaseback transactions. Upon adoption of the new accounting standard in 2003, the Company was required to reclassify the extraordinary item of $1.8 million related to the extinguishment of debt as reported in the 2002 consolidated statement of operations. The reclassification increased other charges expense by $2.9 million and decreased income tax expense by $1.1 million.

2. EARNINGS PER SHARE INFORMATION

The following table shows the amounts used in computing earnings per share and the effect on the weighted average number of shares of dilutive potential common stock.

	Three Months Ended September 30, (In Thousands)		Nine Months Ended September 30, (In Thousands)	
	2003	**2002**	**2003**	**2002**
Weighted average number of shares used in basic EPS	51,676	50,991	51,351	50,935
Net additional common stock equivalent shares outstanding after assumed exercise of stock options	681		102	83
Weighted average number of shares outstanding used in diluted EPS	52,357	50,991	51,453	51,018

3. SEGMENT INFORMATION

The Company currently manages existing operations utilizing financial information accumulated and reported for two business segments.

The small business segment principally engages in the selling of sales lead generation, business directories and consumer DVD products to small and medium sized companies, small office and home office businesses and individual consumers. This segment includes the sale of content via the Internet.

The large business segment principally engages in the selling of data processing services, licensed databases, database marketing solutions, e-mail marketing solutions and list brokerage and list management services to large companies. This segment includes the licensing of databases for Internet directory assistance services.

The small business and large business segments reflect actual net sales, direct order production, and identifiable direct sales and marketing costs related to their operations. The remaining indirect costs are presented as a reconciling item in corporate activities.

Corporate activities principally represent the information systems technology, database compilation, database verification, and administrative functions of the Company. Investment income, interest expense, income taxes, amortization of intangibles, and depreciation expense are only recorded in corporate activities. The Company does not allocate these costs to the two business segments. The Company records unusual or non-recurring items including acquisition costs, non-cash stock compensation expense, asset impairments and other extraordinary items in corporate activities to allow for the analysis of the sales business segments excluding such unusual or non-recurring charges.

The Company accounts for property and equipment on a consolidated basis. The Company s business segments share the Company s property and equipment. Depreciation expense is recorded in corporate activities.

The Company has no intercompany sales or intercompany expense transactions. Accordingly, there are no adjustments necessary to eliminate amounts between the Company s segments.

The following table summarizes segment information:

	For The Three Months Ended September 30, 2003			
	Small Business	Large Business	Corporate Activities	Consolidated Total
	(In thousands)			
Net sales	$37,902	$39,477	$	$77,379
Non-cash stock compensation			(76)	(76)
Restructuring charges			(645)	(645)
Litigation settlement charges			(1,667)	(1,667)
Operating income (loss)	10,423	20,009	(20,690)	9,742
Investment income			394	394
Other charges			(2,240)	(2,240)
Interest expense			(2,243)	(2,243)
Income (loss) before income taxes	10,423	20,009	(24,779)	5,653

	For The Three Months Ended September 30, 2002			
	Small Business	Large Business	Corporate Activities	Consolidated Total
	(In thousands)			
Net sales	$41,084	$36,087	$	$77,171
Non-cash stock compensation			(8)	(8)
Restructuring charges			(804)	(804)
Litigation settlement charges			(110)	(110)
Acquisition costs			(2)	(2)
Operating income (loss)	15,585	18,571	(20,043)	14,113
Investment income			35	35
Other charges			(115)	(115)
Interest expense			(3,404)	(3,404)
Income (loss) before income taxes	15,585	18,571	(23,527)	10,629

	For The Nine Months Ended September 30, 2003			
	Small Business	Large Business	Corporate Activities	Consolidated Total
	(In thousands)			
Net sales	$117,556	$114,734	$	$232,290

Non-cash stock compensation			(145)	(145)
Restructuring charges			(1,630)	(1,630)
Litigation settlement charges			(1,667)	(1,667)
Acquisition costs			(54)	(54)
Operating income (loss)	41,006	57,365	(59,172)	39,199
Investment income			1,222	1,222
Other charges			(6,385)	(6,385)
Interest expense			(9,500)	(9,500)
Income (loss) before income taxes	41,006	57,365	(73,835)	24,536

Table of Contents

	For The Nine Months Ended September 30, 2002			
	Small Business	Large Business	Corporate Activities	Consolidated Total
	(In thousands)			
Net sales	$117,405	$110,531	$	$227,936
Non-cash stock compensation			(35)	(35)
Restructuring charges			(1,616)	(1,616)
Litigation settlement charges			(417)	(417)
Acquisition costs			(175)	(175)
Operating income (loss)	46,066	58,615	(61,795)	42,886
Investment income			133	133
Other charges			(5,355)	(5,355)
Interest expense			(12,562)	(12,562)
Income (loss) before income taxes	46,066	58,615	(79,579)	25,102

4. COMPREHENSIVE INCOME (LOSS)

Comprehensive income (loss), including the components of other comprehensive income (loss), is as follows:

	For The Three Months Ended		For The Nine Months Ended	
	September 30, 2003	September 30, 2002	September 30, 2003	September 30, 2002
	(In thousands)		(In thousands)	
Net income	$ 3,632	$ 6,404	$15,212	$15,496
Other comprehensive income:				
Unrealized gain from investments:				
Unrealized gains (losses)	(57)	(10)	136	(66)
Related tax expense	22	4	(52)	25
Net	(35)	(6)	84	(41)
Interest rate swap agreement:				
Gains				850
Related tax expense				(323)
Net				527
Pension plan:				
Unrealized gains (losses)	(1,397)		(1,397)	
Total other comprehensive income	(1,432)	(6)	(1,313)	486
Comprehensive income	$ 2,200	$ 6,398	$13,899	$15,982

The components of accumulated other comprehensive income (loss) is as follows:

	Unrealized Gains/(Losses) Pension plan	Foreign Currency Translation Adjustments	Unrealized Gains / (Losses) On Securities	Accumulated Other Comprehensive Income (Loss)
	(in thousands)			
Balance at September 30, 2003	$(1,397)	$ (672)	$ (116)	$(2,185)
Balance at December 31, 2002	$	$ (672)	$ (200)	$ (872)

5. ACQUISITIONS

Effective September 14, 2003, the Company purchased the assets of LTWC Corporation (Markado), a provider of email marketing services. Total consideration for the acquisition was cash of $1.0 million. The purchase price for the acquisition has been preliminarily allocated to current assets of $0.3 million, property and equipment of $0.1 million and goodwill of $0.6 million. The acquisition has been accounted for under the purchase method of accounting, and accordingly, the operating results of Markado have been included in the Company s financial statements since the date of acquisition.

Effective March 1, 2003, the Company acquired all issued and outstanding common stock of Yesmail, Inc., a provider of email acquisition and retention services. The acquisition has been accounted for under the purchase method of accounting, and accordingly,

Table of Contents

the operating results of Yesmail, Inc. have been included in the Company s financial statements since the date of acquisition. Total consideration for the acquisition was cash of $5.0 million. The purchase price for the acquisition had been preliminarily allocated to current assets of $3.1 million, property and equipment of $1.4 million, current liabilities of $3.7 million and goodwill of $4.2 million. The transaction is subject to purchase price adjustment represented by an adjustment for finalized working capital and a two-year escrow for other contingent items specified within the merger agreement. During the second quarter of 2003, the Company recorded an adjustment for finalized working capital resulting in a reclassification of $1.0 million from goodwill to current assets and $0.2 million from goodwill to current liabilities. Intangibles recorded as part of the purchase as of September 30, 2003 total $3.4 million.

Assuming Markado and Yesmail, Inc. had been acquired on January 1, 2002, included in the accompanying consolidated statements of operations, unaudited pro forma consolidated net sales, net income and net income per share would have been as follows:

	For the three months ended		For the nine months ended	
	September 30, 2003	September 30, 2002	September 30, 2003	September 30, 2002
	(In thousands, except per share amounts) (unaudited)			
Net sales	$77,856	$81,351	$236,132	$241,815
Net income	$ 3,685	$ 3,729	$ 13,303	$ 3,022
Basic earnings per share	$ 0.07	$ 0.07	$ 0.26	$ 0.06
Diluted earnings per share	$ 0.07	$ 0.07	$ 0.26	$ 0.06

The pro forma information provided above does not purport to be indicative of the results of operations that would actually have resulted if the acquisitions were made as of those dates or of results that may occur in the future. Pro forma net income includes adjustments for amortization of intangible assets and income taxes.

6. NON-CASH STOCK COMPENSATION EXPENSE

At September 30, 2003, the Company has a nonqualified stock option plan. The Company applies the intrinsic value based method of Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees*, and related interpretations in accounting for its stock option plan. No stock-based employee compensation cost is reflected in net income, as all options granted under the plan had an exercise price equal to the market value of the underlying common stock on the date of grant. The Company s pro forma net income and earnings per share would have been as indicated below had the fair value of all option grants been charged to salaries, wages, and benefits in accordance with SFAS No. 123, *Accounting for Stock-Based Compensation*:

	Three months ended September 30,		Nine Months ended September 30,	
	2003	2002	2003	2002
Net income, as reported	$3,632	$6,404	$15,212	$15,496
Less: Total stock-based employee compensation expense determined under fair value based method, net of taxes	527	635	1,747	2,037
Net income, pro forma	$3,105	$5,769	$13,465	$13,459
Earnings per share:				
Basic as reported	$ .07	$ .12	$ .30	$ .30
Basic pro forma	$ .06	$ .11	$ .26	$ .26
Diluted as reported	$ .07	$ .12	$ .30	$ .30

Diluted pro forma	$ .06	$ .11	$ .26	$ .26

The above pro forma results are not likely to be representative of the effects on reported net income for future years since options vest over several years and additional awards generally are made each year.

The fair value of the weighted average of option grants is estimated as of the date of grant using the Black-Scholes option-pricing model with the following assumptions used for grants in 2003 and 2002: expected volatility of 78.89% (2003) and 80.73% (2002), risk free interest rate of 4.67% (2003) and 4.84% (2002) based on the U.S. Treasury strip yield at the date of grant and expected lives of 5 years.

Compensation cost for stock options and warrants granted to non-employees and vendors is measured based upon the fair value of the stock option or warrant granted. When the performance commitment of the non-employee or vendor is not complete as of the

Table of Contents

grant date, the Company estimates the total compensation cost using a fair value method at the end of each period. Generally, the final measurement of compensation cost occurs when the non-employee or vendors related performance commitment is complete. Changes, either increases or decreases, in the estimated fair value of the options between the date of the grant and the final vesting of the options result in a change in the measure of compensation cost for the stock options or warrants. Compensation cost is recognized as expense over the periods in which the benefit is received.

During the second quarter of 2002, the Company granted non-qualified stock options to a non-employee consultant of the Company in connection with a consulting agreement executed by the Company. The options vest evenly over four years and have a five-year life. The fair value of the option was estimated, as of the grant date, using the Black-Scholes option pricing model with the following assumptions: no dividend yield for any year, expected volatility of 78.89%, risk free interest rate of 4.67% and an expected life of 5 years. As such, the Company has recorded a non-cash charge of $145 thousand, related to stock options granted to the consultant during the nine months ended September 30, 2003. The charges were recorded as an addition to paid-in-capital. The consulting agreement commits the Company to make cash payments of $675 thousand, $775 thousand and $200 thousand in 2003, 2004 and 2005 to the consultant for services rendered. Expense recorded for the three months and nine months ended September 30, 2003 for this consulting agreement was $175 thousand and $550 thousand, respectively and $292 thousand for the three months and nine months ended September 30, 2002.

7. RESTRUCTURING CHARGES

During the three and nine months ended September 30, 2003, the Company recorded restructuring charges due to workforce reductions of $645 thousand and $1.6 million, respectively. The charges included involuntary employee separation costs for 64 employees in administration, order production and data processing support staff. As of September 30, 2003, an accrual of $410 thousand was included in the accompanying consolidated balance sheet for severance costs remaining to be paid.

During the three and nine months ended September 30, 2002, the Company recorded restructuring charges due to workforce reductions of $804 thousand and $1.6 million, respectively as a part of the Company s overall strategy to reduce costs and continue commitment to its core businesses. The workforce reduction charges included involuntary employee separation costs for 73 employees in administration, sales support and marketing functions.

8. ACQUISITION COSTS

The Company recorded costs of $54 thousand and $175 thousand during the nine months ended September 30, 2003 and 2002, respectively, for general and administrative expenses incurred in connection with the integration of acquired companies. These costs are not direct costs of acquisition and therefore cannot be capitalized as part of the purchase price.

9. OTHER CHARGES

On May 14, 2002, a principal of one of the acquisitions made by the Company in 1996 was awarded $1.7 million by an arbitrator for settlement of a dispute regarding exercise of stock options issued by the Company. Although the Company has appealed the arbitrator s decision, the Company s management, under advise from outside counsel, determined during the third quarter of 2003 that the Company was not likely to be successful in the appeal. Consequently, the Company recorded a litigation charge of $1.7 million during the three months ended September 30, 2003, for the arbitrators award.

During the nine months ended September 30, 2003, the Company purchased $67 million of its 91/2% Senior Subordinated Notes of which $11.5 million of the notes were held by the Company s Chief Executive Officer. All purchases of 91/2% Senior Subordinated Notes occurred at the same price and under the same terms. As part of these purchases, the Company recorded charges of $1.6 million for related net non-amortized debt issue costs and $3.1 million for amounts paid in excess of carrying value of the debt.

On May 27, 2003 the Company amended and restated the Senior Secured Credit Facility administered by Bank of America, N.A. in order to take advantage of lower interest rates and make significant redemptions of the 91/2% Senior Subordinated Notes. The total credit available was increased from $115 million to $145 million. The existing term loans A and B were combined into a single term loan of $100 million maturing April 30, 2007. In addition, the revolving credit facility of $18 million was increased to $45 million and is due May 27, 2006, reducing to $40 million on April 1, 2004 and reducing to $35 million on April 1, 2005. The Company has expensed $0.8 million in non-amortized costs associated with the issue of the previous

Table of Contents

facility and $0.8 million in bank fees associated with the new facility, which are classified as other charges in the statement of operations.

During the nine months ended September 30, 2002, the Company wrote-off deferred financing costs of $2.9 million in connection with the refinancing of its Senior Secured Credit Facility. Additionally, the refinancing resulted in a loss of $1.2 million for the reclassification of an interest rate swap agreement from Other Comprehensive Income (Loss) included in the Company s consolidated balance sheet. The Company also recorded a loss of $1.1 million for an other-than-temporary decline in the value of a non-marketable equity investment.

10. RELATED PARTY TRANSACTIONS

During 2003, the Company purchased the rights to a skybox at a local university for $617 thousand from Annapurna Corporation, which is 100% owned by Mr. Gupta, the Company s Chief Executive Officer. The cost covers the remaining 21 years of the lease and has been recorded in other assets on the accompanying consolidated balance sheet. Expense recognized for the three and nine months ended September 30, 2003 was $7 thousand and $10 thousand, respectively.

During 2003, the Company purchased $11.5 million of its 91/2% Senior Subordinated Notes from Mr. Gupta at the same terms and prices offered to unrelated parties.

Mr. Gupta was eligible for a cash bonus in 2002 based on Company performance. The criteria for Mr. Gupta s bonus specifies that he would receive 10% of the Company s adjusted EBITDA in excess of $80 million. In January 2002, the Company paid an advance of $1.5 million to Mr. Gupta (based on the Company s 2001 performance) to be off set against any 2002 bonus payable to Mr. Gupta pursuant to his bonus program. The advance was to be applied to part or his entire 2002 bonus or paid back by Mr. Gupta by January 2004. In May 2002, Mr. Gupta paid back $0.6 million of the original advance, leaving an advance balance of $0.9 million. Mr. Gupta s 2002 bonus has been determined to be $0.4 million. The remaining balance of $0.5 million is classified as Officer Note Receivable in the accompanying Balance Sheet.

11. GOODWILL AND OTHER INTANGIBLE ASSETS

Intangible assets consist of the following:

	September 30, 2003	December 31, 2002
	(In thousands)	
Goodwill	$273,560	$262,417
Non-compete agreements	13,534	13,534
Core technology	4,800	4,800
Customer base	8,372	8,372
Trade names	15,802	15,802
Purchased data processing software	73,478	73,478
Acquired database costs	19,000	19,000
Perpetual software license agreement	8,000	8,000
Software development costs, net	2,379	5,565
Deferred financing costs	8,207	8,845
	427,132	419,813
Less accumulated amortization	163,150	146,567
	$263,982	$273,246

12. CONTINGENCIES

The Company and its subsidiaries are involved in legal proceedings, claims and litigation arising in the ordinary course of business. Management believes that any resulting liability should not materially affect the Company s financial position, results of operations, or cash flows.

Table of Contents

ITEM 2.

infoUSA INC. AND SUBSIDIARIES
MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION
AND RESULTS OF OPERATIONS

GENERAL

The Company is a leading provider of business and consumer information, data processing and database marketing services. The Company s key assets include proprietary databases of 14 million businesses and 220 million consumers in the United States and Canada. We believe our proprietary content is the most comprehensive and accurate data available. We leverage these key assets by selling through multiple distribution channels to over 4 million customers that include small and medium-size businesses, Fortune 1000 companies, consumers, and Internet users.

The Company has supplemented its internal growth through strategic acquisitions and has completed over 20 acquisitions since mid 1996. The Company has increased its presence in the consumer marketing information industry, greatly increased its ability to provide data processing solutions, increased its presence in list management and list brokerage services and broadened its offerings for e-mail and business marketing information. During 2002 and 2003, the Company completed the integration of Polk City Directories and enhanced its presence in e-mail marketing, e-mail customer retention and e-mail customer acquisition services with the purchase of DoubleClick s email deployment business, ClickAction, Yesmail and Markado. The Company also continued to consolidate the printed and online directory industry with its acquisition of Hill-Donnelly and City Publishing directory companies.

Since 1996, the Company has systematically integrated the operations of the acquired companies into existing operations of the Company. In most cases, the results of operations for these acquired activities are no longer separately accounted for from existing activities. The Company cannot report the results of the operations of acquired companies upon completion of the integration as the results are commingled with existing results. Additionally, upon integration of the acquired operations, the Company frequently combines acquired products or features with existing products, and experiences significant cross selling of products between business units, including sales of acquired products by existing business units and sales by acquired business units of existing products. Due to recent and potential future acquisitions, future results of operations will not be comparable to historical data.

This discussion and analysis contains forward-looking statements, including without limitation statements in the discussion of comparative results of operations, accounting standards and liquidity and capital resources, within the meaning of Section 21E of the Securities Exchange Act of 1934 and Section 27A of the Securities Act of 1933, which are subject to the safe harbor created by those sections. The Company s actual future results could differ materially from those projected in the forward-looking statements. Some factors which could cause future actual results to differ materially from the company s recent results or those projected in the forward-looking statements are described in Factors that May Affect Operating Results below. The Company assumes no obligation to update the forward-looking statement or such factors.

Table of Contents

RESULTS OF OPERATIONS

The following table sets forth, for the periods indicated, selected financial information and other data. The amounts and related percentages may not be fully comparable due to acquisitions.

	THREE MONTHS ENDED September 30, 2003	THREE MONTHS ENDED September 30, 2002	NINE MONTHS ENDED September 30, 2003	NINE MONTHS ENDED September 30, 2002
CONSOLIDATED STATEMENT OF OPERATIONS DATA:				
Net sales	100%	100%	100%	100%
Costs and expenses:				
Database and production costs	28	27	28	28
Selling, general and administrative	47	45	44	43
Depreciation and amortization	9	9	9	9
Non-cash stock compensation expense				
Restructuring charges	1	1	1	1
Litigation settlement charge	2		1	
Acquisition costs				
Total costs and expenses	87	82	83	81
Operating income	13	18	17	19
Other expense, net	(5)	(5)	(6)	(8)
Income before income taxes	7	13	11	11
Income taxes	2	5	4	5
Net income	5%	8%	7%	6%
OTHER DATA:				
SALES BY SEGMENT:		(in thousands)		
Small business	$ 37,902	$41,084	$117,556	$117,405
Large business	39,477	36,087	114,734	110,531
Total	$ 77,379	$77,171	$232,290	$227,936
SALES BY SEGMENT AS A PERCENTAGE OF NET SALES:				
Small business	49%	53%	51%	52%
Large business	51	47	49	48
Total	100%	100%	100%	100%
Amortization expense of intangible assets (1)	$ 3,310	$ 3,325	$ 9,960	$ 9,986
Earnings before, interest, taxes, depreciation and amortization, (EBITDA), as adjusted (2)	$ 16,824	$20,926	$ 60,558	$ 63,979
EBITDA, as adjusted, as a percentage of net sales	22%	27%	26%	28%

Cash Flow Data:	(in thousands)	
Net cash from operating activities	$ 37,544	$ 35,629
Net cash used in investing activities	$ (9,892)	$ (10,758)
Net cash used in financing activities	$ (30,796)	$ (27,694)

(1) This represents amortization expense recorded by the Company on amortizable intangible assets recorded as part of the acquisition of other companies, and excludes amortization related to deferred financing costs, software development costs and other intangible assets not recorded as part of an acquisition of another company.

(2) EBITDA , as adjusted, is defined as net income adjusted to exclude depreciation and amortization, non-cash impairment of assets, non-operating other charges, income taxes, interest expense, investment income and non-cash stock compensation expenses. EBITDA is presented because it is a widely accepted measure of performance that eliminates the effects of a variety of methods used for deprecation and amortization that have changed over time. However, EBITDA, does not purport to represent cash provided by operating activities as reflected in the Company s consolidated statements of cash flows, is not a measure of financial performance under generally accepted accounting principles (GAAP) and should not be considered in isolation or as a substitute for measures of performance prepared in accordance with GAAP. Also, the measure of EBITDA, may not be comparable to similar measures reported by other companies.

Table of Contents

The following provides a reconciliation of net income to EBITDA, as adjusted:

	Three months ended September 30,		Nine months ended September 30,	
	2003	2002	2003	2002
Net income	$ 3,632	$ 6,404	$ 15,212	$ 15,496
Other charges	2,240	115	6,385	5,355
Investment income	(394)	(35)	(1,222)	(133)
Interest expense	2,243	3,404	9,500	12,562
Income taxes	2,021	4,225	9,324	9,606
Depreciation and amortization	7,006	6,805	21,214	21,058
Non-cash stock compensation	76	8	145	35
EBITDA, as adjusted	$ 16,824	$ 20,926	$ 60,558	$ 63,979

Net sales

Net sales of the Company for the quarter ended September 30, 2003 were $77.4 million compared to $77.2 million for the same period of 2002, an increase of less than 1%. Net sales of the Company for the nine months ended September 30, 2003 were $232.3 million compared to $227.9 million for the same period of 2002, an increase of 2%.

Net sales of the small business segment for the quarter ended September 30, 2003 were $37.9 million, compared to $41.1 million for the same period of 2002, a decrease of $3.2 million or 8%. The decrease was principally due to a decline in net sales for Polk City Directories, a subsidiary of the Company. Net sales of the small business segment for the nine months ended September 30, 2003 were $117.6 million, compared to $117.4 million for the same period of 2002, an increase of less than 1%. The small business segment principally engages in the selling of sales lead generation and consumer DVD products to small to medium sized companies, small office and home office businesses and individual consumers. This segment also includes the sale of content via the Internet.

Net sales of the large business segment for the quarter ended September 30, 2003 were $39.5 million compared to $36.1 million for the same period of 2002, an increase of 9%. Net sales of the large business segment for the nine months ended September 30, 2003 were $114.7 million compared to $110.5 million for the same period of 2002, an increase of 4%. The increase was principally due to the acquisition of ClickAction in December 2002 and Yesmail in March 2003. The large business segment principally engages in the selling of data processing services, licensed databases, database marketing solutions, e-mail marketing solutions and list brokerage and list management services to large companies. This segment includes the licensing of databases for Internet directory assistance services.

Database and production costs

Database and production costs for the quarter ended September 30, 2003 were $21.4 million, or 28% of net sales, compared to $20.6 million, or 27% of net sales for the same period of 2002. Database and production costs for the nine months ended September 30, 2003 were $64.6 million, or 28% of net sales, compared to $63.2 million, or 28% of net sales for the same period of 2002.

Selling, general and administrative expenses

Selling, general and administrative expenses for the quarter ended September 30, 2003 were $36.8 million, or 47% of net sales, compared to $34.7 million, or 45% of net sales for the same period of 2002. Selling, general and administrative expenses for the nine months ended September 30, 2003 were $103.8 million, or 44% of net sales, compared to $98.6 million, or 43% of net sales for the same period of 2002. The increase in selling, general and administrative expenses principally relates to the Company s planned increase in direct marketing costs and the addition of sales staff, beginning during the quarter ended September 30, 2003. Additionally, the increase is partially due to the acquisition of various companies during 2002 and 2003, including Hill-Donnelly, City Publishing, and the e-mail list business of DoubleClick, ClickAction and Yesmail. These acquired companies historically had higher operating sales and marketing cost structures than the Company s existing businesses. The increase in selling, general and administrative expenses was partially offset by a decrease in bad debt expense totaling $0.6 million during the nine months ended September 30, 2003. The decrease in bad debt expense corresponds with the decrease in the Company s total trade accounts receivable outstanding and days sales outstanding (DSO) ratio.

Depreciation and amortization expenses

Depreciation and amortization expenses for the quarter ended September 30, 2003 were $7.0 million, or 9% of net sales, compared to $6.8 million, or 9% of net sales for the same period of 2002. Depreciation and amortization expenses for the nine months ended September 30, 2003 were $21.2 million, or 9% of net sales, compared to $21.1 million, or 9% of net sales for the same period of 2002.

The Company adopted SFAS No. 142, Goodwill and Other Intangible Assets as of January 1, 2002. SFAS No. 142 requires the Company to complete an annual impairment test on goodwill and other intangible assets with an indefinite life rather than record amortization expense on those assets. We currently do not expect to record an impairment charge, however, there can be no assurance that at the time a review is completed a material impairment charge will not be recorded.

Restructuring costs

During the quarter ended September 30, 2003, the Company recorded restructuring charges due to workforce reductions of $0.6 million as part of the Company s continuing strategy to reduce costs and further consolidate data processing operations. The workforce reduction charges included involuntary employee separation costs for 64 employees. During the nine months ended September 30, 2003, the Company recorded restructuring charges due to workforce reductions of $1.6 million for the involuntary employee separation costs for 179 employees.

During the three and nine months ended September 30, 2002, the Company recorded restructuring charges due to workforce reductions of $0.8 million and $1.6 million, respectively, as a part of the Company s continuing strategy to reduce costs and focus on core operations. The workforce reduction charges included involuntary employee separation costs for 73 employees for the nine months ended September 30, 2002.

Acquisition costs

The Company recorded costs of $54 thousand and $175 thousand during the nine months ended September 30, 2003 and 2002, respectively, for general and administrative expenses incurred in connection with the integration of acquired companies. These costs are not direct costs of acquisition and therefore cannot be capitalized as part of the purchase price.

Operating income

Including the factors previously described, the Company had operating income of $9.7 million, or 13% of net sales for the quarter ended September 30, 2003, compared to operating income of $14.1 million, or 18% of net sales for the same period in 2002. The Company had operating income of $39.2 million, or 17% of net sales for the nine months ended September 30, 2003, compared to operating income of $42.9 million, or 19% of net sales for the same period in 2002. The decrease in operating income as a percentage of net sales is a result of the following items: 1) the Company s planned increase in direct marketing costs and the addition of sales staff, beginning during the quarter ended September 30, 2003; 2) a decline in net sales for Polk City Directories during the quarter ended September 30, 2003; 3) a litigation settlement charge of $1.7 million recorded during the quarter ended September 30, 2003; and 4) increased operating expenses represented as percentage of net sales associated with companies acquired during 2002 and 2003 including City Publishing, Hill-Donnelly, ClickAction and Yesmail.

Operating income for the small business segment for the quarter ended September 30, 2003 was $10.4 million, or 27% of net sales, as compared to $15.6 million, or 38% of net sales for the same period in 2002. Operating income for the small business segment for the nine months ended September 30, 2003 was $41.0 million, or 35% of net sales, as compared to $46.1 million, or 39% of net sales for the same period in 2002. The decrease in operating income as a percentage of net sales principally relates to the Company s planned increase in direct marketing costs and the addition of sales staff, beginning during the quarter ended September 30, 2003. Additionally, the decrease is partially due to a decline in net sales for Polk City Directories and increased operating expenses represented as a percentage of net sales associated with companies acquired during 2002 and 2003 including City Publishing and Hill-Donnelly.

Operating income for the large business segment for the quarter ended September 30, 2003 was $20.0 million, or 51% of net sales, as compared to $18.6 million, or 51% of net sales for the same period in 2002. Operating income for the large business segment for the nine months ended September 30, 2003 was $57.4 million, or 50% of net sales, as compared to $58.6 million, or 53% of net sales for the same period in 2002. The decrease in operating income as a percentage of net sales is principally due to increased operating expenses represented as a percentage of net sales associated with companies acquired during 2002 and 2003 including ClickAction and Yesmail.

Other income (expense), net

Other income (expense) net, was $(4.1) million, or (5)% of net sales, and $(3.5) million, or (5)% of net sales, for the quarters ended September 30, 2003 and 2002, respectively. Other income (expense) net, was $(14.7) million, or (6)% of net sales, and $(17.8) million, or (8)% of net sales, for the nine months ended September 30, 2003 and 2002, respectively. Other income (expense) is comprised of interest expense, investment income and other income or expense items, which do not represent components of operating income (expense) of the Company.

Interest expense was $2.2 million and $3.4 million for the quarters ended September 30, 2003 and 2002, respectively. Interest

expense was $9.5 million and $12.6 million for the nine months ended September 30, 2003 and 2002, respectively. Interest expense has decreased due to the continued reduction in the amount of total debt outstanding and favorable interest rates. Investment income was $394 thousand and $35 thousand for the quarters ended September 30, 2003 and 2002. Investment income was $1.2 million and $133 thousand for the nine months ended September 30, 2003 and 2002.

During 1999 in conjunction with the acquisition of Donnelley, the Company negotiated a credit arrangement (Senior Debt Credit Facility). According to the terms of the Senior Debt Credit Facility, the Company entered into an interest rate swap agreement with Union Bank of California, to fix the rate on $60.5 million of the debt at an interest rate of 6.385% for the term of 3 years. On March 6, 2002, the Company refinanced the Senior Debt Credit facility with Bank of America, N.A. As a result of the refinancing, the Company recorded a charge of $1.2 million (classified with other non-operating charges) for amounts reported in Other Comprehensive Income related to the fair value of the interest rate swap agreement. Also during the quarter ended September 30, 2002, the Company wrote-off deferred financing costs of $2.9 million in connection with the refinancing of its Senior Debt Credit Facility as described above. On May 27, 2003 the Bank of America Senior Secured Credit Facility was amended and restated to increase the credit available from $115 million to $145 million to facilitate the partial redemption of the Company s 91/2% Senior Subordinated Notes. As a result of the refinancing, the Company expensed $0.8 million in non-amortized deferred financing costs associated with the issue of the previous facility and $0.7 million in bank fees associated with the new facility. During the nine months ended September 30, 2003, the Company purchased $67 million of its 91/2% Senior Subordinated Notes. As part of these purchases, the Company recorded charges of $1.6 million for related net non-amortized debt issue costs and $3.1 million for amounts paid in excess of carrying value of the debt.

Income taxes

A provision for income taxes of $2.0 million and $4.2 million was recorded for the quarters ended September 30, 2003 and 2002, respectively. A provision for income taxes of $9.3 million and $9.6 million was recorded for the nine months ended September 30, 2003 and 2002, respectively.

EBITDA

The Company s EBITDA, as adjusted was $16.8 million, or 22% of net sales and $20.9 million, or 27% of net sales for the quarters ended September 30, 2003 and 2002, respectively. EBITDA as adjusted was $60.6 million, or 26% of net sales and $64.0 million, or 28% of net sales for the nine months ended September 30, 2003 and 2002, respectively. EBITDA , as adjusted, is defined as net income adjusted to exclude depreciation and amortization, non-cash impairment of assets, non-operating other charges, income taxes, interest expense, investment income and non-cash stock compensation expenses.

LIQUIDITY AND CAPITAL RESOURCES

Consolidated Statements of Cash Flows Information:

As of September 30, 2003, the Company s principal sources of liquidity included cash and cash equivalents of $3.1 million, and $25.5 million available under the revolving credit facility described above. As of September 30, 2003, the Company had a working capital deficit of $12.8 million.

Net cash provided by operating activities during the nine months ended September 30, 2003, totaled $37.5 million compared to $35.6 million during the same period of 2002.

During the nine months ended September 30, 2003, the Company spent $4.7 million for additions of property and equipment, $0.7 million related to software and database development costs, $5.5 million for the acquisition of businesses and a net amount of $37.0 million on the repayment of long-term debt.

The amended Senior Secured Credit Facility provides for a term loan of $100 million due April 30, 2007 ($92.5 million outstanding at September 30, 2003) and $45.0 million ($19.5 million outstanding at September 30, 2003) under a revolving credit facility due May 2006, reduces to $40 million on April 1, 2004 and reducing to $35 million on April 1, 2005.

The Senior Secured Credit Facility provides for grid-based interest pricing based upon the Company s consolidated leverage ratio and ranges from base rate + 1.00% to 2.00% for base rate loans and from LIBOR + 2.00% to 3.00% for LIBOR loans for use of the revolving credit facility for loans of up to $45.0 million. The term loan interest rate is base rate +3.00% or LIBOR + 4.00%.

Substantially all of the assets of the Company are pledged as security under the terms of the credit facility. As of December 31, 2002, term loan A had a balance of $34.3 million, with an interest rate of 4.30% and term loan B had a balance of $40.8 million, with an interest rate of 4.80% under the previous credit agreement. At September 30, 2003, the term loan had a balance of $92.5 million with an interest rate of 5.1% and $25.5 million was available under the revolving credit facility. Additionally, the Company is required to pay a commitment fee of between 0.35% and 0.50%, dependent on the consolidated leverage ratio, on the average unused amount of the revolving credit facility.

The Company is subject to certain financial covenants in its various credit facilities, including total funded debt leverage ratio, senior debt leverage ratio, fixed charge coverage ratio, net worth and minimum consolidated EBITDA. The Company was in compliance with all restrictive covenants of the Company s various credit facilities at September 30, 2003.

The Company believes that its existing sources of liquidity and cash generated from operations will satisfy the Company s projected working capital, debt repayments and other cash requirements for at least the next 12 months. Acquisitions of other technologies, products or companies, or internal product development efforts may require the Company to obtain additional equity or debt financing, which may not be available or may be dilutive.

CONSOLIDATED BALANCE SHEET INFORMATION:

Trade accounts receivable decreased from $40.6 million at September 30, 2002 to $34.2 million at September 30, 2003, with related days sales outstanding (DSO) decreasing to 40 days for the quarter ended September 30, 2003 from 47 days for the same period in 2002. The allowance for bad debts has been reduced from 9% of trade accounts receivable to 8% of trade accounts receivable during the quarter ended September 30, 2003 primarily due to the reduction in DSO and better credit and collection techniques.

RECENT ACCOUNTING PRONOUNCEMENTS

In September 2001, the FASB released SFAS No. 143, Accounting for Asset Retirement Obligations, which addresses financial accounting and reporting for obligations associated with retirement of tangible long-lived assets and the associated asset retirement costs. SFAS No. 143 requires recognition of asset retirement obligations as a liability rather than a contra-asset. SFAS No. 143 is effective for the Company s fiscal year ending December 31, 2003. SFAS No. 143 did not impact the Company s consolidated financial statements.

In April 2002, the FASB issued SFAS No. 145, Rescission of FASB Statements No. 4, 44 and 64, Amendment of FASB Statement No. 13 and Technical Corrections. SFAS No. 145, among other things, rescinds SFAS No. 4 which required all gains and losses from the extinguishments of debt to be classified as an extraordinary item and amends SFAS No. 13 to require that certain lease modification that have economic effect similar to sale-leaseback transactions be accounted for in the same manner as sale-leaseback transactions. Upon adoption of the new accounting standard in 2003, the Company reclassified the extraordinary item of $1.8 million related to the extinguishment of debt as reported in the 2002 consolidated statement of operations. The reclassification increased other non-operating expense by $2.9 million and decreased income tax expense by $1.1 million.

In June 2002, the FASB released SFAS No. 146, Accounting for Costs Associated with Exit or Disposal Activities, which addresses accounting and reporting for costs associated with exit or disposal activities, and nullifies EITF 94-3, Liability Recognition for Certain Employee Termination Benefits and Other Costs to exit an Activity. SFAS No. 146 addresses involuntary one-time employee termination benefits, cost to terminate a contract that is not a capital lease, and other associated exit costs. Existing accounting guidelines require companies to recognize a liability when management commits itself or announces plans to exit or dispose of an activity. SFAS No. 146 will prohibit companies from recognizing an exit or disposal liability that cannot be measured at fair value. The Company has applied the provisions of SFAS No. 146 for liability recognition for disposal activities that have been initiated after December 31, 2002.

In May 2003, the Emerging Issues Task Force of the FASB issued EITF 00-21, *Revenue Arrangements with Multiple Deliverables.* EITF 00-21 addresses how to determine whether an arrangement involving multiple deliverables contains more than one unit of accounting. EITF 00-21 is effective for revenue arrangements entered into in fiscal periods beginning after June 15, 2003. EITF 00-21 has not had a material impact on the Company s consolidated financial statements.

Table of Contents

In November 2002, the FASB issued Interpretation No. 45, Guarantor s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others, an interpretation of SFAS No. 5, 57 and 107 and rescission of FASB Interpretation No. 34. This interpretation requires additional disclosures to be made by a guarantor in its interim and annual financial statements about its obligations under certain guarantees that it has issued. It also specifies the requirements for liability recognition (at fair value) for obligations undertaken in issuing the guarantee. The disclosure requirements are effective for interim and annual financial statements ending after December 15, 2002, (December 31, 2002 financial statements for calendar year companies). The initial recognition and measurement provisions are effective for all guarantees within the scope of Interpretation 45 issued or modified after December 31, 2002. Interpretation No. 45 does not have a material impact on the Company s consolidated financial statements.

In April 2003, the Financial Accounting Standards Board (FASB) issued SFAS No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities.* This statement amends and clarifies financial accounting and reporting for derivative instruments and for hedging activities under SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities.* As of September 30, 2003, management believes that SFAS No. 149 does not have a significant effect on the financial position, results of operations, and cash flows of the Company.

In May 2003, the FASB issued SFAS No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity.* This statement requires that an issuer classify a financial instrument that is within its scope as a liability. The provisions of this statement are effective for financial instruments entered into of modified after May 31, 2003. As of September 30, 2003, management believes that SFAS No. 150 has no significant effect on the financial position, results of operations, and cash flows of the Company.

In January 2003, the FASB issued FASB interpretation No. 46, *Consolidation of Variable Interest Entities.* FIN no. 46 address consolidation by business enterprises of certain variable interest entities. The provisions of FIN No. 46 are effective immediately for variable interest entities created after January 31, 2003 and for variable interest entities in which an enterprise obtains an interest after that date. The provisions are effective in the first fiscal year of interim period beginning after December 15, 2003, for variable interest entities in which an enterprise hold a variable interest that it acquired before February 1, 2003. The Company does not believe FIN No. 46 will have a material impact on the financial position, results of operations, and cash flows of the Company.

FACTORS THAT MAY AFFECT OPERATING RESULTS

Our Internet strategy is subject to review and revision.

Our Internet strategy is to leverage our proprietary content into multiple vertical market applications and provide marketing solutions for electronic commerce applications. The strategy we introduced in fiscal 2000 of being an incubator of Internet database companies has been revised to a strategy of developing more efficient and profitable applications of our content through the Internet. We cannot guarantee that our customers will choose to have our products and services delivered to them over the Internet. If we are successful in developing Internet applications, we may face strong competition from current and potential competitors, including other Internet companies and other providers of business and consumer databases. We will review our Internet strategy from time to time and may continue to revise it.

Our markets are highly competitive and many of our competitors have greater resources than we do.

The business and consumer marketing information industry in which we operate is highly competitive. Intense competition could harm us by causing, among other things, price reductions, reduced gross margins, and loss of market share. Our competition includes:

In consumer sales lead generation products, Acxiom, Experian (a subsidiary of Great Universal Stores, P.L.C. (GUS)), and Equifax, both directly and through reseller networks.

In data processing services, Acxiom, Experian, Direct Marketing Technologies (a subsidiary of GUS), and Harte-Hanks Communications, Inc.

In business sales lead generation products, Experian and Dun s Marketing Services (DMS), a division of Dun & Bradstreet. DMS, which relies upon information compiled from Dun & Bradstreet s credit database, tends to focus on marketing to large companies.

In business directory publishing, from Regional Bell Operating Companies and many smaller, regional directory publishers.

Table of Contents

In consumer products, certain smaller producers of CD-Rom products.

Technologies which companies may install and implement in-house as part of their internal IS functions, instead of purchasing or outsourcing such functions.

In addition, we may face competition from new entrants to the business and consumer marketing information industry as a result of the rapid expansion of the Internet, which creates a substantial new channel for distributing business information to the market. Many of our competitors have longer operating histories, better name recognition and greater financial resources than we do, which may enable them to implement their business strategies more readily than we can.

We are highly leveraged. If we are unable to service our debt as it becomes due, our business would be harmed.

As of September 30, 2003, we had total indebtedness of approximately $153.4 million, including $30.0 million of Notes under an indenture (the Indenture) and $112 million under a $145 million Senior Secured Credit Agreement. Substantially all of our assets are pledged as security under the terms of the Senior Secured Credit Agreement. The indebtedness under the Senior Secured Credit Agreement was refinanced March 6, 2002 (amended and restated May 27, 2003) and originally incurred in connection with our acquisition of Donnelley Marketing in 1999. Our ability to pay principal and interest on the Notes issued under the Indenture and the indebtedness under the Senior Secured Credit Agreement and to satisfy our other debt obligations will depend upon our future operating performance. Our performance will be affected by prevailing economic conditions and financial, business and other factors. Certain of these factors are beyond our control. The future availability of revolving credit under the Senior Secured Credit Agreement will depend on, among other things, our ability to meet certain specified financial ratios and maintenance tests. We expect that our operating cash flow should be sufficient to meet our operating expenses, to make necessary capital expenditures and to service our debt requirements as they become due. If we are unable to service our indebtedness, however, we will be forced to take actions such as reducing or delaying acquisitions and/or capital expenditures, selling assets, restructuring or refinancing our indebtedness (including the Notes issued under the Indenture and the Senior Secured Credit Agreement) or seeking additional equity capital. We may not be able to implement any such measures or obtain additional financing.

The terms of our current indebtedness restrict our ability to take certain actions that fit our business strategy.

Our existing credit facilities contain certain covenants which restrict our ability to:

Incur additional indebtedness;

Pay dividends and make certain other similar payments;

Guarantee indebtedness of others;

Enter into certain transactions with affiliates;

Consummate certain asset sales, certain mergers and consolidations, sales or other dispositions of all or substantially all of our assets

Acquire other companies; and

Obtain dividends or certain other payments from our subsidiaries.

These restrictions may impair our ability to take certain actions that fit our business strategy. A breach of any of these covenants could result in an event of default under the terms of our existing credit facilities. Upon the occurrence of an event of default, the lenders could elect to declare all amounts outstanding, together with accrued interest, to be immediately due and payable. If the payment of any such indebtedness is accelerated, our assets may not be sufficient to repay in full the indebtedness under our credit facilities and our other indebtedness. Moreover, if we were unable to repay amounts owed to the lenders under our credit facilities, the lenders could foreclose on our assets that secure the indebtedness.

Under the terms of our current indebtedness, the occurrence of a change of control of infoUSA could have serious adverse financial consequences to us.

Table of Contents

If a change of control of *info*USA were to occur, we would in certain circumstances be required to make an offer to purchase all outstanding Notes under the Indenture at a purchase price equal to 101% of the principal amount of the Notes, together with accrued and unpaid interest. There can be no guarantee that, if this were to happen, we would have sufficient funds to purchase the Notes. In addition, a change of control and any repurchase of the Notes upon a change of control may constitute an event of default under our other current or future credit facilities. In that event, our obligations under such credit facilities could be declared due and payable by the lenders, and the lenders may also have the right to be paid for all outstanding obligations under such credit facilities before we repurchase any of the Notes.

Fluctuations in our operating results may result in decreases in the market price of our common stock.

Our operating results may fluctuate on a quarterly and annual basis. Our expense levels are relatively fixed and are based, in part, on our expectations as to future revenues. As a result, unexpected changes in revenue levels may have a disproportionate effect on operating performance in any given period. In some period or periods our operating results may be below the expectations of public market analysts and investors. Our failure to meet analyst or investor expectations could result in a decrease in the market price of our common stock.

If we do not adapt our products and services to respond to changes in technology, they could become obsolete.

We provide marketing information and services to our customers in a variety of formats, including printed formats, electronic formats such as CD-Rom and DVD, and over the Internet. Advances in information technology may result in changing customer preferences for products and product delivery formats. If we do not successfully adapt our products and services to take advantage of changes in technology and customer preferences, our business, financial condition and results of operations would be adversely affected.

We have adopted an Internet strategy because we believe that the Internet represents an important and rapidly evolving market for marketing information products and services. Our business, financial condition and results of operations would be adversely affected if we:

- Fail to develop products and services that are well suited to the Internet market;
- Experience difficulties that delay or prevent the successful development, introduction and marketing of these products and services; or
- Fail to achieve sufficient traffic to our Internet sites to generate significant revenues, or to successfully implement electronic commerce operations.

Changes in laws and regulations relating to data privacy could adversely affect our business.

We engage in direct marketing, as do many of our customers. Certain data and services provided by us are subject to regulation by federal, state and local authorities in the United States as well as those in Canada and the United Kingdom. In addition, growing concerns about individual privacy and the collection, distribution and use of information about individuals have led to self-regulation of such practices by the direct marketing industry through guidelines suggested by the Direct Marketing Association and to increased federal and state regulation. There is increasing awareness and concern among the general public regarding marketing and privacy concerns, particularly as it relates to the Internet. This concern is likely to result in new laws and regulations. Compliance with existing federal, state and local laws and regulations and industry self-regulation has not to date seriously affected our business, financial condition or results of operations. Nonetheless, federal, state and local laws and regulations designed to protect the public from the misuse of personal information in the marketplace and adverse publicity or potential litigation concerning the commercial use of such information may increasingly affect our operations. This could result in substantial regulatory compliance or litigation expense or a loss of revenue.

Our business would be harmed if we do not successfully integrate future acquisitions.

Our business strategy includes continued growth through acquisitions of complementary products, technologies or businesses. We have made over 20 acquisitions since mid-1996 and completed the integration of these acquisitions into our existing business. We continue to evaluate strategic opportunities available to us and intend to pursue opportunities that we believe fit our business strategy.

Table of Contents

Acquisitions of companies, products or technologies may result in the diversion of management s time and attention from day-to-day operations of our business and may entail numerous other risks, including difficulties in assimilating and integrating acquired operations, databases, products, corporate cultures and personnel, potential loss of key employees of acquired businesses, difficulties in applying our internal controls to acquired businesses, and particular problems, liabilities or contingencies related to the businesses being acquired. To the extent our efforts to integrate future acquisitions fail, our business, financial condition and results of operations would be adversely affected.

ITEM 3.
QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The Company is exposed to material future earnings or cash flow exposures from changes in interest rates as more than 50% of the Company s debt is not at fixed rates. At September 30, 2003, the fair value of the Company s long-term debt is based on quoted market prices at the reporting date or is estimated by discounting the future cash flows of each instrument at rates currently offered to the Company for similar debt instruments of comparable maturities. At September 30, 2003, the Company had long-term debt with a carrying value of $153.4 million and estimated fair value of the same. The Company has no significant operations subject to risks of foreign currency fluctuations.

ITEM 4.
CONTROLS AND PROCEDURES

As of September 30, 2003, the Company carried out an evaluation, under the supervision and with the participation of the Company s management, including the Company s Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the Company s disclosure controls and procedures, as defined in Exchange Act Rule 15d-15(e) and Rule 13a-15(e). Based upon that evaluation, the Company s Chief Executive Officer and Chief Financial Officer concluded that the Company s disclosure controls and procedures were effective in enabling the Company to record, process, summarize and report information required to be included in the Company s periodic SEC filings within the required time period. There have been no changes in internal controls over financial reporting that has materially affected, or are reasonably likely to materially affect, the Company s internal control over financial reporting, subsequent to the date the Chief Executive Officer and Chief Financial Officer completed their evaluation.

Table of Contents

infoUSA INC.
FORM 10-Q

FOR THE QUARTER ENDED

SEPTEMBER 30, 2003

PART II

OTHER INFORMATION

ITEM 1.
LEGAL PROCEEDINGS

On May 14, 2002, a principal of one of the acquisitions made by the Company in 1996 was awarded $1.7 million by an arbitrator for settlement of a dispute regarding exercise of stock options issued by the Company. Although the Company has appealed the arbitrator s decision, the Company s management, under advise from outside counsel, determined during the third quarter of 2003 that the Company was not likely to be successful in the appeal. Consequently, the Company recorded a litigation charge of $1.7 million during the three months ended September 30, 2003, for the arbitrators award.

ITEM 5.
SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

There were no matters submitted to a vote of security holders during the three months ended September 30, 2003.

ITEM 6.
EXHIBITS AND REPORTS ON FORM 8-K

(a) Exhibits

10.1*	Credit Agreement by and among *info*USA, Inc., various Lenders (as defined therein) and Bank of America, N.A. dated as of May 27, 2003.
10.2*	Pledge Agreement by and among *info*USA, Inc., Various Lenders (as defined therein) and Bank of America, N.A. dated as of May 27, 2003.
10.3*	Security Agreement by and among *info*USA, Inc., various Lenders (as defined therein) and Bank of America, N.A. dated as of May 27, 2003
10.4*	Subsidiaries Guaranty Agreement by and among *info*USA, Inc., various Lenders (as defined therein) and Bank of America, N.A. dated as of May 27, 2003.
31.1*	Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002, filed herewith.
31.2*	Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002, filed herewith.
32.1*	Certification of Chief Executive Officer pursuant to Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, filed herewith.

32.2*	Certification of Chief Financial Officer pursuant to Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, filed herewith.

* Filed herewith

(b) Reports on Form 8-K

The Company filed a Form 8-K under Items 7 and 12 (filed under Item 9 as permitted by SEC guidance) on July 18, 2003 for a press release announcing second quarter results; Form 8-K under Items 5, 7 and 9 (filed under Item 9 as permitted by SEC guidance) on August 20, 2003 press releases announcing lower interest rates on the revolving line of credit, Tim Hoffman s appointment to Chief Accounting Officer and Stormy Dean s departure as Chief Financial Officer; Form 8-K under Items 5, 7 and 9 (filed under Item 9 as permitted by SEC guidance) on September 12, 2003 press releases announcing the Appointment of Raj Das as Chief Financial Officer and revision of guidance for 2003; and a Form 8-K under Items 7 and 12 (filed under Item 9 as permitted by SEC guidance) on October 15, 2003 for a press release announcing third quarter results.

Table of Contents

SIGNATURES

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

	infoUSA INC.
Date: November 13, 2003	*/s/ Tim Hoffman*
	Tim Hoffman, Chief Accounting Officer (principal accounting officer)

24

Table of Contents

Exhibit Index

Exhibit		Description
10.1	-	Credit Agreement by and among *info*USA, Inc., various Lenders (as defined therein) and Bank of America, N.A. dated as of May 27, 2003.
10.2	-	Pledge Agreement by and among *info*USA, Inc., Various Lenders (as defined therein) and Bank of America, N.A. dated as of May 27, 2003.
10.3	-	Security Agreement by and among *info*USA, Inc., various Lenders (as defined therein) and Bank of America, N.A. dated as of May 27, 2003
10.4	-	Subsidiaries Guaranty Agreement by and among *info*USA, Inc., various Lenders (as defined therein) and Bank of America, N.A. dated as of May 27, 2003.
31.1	-	Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002, filed herewith.
31.2	-	Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002, filed herewith.
32.1	-	Certification of Chief Executive Officer pursuant to Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, filed herewith.
32.2	-	Certification of Chief Financial Officer pursuant to Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, filed herewith.

consideration in the same form as previously paid by the interested stockholder for its shares.

The statute permits various exemptions from its provisions, including business combinations that are approved by the board of directors before the time that the interested stockholder becomes an interested stockholder.

Our board of directors has by resolution exempted any business combination between the corporation and our officers and directors from these provisions of the MGCL and, consequently, the five-year prohibition and the super-majority vote requirements will not apply to business combinations between us and any of our officers and directors unless our board later resolves otherwise.

Subtitle 8

Subtitle 8 of Title 3 of the MGCL permits a Maryland corporation with a class of equity securities registered under the Exchange Act and at least three independent directors to elect to be subject, by provision in its charter or bylaws or a resolution of its board of directors and notwithstanding any contrary provision in the charter or bylaws, to any or all of five provisions:

a classified board of directors;

- a two-thirds vote requirement for removing a director;
- a requirement that the number of directors be fixed only by vote of the directors;
- a requirement that a vacancy on the board be filled only by the remaining directors and for the remainder of the full term of the class of directors in which the vacancy occurred; and
- a majority requirement for the calling by stockholders of a special meeting of stockholders.

We have elected to be subject to each of the above provisions of Title 3, Subtitle 8 of the MGCL.

Amendments to Our Charter and Bylaws

Our charter generally may be amended only if the amendment is declared advisable by our board of directors and approved by the affirmative vote of stockholders entitled to cast a majority of all of the votes entitled to be cast on the matter. Our board of directors, with the approval of a majority of the entire board, and without any action by our stockholders, may also amend our charter from time to time to increase or decrease the aggregate number of shares of stock or the number of shares of stock of any class or series we are authorized to issue.

Each of our board of directors and stockholders has the power to adopt, alter or repeal any provision of our bylaws and to make new bylaws.

Extraordinary Transactions

Under the MGCL, a Maryland corporation generally cannot dissolve, merge, sell all or substantially all of its assets, engage in a statutory share exchange or engage in similar transactions outside the ordinary course of business unless approved by the affirmative vote of stockholders entitled to cast at least two-thirds of the votes entitled to be cast on the matter unless a lesser percentage (but not less than a majority of all of the votes entitled to be cast on the matter) is set forth in the corporation s charter. As permitted by the MGCL, our charter provides that any of these actions may be approved by the affirmative vote of stockholders entitled to cast a majority of all of the votes entitled to be cast on the matter.

Table of Contents

Operations

We generally are prohibited from engaging in certain activities, including acquiring or holding property or engaging in any activity that would cause us to fail to qualify as a REIT.

Term and Termination

Our charter provides for us to have a perpetual existence. Pursuant to our charter, and subject to the provisions of any of our classes or series of stock then outstanding and the approval by a majority of the entire board of directors, our stockholders by the affirmative vote of a majority of all of the votes entitled to be cast on the matter, may approve a plan of liquidation and dissolution.

Advance Notice of Director Nominations and New Business

Our bylaws provide that, with respect to an annual meeting of stockholders, nominations of persons for election to our board of directors and the proposal of business to be considered by stockholders at the annual meeting may be made only:

- pursuant to our notice of the meeting;
- by or at the direction of our board of directors; or
- by a stockholder who was a stockholder of record at the time of the provision of notice, who is entitled to vote at the meeting and who has complied with the advance notice procedures set forth in our bylaws.

With respect to special meetings of stockholders, only the business specified in our notice of meeting may be brought before the meeting of stockholders and nominations of persons for election to our board of directors at which directors are to be elected pursuant to our notice of the meeting may be made only:

- by or at the direction of our board of directors; or
- by a stockholder who was a stockholder of record at the time of the provision of notice, who is entitled to vote at the meeting and who has complied with the advance notice provisions set forth in our bylaws.

Power to Issue Additional Shares

We currently do not intend to issue any securities other than the shares described in this prospectus, although we may do so at any time, including upon the redemption of limited partnership interests that we may issue in connection with acquisitions of real property. We believe that the power to issue additional shares of stock and to classify or reclassify unissued shares of common stock or preferred stock and thereafter to issue the classified or reclassified shares provides us with increased flexibility in structuring possible future financings and acquisitions and in meeting other needs which might arise. These actions can be taken without stockholder approval, unless stockholder approval is required by applicable law or the rules of any stock exchange or automated quotation system on which our securities may be listed or traded. Although we have no present intention of doing so, we could issue a class or series of shares that could delay, defer or prevent a transaction or a change in control that might involve a premium price for holders of common stock or otherwise be in their best interest.

Control Share Acquisitions

The MGCL provides that a holder of control shares of a Maryland corporation acquired in a control share acquisition has no voting rights with respect to such shares except to the extent approved at a special meeting by the affirmative vote of two-thirds of the votes entitled to be cast on the matter, excluding shares of stock in a corporation in respect of which any of the following persons is entitled to exercise or direct the exercise of the voting power of shares of stock of the corporation in the election of directors: (i) a person who makes or proposes to make a control share acquisition, (ii) an officer of the corporation or (iii) an employee of the corporation who is also a director of the corporation. Control shares are voting shares of stock which, if aggregated with all other such shares of stock previously acquired by the acquiror or in respect of which the acquiror is able to exercise or direct the exercise of voting power (except solely by virtue of a revocable proxy), would entitle the acquiror to exercise voting power in electing directors within one of the following ranges of voting power: (i) one-tenth or more but less than one-third, (ii) one-third or more but less than a majority, or (iii) a majority or more of all voting power. Control shares do not include shares that the acquiring person is then entitled to vote as a result of having previously obtained stockholder approval. A control share acquisition means the acquisition of issued and outstanding control shares, subject to certain exceptions.

A person who has made or proposes to make a control share acquisition, upon satisfaction of certain conditions (including an undertaking to pay expenses), may compel our board of directors to call a special meeting of stockholders to be held within 50 days of demand to consider the voting rights of the shares. If no request for a meeting is made, the corporation may itself present the question at any stockholders meeting.

If voting rights are not approved at the meeting or if the acquiring person does not deliver an acquiring person statement as required by the statute, then, subject to certain conditions and limitations, the corporation may redeem any or all of the control shares (except those for which voting rights have previously been approved) for fair value determined, without regard to the absence of voting rights for the control shares, as of the date of the last control share acquisition by the acquiror or of any meeting of stockholders at which the voting rights of such shares are considered and not approved. If voting rights for control shares are approved at a stockholders meeting and the acquiror becomes entitled to vote a majority of the shares entitled to vote, all other stockholders may exercise appraisal rights. The fair value of the shares as determined for purposes of such appraisal rights may not be less than the highest price per share paid by the acquiror in the control share acquisition.

The control share acquisition statute does not apply (a) to shares acquired in a merger, consolidation or share exchange if the corporation is a party to the transaction or (b) to acquisitions approved or exempted by the charter or bylaws of the corporation.

We have not opted out of the control share acquisition statute.

Possible Anti-Takeover Effect of Certain Provisions of Maryland Law and of Our Charter and Bylaws

The business combination provisions and the control share acquisition provisions of the MGCL; the classification of our board of directors; the restrictions on the transfer and ownership of stock and the advance notice provisions of our bylaws could have the effect of delaying, deferring or preventing a transaction or a change in control that might involve a premium price for holders of common stock or otherwise be in their best interests.

MATERIAL U.S. FEDERAL INCOME TAX CONSIDERATIONS

This section summarizes the current material federal income tax consequences generally resulting from our election to be taxed as a REIT and the current material federal income tax considerations relating to the ownership and disposition of our common stock, senior common stock and preferred stock. As used in this section, the terms we and our refer solely to Gladstone Commercial Corporation and not to our subsidiaries and affiliates which have not elected to be taxed as REITs for federal income tax purposes.

Table of Contents

This discussion is not exhaustive of all possible tax considerations and does not provide a detailed discussion of any state, local or foreign tax considerations. This discussion does not address all aspects of taxation that may be relevant to particular investors in light of their personal investment or tax circumstances, or to certain types of investors that are subject to special treatment under the federal income tax laws, such as insurance companies, tax-exempt organizations (except to the limited extent discussed below under Taxation of Tax-Exempt Stockholders), financial institutions or broker-dealers, non-U.S. individuals and foreign corporations (except to the limited extent discussed below under Taxation of Non-U.S. Stockholders) and other persons subject to special tax rules. Moreover, this summary assumes that our stockholders hold our stock as a capital asset for federal income tax purposes, which generally means property held for investment. The statements in this section are based on the current federal income tax laws, including the Code, the regulations promulgated by the U.S. Treasury Department, or the Treasury Regulations, rulings and other administrative interpretations and practices of the IRS, and judicial decisions, all as currently in effect, and all of which are subject to differing interpretations or to change, possibly with retroactive effect. This discussion is for general purposes only and is not tax advice. We cannot assure you that new laws, interpretations of law, or court decisions, any of which may take effect retroactively, will not cause any statement in this section to be inaccurate.

As discussed below in Taxation in Connection with Holding Securities other than our Stock, we intend to describe in any prospectus supplement related to the offering of our debt securities, depositary shares or subscription rights, the material federal income tax considerations relating to the ownership and disposition of such securities as will be sold by us pursuant to that prospectus supplement.

We urge you to consult your own tax advisor regarding the specific tax consequences to you of acquisition, ownership and disposition of our securities and of our election to be taxed as a REIT. Specifically, you should consult your own tax advisor regarding the federal, state, local, foreign, and other tax consequences of such acquisition, ownership, disposition and election, and regarding potential changes in applicable tax laws.

Taxation of Our Company

We elected to be taxed as a REIT under the federal income tax laws beginning with our taxable year ended December 31, 2003. We believe that, beginning with such taxable year, we have been organized and have operated in such a manner as to qualify for taxation as a REIT under the Code, and we intend to continue to operate in such a manner. However, no assurances can be given that our beliefs or expectations will be fulfilled, since qualification as a REIT depends on our continuing to satisfy numerous asset, income, stock ownership and distribution tests described below, the satisfaction of which depends, in part, on our operating results.

The sections of the Code relating to qualification, operation and taxation as a REIT are highly technical and complex. The following discussion sets forth only the material aspects of those sections. This summary is qualified in its entirety by the applicable Code provisions and the related Treasury Regulations and administrative and judicial interpretations thereof.

In connection with the filing of this registration statement, Bass, Berry & Sims PLC has rendered an opinion that we have been organized and have operated in conformity with the requirements for qualification and taxation as a REIT pursuant to Sections 856 through 860 of the Code for our taxable years ended December 31, 2010 through December 31, 2012, and our organization and current and proposed method of operation will enable us to continue to qualify as a REIT for our taxable year ending December 31, 2013 and thereafter. Investors should be aware that Bass, Berry & Sims PLC s opinion is based on the federal income tax laws governing qualification as a REIT as of the date of such opinion, which is subject to change, possibly on a retroactive basis, is not binding on the IRS or any court, and speaks only as of the date issued. In addition, Bass, Berry & Sims PLC s opinion is based on customary assumptions and is conditioned upon certain representations made by us as to factual matters, including representations regarding the nature of our assets and the future conduct of our

28

Table of Contents

business. Moreover, our continued qualification and taxation as a REIT depend on our ability to meet, on a continuing basis, through actual results, certain qualification tests set forth in the federal income tax laws. Those qualification tests involve the percentage of our gross income that we earn from specified sources, the percentage of our assets that falls within specified categories, the diversity of our stock ownership, and the percentage of our earnings that we distribute. Bass, Berry & Sims PLC will not review our compliance with those tests on a continuing basis. Accordingly, no assurance can be given that the actual results of our operations for any particular taxable year will satisfy such requirements. Bass, Berry & Sims PLC s opinion does not foreclose the possibility that we may have to use one or more of the REIT savings provisions described below, which may require us to pay a material excise or penalty tax in order to maintain our REIT qualification. For a discussion of the tax consequences of our failure to maintain our qualification as a REIT, see Failure to Qualify as a REIT below.

If we maintain our qualification as a REIT, we generally will not be subject to federal income tax on the taxable income that we distribute to our stockholders because we will be entitled to a deduction for dividends that we pay. The benefit of that tax treatment is that it avoids the double taxation, or taxation at both the corporate and stockholder levels, that generally results from owning stock in a corporation. In general, income generated by a REIT is taxed only at the stockholder level if such income is distributed by the REIT to its stockholders. We will be subject to federal tax, however, in the following circumstances:

We are subject to the corporate federal income tax on any REIT taxable income, including net capital gain, that we do not distribute to our stockholders during, or within a specified time period after, the calendar year in which the income is earned.

We may be subject to the corporate alternative minimum tax on any items of tax preference, including any deductions of net operating losses.

We are subject to tax, at the highest corporate rate, on:

- net income from the sale or other disposition of property acquired through foreclosure (foreclosure property), as described below under Gross Income Tests Foreclosure Property, that we hold primarily for sale to customers in the ordinary course of business, and
- other non-qualifying income from foreclosure property.

We are subject to a 100% tax on net income from sales or other dispositions of property, other than foreclosure property, that we hold primarily for sale to customers in the ordinary course of business.

If we fail to satisfy one or both of the 75% gross income test or the 95% gross income test, as described below under Gross Income Tests, but nonetheless maintain our qualification as a REIT because we meet certain other requirements, we will be subject to a 100% tax on:

- the greater of the amount by which we fail the 75% gross income test or the 95% gross income test, in either case, multiplied by

- a fraction intended to reflect our profitability.

If we fail to distribute during a calendar year at least the sum of: (1) 85% of our REIT ordinary income for the year, (2) 95% of our REIT capital gain net income for the year, and (3) any undistributed taxable income required to be distributed from earlier periods, then we will be subject to a 4% nondeductible excise tax on the excess of the required distribution over the amount we actually distributed.

If we fail any of the asset tests, other than a de minimis failure of the 5% asset test, the 10% vote test or the 10% value test, as described below under Asset Tests, as long as (1) the failure was due to reasonable cause and not to willful neglect, (2) we file a description of each asset that caused such failure with the IRS, and (3) we dispose of the assets causing the failure or otherwise comply with the

29

asset tests within six months after the last day of the quarter in which we identify such failure, we will pay a tax equal to the greater of $50,000 or the highest federal corporate income tax rate (currently 35%) multiplied by the net income from the nonqualifying assets during the period in which we failed to satisfy the asset tests.

If we fail to satisfy one or more requirements for REIT qualification, other than the gross income tests and the asset tests, and such failure is due to reasonable cause and not to willful neglect, we will be required to pay a penalty of $50,000 for each such failure.

We will be subject to a 100% excise tax on transactions with a taxable REIT subsidiary that are not conducted on an arm s-length basis.

If we acquire any asset from a C corporation, or a corporation that generally is subject to full corporate-level tax, in a merger or other transaction in which we acquire a basis in the asset that is determined by reference either to the C corporation s basis in the asset or to another asset, we will pay tax at the highest corporate rate applicable if we recognize gain on the sale or disposition of the asset during the 10-year period after we acquire the asset. The amount of gain on which we will pay tax generally is the lesser of:

- the amount of gain that we recognize at the time of the sale or disposition, and

- the amount of gain that we would have recognized if we had sold the asset at the time we acquired it.

The earnings of our subsidiary entities that are C corporations, including taxable REIT subsidiaries, are subject to federal corporate income tax.

In addition, we may be subject to a variety of taxes, including payroll taxes and state, local and foreign income, property and other taxes on our assets and operations. We also could be subject to tax in situations and on transactions not presently contemplated.

Requirements for Qualification as a REIT

A REIT is a corporation, trust or association that satisfies each of the following requirements:

(1) It is managed by one or more trustees or directors;

(2) Its beneficial ownership is evidenced by transferable shares of stock, or by transferable shares or certificates of beneficial interest;

(3) It would be taxable as a domestic corporation, but for Sections 856 through 860 of the Code, i.e. the REIT provisions;

(4) It is neither a financial institution nor an insurance company subject to special provisions of the federal income tax laws;

(5) At least 100 persons are beneficial owners of its stock or ownership shares or certificates (determined without reference to any rules of attribution);

(6) Not more than 50% in value of its outstanding stock or shares of beneficial interest are owned, directly or indirectly, by five or fewer individuals, which the federal income tax laws define to include certain entities, during the last half of any taxable year;

(7) It elects to be a REIT, or has made such election for a previous taxable year, and satisfies all relevant filing and other administrative requirements established by the IRS that must be met to qualify to be taxed as a REIT for federal income tax purposes;

(8) It uses a calendar year for federal income tax purposes and complies with the recordkeeping requirements of the federal income tax laws; and

(9) It meets certain other qualifications, tests described below, regarding the sources of its gross income, the nature and diversification of its assets and the distribution of its income.

We must satisfy requirements 1 through 4, and 8 during our entire taxable year and must satisfy requirement 5 during at least 335 days of a taxable year of 12 months, or during a proportionate part of a taxable year of less than 12 months. If we comply with certain requirements for ascertaining the beneficial ownership of our outstanding stock in a taxable year and have no reason to know that we violated requirement 6, we will be deemed to have satisfied requirement 6 for that taxable year. For purposes of determining stock ownership under requirement 6, an individual generally includes a supplemental unemployment compensation benefits plan, a private foundation, or a portion of a trust permanently set aside or used exclusively for charitable purposes. An individual, however, generally does not include a trust that is a qualified employee pension or profit sharing trust under the federal income tax laws, and beneficiaries of such a trust will be treated as holding our stock in proportion to their actuarial interests in the trust for purposes of requirement 6.

Our charter provides for restrictions regarding the ownership and transfer of our stock that should allow us to continue to satisfy these requirements. The provisions of the charter restricting the ownership and transfer of our stock are described in Certain Provisions of Maryland Law And of Our Charter And Bylaws Restrictions on Ownership and Transfer. We believe we have issued sufficient stock with enough diversity of ownership to satisfy requirements 5 and 6 set forth above. For purposes of requirement 8, we have adopted December 31 as our year end for federal income tax purposes, and thereby satisfy this requirement.

Qualified REIT Subsidiaries. A qualified REIT subsidiary generally is a corporation, all of the stock of which is owned, directly or indirectly, by a REIT and that is not treated as a taxable REIT subsidiary. A corporation that is a qualified REIT subsidiary is treated as a division of the REIT that owns, directly or indirectly, all of its stock and not as a separate entity for federal income tax purposes. Thus, all assets, liabilities, and items of income, deduction, and credit of a qualified REIT subsidiary are treated as assets, liabilities, and items of income, deduction, and credit of the REIT that directly or indirectly owns the qualified REIT subsidiary. Consequently, in applying the REIT requirements described herein, the separate existence of any qualified REIT subsidiary that we own will be ignored, and all assets, liabilities, and items of income, deduction, and credit of such subsidiary will be treated as our assets, liabilities, and items of income, deduction, and credit.

Other Disregarded Entities and Partnerships. An unincorporated domestic entity, such as a partnership or limited liability company, that has a single owner, as determined under the federal income tax laws, generally is not treated as an entity separate from its owner for federal income tax purposes. We own various direct and indirect interests in entities that are classified as partnerships, limited liability companies and trusts for state law purposes. Nevertheless, these entities currently are not treated as entities separate from us for federal income tax purposes because we currently own, directly or indirectly, all of the ownership interests in these entities. Consequently, the assets and items of gross income of these entities will be treated as our assets and items of gross income for purposes of applying the various REIT qualification tests.

An unincorporated domestic entity with two or more owners, as determined under the federal income tax laws, generally is taxed as a partnership for federal income tax purposes. In the case of a REIT that is a partner in a partnership, the REIT is treated as owning its proportionate share of the assets of the partnership and as earning its allocable share of the gross income of the partnership for purposes of the applicable REIT qualification tests. Thus, our proportionate share of the assets and items of gross income of any partnership, joint venture, or limited liability company that is taxed as a partnership for federal income tax purposes would be treated as our assets and items of gross income for purposes of applying the various REIT qualification tests. For purposes of the 10% value test (described in Asset Tests), our proportionate share would be based on our proportionate interest in the equity interests and certain debt securities issued by a partnership. For all of the other asset and income tests, our proportionate share would be based on our proportionate interest in the capital of the partnership.

31

Table of Contents

Taxable REIT Subsidiaries. A REIT is permitted to own, directly or indirectly, up to 100% of the stock of one or more taxable REIT subsidiaries. The subsidiary and the REIT generally must jointly elect to treat the subsidiary as a taxable REIT subsidiary. A corporation of which a taxable REIT subsidiary directly or indirectly owns more than 35% of the voting power or value of the securities, however, is automatically treated as a taxable REIT subsidiary without an election. The separate existence of a taxable REIT subsidiary is not ignored for federal income tax purposes. A taxable REIT subsidiary is a fully taxable corporation that may earn income that would not be qualifying income for purposes of the gross income tests, as described below, if earned directly by the parent REIT. Accordingly, a taxable REIT subsidiary generally is subject to corporate income tax on its earnings, which may reduce the cash flow generated by us and our subsidiaries in the aggregate, and may reduce our ability to make distributions to our stockholders.

We are not treated as holding the assets of a taxable REIT subsidiary or as receiving any income that the taxable REIT subsidiary earns. Rather, the stock issued by a taxable REIT subsidiary to us is an asset in our hands, and we treat the distributions paid to us from such taxable REIT subsidiary, if any, as income. This treatment may affect our compliance with the gross income tests and asset tests. Because a REIT does not include the assets and income of taxable REIT subsidiaries in determining the REIT s compliance with REIT requirements, such entities may be used by the REIT to indirectly undertake activities that the REIT requirements might otherwise preclude the REIT from doing directly or through a pass-through subsidiary (e.g., a partnership). If dividends are paid to us by one or more of our domestic taxable REIT subsidiaries that we may own, then a portion of such dividends that we distribute to our stockholders who are taxed at individual rates generally will be eligible for taxation at the preferential income tax rates applicable to qualified dividend income rather than at ordinary income rates. See Annual Distribution Requirements and Taxation of Taxable U.S. Stockholders Distributions.

A taxable REIT subsidiary pays federal income tax at corporate rates on any income that it earns. Restrictions imposed on REITs and their taxable REIT subsidiaries are intended to ensure that taxable REIT subsidiaries will be subject to appropriate levels of federal income taxation. These restrictions limit the deductibility of interest paid or accrued by a taxable REIT subsidiary to its parent REIT and impose a 100% excise tax on transactions between a taxable REIT subsidiary and its parent REIT or the REIT s tenants that are not conducted on an arm s-length basis. We may engage in activities indirectly through a taxable REIT subsidiary as necessary or convenient to obtain the benefit of income or services that would jeopardize our REIT status if we engaged in the activities directly. In particular, we likely would engage in activities through a taxable REIT subsidiary if we wished to provide services to unrelated parties which might produce income that does not qualify under the gross income tests described below. We also might dispose of an unwanted asset through a taxable REIT subsidiary as necessary or convenient to avoid the 100% tax on income from prohibited transactions. See Gross Income Tests Rents from Real Property and Gross Income Tests Prohibited Transactions.

Gross Income Tests

We must satisfy two gross income tests annually to maintain our qualification as a REIT. First, at least 75% of our gross income for each taxable year must consist of defined types of income that we derive, directly or indirectly, from investments relating to real property or mortgages on real property or qualified temporary investment income. Qualifying income for purposes of that 75% gross income test generally includes:

rents from real property;

interest on debt secured by mortgages on real property or on interests in real property;

dividends or other distributions on, and gain from the sale of, stock or shares of beneficial interest in other REITs;

gain from the sale of real estate assets;

income and gain derived from foreclosure property; and income derived from the temporary investment of new capital that is attributable to the issuance of our stock or a public offering of our debt with a maturity date of at least five years and that we receive during the one-year period beginning on the date on which we receive such new capital.

Second, in general, at least 95% of our gross income for each taxable year must consist of income that is qualifying income for purposes of the 75% gross income test, other types of interest and dividends, gain from the sale or disposition of stock or securities, or any combination of these.

Cancellation of indebtedness income and gross income from a sale of property that we hold primarily for sale to customers in the ordinary course of business will be excluded from gross income for purposes of the 75% and 95% gross income tests. In addition, any gains from hedging transactions, as defined in Hedging Transactions, that are clearly and timely identified as such will be excluded from gross income for purposes of the 75% and 95% gross income tests. Finally, certain foreign currency gains will be excluded from gross income for purposes of one or both of the gross income tests.

The following paragraphs discuss the specific application of the gross income tests to us.

Rents from Real Property. Rent that we receive for the use of our real property will qualify as rents from real property, which is qualifying income for purposes of the 75% and 95% gross income tests, only if the following conditions are met:

First, the rent must not be based in whole or in part on the income or profits of any person. Participating rent, however, will qualify as rents from real property if it is based on percentages of receipts or sales and the percentages:

- are fixed at the time the leases are entered into;
- are not renegotiated during the term of the leases in a manner that has the effect of basing percentage rent on income or profits; and
- conform with normal business practice.

More generally, the rent will not qualify as rents from real property if, considering the relevant lease and all the surrounding circumstances, the arrangement does not conform with normal business practice, but is in reality used as a means of basing the rent on income or profits. We intend to set and accept rents which are fixed dollar amounts or a fixed percentage of gross revenue and not to any extent determined by reference to any person s income or profits, in compliance with the rules above.

Second, we generally must not own, actually or constructively, 10% or more of the stock or the assets or net profits of any tenant, referred to as a related-party tenant, other than a taxable REIT subsidiary. The constructive ownership rules generally provide that, if 10% or more in value of our stock is owned, directly or indirectly, by or for any person, we are considered as owning the stock owned, directly or indirectly, by or for such person. Because the constructive ownership rules are broad and it is not possible to monitor direct and indirect transfers of our stock continually, no absolute assurance can be given that such transfers or other events of which we have no knowledge will not cause us to own constructively 10% or more of a tenant (or a subtenant, in which case only rent attributable to the subtenant is disqualified), other than a taxable REIT subsidiary.

Under an exception to the related-party tenant rule described in the preceding paragraph, rent that we receive from a taxable REIT subsidiary will qualify as rents from real property as long as (1) at least 90% of the leased space in the property is leased to persons other than taxable REIT subsidiaries and related-party tenants, and (2) the amount paid by the taxable REIT subsidiary to rent space at the property is substantially comparable to rents paid by other tenants of the property for comparable space. The substantially comparable requirement must be satisfied when the lease is entered into, when it is extended, and when the lease is modified,

33

Table of Contents

if the modification increases the rent paid by the taxable REIT subsidiary. If the requirement that at least 90% of the leased space in the related property is rented to unrelated tenants is met when a lease is entered into, extended, or modified, such requirement will continue to be met as long as there is no increase in the space leased to any taxable REIT subsidiary or related-party tenant. Any increased rent attributable to a modification of a lease with a taxable REIT subsidiary in which we own, directly or indirectly, more than 50% of the voting power or value of the stock (a controlled taxable REIT subsidiary) will not be treated as rents from real property.

Third, we must not furnish or render noncustomary services, other than a de minimis amount of noncustomary services, as described below, to the tenants of our properties, or manage or operate our properties, other than through an independent contractor from whom we do not derive or receive any income or a taxable REIT subsidiary. We generally may provide services directly to our tenants, however, if such services are usually or customarily rendered in connection with the rental of space for occupancy only and are not considered to be provided for the tenants convenience. In addition, we may provide a minimal amount of noncustomary services to the tenants of a property, other than through an independent contractor from whom we do not derive or receive any income or a taxable REIT subsidiary, as long as the income attributable to the services (valued at not less than 150% of the direct cost of performing such services) does not exceed 1% of the income from the related property. We have not performed, and do not intend to perform, any services other than customary ones for our tenants, unless such services are provided through independent contractors from whom we do not derive or receive any income or taxable REIT subsidiaries.

If the rent from a lease of property does not qualify as rents from real property because (1) the rent is based on the net income or profits of the tenant, (2) the lessee is a related-party tenant or fails to qualify for the exception to the related-party tenant rule for qualifying taxable REIT subsidiaries, or (3) we furnish noncustomary services to the tenants of the property, or manage or operate the property, other than through a qualifying independent contractor or a taxable REIT subsidiary, that are in excess of 1% of our gross income from the related property, none of the rent from the property would qualify as rents from real property. In any of these circumstances, we could lose our REIT status, unless we qualified for certain statutory relief provisions, because we might be unable to satisfy either the 75% or 95% gross income test.

Tenants may be required to pay, in addition to base rent, reimbursements for certain amounts we are obligated to pay to third parties (such as a lessee s proportionate share of a property s operational or capital expenses), penalties for nonpayment or late payment of rent or additions to rent. These and other similar payments should qualify as rents from real property. To the extent they do not, they should be treated as interest that qualifies for the 95% gross income test.

In addition, rent attributable to any personal property leased in connection with a lease of real property will not qualify as rents from real property if the rent attributable to such personal property exceeds 15% of the total rent received under the lease. The rent attributable to personal property under a lease is the amount that bears the same ratio to total rent under the lease for the taxable year as the average of the fair market values of the leased personal property at the beginning and at the end of the taxable year bears to the average of the aggregate fair market values of both the real and personal property covered by the lease at the beginning and at the end of such taxable year, or the personal property ratio. If a portion of the rent that we receive from a property does not qualify as rents from real property because the rent attributable to personal property exceeds 15% of the total rent for a taxable year, the portion of the rent that is attributable to personal property will not be qualifying income for purposes of either the 75% or 95% gross income test. Thus, if such rent attributable to personal property, plus any other income that is nonqualifying income for purposes of the 95% gross income test, during a taxable year exceeds 5% of our gross income during the year, we would lose our REIT status, unless we qualified for certain statutory relief provisions. We believe that any income attributable to personal property will not jeopardize our ability to maintain our qualification as a REIT. There can be no assurance, however, that the IRS would not challenge our calculation of a personal property ratio, or that a court would agree with our

34

calculation. If such a challenge were successful, we could fail to satisfy the 75% or 95% gross income test and thus potentially lose our REIT status.

Interest. For purposes of the 75% and 95% gross income tests, the term interest generally does not include any amount received or accrued, directly or indirectly, if the determination of such amount depends in whole or in part on the income or profits of any person. However, an amount received or accrued generally will not be excluded from the term interest solely because it is based on a fixed percentage or percentages of receipts or sales. Furthermore, to the extent that interest from a loan that is based on the profit or net cash proceeds from the sale of the property securing the loan constitutes a shared appreciation provision, income attributable to such participation feature will be treated as gain from the sale of the secured property.

We may invest opportunistically from time to time in mortgage debt and mezzanine loans. Interest on debt secured by a mortgage on real property or on interests in real property, including, for this purpose, discount points, prepayment penalties, loan assumption fees, and late payment charges that are not compensation for services, generally is qualifying income for purposes of the 75% gross income test. In general, if a loan is secured by real property and other property and the highest principal amount of the loan outstanding during a taxable year exceeds the fair market value of the real property securing the loan, determined as of (i) the date we agreed to acquire or originate the loan or (ii) in the event of a significant modification, the date we modified the loan, then a portion of the interest income from such loan will not be qualifying income for purposes of the 75% gross income test, but will be qualifying income for purposes of the 95% gross income test. The portion of the interest income that will not be qualifying income for purposes of the 75% gross income test will be equal to the interest income attributable to the portion of the principal amount of the loan that is not secured by real property. The principal amount of the loan that is not secured by real property is the amount by which the loan exceeds the value of the real estate that is security for the loan.

Mezzanine loans are loans secured by equity interests in an entity that directly or indirectly owns real property, rather than by a direct mortgage of the real property. IRS Revenue Procedure 2003-65 provides a safe harbor pursuant to which a mezzanine loan, if it meets each of the requirements contained in the Revenue Procedure, will be treated by the IRS as a real estate asset for purposes of the REIT asset tests described below, and interest derived from it will be treated as qualifying mortgage interest for purposes of the 75% gross income test. Although the Revenue Procedure provides a safe harbor on which taxpayers may rely, it does not prescribe rules of substantive tax law. We anticipate that any mezzanine loans that we originate or acquire typically will not meet all of the requirements for reliance on this safe harbor. Nevertheless, we intend to invest in any mezzanine loans in a manner that will enable us to continue to satisfy the gross income tests and asset tests.

Dividends. Our share of any dividends received from any corporation (including any taxable REIT subsidiary, but excluding any REIT or qualified REIT subsidiary) in which we own an equity interest will qualify for purposes of the 95% gross income test but not for purposes of the 75% gross income test. Our share of any dividends received from any other REIT in which we own an equity interest will be qualifying income for purposes of the 75% and 95% gross income tests. Any dividends received by us from a qualified REIT subsidiary will be excluded from gross income for purposes of the 75% and 95% gross income tests.

Prohibited Transactions. A REIT will incur a 100% tax on the net income derived from any sale or other disposition of property, other than foreclosure property, that the REIT holds primarily for sale to customers in the ordinary course of a trade or business, and net income derived from such prohibited transactions is excluded from gross income solely for purposes of the 75% and 95% gross income tests. Whether a REIT holds an asset primarily for sale to customers in the ordinary course of a trade or business depends, however, on the facts and circumstances that exist from time to time, including those related to a particular asset. A safe harbor to the characterization of the sale of property by a REIT as a prohibited transaction and the resulting imposition of the 100% prohibited transactions tax is available, however, if the following requirements are met:

the REIT has held the property for not less than two years;

35

Table of Contents

the aggregate expenditures made by the REIT, or any partner of the REIT, during the two-year period preceding the date of the sale that are includable in the basis of the property do not exceed 30% of the selling price of the property;

either (1) during the year in question, the REIT did not make more than seven property sales other than sales of foreclosure property or sales to which Section 1033 of the Code applies, (2) the aggregate adjusted bases of all such properties sold by the REIT during the year did not exceed 10% of the aggregate bases of all of the assets of the REIT at the beginning of the year or (3) the aggregate fair market value of all such properties sold by the REIT during the year did not exceed 10% of the aggregate fair market value of all of the assets of the REIT at the beginning of the year;

in the case of property not acquired through foreclosure or lease termination, the REIT has held the property for at least two years for the production of rental income; and

if the REIT has made more than seven property sales (excluding sales of foreclosure property) during the taxable year, substantially all of the marketing and development expenditures with respect to the property were made through an independent contractor from whom the REIT derives no income.

We will attempt to comply with the terms of the safe-harbor provisions in the federal income tax laws prescribing when an asset sale will not be characterized as a prohibited transaction. We cannot assure you, however, that we will be able to comply with the safe-harbor provisions or that we will avoid owning property that may be characterized as property held primarily for sale to customers in the ordinary course of a trade or business. We may hold and dispose of certain properties through a taxable REIT subsidiary if we conclude that the sale or other disposition of such property may not fall within the safe-harbor provisions. The 100% prohibited transaction tax will not apply to gains from the sale of property that is held through a taxable REIT subsidiary or other taxable corporation, although such income will be taxed to the taxable REIT subsidiary or other taxable corporation at federal corporate income tax rates.

Foreclosure Property. We will be subject to tax at the maximum corporate rate on any income from foreclosure property, which includes certain foreign currency gains and related deductions, other than income that otherwise would be qualifying income for purposes of the 75% gross income test, less expenses directly connected with the production of that income. Gross income from foreclosure property, however, will qualify under the 75% and 95% gross income tests. Foreclosure property is any real property, including interests in real property, and any personal property incident to such real property:

that is acquired by a REIT as the result of the REIT having bid on such property at foreclosure, or having otherwise reduced such property to ownership or possession by agreement or process of law, after there was a default or default was imminent on a lease of such property or on indebtedness that such property secured;

for which the related loan or leased property was acquired by the REIT at a time when the default was not imminent or anticipated; and for which the REIT makes a proper election to treat the property as foreclosure property.

A REIT will not be considered to have foreclosed on a property, however, where the REIT takes control of the property as a mortgagee-in-possession and cannot receive any profit or sustain any loss except as a creditor of the mortgagor. Property generally ceases to be foreclosure property at the end of the third taxable year following the taxable year in which the REIT acquired the property (or longer if an extension is granted by the Secretary of the U.S. Treasury). This period (as extended, if applicable) terminates, and foreclosure property ceases to be foreclosure property on the first day:

on which a lease is entered into for the property that, by its terms, will give rise to income that does not qualify for purposes of the 75% gross income test, or any amount is received or accrued, directly or

36

indirectly, pursuant to a lease entered into on or after such day that will give rise to income that does not qualify for purposes of the 75% gross income test;

on which any construction takes place on the property, other than completion of a building or any other improvement, where more than 10% of the construction was completed before default became imminent; or

which is more than 90 days after the day on which the REIT acquired the property and the property is used in a trade or business which is conducted by the REIT, other than through an independent contractor from whom the REIT itself does not derive or receive any income.

Hedging Transactions. From time to time, we or our subsidiaries may enter into hedging transactions with respect to one or more of our or our subsidiaries assets or liabilities. Our or our subsidiaries hedging activities may include entering into interest rate swaps, caps, and floors, options to purchase such items, and futures and forward contracts. Income and gain from hedging transactions will be excluded from gross income for purposes of both the 75% and 95% gross income tests. A hedging transaction means either (1) any transaction entered into in the normal course of our or our subsidiaries trade or business primarily to manage the risk of interest rate, price changes, or currency fluctuations with respect to borrowings made or to be made, or ordinary obligations incurred or to be incurred, to acquire or carry real estate assets or (2) any transaction entered into primarily to manage the risk of currency fluctuations with respect to any item of income or gain that would be qualifying income under the 75% or 95% gross income test (or any property which generates such income or gain). We are required to clearly identify any such hedging transaction before the close of the day on which it was acquired, originated, or entered into and to satisfy other identification requirements. We intend to structure any hedging transactions in a manner that does not jeopardize our qualification as a REIT; however, no assurance can be given that our hedging activities will give rise to income that qualifies for purposes of either or both of the gross income tests.

Failure to Satisfy Gross Income Tests. We intend to monitor our sources of income, including any non-qualifying income received by us, and manage our assets so as to ensure our compliance with the gross income tests. If we fail to satisfy one or both of the gross income tests for any taxable year, we nevertheless may maintain our qualification as a REIT for that year if we qualify for relief under certain provisions of the federal income tax laws. Those relief provisions are available if:

our failure to meet the applicable test is due to reasonable cause and not to willful neglect; and

following such failure for any taxable year, we file a schedule of the sources of our income with the IRS in accordance with the Treasury Regulations.

We cannot predict, however, whether any failure to meet these tests will qualify for the relief provisions. In addition, as discussed above in Taxation of Our Company, even if the relief provisions apply, we would incur a 100% tax on the gross income attributable to the greater of (1) the amount by which we fail the 75% gross income test, or (2) the amount by which we fail the 95% gross income test, multiplied, in either case, by a fraction intended to reflect our profitability.

Asset Tests

To maintain our qualification as a REIT, we also must satisfy the following asset tests at the end of each quarter of each taxable year.

First, at least 75% of the value of our total assets, or the 75% asset test, must consist of:

- cash or cash items, including certain receivables;
- government securities;

interests in real property, including leaseholds and options to acquire real property and leaseholds;

interests in mortgage loans secured by real property;

stock or shares of beneficial interest in other REITs; and

investments in stock or debt instruments during the one-year period following our receipt of new capital that we raise through equity offerings or public offerings of debt with at least a five-year term.

Second, of our assets that are not qualifying assets for purposes of the 75% asset test described above, the value of our interest in any one issuer s securities may not exceed 5% of the value of our total assets, or the 5% asset test.

Third, of our assets that are not qualifying assets for purposes of the 75% asset test described above, we may not own more than 10% of the voting power of any one issuer s outstanding securities, or the 10% vote test, or more than 10% of the value of any one issuer s outstanding securities, or the 10% value test.

Fourth, no more than 25% of the value of our total assets may consist of the securities of one or more taxable REIT subsidiaries.

Fifth, no more than 25% of the value of our total assets may consist of the securities of taxable REIT subsidiaries and other taxable subsidiaries and other assets that are not qualifying assets for purposes of the 75% asset test.

For purposes of the 5% asset test, the 10% vote test and the 10% value test, the term securities does not include stock in another REIT, equity or debt securities of a qualified REIT subsidiary or taxable REIT subsidiary, mortgage loans that constitute real estate assets, or equity interests in an entity taxed as a partnership. The term securities, however, generally includes debt securities issued by an entity taxed as a partnership or another REIT, except that for purposes of the 10% value test, the term securities does not include:

Straight debt securities, which is defined as a written unconditional promise to pay on demand or on a specified date a sum certain in money if (1) the debt is not convertible, directly or indirectly, into equity, and (2) the interest rate and interest payment dates are not contingent on profits, the borrower s discretion, or similar factors. Straight debt securities do not include any securities issued by an entity taxed as a partnership or a corporation in which we or any controlled taxable REIT subsidiary hold non- straight debt securities that have an aggregate value of more than 1% of the issuer s outstanding securities. Straight debt securities include, however, debt subject to the following contingencies:

¡ a contingency relating to the time of payment of interest or principal, as long as either (1) there is no change to the effective yield of the debt obligation, other than a change to the annual yield that does not exceed the greater of 0.25% or 5% of the annual yield, or (2) neither the aggregate issue price nor the aggregate face amount of the issuer s debt obligations held by us exceeds $1 million and no more than 12 months of unaccrued interest on the debt obligations can be required to be prepaid; and

- a contingency relating to the time or amount of payment on a default or prepayment of a debt obligation, as long as the contingency is consistent with customary commercial practice.

Any loan to an individual or an estate.

Any section 467 rental agreement, other than an agreement with a related-party tenant.

Any obligation to pay rents from real property.

Certain securities issued by governmental entities.

Any security issued by a REIT.

38

Table of Contents

Any debt instrument issued by an entity taxed as a partnership for federal income tax purposes in which we are an owner to the extent of our proportionate interest in the debt and equity securities of the entity.

Any debt instrument issued by an entity taxed as a partnership for federal income tax purposes not described in the preceding bullet points if at least 75% of the entity s gross income, excluding income from prohibited transactions, is qualifying income for purposes of the 75% gross income test described above in Gross Income Tests.

For purposes of the 10% value test, our proportionate share of the assets of an entity taxed as a partnership is our proportionate interest in any securities issued by such entity, without regard to the securities described in the preceding two bullet points above.

We believe that the assets that we hold satisfy the foregoing asset test requirements. We will not obtain, however, nor are we required to obtain under the federal income tax laws, independent appraisals to support our conclusions as to the value of our assets and securities or the real estate collateral for the mortgage or mezzanine loans that we may originate or acquire. Moreover, the values of some assets may not be susceptible to a precise determination. As a result, there can be no assurance that the IRS will not contend that our ownership of securities and other assets violates one or more of the asset tests applicable to REITs.

As noted above, we may invest opportunistically in loans secured by interests in real property. If the outstanding principal balance of a loan during a taxable year exceeds the fair market value of the real property securing such loan as of the date we agreed to originate or acquire the loan, a portion of such loan likely will not constitute a qualifying real estate asset for purposes of the 75% asset test. Although the law on the matter is not entirely clear, it appears that the nonqualifying portion of such loan will be equal to the portion of the loan amount that exceeds the value of the associated real property that serves as security for that loan.

Failure to Satisfy Asset Tests. We will monitor the status of our assets for purposes of the various asset tests and will manage our portfolio in order to comply at all times with such tests. Nevertheless, if we fail to satisfy the asset tests at the end of a calendar quarter, we will not lose our REIT status if:

we satisfied the asset tests at the end of the preceding calendar quarter; and

the discrepancy between the value of our assets and the asset test requirements arose from changes in the market values of our assets and was not caused, in part or in whole, by the acquisition of one or more non-qualifying assets.

If we did not satisfy the condition described in the second bullet point immediately above, we still could avoid REIT disqualification by eliminating any discrepancy within 30 days after the close of the calendar quarter in which the discrepancy arose.

In the event that we violate the 5% asset test, the 10% vote test or the 10% value test described above, we will not lose our REIT status if (1) the failure is de minimis (up to the lesser of 1% of our assets or $10 million) and (2) we dispose of assets causing the failure or otherwise comply with the asset tests within six months after the last day of the quarter in which we identify such failure. In the event of a failure of any of such asset tests other than a de minimis failure, as described in the preceding sentence, we will not lose our REIT status if (1) the failure was due to reasonable cause and not to willful neglect, (2) we file a description of each asset causing the failure with the IRS, (3) we dispose of assets causing the failure or otherwise comply with the asset tests within six months after the last day of the quarter in which we identify the failure, and (4) we pay a tax equal to the greater of $50,000 or the highest corporate federal income tax rate multiplied by of the net income from the nonqualifying assets during the period in which we failed to satisfy the asset tests.

Table of Contents

Annual Distribution Requirements

Each taxable year, we must make distributions, other than capital gain dividend distributions and deemed distributions of retained capital gain, to our stockholders in an aggregate amount at least equal to:

the sum of:

- 90% of our REIT taxable income, computed without regard to the dividends paid deduction and excluding any net capital gain, and
- 90% of our after-tax net income, if any, from foreclosure property, minus

the sum of certain items of non-cash income.

Generally, we must pay such distributions in the taxable year to which they relate, or in the following taxable year if either (1) we declare the distribution before we timely file our federal income tax return for the year and pay the distribution on or before the first regular dividend payment date after such declaration or (2) we declare the distribution in October, November, or December of the taxable year, payable to stockholders of record on a specified day in any such month, and we actually pay the dividend before the end of January of the following year. In both instances, these distributions relate to our prior taxable year for purposes of the annual distribution requirement.

We will pay federal income tax on any taxable income, including net capital gain, that we do not distribute to our stockholders. Furthermore, if we fail to distribute during a calendar year, or by the end of January of the following calendar year in the case of distributions with declaration and record dates falling in the last three months of the calendar year, at least the sum of:

85% of our REIT ordinary income for the year,

95% of our REIT capital gain net income for the year, and

any undistributed taxable income from prior years,

we will incur a 4% nondeductible excise tax on the excess of such required distribution over the amounts we actually distributed.

We may elect to retain and pay federal income tax on the net long-term capital gain that we receive in a taxable year. If we so elect, we will be treated as having distributed any such retained amount for purposes of the 4% nondeductible excise tax described above. We intend to make timely distributions sufficient to satisfy the annual distribution requirement and to minimize corporate income tax and avoid the 4% nondeductible excise tax.

In addition, if we were to recognize built-in gain on the disposition of any assets acquired from an entity treated as a C corporation for federal income tax purposes in a transaction in which our basis in the assets was determined by reference to such entity s tax basis (for instance, if the assets were acquired in a tax-free reorganization), we would be required to distribute at least 90% of the built-in-gain net of the tax we would pay on such gain. Built-in gain is the excess of (1) the fair market value of the asset (measured at the time of acquisition) over (2) the basis of the asset (measured at the time of acquisition).

It is possible that, from time to time, we may experience timing differences between the actual receipt of income and actual payment of deductible expenses and the inclusion of that income and deduction of such expenses in arriving at our REIT taxable income. Further, it is possible that, from time to time, we may be allocated a share of net capital gain from a partnership (or an entity taxed as a partnership for federal income tax purposes) in which we own an interest that is attributable to the sale of depreciated property that exceeds our allocable share of cash attributable to that sale. As a result of the foregoing, we may have less cash than is necessary to make distributions to our stockholders that are sufficient to avoid corporate income tax and the 4% nondeductible excise tax imposed on certain undistributed income or even to meet the annual distribution requirement. In such a situation, we may need to borrow funds or issue additional stock or, if possible, pay dividends consisting, in whole or in part, of our stock or debt securities.

In order for distributions to be counted as satisfying the annual distribution requirement applicable to REITs and to provide us with a REIT-level tax deduction, the distributions must not be preferential dividends. A distribution is not a preferential dividend if the distribution is (1) pro rata among all outstanding shares within a particular class, and (2) in accordance with the preferences among different classes of stock as set forth in our organizational documents.

Under certain circumstances, we may be able to correct a failure to meet the distribution requirement for a year by paying deficiency dividends to our stockholders in a later year. We may include such deficiency dividends in our deduction for dividends paid for the earlier year. Although we may be able to avoid income tax on amounts distributed as deficiency dividends, we will be required to pay interest to the IRS based on the amount of any deduction we take for deficiency dividends.

Recordkeeping Requirements

We must maintain certain records in order to maintain our qualification as a REIT. To avoid paying monetary penalties, we must demand, on an annual basis, information from certain of our stockholders designed to disclose the actual ownership of our outstanding stock, and we must maintain a list of those persons failing or refusing to comply with such demand as part of our records. A stockholder that fails or refuses to comply with such demand is required by the Treasury Regulations to submit a statement with its tax return disclosing the actual ownership of our stock and other information. We intend to comply with these recordkeeping requirements.

Failure to Qualify as a REIT

If we fail to satisfy one or more requirements for REIT qualification, other than the gross income tests and the asset tests, we could avoid disqualification if our failure is due to reasonable cause and not to willful neglect and we pay a penalty of $50,000 for each such failure. In addition, there are relief provisions available under the Code for a failure of the gross income tests and asset tests, as described in Gross Income Tests and Asset Tests.

If we were to fail to maintain our qualification as a REIT in any taxable year, and no relief provision applied, we would be subject to federal income tax on our taxable income at federal corporate income tax rates and any applicable alternative minimum tax. In calculating our taxable income for a year in which we failed to maintain our qualification as a REIT, we would not be able to deduct amounts distributed to our stockholders, and we would not be required to distribute any amounts to our stockholders for that year. In such event, to the extent of our current and accumulated earnings and profits, distributions to our stockholders generally would be taxable to our stockholders as ordinary income. Subject to certain limitations of the federal income tax laws, our corporate stockholders may be eligible for the dividends received deduction, and stockholders taxed at individual rates may be eligible for a maximum federal income tax rate of 20% on such dividends. Unless we qualified for relief under the statutory relief provisions described in the preceding paragraph, we also would be disqualified from taxation as a REIT for the four taxable years following the year during which we ceased to maintain our qualification as a REIT. We cannot predict whether in all circumstances we would qualify for such statutory relief.

Taxation in Connection with Holding Securities other than our Stock

We intend to describe in any prospectus supplement related to the offering of our debt securities, depositary shares or subscription rights, the material federal income tax considerations relating to the ownership and disposition of such securities, including, if applicable, (1) the taxation of any debt securities that will be sold with original issue discount or acquired with market discount or amortizable bond premium and (2) the tax treatment of sales, exchanges or retirements of our debt securities.

41

Table of Contents

Taxation of Taxable U.S. Stockholders

For purposes of our discussion, the term U.S. stockholder means a holder of our common stock, senior common stock and preferred stock that, for federal income tax purposes, is:

- a citizen or resident of the United States;
- a corporation (including an entity treated as a corporation for federal income tax purposes) created or organized under the laws of the United States, any of its states or the District of Columbia;
- an estate whose income is subject to federal income taxation regardless of its source; or
- any trust if (1) a U.S. court is able to exercise primary supervision over the administration of such trust and one or more U.S. persons have the authority to control all substantial decisions of the trust or (2) it has a valid election in place to be treated as a U.S. person.

If a partnership, entity or arrangement taxed as a partnership for federal income tax purposes (a partnership) holds our stock, the federal income tax treatment of an owner of the partnership generally will depend on the status of the owner and the activities of the partnership. If you are an owner of a partnership that may acquire our stock, you should consult your tax advisor regarding the tax consequences of the ownership and disposition of our stock by the partnership.

Distributions. As long as we qualify as a REIT, distributions made out of our current or accumulated earnings and profits that we do not designate as capital gain dividends or retained long-term capital gains will be dividend income to taxable U.S. stockholders. In determining the extent to which a distribution with respect to our stock constitutes a dividend for federal income tax purposes, our earnings and profits will be allocated first to distributions with respect to our preferred stock and senior common stock and then to our common stock. A corporate U.S. stockholder will not qualify for the dividends-received deduction generally available to corporations. Dividends paid to a U.S. stockholder generally will not qualify for the tax rates applicable to qualified dividend income. Qualified dividend income generally includes dividends paid by domestic C corporations and certain qualified foreign corporations to U.S. stockholders that are taxed at individual rates. Because we are not generally subject to federal income tax on the portion of our REIT taxable income that we distribute to our stockholders, our dividends generally will not constitute qualified dividend income. As a result, our REIT dividends generally will be taxed at the higher tax rates applicable to ordinary income. The highest marginal individual income tax rate on ordinary income is 39.6%. The federal income tax rates applicable to qualified dividend income generally will apply, however, to our ordinary REIT dividends, if any, that are (1) attributable to qualified dividends received by us from non-REIT corporations, such as any taxable REIT subsidiaries, or (2) attributable to income recognized by us and on which we have paid federal corporate income tax (e.g., to the extent that we distribute less than 100% of our taxable income). In general, to qualify for the reduced federal income tax rate on qualified dividend income under such circumstances, a U.S. stockholder must hold our stock for more than 60 days during the 121-day period beginning on the date that is 60 days before the date on which our stock becomes ex-dividend. In addition, a taxable U.S. stockholder that is an individual, an estate or an enumerated trust and that has taxable income in excess of certain thresholds is subject to a 3.8% Medicare tax on dividends received from us.

Any distribution we declare in October, November, or December of any year that is payable to a U.S. stockholder of record on a specified date in any of those months will be treated as paid by us and received by the U.S. stockholder on December 31 of that year to the extent it is a dividend attributable to earnings and profits, provided that we actually pay the distribution during January of the following calendar year.

Distributions to a U.S. stockholder which we designate as capital gain dividends generally will be treated as long-term capital gain, without regard to the period for which the U.S. stockholder has held our stock. See Capital Gains and Losses below. A corporate U.S. stockholder may be required to treat up to 20% of certain capital gain dividends as ordinary income.

We may elect to retain and pay federal corporate income tax on the net long-term capital gain that we receive in a taxable year. In that case, to the extent that we designate such amount in a timely notice to our stockholders, a U.S. stockholder would be taxed on its proportionate share of our undistributed long-term capital gain. The U.S. stockholder would receive a credit or refund for its proportionate share of the federal corporate income tax we paid, however, the U.S. stockholder would increase its basis in our stock by the amount of its proportionate share of our undistributed long-term capital gain, minus its share of the federal corporate income tax we paid.

A U.S. stockholder will not incur federal income tax on a distribution in excess of our current and accumulated earnings and profits if the distribution does not exceed the U.S. stockholder s adjusted basis in our stock. Instead, the distribution will reduce the U.S. stockholder s adjusted basis in our stock, and any amount in excess of both its share of our current and accumulated earnings and profits and its adjusted basis will be treated as capital gain, long-term if the stock has been held for more than one year, provided the stock is a capital asset in the hands of the U.S. stockholder.

U.S. stockholders may not include in their individual federal income tax returns any of our net operating losses or capital losses. Instead, these losses are generally carried over by us for potential offset against our future income. Taxable distributions from us and gain from the disposition of our stock will not be treated as passive activity income, and, therefore, U.S. stockholders generally will not be able to apply any passive activity losses, such as, for example, losses from certain types of entities in which the U.S. stockholder is treated as a limited partner for federal income tax purposes, against such income. In addition, taxable distributions from us and gain from the disposition of our stock generally will be treated as investment income for purposes of the investment interest limitations. We will notify U.S. stockholders after the close of our taxable year as to the portions of the distributions attributable to that taxable year that constitute ordinary income, return of capital and capital gain.

Dispositions. A U.S. stockholder who is not a dealer in securities generally must treat any gain or loss realized on a taxable disposition of our stock as long-term capital gain or loss if the U.S. stockholder has held such stock for more than one year, and otherwise as short-term capital gain or loss. In general, a U.S. stockholder will realize gain or loss in an amount equal to the difference between (1) the sum of the fair market value of any property and the amount of cash received in such disposition and (2) the U.S. stockholder s adjusted tax basis in such stock. A U.S. stockholder s adjusted tax basis in our stock generally will equal the U.S. stockholder s acquisition cost, increased by the excess of undistributed net capital gains deemed distributed to the U.S. stockholder over the federal corporate income tax deemed paid by the U.S. stockholder on such gains and reduced by any returns of capital. However, a U.S. stockholder must treat any loss on a sale or exchange of our stock held by such stockholder for six months or less as a long-term capital loss to the extent of capital gain dividends and any other actual or deemed distributions from us that such U.S. stockholder treats as long-term capital gain. All or a portion of any loss that a U.S. stockholder realizes on a taxable disposition of shares of our stock may be disallowed if the U.S. stockholder purchases other shares of our stock within 30 days before or after the disposition. In addition, a taxable U.S. stockholder that is an individual, an estate or a enumerated trust and that has taxable income in excess of certain thresholds generally is subject to a 3.8% Medicare tax on gain from the sale of our stock.

Capital Gains and Losses. The federal income tax-rate differential between long-term capital gain and ordinary income for non-corporate taxpayers may be significant. A taxpayer generally must hold a capital asset for more than one year for gain or loss derived from its sale or exchange to be treated as long-term capital gain or loss. The maximum federal income tax rate on ordinary gain applicable to U.S. stockholders that are taxed at individual rates, currently is 39.6%, and the maximum federal income tax rate on long-term capital gain applicable to U.S. stockholders that are taxed at individual rates currently is 20%. The maximum tax rate on long-term capital gain from the sale or exchange of section 1250 property (i.e., generally, depreciable real property) is 25% to the extent the gain would have been treated as ordinary income if the property were section 1245 property (i.e., generally, depreciable personal property). We generally will designate whether a

distribution that we designate as capital gain dividends (and any retained capital gain that we are deemed to distribute) is attributable to the sale or exchange of section 1250 property. The characterization of income as capital gain or ordinary income may affect the deductibility of capital losses. A non-corporate taxpayer may deduct capital losses not offset by capital gains against its ordinary income only up to a maximum annual amount of $3,000. A non-corporate taxpayer may carry forward unused capital losses indefinitely. A corporate taxpayer must pay tax on its net capital gain at federal corporate income tax rates, whether or not such gains are classified as long-term capital gains. A corporate taxpayer may deduct capital losses only to the extent of capital gains, with unused losses carried back three years and forward five years.

Taxation of Tax-Exempt Stockholders

Tax-exempt entities, including qualified employee pension and profit sharing trusts and individual retirement accounts and annuities, generally are exempt from federal income taxation. However, they are subject to taxation on their unrelated business taxable income, or UBTI. Amounts that we distribute to tax-exempt stockholders generally should not constitute UBTI. If a tax-exempt stockholder were to finance its acquisition of our stock with debt, however, a portion of the distribution that it received from us would constitute UBTI pursuant to the debt-financed property rules. Furthermore, social clubs, voluntary employee benefit associations, supplemental unemployment benefit trusts, and qualified group legal services plans that are exempt from taxation under special provisions of the federal income tax laws are subject to different UBTI rules, which generally will require them to characterize distributions that they receive from us as UBTI.

Finally, in certain circumstances, a qualified employee pension or profit-sharing trust that owns more than 10% of the value of our stock must treat a percentage of the dividends that it receives from us as UBTI. Such percentage is equal to the gross income that we derive from unrelated trades or businesses, determined as if we were a pension trust, divided by our total gross income for the year in which we pay the dividends. Such rule applies to a pension trust holding more than 10% of the value of our stock only if:

- we are classified as a pension-held REIT ; and
- the amount of gross income that we derive from unrelated trades or businesses for the year in which we pay the dividends, determined as if we were a pension trust, is at least 5% of our total gross income for such year.

We will be classified as a pension-held REIT if:

- we qualify as a REIT by reason of the modification of the rule requiring that no more than 50% of our stock be owned by five or fewer individuals that allows the beneficiaries of the pension trust to be treated as holding our stock in proportion to their actuarial interests in the pension trust; and
- either:
  - one pension trust owns more than 25% of the value of our stock; or

- a group of pension trusts, of which each pension trust holds more than 10% of the value of our stock, collectively owns more than 50% of the value of our stock.

As a result of limitations included in our charter on the transfer and ownership of our stock, we do not expect to be classified as a pension-held REIT, and, therefore, the tax treatment described in this paragraph should be inapplicable to our stockholders. However, because certain classes of our stock are publicly traded, we cannot guarantee that this will always be the case.

Taxation of Non-U.S. Stockholders

For purposes of our discussion, the term non-U.S. stockholder means a holder of our stock that is not a U.S. stockholder, an entity or arrangement taxed as a partnership for U.S. federal income tax purposes or a tax-

Table of Contents

exempt stockholder. Special rules may apply to non-U.S. stockholders that are subject to special treatment under the Code, including controlled foreign corporations, passive foreign investment companies, U.S. expatriates and foreign persons eligible for benefits under an applicable income tax treaty with the United States.

We urge non-U.S. stockholders to consult their own tax advisors to determine the impact of federal, state, local and foreign income tax laws on the acquisition, ownership and disposition of our stock, including any reporting requirements.

Distributions. A non-U.S. stockholder that receives a distribution that is not attributable to gain from our sale or exchange of a United States real property interest, or a USRPI (discussed below), and that we do not designate as a capital gain dividend or retained long-term capital gain will recognize ordinary income to the extent that we pay such distribution out of our current and accumulated earnings and profits. A withholding tax equal to 30% of the gross amount of the distribution ordinarily will apply unless an applicable tax treaty reduces or eliminates the tax. A non-U.S. stockholder generally will be subject to federal income tax at graduated rates, however, on any distribution treated as effectively connected with the non-U.S. stockholder s conduct of a U.S. trade or business, in the same manner as U.S. stockholders are taxed on distributions. A corporate non-U.S. stockholder may, in addition, be subject to the 30% branch profits tax with respect to any such distribution. We plan to withhold federal income tax at the rate of 30% on the gross amount of any distribution paid to a non-U.S. stockholder unless either:

- a lower treaty rate applies and the non-U.S. stockholder submits an IRS Form W-8BEN to us evidencing eligibility for that reduced rate;

- the non-U.S. stockholder submits an IRS Form W-8ECI to us claiming that the distribution is effectively connected income; or

- the distribution is treated as attributable to a sale of a USRPI under FIRPTA (discussed below).

A non-U.S. stockholder will not incur tax on a distribution in excess of our current and accumulated earnings and profits if the excess portion of such distribution does not exceed such non-U.S. stockholder s adjusted basis in our stock. Instead, the excess portion of such distribution will reduce the non-U.S. stockholder s adjusted basis in our stock. A non-U.S. stockholder will be subject to tax on a distribution that exceeds both our current and accumulated earnings and profits and the non-U.S. stockholder s adjusted basis in our stock, if the non-U.S. stockholder otherwise would be subject to tax on gain from the sale or disposition of our stock, as described below. See Dispositions below. Under FIRPTA (discussed below), we may be required to withhold 10% of any distribution that exceeds our current and accumulated earnings and profits. Although we intend to withhold at a rate of 30% on the entire amount of any distribution (other than a distribution attributable to a sale of a USRPI), to the extent that we do not do so, we may withhold at a rate of 10% on any portion of a distribution not subject to withholding at a rate of 30%. Because we generally cannot determine at the time we make a distribution whether the distribution will exceed our current and accumulated earnings and profits, we may withhold tax on the entire amount of any distribution. However, a non-U.S. stockholder may obtain a refund of amounts that we withhold if we later determine that a distribution in fact exceeded our current and accumulated earnings and profits.

For any year in which we maintain our qualification as a REIT, the Foreign Investment in Real Property Tax Act of 1980, or FIRPTA, may apply to our sale or exchange of a USRPI. A USRPI includes certain interests in real property and stock in corporations at least 50% of whose assets consist of interests in real property. Under FIRPTA, a non-U.S.

stockholder is taxed on distributions attributable to gain from sales of USRPIs as if such gain were effectively connected with the conduct of a U.S. trade or business of the non-U.S. stockholder. A non-U.S. stockholder thus would be taxed on such a distribution at the normal capital gains rates applicable to U.S. stockholders, subject to applicable alternative minimum tax and a special alternative minimum tax in the case of a nonresident alien individual. A non-U.S. corporate stockholder not entitled to treaty relief or exemption also may be subject to the 30% branch profits tax on such a distribution.

Table of Contents

If a class of our stock is regularly traded on an established securities market in the United States (any such class of our stock referred to as a publicly traded class), capital gain distributions to a non-U.S. stockholder in respect of stock of such publicly traded class that is attributable to our sale of real property will be treated as ordinary dividends rather than as gain from the sale of a USRPI, as long as such non-U.S. stockholder did not own more than 5% of the outstanding stock of such publicly traded class at any time during the one-year period preceding the distribution. As a result, non-U.S. stockholders owning 5% or less of the outstanding stock of such publicly traded class generally would be subject to withholding tax on such capital gain distributions in the same manner as they are subject to withholding tax on other distributions. If a non-U.S. stockholder owned more than 5% of the outstanding stock of a publicly traded class at any time during the one-year period preceding the distribution, capital gain distributions to such non-U.S. stockholder in respect of the stock of such publicly traded class that are attributable to our sale of USRPIs would be subject to tax under FIRPTA, as described above. Additionally, capital gain distributions to a non-U.S. stockholder in respect of stock of a class that is not a publicly traded class that are attributable to our sale of real property would be subject to tax under FIRPTA, as described above.

If a distribution is subject to FIRPTA, we must withhold 35% of such distribution that we could designate as a capital gain dividend. A non-U.S. stockholder may receive a credit against its tax liability for the amount that we withhold. Moreover, if a non-U.S. stockholder disposes of our stock during the 30-day period preceding a dividend payment, and such non-U.S. stockholder (or a person related to such non-U.S. stockholder) acquires or enters into a contract or option to acquire our stock within 61 days of the first day of the 30-day period described above, and any portion of such dividend payment would, but for the disposition, be treated as a USRPI capital gain to such non-U.S. stockholder, then such non-U.S. stockholder will be treated as having USRPI capital gain in an amount that, but for the disposition, would have been treated as USRPI capital gain.

Dispositions. Non-U.S. stockholders may incur tax under FIRPTA with respect to gain realized on a disposition of our stock since our stock will constitute a USRPI unless one of the applicable exceptions, as described below, applies. Any gain subject to tax under FIRPTA will be treated in the same manner as it would be in the hands of U.S. stockholders subject to alternative minimum tax, but under a special alternative minimum tax in the case of nonresident alien individuals.

Non-U.S. stockholders generally will not incur tax under FIRPTA with respect to gain on a sale of our stock, however, as long as, at all times, we are domestically controlled, i.e., non-U.S. persons hold, directly or indirectly, less than 50% in value of our outstanding stock. We cannot assure you that we will be domestically controlled. In addition, even if we are not domestically controlled, a non-U.S. stockholder that owned, actually or constructively, 5% or less of the outstanding stock of a publicly traded class at all times during a specified testing period will not incur tax under FIRPTA on gain from a sale of such stock.

Even if stock of a non-publicly traded class would otherwise constitute a USRPI, gain arising from the sale or other taxable disposition of such stock by a non-U.S. stockholder will not be subject to tax under FIRPTA as a sale of a USRPI if we have a publicly traded class and the applicable non-U.S. stockholder has not, at the time it acquires the stock of a non-publicly traded class, and at certain other times described in the applicable Treasury Regulations, directly or indirectly held stock of a non-publicly traded class (and in certain cases other direct or indirect interests in our stock) that had a fair market value in excess of 5% of the fair market value of our publicly traded class with the lowest fair market value. In addition, stock of a non-publicly traded class that is convertible into a stock of a publicly traded class and that is owned by a non-U.S. stockholder would not be considered a USRPI if, on the acquisition date, such stock had a fair market value that did not exceed the fair market value on such date of 5% of the total outstanding stock of the publicly traded class into which the stock of the non-publicly traded class is convertible.

46

Table of Contents

A non-U.S. stockholder generally will incur tax on gain from a disposition of our stock not subject to FIRPTA if:

- the gain is effectively connected with the conduct of the non-U.S. stockholder s U.S. trade or business, in which case the non-U.S. stockholder will be subject to the same treatment as U.S. stockholders with respect to such gain, except that a non-U.S. stockholder that is a corporation also may be subject to the 30% branch profits tax; or

- the non-U.S. stockholder is a nonresident alien individual who was present in the U.S. for 183 days or more during the taxable year and certain other conditions are satisfied, in which case the non-U.S. stockholder will incur a 30% tax on its capital gains.

Information Reporting Requirements, Backup Withholding and Certain Other Required Withholding

We will report to our stockholders and to the IRS the amount of distributions that we pay during each calendar year, and the amount of tax that we withhold, if any. Under the backup withholding rules, a stockholder may be subject to backup withholding (at a rate of 28%) with respect to distributions unless the stockholder:

- is a corporation or qualifies for certain other exempt categories and, when required, demonstrates this fact; or

- provides a taxpayer identification number, certifies as to no loss of exemption from backup withholding, and otherwise complies with the applicable requirements of the backup withholding rules.

A stockholder who does not provide us with its correct taxpayer identification number also may be subject to penalties imposed by the IRS. Any amount paid as backup withholding will be creditable against the stockholder s federal income tax liability. In addition, we may be required to withhold a portion of capital gain distributions to any stockholders who fail to certify their non-foreign status to us.

Backup withholding generally will not apply to payments of dividends made by us or our paying agents, in their capacities as such, to a non-U.S. stockholder provided that such non-U.S. stockholder furnishes to us or our paying agent the required certification as to its non-U.S. status, such as providing a valid IRS Form W-8BEN or W-8ECI, or certain other requirements are met. Notwithstanding the foregoing, backup withholding may apply if either we or our paying agent has actual knowledge, or reason to know, that the holder is a U.S. person that is not an exempt recipient. Payments of the proceeds from a disposition or a redemption of our stock that occurs outside the U.S. by a non-U.S. stockholder made by or through a foreign office of a broker generally will not be subject to information reporting or backup withholding. However, information reporting (but not backup withholding) generally will apply to such a payment if the broker has certain connections with the U.S. unless the broker has documentary evidence in its records that demonstrates that the beneficial owner is a non-U.S. stockholder and specified conditions are met or an exemption is otherwise established. Payment of the proceeds from a disposition of our stock by a non-U.S. stockholder made by or through the U.S. office of a broker generally is subject to information reporting and backup withholding unless the non-U.S. stockholder certifies under penalties of perjury that it is not a U.S. person and satisfies certain other requirements, or otherwise establishes an exemption from information reporting and backup withholding.

Backup withholding is not an additional tax. Any amounts withheld under the backup withholding rules may be refunded or credited against the stockholder s federal income tax liability if certain required information is furnished to the IRS. Stockholders should consult their own tax advisors regarding application of backup withholding to them and the availability of, and procedure for obtaining an exemption from, backup withholding.

The Foreign Account Tax Compliance Act (FATCA) imposes a 30% withholding tax on certain types of payments made to foreign financial institutions and certain other non-U.S. entities unless certain due diligence, reporting, withholding, and certification obligation requirements are satisfied. The U.S. Treasury Department and the IRS recently issued final Treasury Regulations under FATCA. FATCA generally imposes a 30% withholding tax on dividends on, and gross proceeds from the sale or other disposition of, our stock if paid to a foreign entity unless either (i) the foreign entity is a foreign financial institution that undertakes certain due diligence, reporting, withholding, and certification obligations, or in the case of a foreign financial institution that is a resident in a jurisdiction that has entered into an intergovernmental agreement to implement FATCA, the entity complies with the diligence and reporting requirements of such agreement, (ii) the foreign entity is not a foreign financial institution and identifies certain of its U.S. investors, or (iii) the foreign entity otherwise is excepted under FATCA. Under delayed effective dates provided for in the Treasury Regulations and other IRS guidance, such required withholding would not begin until July 1, 2014 with respect to dividends on our stock, and January 1, 2017 with respect to gross proceeds from a sale or other disposition of our stock.

If withholding is required under FATCA on a payment related to our stock, holders of our stock that otherwise would not be subject to withholding (or that otherwise would be entitled to a reduced rate of withholding) generally will be required to seek a refund or credit from the IRS to obtain the benefit of such exemption or reduction (provided that such benefit is available). You should consult your own tax advisor regarding the effect of FATCA on an investment in our stock.

Tax Aspects of Our Investments in Our Operating Partnership and Subsidiary Partnerships.

We currently hold, directly and indirectly, all of the ownership interests in our Operating Partnership and our other subsidiaries; therefore, our Operating Partnership and our other subsidiaries (other than any taxable REIT subsidiaries) currently are disregarded for federal income tax purposes. See Requirements for Qualification as a REIT Qualified REIT Subsidiaries and Requirements for Qualification as a REIT Other Disregarded Entities and Partnerships above. If additional partners or members are admitted to our Operating Partnership or any of our other subsidiaries, as applicable, we intend for such entity to be taxed as a partnership for federal income tax purposes. The following discussion summarizes certain federal income tax considerations that would be applicable if our Operating Partnership or other subsidiaries were taxed as partnerships for federal income tax purposes, each individually referred to as a Partnership and, collectively, as the Partnerships. The following discussion does not address state or local tax laws or any federal tax laws other than income tax laws.

Classification as Partnerships

We are required to include in our income our distributive share of each Partnership s income and to deduct our distributive share of each Partnership s losses but only if such Partnership is classified for federal income tax purposes as a partnership, rather than as a corporation or an association taxable as a corporation. An unincorporated entity with at least two owners or members, as determined for federal income tax purposes, will be classified as a partnership, rather than as a corporation, for federal income tax purposes if it:

- is treated as a partnership under the Treasury Regulations relating to entity classification, or the check-the-box regulations; and

- is not a publicly traded partnership.

Under the check-the-box regulations, an unincorporated entity with at least two owners or members may elect to be classified either as an association taxable as a corporation or as a partnership. If such an entity does not make an election, it generally will be taxed as a partnership for federal income tax purposes.

A publicly traded partnership is a partnership whose interests are traded on an established securities market or are readily tradable on a secondary market or the substantial equivalent thereof. A publicly traded partnership generally is treated as a corporation for federal income tax purposes, but will not be so treated if, for each taxable year beginning after December 31, 1987 in which it was classified as a publicly traded partnership, at least 90% of the partnership s gross income consisted of specified passive income, including real property rents, gains from the sale or other disposition of real property, interest, and dividends, or the 90% passive income exception. The

48

Table of Contents

Treasury Regulations provide limited safe harbors from treatment as a publicly traded partnership. Pursuant to one of those safe harbors, interests in a partnership will not be treated as readily tradable on a secondary market or the substantial equivalent thereof if (1) all interests in the partnership were issued in a transaction or transactions that were not required to be registered under the Securities Act of 1933, as amended, and (2) the partnership does not have more than 100 partners at any time during the partnership s taxable year. In determining the number of partners in a partnership, a person owning an interest in a partnership, grantor trust, or S corporation that owns an interest in the partnership is treated as a partner in such partnership only if (1) substantially all of the value of the owner s interest in the entity is attributable to the entity s direct or indirect interest in the partnership and (2) a principal purpose of the use of the entity is to permit the partnership to satisfy the 100-partner limitation. If any Partnership does not qualify for any safe harbor and is treated as a publicly traded partnership, we believe that such Partnership would have sufficient qualifying income to satisfy the 90% passive income exception and, therefore, would not be treated as a corporation for federal income tax purposes.

We have not requested, and do not intend to request, a ruling from the IRS that any of our direct or indirect subsidiaries is or will be classified as a partnership for federal income tax purposes. If, for any reason, a Partnership were taxable as a corporation, rather than as a partnership, for federal income tax purposes, we may not be able to maintain our qualification as a REIT, unless we qualify for certain statutory relief provisions. See Gross Income Tests and Asset Tests. In addition, any change in a Partnership s status for tax purposes might be treated as a taxable event, in which case we might incur tax liability without any related cash distribution. See Annual Distribution Requirements. Further, items of income and deduction of such Partnership would not pass through to us, and we would be treated as a stockholder for federal income tax purposes. Consequently, such Partnership would be required to pay income tax at corporate rates on its net income, and distributions to us would constitute dividends that would not be deductible in computing such Partnership s taxable income.

Income Taxation of the Partnerships and Their Partners

Partners, Not the Partnerships, Subject to Tax. A Partnership is not a taxable entity for federal income tax purposes. Rather, we are required to take into account our distributive share of each Partnership s income, gains, losses, deductions, and credits for each taxable year of the Partnership ending with or within our taxable year, even if we receive no distribution from the Partnership for that year or a distribution that is less than our share of taxable income. Similarly, even if we receive a distribution, it may not be taxable if the distribution does not exceed our adjusted tax basis in our interest in the Partnership.

Partnership Allocations. Although an agreement among the owners of an entity taxed as a partnership for federal income tax purposes generally will determine the allocation of income and losses among the owners, such allocations will be disregarded for tax purposes if they do not comply with the provisions of the federal income tax laws governing partnership allocations. If an allocation is not recognized for federal income tax purposes, the item subject to the allocation will be reallocated in accordance with the partners interests in the partnership, which will be determined by taking into account all of the facts and circumstances relating to the economic arrangement of the owners with respect to such item.

Tax Allocations With Respect to Contributed Properties. Income, gain, loss, and deduction attributable to appreciated or depreciated property that is contributed to an entity taxed as a partnership for federal income tax purposes in exchange for an interest in such entity must be allocated for federal income tax purposes in a manner such that the contributing owner is charged with, or benefits from, respectively, the unrealized gain or unrealized loss associated with the property at the time of the contribution (the 704(c) Allocations). The amount of such unrealized gain or unrealized loss, referred to as built-in gain or built-in loss, at the time of contribution is generally equal to the difference between the fair market value of the contributed property at the time of contribution and the adjusted tax basis of such property at that time, referred to as a book-tax difference. A book-tax difference attributable to depreciable property generally is decreased on an annual basis as a result of the allocation of depreciation deductions to the contributing owner for book purposes, but not for tax purposes. The

Table of Contents

704(c) Allocations are solely for federal income tax purposes and do not affect the book capital accounts or other economic or legal arrangements among the owners. The Treasury Regulations require entities taxed as a partnership for federal income tax purposes to use a reasonable method for allocating items with respect to which there is a book-tax difference and outline several reasonable allocation methods.

If our Operating Partnership were to admit additional partners and therefore be taxed as a partnership for federal income tax purposes, the properties owned by the Operating Partnership would be deemed to have been contributed to a partnership for federal income tax purposes, which could result in future 704(c) Allocations to us. In addition, the carryover basis of any properties actually contributed to our Operating Partnership by an additional partner, under certain reasonable methods available to us, including the traditional method, (1) would cause us to be allocated lower amounts of depreciation deductions for tax purposes than would be allocated to us if all contributed properties were to have a tax basis equal to their fair market value at the time of the contribution and (2) in the event of a sale of such properties, could cause us to be allocated taxable gain in excess of the economic or book gain allocated to us as a result of such sale, with a corresponding tax benefit to the contributing partners. An allocation described in clause (2) of the immediately preceding sentence may cause us to recognize taxable income in excess of cash proceeds in the event of a sale or other disposition of property, which might adversely affect our ability to comply with the REIT distribution requirements and may result in a greater portion of our distributions being taxed as dividends.

Basis in Partnership Interest. Our adjusted tax basis in any Partnership interest we own generally will be:

- the amount of cash and the basis of any other property we contribute to the Partnership;

- increased by our distributive share of the Partnership s income (including tax-exempt income) and any increase in our allocable share of indebtedness of the Partnership; and

- reduced, but not below zero, by our distributive share of the Partnership s loss (including any non-deductible items), the amount of cash and the basis of property distributed to us, and any reduction in our allocable share of indebtedness of the Partnership.

Loss allocated to us in excess of our basis in a Partnership interest will not be taken into account for federal income tax purposes until we again have basis sufficient to absorb the loss. A reduction of our allocable share of indebtedness of the Partnership will be treated as a constructive cash distribution to us, and will reduce our adjusted tax basis in the Partnership interest. Distributions, including constructive distributions, in excess of the basis of our partnership interest will constitute taxable income to us. Such distributions and constructive distributions normally will be characterized as long-term capital gain.

Sale of a Partnership s Property. Generally, any gain realized by a Partnership on the sale of property held for more than one year will be long-term capital gain, except for any portion of the gain treated as depreciation or cost recovery recapture. Our share of any Partnership s gain from the sale of inventory or other property held primarily for sale to customers in the ordinary course of the Partnership s trade or business will be treated as income from a prohibited transaction subject to a 100% tax. Income from a prohibited transaction may have an adverse effect on our ability to satisfy the gross income tests for REIT status. See Gross Income Tests. We presently do not intend to acquire or hold, or to allow any Partnership to acquire or hold, any property that is likely to be treated as inventory or property held primarily for sale to customers in the ordinary course of our, or any Partnership s, trade or business.

State and Local Taxes

We and/or you may be subject to taxation by various states and localities, including those in which we or a stockholder transacts business, owns property or resides. The state and local tax treatment may differ from the federal income tax treatment described above. Consequently, you should consult your own tax advisors regarding the effect of state and local tax laws on an investment in our securities.

50

Table of Contents

PLAN OF DISTRIBUTION

Offering and Sale of Securities

We may sell the securities being offered hereby, from time to time, in one or more offerings, on a continuous or delayed basis, by one or more of the following methods:

- to or through underwriting syndicates represented by managing underwriters;
- through one or more underwriters without a syndicate for them to offer and sell to the public;
- to or through dealers, brokers, placement agents or other agents; and
- to investors directly in negotiated sales or in competitively bid transactions.

One or more prospectus supplements will describe the terms of the offering of the securities, including:

- the name or names of any underwriters, dealers or agents, if any;
- the purchase price of the securities and the proceeds we will receive from the sale;
- any over-allotment options under which underwriters may purchase additional securities from us;
- any agency fees or underwriting discounts and other items constituting agents or underwriters compensation;
- any public offering price;
- any discounts or concessions allowed or reallowed or paid to dealers; and
- any securities exchange or market on which the securities may be listed.

The distribution of the securities may be effected from time to time in one or more transactions:

- at fixed prices which may be changed;

- at market prices prevailing at the time of the sale;
- at varying prices determined at the time of sale; or
- at negotiated prices.

Each prospectus supplement will set forth the manner and terms of an offering of securities including:

- the number and terms of the securities to which such prospectus relates;
- the name or names of any underwriters or agents with whom we have entered into arrangements with respect to the sale of such securities;
- the rules and procedures for any auction or bidding process, if used; and
- the public offering or purchase price of such securities and the net proceeds we will receive from such sale.

We may enter into derivative transactions with third parties or sell securities not covered by this prospectus to third parties in privately negotiated transactions. If the related prospectus supplement so indicates, in connection with those derivatives, the third parties may sell securities covered by this prospectus and the related prospectus supplement, including in short sale transactions. If so, the third party may use securities pledged by us or borrowed from us or others to settle those sales or to close out any related open borrowings of stock and may use securities received from us in settlement of those derivatives to close out any related open borrowings of stock. The third party in such sale transactions will be an underwriter and, if not identified in this prospectus, will be identified in the related prospectus supplement (or a post-effective amendment).

Table of Contents

Sales Through Underwriters

If underwriters are used in the sale, they will acquire the securities for their own account and may resell them from time to time in one or more transactions at a fixed public offering price. The obligations of the underwriters to purchase the securities will be subject to the conditions set forth in the applicable underwriting agreement. We may offer the securities to the public through underwriting syndicates represented by managing underwriters or by underwriters without a syndicate. Subject to certain conditions, the underwriters will be obligated to purchase all of the securities of the series offered by the prospectus supplement. Any public offering price and any discounts or concessions allowed or reallowed or paid to dealers may change from time to time. We may use underwriters with whom we have a material relationship. We will describe in the prospectus supplement, naming the underwriter, the nature of any such relationship.

Sales Through Agents

We may sell securities directly or through agents that we designate from time to time. We will name any agent involved in the offering and sale of securities, and we will describe any commissions that we will pay the agent in the prospectus supplement. Unless the prospectus supplement states otherwise, our agent will act on a best-efforts basis for the period of its appointment.

Securities bought in accordance with a redemption or repayment under their terms also may be offered and sold, if so indicated in the accompanying prospectus supplement, in connection with a remarketing by one or more firms acting as principals for their own accounts or as agents for us. Any remarketing firm will be identified, and the terms of its agreement, if any, with us and its compensation will be described in the prospectus supplement. Remarketing firms may be deemed to be underwriters in connection with the securities remarketed by them. If so indicated in the applicable prospectus supplement, we may authorize agents, underwriters or dealers to solicit offers by certain specified institutions to purchase securities at a price set forth in the prospectus supplement pursuant to delayed delivery contracts providing for payment and delivery on a future date specified in the prospectus supplement. These contracts will be subject only to those conditions set forth in the accompanying prospectus supplement, and the prospectus supplement will set forth the commissions payable for solicitation of these contracts.

Direct Sales

We may authorize agents or underwriters to solicit offers by certain types of institutional investors to purchase securities from us at the public offering price set forth in the prospectus supplement pursuant to delayed delivery contracts providing for payment and delivery on a specified date in the future. We will describe the conditions to these contracts and the commissions that we must pay for solicitation of these contracts in the prospectus supplement.

General Information

We will file a supplement to this prospectus, if required, pursuant to Rule 424(b) under the Securities Act, if we enter into any material arrangement with a broker, dealer, agent or underwriter for the sale of securities through a block trade, special offering, exchange distribution or secondary distribution or a purchase by a broker or dealer. Such prospectus supplement will disclose:

- the name of any participating broker, dealer, agent or underwriter;

the number and type of securities involved;

any securities exchanges on which such securities may be listed;

the commissions paid or discounts or concessions allowed to any such broker, dealer, agent or underwriter where applicable; and

Table of Contents

other facts material to the transaction.

We may provide agents and underwriters with indemnification against certain civil liabilities, including liabilities under the Securities Act, or contribution with respect to payments that the agents or underwriters may make with respect to such liabilities. Agents and underwriters may engage in transactions with, or perform services for, us in the ordinary course of business.

Our common stock trades on the NASDAQ Global Select Market under the symbol GOOD. Our 7.75% Series A Cumulative Redeemable Preferred Stock trades on the NASDAQ Global Select Market under the symbol GOODP, our 7.50% Series B Cumulative Redeemable Preferred Stock trades on the NASDAQ Global Select Market under the symbol GOODO and our 7.125% Series C Cumulative Term Preferred Stock trades on the NASDAQ Global Select Market under the symbol GOODN. Our Senior Common Stock is not listed on an exchange. All securities that we offer, other than our Listed Common Stock or Senior Common Stock, and other than securities issued upon a reopening of a previous series, will be new issues of securities with no established trading market. Any underwriters may make a market in these securities but will not be obligated to do so and may discontinue any market making at any time without notice. No assurance can be given as to the liquidity of the trading market for any securities sold by us.

Any underwriter may engage in over-allotment, stabilizing transactions, short covering transactions and penalty bids in accordance with Regulation M under the Exchange Act. Over-allotment involves sales in excess of the offering size which create a short position. Stabilizing transactions permit bids to purchase the underlying security so long as the stabilizing bids do not exceed a specified maximum price. Short covering transactions involve purchases of the securities in the open market after the distribution is completed to cover short positions. Penalty bids permit the underwriters to reclaim a selling concession from a dealer when the securities originally sold by the dealer are purchased in a covering transaction to cover short positions. Those activities may cause the price of the securities to be higher than it would otherwise be. If commenced, the underwriters may discontinue any of the activities at any time.

Any underwriters who are qualified market makers on the NASDAQ Global Select Market may engage in passive market making transactions in the securities on the NASDAQ Global Select Market in accordance with Rule 103 of Regulation M under the Exchange Act during the business day prior to the pricing of the offering and before the commencement of offers or sales of the securities. Passive market makers must comply with applicable volume and price limitations and must be identified as passive market makers. In general, a passive market maker must display its bid at a price not in excess of the highest independent bid for such security; if all independent bids are lowered below the passive market maker s bid, however, the passive market maker s bid must then be lowered when certain purchase limits are exceeded.

Some of the underwriters, dealers and agents and their affiliates may engage in transactions with or perform services for us and our affiliates in the ordinary course of business. Underwriters have from time to time in the past provided, and may from time to time in the future provide, investment banking services to us for which they have in the past received, and in the future may receive, customary fees.

Table of Contents

LEGAL MATTERS

Certain federal income tax matters will be passed upon for us by Bass, Berry & Sims PLC, Memphis, Tennessee. Certain matters of Maryland law, including the validity of the securities to be offered by means of this prospectus, will be passed upon for us by Venable LLP, Baltimore, Maryland.

EXPERTS

The financial statements of Gladstone Commercial Corporation and management s assessment of the effectiveness of internal control over financial reporting (which is included in Management s Report on Internal Control over Financial Reporting) incorporated in this Prospectus by reference to the Annual Report on Form 10-K for the year ended December 31, 2012 and the Historical Summary of Revenue for the year ended December 31, 2012 of 717 East Parmer Lane included on page 4 of Gladstone Commercial Corporation s Current Report on Form 8-K dated August 29, 2013 have been so incorporated in reliance on the reports of PricewaterhouseCoopers LLP, an independent registered public accounting firm, given on the authority of said firm as experts in auditing and accounting.

WHERE YOU CAN FIND MORE INFORMATION

We are a public company and file annual, quarterly and current reports, proxy statements and other information with the SEC. You may read and copy any document that we file at the SEC s public reference room at 100 F Street, NE, Washington, D.C. 20549. You may request copies of these documents by writing to the SEC and paying a fee for the copying cost. Please call the SEC at 1-800-SEC-0330 for more information about the operation of the public reference room. Our SEC filings are also available to the public at the SEC s website at www.sec.gov. We also make available free of charge through our website our Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Exchange Act as well as our definitive proxy statement and Section 16 reports on Forms 3, 4 and 5. Our website address is www.GladstoneCommercial.com. However, the information located on, or accessible from, our website is not, and shall not be deemed to be, except as described below, a part of this prospectus or any accompanying prospectus supplement or incorporated into any other filings that we make with the SEC.

This prospectus comprises only part of a registration statement on Form S-3 that we have filed with the SEC under the Securities Act and, therefore, omits some of the information contained in the registration statement. We have also filed exhibits and schedules to the registration statement which are excluded from this prospectus, and you should refer to the applicable exhibit or schedule for a complete description of any statement referring to any contract or other document. You may inspect or obtain a copy of the registration statement, including the exhibits and schedules, as described in the previous paragraph.

INCORPORATION OF CERTAIN DOCUMENTS BY REFERENCE

This prospectus is part of a registration statement that we have filed with the SEC. The SEC allows us to incorporate by reference the information that we file with it which means that we can disclose important information to you by referring you to those documents. The information incorporated by reference is considered to comprise a part of this prospectus from the date we file that document. Any reports filed by us with the SEC after the date of this prospectus and before the date that the offering of the securities by means of this prospectus is terminated will automatically update and, where applicable, supersede any information contained in this prospectus or incorporated by reference in this prospectus.

Table of Contents

We previously filed the following documents with the SEC, and such filings are incorporated by reference into this prospectus.

Annual Report on Form 10-K for the fiscal year ended December 31, 2012, filed February 19, 2013 (including portions of our definitive Proxy Statement for the 2013 Annual Meeting of Stockholders incorporated therein by reference);

Quarterly Report on Form 10-Q for the fiscal quarter ended March 31, 2013, filed April 29, 2013;

Quarterly Report on Form 10-Q for the fiscal quarter ended June 30, 2013, filed July 30, 2013;

Current Report on Form 8-K filed March 27, 2013;

Current Report on Form 8-K filed April 26, 2013;

Current Report on Form 8-K filed May 3, 2013;

Current Report on Form 8-K filed May 28, 2013;

Current Report on Form 8-K filed June 14, 2013;

Current Report on Form 8-K filed June 21, 2013;

Current Report on Form 8-K filed July 15, 2013;

Current Report on Form 8-K filed August 9, 2013;

Current Report on Form 8-K filed August 29, 2013;

The description of our common stock contained in our Registration Statement on Form 8-A filed August 12, 2003, as updated through subsequently filed reports;

The description of our 7.75% Series A Cumulative Redeemable Preferred Stock contained in our Registration Statement on Form 8-A, filed January 19, 2006, as updated through subsequently filed reports;

The description of our 7.50% Series B Cumulative Redeemable Preferred Stock contained in our Registration Statement on Form 8-A filed, October 19, 2006, as amended in our Registration Statement on Form 8-A/A filed on October 23, 2006, as updated through subsequently filed reports; and

The description of our 7.125% Series Cumulative Term Preferred Stock contained in our Registration Statement on Form 8-A, filed January 31, 2012, as updated through subsequently filed reports.

We also incorporate by reference into this prospectus additional documents that we may file with the SEC under Section 13(a), 13(c), 14 or 15(d) of the Exchange Act, from the date of this prospectus until all of the securities offered by this prospectus have been sold or we otherwise terminate the offering of these securities, including all filings made after the date of the initial filing of the registration statement of which this prospectus is a part and prior to the effectiveness of the registration statement; provided, however, that information furnished under Item 2.02 or Item 7.01 of Form 8-K or other information furnished to the SEC which is not deemed filed is not incorporated by reference in this prospectus and any accompanying prospectus supplement. Information that we subsequently file with the SEC will automatically update and may supersede information in this prospectus, any accompanying prospectus supplement and information previously filed with the SEC.

You may request a copy of these filings (other than exhibits, unless the exhibits are specifically incorporated by reference into these documents) at no cost by writing or calling Investor Relations at the following address and telephone number:

Investor Relations

Gladstone Commercial Corporation

1521 Westbranch Drive, Suite 200

McLean, Virginia 22102

(703) 287-5893

55

Table of Contents

1,377,500 Shares

Common Stock

PROSPECTUS SUPPLEMENT

Joint Book-Running Managers

Jefferies

Janney Montgomery Scott

Lead Manager

Oppenheimer & Co.

November 20, 2013