

ASSOCIATED ESTATES REALTY CORP  
Form 10-K  
February 28, 2007

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

**Form 10-K**

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15 (d)

OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended **December 31, 2006**

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15 (d) OF THE

SECURITIES EXCHANGE ACT OF 1934

For the transition period from \_\_\_\_\_ to \_\_\_\_\_ Commission File Number **1-12486**

**Associated Estates Realty Corporation**

(Exact name of registrant as specified in its charter)

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<u>Ohio</u> (State or other jurisdiction of incorporation or organization)	<u>34-1747603</u> (I.R.S. Employer Identification Number)
<u>1 AEC Parkway, Richmond Heights, Ohio</u> (Address of principal executive offices)	<u>44143-1467</u> (Zip Code)

Registrant's telephone number, including area code (216) 261-5000

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

<u>Title of Each Class</u>	<u>Name of Each Exchange on Which Registered</u>
Common Shares, without par value	New York Stock Exchange, Inc.
Depository Shares, each representing 1/10 of a Share of 8.70% Class B Series II Cumulative Redeemable Preferred Shares, without par value	New York Stock Exchange, Inc.

Securities registered pursuant to Section 12(g) of the Act: None

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

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

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

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer.

See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer [ ] Accelerated filer [ x ] Non-accelerated filer [ ]

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

The aggregate market value of the voting stock held by non-affiliates of the Registrant, was \$172.4 million as of June 30, 2006.

The number of Common Shares outstanding as of February 23, 2007 was 17,262,567.

DOCUMENTS INCORPORATED BY REFERENCE (To The Extent Indicated Herein)

Notice of Annual Meeting and Proxy Statement for the Annual Meeting of Shareholders to be held on May 2, 2007 (in Part III).

**ASSOCIATED ESTATES REALTY CORPORATION**

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**PART I**

## Edgar Filing: ASSOCIATED ESTATES REALTY CORP - Form 10-K

*Except as the context otherwise requires, all references to "we", "our", "us" and the "Company" in this report collectively refer to Associated Estates Realty Corporation ("AERC") and its consolidated subsidiaries.*

### Item 1. Business

#### GENERAL DEVELOPMENT OF BUSINESS

We are a self-administered and self-managed equity real estate investment trust ("REIT"). We are publicly traded on the New York Stock Exchange ("NYSE") under the ticker symbol "AEC". Our headquarters is located at 1 AEC Parkway in Richmond Heights, Ohio. The headquarters is comprised of one office building of approximately 41,000 square feet and an adjacent 3.7 acre parcel of land suitable for further development or expansion, both of which we own under a ground lease.

We are a fully integrated multifamily real estate company engaged in property acquisition, advisory, development, management, disposition, operation and ownership activities. We own three taxable REIT subsidiaries that provide management and other services to us and to third parties (collectively the "Service Companies"). As of December 31, 2006, we owned or property managed 99 apartment communities in nine states consisting of 20,558 units. See Item 2 for a state-by-state listing of our portfolio. We own, either directly or indirectly through subsidiaries, or hold ownership interests in 66 of the 99 apartment communities containing 15,355 units in eight states. Twelve of those owned or partially owned apartment communities, consisting of 1,254 units, are Affordable Housing communities. We also property manage 33 communities in which we do not have an ownership interest, consisting of 5,203 units. Additionally, we asset manage a 186-unit apartment community and one commercial property containing approximately 145,000 square feet. Large pension funds, non-profit organizations, and affiliated or non-affiliated third parties own the managed properties. In January 2007, we assumed property management responsibilities for a 200-unit Affordable Housing property located in Pennsylvania. In February 2007 we completed the sale of a 120-unit congregate care property located in Northeast Ohio. Our consolidated financial statements include the accounts of all subsidiaries and qualified REIT subsidiaries, which include but are not limited to, separate legal entities that were formed in connection with project specific, nonrecourse mortgage refinancing for which records, books of accounts and depository accounts must be maintained separately and apart from any other person or entity; the Service Companies, each of which is taxed as a Taxable REIT Subsidiary ("TRS") under the REIT Modernization Act ("RMA") implemented in 1999, certain variable interest entities of which we are the primary beneficiary and holder of a majority voting interest, and an Operating Partnership structured as a DownREIT, of which we own 97.4%.

#### BUSINESS SEGMENTS

We have four reportable segments: (1) Acquisition/Disposition multifamily properties, (2) Same Community Market-Rate ("Market-Rate") multifamily properties, (3) Affordable Housing multifamily properties, and (4) Management and Service Operations. We have identified these segments based upon types of property and services. All of our segments are located in the United States.

See Note 19 of the Notes to the Consolidated Financial Statements presented in Part II, Item 8 of this report on Form 10-K for the segment financial information.

**Acquisition/Disposition.** The Acquisition/Disposition properties represent acquired or developed properties which have not yet reached stabilization (we consider a property stabilized when its occupancy rate reaches 93.0% and we have owned the property for one year) and properties that have been sold or are classified as held for sale in accordance with SFAS 144, "Accounting for the Impairment or Disposal of Long-Lived Assets."

**Market-Rate.** The Market-Rate properties are wholly owned conventional multifamily residential properties that we have owned for the entirety of the comparison periods.

**Affordable Housing.** The Affordable Housing properties are multifamily properties for which the rents are subsidized and certain aspects of the operations are regulated by U.S. Department of Housing and Urban Development ("HUD") in compliance with Section 8 of the National Housing Act of 1937.

**Management and Service Operations.** The Management and Service Operations provide management and advisory services to the Acquired, Market-Rate and Affordable Housing properties that we own or have an investment in, as well as to non-owned properties that we manage. This segment also includes the results from our painting subsidiary, Merit Painting Services.

## **OPERATING STRATEGY AND BUSINESS OBJECTIVES**

See Part II, Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operations" of this report on Form 10-K for additional discussion of 2007 outlook and strategy.

**Acquisition/Disposition.** Our objective is to systematically migrate our portfolio to higher growth markets such as Florida, Atlanta, and the Baltimore/Washington, DC/Northern Virginia corridor, and to reduce the number of markets in which we operate. In doing so, we expect to continue to sell non-core properties located in the Midwest while evaluating potential acquisition opportunities in the markets noted above and other markets that we believe will offer an acceptable return on our investment. We continually monitor the profitability of all of our properties and therefore we may also consider opportunistic sales of properties in any market, including our targeted growth markets, if we determine that the proceeds from such sales would provide a greater return on equity and increased cash flow when invested in other properties or used to reduce debt or repurchase our shares. During 2006, we sold eight properties totaling 2,040 units, seven of which were located in Ohio and one property located in North Carolina, which was the only property that we owned or managed in that market. Strong competition for the acquisition of apartment communities in our targeted growth markets during 2006 resulted in acquisition prices that did not meet our investment criteria, thus impeding our ability to execute new property acquisitions. During 2007, we expect to sell five properties located in Ohio and the one property we own in Texas, and reinvest the sale proceeds in the higher growth markets that we have identified, provided we are able to acquire properties in accordance with our investment criteria and to pay off debt.

**Property Operations: Market-Rate Properties.** We operate in many different markets and sub-markets. Each of these markets may have economic characteristics that differ from other markets, and as a result, the degree to which we can increase rents may vary between markets. However, our goal is to maximize Market-Rate property operating income in all of our markets through a combination of increasing net collected rents and by continual efforts to contain controllable operating expenses. Strategies to increase rents include constant monitoring of our markets, providing superior resident service and desirable communities in which to live, and the implementation of new programs such as utility and refuse reimbursements. Our AEC Academy for Career Development provides training and support for our employees, which we believe results in high quality personnel at the communities and aids in employee retention. Additionally, we attempt to minimize controllable operating expenses through strategies such as the negotiation of centralized purchasing contracts benefitting multiple properties and through diligent upkeep and regular maintenance at our apartment communities.

**Property Operations: Affordable Housing Properties.** We wholly own 11 Affordable Housing properties comprised of 1,146 units, which have been part of the portfolio since 1993. While these properties' rent growth is limited, due to regulatory restrictions, they have provided a stabilizing influence on the portfolio. We have developed detailed systems and processes to effectively operate these properties, which by their nature, exist within a complex, highly regulated environment. Economic efficiencies are realized in conjunction with the management of another 30 Affordable Housing properties (4,804 units) owned by third parties and one property (108 units) in which we are a joint venture partner.

**Fee Management/Advisory Business.** We apply our management approach to the management of properties for third parties. We believe that third party property management broadens our knowledge of a market, creates opportunities for future acquisitions, enhances purchasing power and provides a network for new personnel while at the same time generating fee income.

**Financing and Capital.** Our overall investment goal is to maximize the return on our investments in order to increase shareholder value. Proceeds received from new debt, debt refinancing, property sales, or equity issuances are invested based upon the expected return and the impact on our balance sheet. The reduction of overall interest costs and an increase in the number of unencumbered assets are two of our objectives. During 2006, we focused on reducing our total debt in order to reduce our debt to real estate assets ratio (on an undepreciated basis). We believe that this is an important measure of our long term liquidity. Proceeds received from debt refinancings and the sale of eight properties in 2006 and one property at the end of 2005 were used to defease/prepay 19 mortgage loans totaling \$201.8 million, pay \$14.4 million in related defeasement and other prepayment costs, and to repurchase \$10.2 million of our common shares. Our ratio of total debt to real estate assets (on an undepreciated basis) was reduced to 56.8% at December 31, 2006 compared to 60.7% at December 31, 2005. We expect to further reduce this ratio during 2007. We estimate the fair value of our unencumbered assets at December 31, 2006 to currently be in excess of \$200.0 million. Additionally, in January 2007, we prepaid a \$15.2 million mortgage loan and incurred \$1.6 million in related prepayment costs. We estimate the fair value of this asset to be approximately \$29.0 million.

## INCOME TAXES

See Note 1 of the Notes to the Consolidated Financial Statements presented in Part II, Item 8 of this report on Form 10-K.

## COMPETITIVE CONDITIONS

See Part II, Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operations" of this report on Form 10-K.

## **CUSTOMERS**

Our business, taken as a whole, is not dependent upon any single customer or a few customers.

## **EMPLOYEES**

At February 21, 2007, we employed approximately 650 people. Satisfactory relations have generally prevailed between us and our employees.

## **AVAILABLE INFORMATION**

Shareholders may obtain, free of charge from our Internet site at <http://www.aecrealty.com>, a copy of our annual report 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 of 1934, as amended, as soon as reasonably practicable after we file such material electronically with, or furnish it to, the Securities and Exchange Commission ("SEC").

## **REPORTS TO SECURITY HOLDERS**

We issue annual reports to our security holders which contain financial statements.

### **Item 1A. Risk Factors**

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We are subject to certain risks and uncertainties as described below. These risks and uncertainties are not the only ones we face and there may be additional risks that we do not presently know of or that we currently consider immaterial. All of these risks could adversely affect our business, financial condition, results of operations and cash flows. Our ability to pay dividends on, and the market price of, our equity securities may be adversely affected if any of such risks are realized.

**We are subject to risks inherent in the ownership of real estate.** We own and manage multifamily apartment communities that are subject to varying degrees of risk generally incident to the ownership of real estate. Our financial condition, the value of our properties and our ability to make distributions to our shareholders will be dependent upon our ability to operate our properties in a manner sufficient to generate income in excess of operating expenses and debt service charges, which may be affected by the following risks, some of which are discussed in more detail below:

- changes in the economic climate in the markets in which we own and manage properties, including interest rates, our ability to consummate the sale of properties pursuant to our current plan, the overall level of economic activity, the availability of consumer credit and mortgage financing, unemployment rates and other similar factors;
- a lessening of demand for the multifamily units that we own or manage;
- competition from other available multifamily units and changes in market rental rates;
- increases in property and liability insurance costs;
- unanticipated increases in real estate taxes and other operating expenses (e.g., cleaning, utilities, repair and maintenance costs, insurance and administrative costs, security, landscaping, staffing and other general costs);
- weather conditions that adversely affect operating expenses;
- expenditures that cannot be anticipated, such as utility rate and usage increases, unanticipated repairs and real estate tax valuation reassessments or millage rate increases;
- our inability to control operating expenses or achieve increases in revenue;
- the results of litigation filed or to be filed against us;

changes in tax legislation;

risks of personal injury claims and property damage related to mold claims because of diminished insurance coverage;

catastrophic property damage losses that are not covered by our insurance;

risks associated with property acquisitions such as environmental liabilities, among others;

changes in government regulations affecting properties the rents of which are subsidized and certain aspects of which are regulated by the United States Department of Housing and Urban Development ("HUD") and other properties we own;

- our inability to renew current contracts with HUD for rent-subsidized properties at existing rents;
- changes in or termination of contracts relating to our third party management and advisory business;
- risks related to our joint ventures;
- the perception of residents and prospective residents as to the attractiveness, convenience and safety of our properties or the neighborhoods in which they are located; and

our ability to acquire properties at prices consistent with our investment criteria.

**We are dependent on rental income from our multifamily apartment communities.** If we are unable to attract and retain residents or if our residents are unable to pay their rental obligations, our financial condition and funds available for distribution to our shareholders will be adversely affected.



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**Our multifamily apartment communities are subject to competition.** Our apartment communities are located in developed areas that include other apartment communities. Our apartment communities also compete with other housing alternatives, such as condominiums, single and multifamily rental homes and owner occupied single and multifamily homes, in attracting residents. In certain markets, such as Florida, failed condominium conversions are reverting back to apartment rentals creating increasing competition in those markets. Such competition may affect our ability to attract and retain residents and to increase or maintain rental rates.

**The properties we own are primarily concentrated in Ohio, Michigan, Indiana, Maryland, Pennsylvania, Florida and Georgia.** As of December 31, 2006, approximately 50%, 20%, 6%, 5%, 3%, 9% and 6% of the units in properties we own are located in Ohio, Michigan, Indiana, Maryland, Pennsylvania, Florida and Georgia, respectively. Our performance, therefore, is linked to economic conditions and the market for available rental housing in these states and, more importantly, their respective sub-markets. The decline in the market for apartment housing in the various sub-markets in Ohio, or to a lesser extent, the sub-markets in the other states, may adversely affect our financial condition, results for third parties of operations and ability to make distributions to our shareholders.

**We own or manage properties that are subject to government programs.** As of December 31, 2006, we own directly or through subsidiaries or joint ventures 12 properties with 1,254 units and manage, for third parties with one or more of our affiliates, 29 properties with approximately 4,604 units, which benefit from some form of interest rate or rental subsidy subject to governmental programs administered by HUD. As a condition to the receipt of assistance under HUD programs, many of the properties must comply with various HUD requirements, which typically include maintenance of decent, safe and sanitary housing, HUD approval of rent adjustments, and, in the case of a HUD insured mortgage, approval of a transfer of the property. We can give no assurance that we will be able to renew current agreements with HUD at existing or higher rents. HUD requirements, and other current and future laws regarding the provision of affordable housing and any changes to existing law making it more difficult to meet such requirements, could adversely affect our results of operations, financial condition and ability to make distributions to our shareholders.

**Our insurance may not be adequate to cover certain risks.** There are certain types of risks, generally of a catastrophic nature, such as earthquakes, floods, windstorms, act of war and terrorist attacks that may be uninsurable, or are not economically insurable, or are not fully covered by insurance. Moreover, certain risks, such as mold and environmental exposures, generally are not covered by our insurance. Any such uninsured loss could have a material adverse effect on our business, financial condition and results of operations.

**Debt financing could adversely affect our performance.** A majority of our assets are encumbered by project specific, non-recourse, and except for five properties non-cross-collateralized mortgage debt. There is a risk that these properties may not have sufficient cash flow from operations to pay required principal and interest. We may not be able to refinance these loans at an amount equal to the loan balance and the terms of any refinancing may not be as favorable as the terms of existing indebtedness. If we are unable to make required payments on indebtedness that is secured by a mortgage, the property securing the mortgage may be foreclosed with a consequent loss of income and value to us.

**Real estate investments are generally illiquid, and we may not be able to sell our properties when it is economically or strategically advantageous to do so.** Real estate investments generally cannot be sold quickly, and our ability to sell properties may be affected by market conditions. We may not be able to diversify or vary our portfolio promptly in accordance with our strategies or in response to economic or other conditions. In addition, provisions of the Internal Revenue Code of 1986, as amended (the "Code") limit the ability of a REIT to sell its properties in some situations when it may be economically advantageous to do so, thereby potentially adversely affecting our ability to make

distributions to our shareholders.

**Our access to public debt markets is limited.** Substantially all of our debt financings are secured by mortgages on our properties because of our limited access to public debt markets.

**Revenue from third party management may further decline.** We could lose a significant portion of our third party management revenue if a client failed to renew or terminated our management agreements. Sixty-seven percent of the properties we manage for third parties are owned or controlled by a single client. The asset advisory and property management contracts with pension funds and non-affiliated third party owners are generally terminable upon 30 days notice.

**Litigation that may result in unfavorable outcomes.** Like many real estate operators, we are frequently involved in lawsuits involving premises liability claims, housing discrimination claims and alleged violations of landlord-tenant laws, which may give rise to class action litigation or governmental investigations. Any material litigation not covered by insurance, such as a class action, could result in substantial costs being incurred.

**Our financial results may be adversely impacted if we are unable to sell properties and employ the proceeds in accordance with our strategic plan.** Our ability to pay down debt, reduce our interest costs, buy back stock and acquire properties is impacted by our ability to sell the properties we have selected for disposition at the prices and within the deadlines we have established for each respective property. Moreover, if we are unable to acquire properties at prices consistent with our investment criteria, we may reduce or discontinue selling properties.

**The costs of complying with laws and regulations could adversely affect our cash flow and ability to make distributions to our shareholders.** Our properties must comply with Title III of the Americans with Disabilities Act (the "ADA") to the extent that they are "public accommodations" or "commercial facilities" as defined in the ADA. The ADA does not consider apartment communities to be public accommodations or commercial facilities, except for portions of such communities that are open to the public. In addition, the Fair Housing Amendments Act of 1988 (the "FHAA") requires apartment communities first occupied after March 13, 1990, to be accessible to the handicapped. Other laws also require apartment communities to be handicap accessible. Noncompliance with these laws could result in the imposition of fines or an award of damages to private litigants. We have been subject to lawsuits alleging violations of handicap design laws in connection with certain of our developments. If compliance with these laws involves substantial expenditures or must be made on an accelerated basis, our ability to make distributions to our shareholders could be adversely affected.

Under various federal, state and local laws, an owner or operator of real estate may be liable for the costs of removal or remediation of certain hazardous or toxic substances on, under or in the property. This liability may be imposed without regard to whether the owner or operator knew of, or was responsible for, the presence of the substances. Other law imposes on owners and operators certain requirements regarding conditions and activities that may affect human health or the environment. Failure to comply with applicable requirements could complicate our ability to lease or sell an affected property and could subject us to monetary penalties, costs required to achieve compliance and potential liability to third parties. We are not aware of any material noncompliance, liability or claim relating to hazardous or toxic substances or other environmental matters in connection with any of our properties. Nonetheless, it is possible that material environmental contamination or conditions exist, or could arise in the future in the apartment communities or on the land upon which they are located.

**We are subject to the risks associated with investments through joint ventures.** Two of our properties are owned by joint ventures in which we do not have a controlling interest. We may enter into joint ventures, including joint ventures that we do not control, in the future. Any joint venture investment involves risks such as the possibility that the co-venturer may seek relief under federal or state insolvency laws, or have economic or business interests or goals that are inconsistent with our business interests or goals. While the bankruptcy or insolvency of our co-venturer generally should not disrupt the operations of the joint venture, we could be forced to purchase the co-venturer's interest in the joint venture or the interest could be sold to a third party. We also may guarantee the indebtedness of our joint ventures. If we do not have control over a joint venture, the value of our investment may be affected adversely by a third party that may have different goals and capabilities than ours.

**We are subject to risks associated with development, acquisition and expansion of multifamily apartment communities.** Development projects and acquisitions and expansions of apartment communities are subject to a number of risks, including:

- availability of acceptable financing;
- competition with other entities for investment opportunities;
- failure by our properties to achieve anticipated operating results;
- construction costs of a property exceeding original estimates;
- delays in construction; and
- expenditure of funds on, and the devotion of management time to, transactions that may not come to fruition.

**We may fail to qualify as a REIT and you may incur tax liability as a result.** Commencing with our taxable year ending December 31, 1993, we have operated in a manner so as to permit us to qualify as a REIT under the Code, and we intend to continue to operate in such a manner. Although we believe that we will continue to operate as a REIT, no assurance can be given that we will remain qualified as a REIT. If we were to fail to qualify as a REIT in any taxable year, we would not be allowed a deduction for distributions to our shareholders in computing our taxable income and would be subject to federal income tax (including any applicable alternative minimum tax) on our taxable income at regular corporate rates. Unless we are entitled to relief under certain Code provisions, we also would be disqualified from treatment as a REIT for the four taxable years following the year during which REIT qualification was lost. As a result, the cash available for distribution to our shareholders could be reduced or eliminated for each of the years involved.

**Our ownership limit may discourage takeover attempts.** With certain limited exceptions, our Second Amended and Restated Articles of Incorporation, as amended and supplemented to date, prohibit the ownership of more than 4.0% of the outstanding common shares and more than 9.8% of the shares of any series of any class of our preferred shares by any person. These restrictions are likely to have the effect of precluding acquisition of control of us without our consent even if a change in control is in the interests of shareholders.

**We are subject to control by our directors and officers.** Our directors and executive officers and some members of their respective families owned approximately 18.0% of our common shares as of December 31, 2006. Accordingly, those persons have substantial influence over us and the outcome of matters submitted to our shareholders for approval.

**We depend on our key personnel.** Our success depends to a significant degree upon the continued contribution of key members of our management team, who may be difficult to replace. The loss of services of these executives could have a material adverse effect on us. There

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can be no assurance that the services of such personnel will continue to be available to us. Mr. Jeffrey I. Friedman, Associated Estates' Chairman of the Board, President and Chief Executive Officer, is a party to an employment agreement with Associate Estates. We do not hold key-man life insurance on any of our key personnel.

**Item 1B. Unresolved Staff Comments**

None.

**Item 2. Properties**

*Our Portfolio.* The following table represents our portfolio as of December 31, 2006, which consists of properties we owned, directly or indirectly, properties in which we are a joint venture partner and properties we manage.

	Total Number of Properties at <u>December 31, 2006</u>	Total Number of Units at <u>December 31, 2006</u>
<b>Wholly Owned Properties</b>		
Market-Rate Properties:		
Florida	3	956
Georgia	2	706
Indiana	3	836
Maryland	3	667
Michigan	11	2,888
Ohio	26	6,029
Pennsylvania	1	468
Texas	<u>1</u>	<u>104</u>
	50	12,654
Affordable Housing Properties:		
Ohio	<u>11</u>	<u>1,146</u>
Acquisition/Disposition Properties:		
Florida	1	316
Georgia	1	168
Ohio	<u>1</u>	<u>120</u>
	<u>3</u>	<u>604</u>
Total wholly owned properties	64	14,404
<b>Joint Ventures:</b>		
Market-Rate Property:		
49.0% owned - Georgia	1	843
Affordable Housing Property:		
50.0% owned - Ohio	<u>1</u>	<u>108</u>
Total joint ventures	2	951

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<b>Managed for Pension Fund Clients:</b>		
Market-Rate Properties:		
Colorado	1	258
<b>Managed for Other Third Parties:</b>		
Affordable Housing Properties:		
Florida	2	200
Ohio	23	3,908
Pennsylvania	4	496
	29	4,604
Market-Rate Properties:		
Ohio	3	341
	32	4,945
Total managed properties	33	5,203
<b>Total Portfolio</b>	<b>99</b>	<b>20,558</b>
<b>Other Properties:</b>		<b>Units/Square Feet</b>
<b>Asset Managed for Third Parties:</b>		
Multifamily:		
Texas	1	186
Commercial:		
California	1	145,000
	2	

Wholly Owned and Joint Venture Properties	Total Number of Units at December 31, 2006	Age of Owned Properties at December 31, 2006 <sup>(a)</sup>
<b>Wholly Owned Properties</b>		
Market-Rate Properties:		
<b>Florida</b>		
Courtney Chase	288	3
Cypress Shores	300	15
Windsor Pines	368	8
	956	
<b>Georgia</b>		
The Falls	520	20
Morgan Place	186	17
	706	
<b>Indiana</b>		
Residence at White River	228	15
Steeplechase	264	8
Waterstone Apartments	344	9
	836	
<b>Maryland</b>		
Annen Woods	131	19
Hampton Point	352	20
Reflections	184	21
	667	

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<b>Michigan</b>		
Arbor Landings	328	11
Aspen Lakes Apartments	144	25
Central Park Place	216	18
Country Place Apartments	144	17
Clinton Place Apartments	202	18
Georgetown Park Apartments	480	12
Oaks and Woods at Hampton	544	18
The Landings at the Preserve	190	15
Spring Brook Apartments	168	18
Spring Valley Apartments	224	19
Summer Ridge	<u>248</u>	15
	2,888	
<b>Ohio</b>		
St. Andrews at Little Turtle	102	19
Barrington	288	7
Bay Club	96	16
Bedford Commons	112	19
Bradford at Easton	324	10
Country Club Apartments	316	17
The Cloisters	506	16
Hawthorne Hills Apartments	88	33
Heathermoor	280	17

(a) Age of property is determined by subtracting the year the property was built or the year the property was rehabilitated from 2006.

<b>Wholly Owned and Joint Venture Properties</b>	<b>Total Number of Units at December 31, 2006</b>	<b>Age of Owned Properties at December 31, 2006 <sup>(a)</sup></b>
<b>Wholly Owned Properties</b>		
<b>Ohio (Continued)</b>		
Kensington Grove	76	11
Lake Forest	192	12
Mallard's Crossing	192	16
Muirwood Village at Bennell	164	18
Perimeter Lakes	189	14
Remington Place	234	16
Residence at Christopher Wren	264	13
Residence at Turnberry	216	15
Saw Mill Village	340	19
Sterling Park	128	12
Village at Avon	312	5
North Pointe	949	35

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Westchester Townhouses	136	17
Western Reserve	108	8
Westlake Townhouses	7	21
Williamsburg at Greenwood Village	260	16
The Woodlands	150	32
	6,029	
<b>Pennsylvania</b>		
Chestnut Ridge	468	20
<b>Texas</b>		
Fleetwood	104	13
Affordable Housing Properties:		
<b>Ohio</b>		
Ellet	100	28
Puritas Place	100	25
Riverview Towers	98	27
Shaker Park Gardens II	151	42
State Road Apartments	72	29
Statesman II	47	19
Sutliff Apartments	185	27
Tallmadge Acres	125	25
Twinsburg Apartments	100	27
Village Towers	100	27
West High Apartments	68	25
	1,146	

(a) Age of property is determined by subtracting the year the property was built or the year the property was rehabilitated from 2006.

	<b>Total Number of Units</b>	<b>Age of Owned Properties at</b>
	<b>December 31, 2006</b>	<b>December 31, 2006 <sup>(a)</sup></b>
Acquisition/Disposition Properties:		
<b>Florida</b>		
Vista Lago (Acquired March 2005)	316	3
<b>Georgia</b>		
Cambridge at Buckhead (Acquired October 2005)	168	11
<b>Ohio</b>		
Gates Mills Club (Held for Sale at December 31, 2006)	120	26
<b>Total wholly owned properties</b>	14,404	
<b>Joint Venture Properties</b>		
Market-Rate Property:		
<b>49% Owned - Georgia</b>		
Idlewylde	843	6
Affordable Housing Property:		
<b>50% Owned - Ohio</b>		
Lakeshore Village	108	24

<b>Total joint venture properties</b>	951
---------------------------------------	-----

	<u>Location</u>	<u>Units</u>	<u>Anticipated Completion</u>
<b>Undeveloped Land Parcels:</b>		<u>Acres</u>	
Aspen Lakes land	Grand Rapids, MI	19.5	On Hold
Landings at the Preserve land	Battle Creek, MI	4.3	On Hold
Westlake land	Westlake, OH	39.0	On Hold
Wyndemere land	Franklin, OH	<u>10.0</u>	On Hold
Total undeveloped land parcels		<b>72.8</b>	

(a) Age of property is determined by subtracting the year the property was built or the year the property was rehabilitated from 2006.

***Indebtedness Encumbering the Properties.*** We have financed and, in many cases, refinanced the acquisition, development and rehabilitation of our properties with a variety of sources of mortgage indebtedness. At December 31, 2006, twenty-one of the sixty-four wholly owned properties were unencumbered (eleven of which are Affordable Housing properties and one that was classified as held for sale), thirty-six properties were encumbered by conventional mortgages, five properties were encumbered by cross-collateralized, cross-defaulted mortgage loans, and two properties secured our lines of credit.

### **Item 3. Legal Proceedings**

For information concerning current legal proceedings, see Note 10 of the Notes to Consolidated Financial Statements presented in Part II, Item 8 of this report on Form 10-K.

### **Item 4. Submission of Matters to a Vote of Security Holders**

No matter was submitted to a vote of security holders during the fourth quarter of the fiscal year covered by this report.

### **Executive Officers of the Registrant and Other Key Employees**



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The following information regarding our executive officers is provided pursuant to Instruction 3 to Item 401(b) of Regulation S-K.

<u>Name</u>	<u>Age</u>	<u>Position with the Company</u>
Jeffrey I. Friedman	55	Chairman of the Board, President and Chief Executive Officer
Martin A. Fishman	65	Vice President, General Counsel and Secretary
Lou Fatica	40	Vice President, Treasurer and Chief Financial Officer
John T. Shannon	45	Senior Vice President, Operations

Jeffrey I. Friedman has served as our Chairman of the Board and Chief Executive Officer since the Company was organized in 1993 and served as our President from the Company's organization until February 24, 2000. In August 2002, Mr. Friedman reassumed the role of President. Mr. Friedman joined the Company's predecessor, Associated Estates Group, ("AEG"), in 1974 and was the Chief Executive Officer and President of Associated Estates Corporation, a company in the AEG group, from 1979 to 1993.

Martin A. Fishman has been our Vice President, General Counsel and Secretary since the Company's organization. Mr. Fishman joined AEG in 1986 as Vice President - General Counsel of Associated Estates Corporation, a position he held until the formation of the Company.

Lou Fatica joined the Company in 1999 as Controller, and was promoted to Vice President-Controller during 2000. On March 15, 2001, Mr. Fatica became Vice President, Treasurer and Chief Financial Officer of the Company. Mr. Fatica is a Certified Public Accountant (CPA), a member of the American Institute of Certified Public Accountants (AICPA) and the Ohio Society of CPA's.

John T. Shannon joined the Company in 2004 as Senior Vice President, Operations. Mr. Shannon had previously held the position of Vice President of Operations at The Shelter Group and has 17 years of property management experience.

In addition to the officers named in the table above, the following persons have been appointed as officers of the Company and hold positions in senior management as indicated:

Patrick Duffy joined the Company in 2005 as Vice President of Strategic Marketing. Mr. Duffy plays a key role in our diversification plan by assisting in identifying markets for asset acquisitions and dispositions. In addition, he is responsible for developing property-specific marketing plans and strategies to assist in maximizing top line revenue growth for our Market-Rate properties, while also assisting with pricing and positioning strategies. Mr. Duffy previously held the position of Senior Vice President of Marketing at The Shelter Group. He graduated from Loyola College and holds a Master's Degree in Administrative Sciences from Johns Hopkins University. Mr. Duffy has over 20 years of experience in the real estate industry and is 45 years old.

Kara Florack joined the Company in 2004 as Director of Compensation, and was promoted to Director of Human Resources in November 2005. In January 2007, she became Vice President of Human Resources. Ms. Florack previously held the position of Assistant Manager of Compensation at Charter One Bank where she worked for 3 years. Ms. Florack has a Bachelor's degree from Boston University and is 31 years old.

Jenee McClain-Bankhead joined the Company in 1994. She is currently a Regional Vice President and is responsible for the Company's Affordable Housing portfolio and related Affordable Housing fee management business. Ms. McClain-Bankhead holds the designations of Certified Financial Manager, Certified Occupancy Specialist and Certified Credit Compliance Professional and is 36 years old.

Miria C. Rabideau joined the Company in 1994 as a Property Manager, and was promoted to Regional Manager in 2003. During 2006, she was promoted to Regional Vice President. Ms. Rabideau is responsible for properties in Colorado, Indiana, Michigan, Northwest Ohio and Texas. Ms. Rabideau has 14 years of asset and property management experience. She has a Bachelor's degree from Michigan State University and is 37 years old.

Beth L. Stoll joined the Company in 2004 as a Regional Vice President, and was promoted to Vice President of Operations during 2006. She is responsible for the Market-Rate properties that we own and manage in Georgia, Maryland, Florida and Central Ohio. Ms. Stoll is also responsible for the AEC Academy for Career Development, which provides training and support for our employees. Ms. Stoll previously held the position of Regional Vice President at The Shelter Group. Ms. Stoll has over 20 years of property management experience and is 51 years old.

## PART II

### **Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities**

Our common shares are traded on the New York Stock Exchange under the trading symbol "AEC."

The following table sets forth for the periods indicated the high and low closing sale prices per common share as reported on the New York Stock Exchange (composite tape) and the dividends declared per common share.

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	<u>Price Range</u>				<u>Dividends Declared</u>	
	<u>2006</u>		<u>2005</u>		<u>Per Share</u>	
	<u>High</u>	<u>Low</u>	<u>High</u>	<u>Low</u>	<u>2006</u>	<u>2005</u>
First Quarter	\$ 11.56	\$ 9.16	\$ 10.08	\$ 9.69	\$ 0.17	\$ 0.17
Second Quarter	12.40	10.42	10.00	8.65	0.17	0.17
Third Quarter	15.90	12.50	9.92	9.19	0.17	0.17
Fourth Quarter	16.49	13.59	9.78	8.67	<u>0.17</u>	<u>0.17</u>
					\$ 0.68	\$ 0.68

On February 21, 2007, there were approximately 980 holders of record of our common shares.

For information concerning security ownership of certain beneficial owners and management and related shareholder matters, reference is made to Part III, Item 12 of this report on Form 10-K.

We maintain a dividend reinvestment plan under which shareholders may elect to reinvest their dividends automatically in our common shares. Under the plan, the administrator of the plan will purchase shares directly from us (either treasury shares or newly-issued common shares), in the open market, or in privately negotiated transactions with third parties on behalf of participating shareholders.

Our Board of Directors has authorized the repurchase of up to \$50.0 million of our common and preferred shares. Additionally, we have a policy which allows employees to pay their portion of the payroll taxes related to restricted share vesting by surrendering a number of shares to us equal in value on the day of vesting to the amount of taxes due. The following table sets forth our repurchase activities for the fourth quarter of 2006:

<u>Issuer Purchases of Equity Securities For the Three Months Ended December 31, 2006</u>				
<u>Period</u>	<u>Total Number of Shares Purchased</u>	<u>Average Price Paid Per Share</u>	<u>Total Number of Shares Purchased As Part of Publicly Announced Plans or Programs</u>	<u>Approximate Dollar Value of Shares That May Yet Be Purchased Under the Plans or Programs</u>
				<u>(in thousands)</u>
October 1 through				
October 31	496	\$ 16.11	-	\$ 22,433
November 1 through				

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November 30	141	\$ 14.82	-	\$ 22,433
December 1 through				
December 31	=	=	=	\$ 22,433
Total	637	\$ 15.83	-	

**Item 6. Selected Financial Data**

The following tables set forth selected financial and other data for us on a consolidated basis. The historical financial information contained in the tables has been derived from and should be read in conjunction with (i) our consolidated financial statements and notes thereto and (ii) Management's Discussion and Analysis of Financial Condition and Results of Operations both included elsewhere herein.

<b>Associated Estates Realty Corporation</b>					
<i>(Dollars in thousands except per share amounts and average monthly net collected rent)</i>					
	<u>2006</u>	<u>2005</u>	<u>2004</u>	<u>2003</u>	<u>2002</u>
<b>Operating Data:</b>					
<i>Revenue</i>					
Property revenue	\$ 132,994	\$ 123,594	\$ 116,145	\$ 114,325	\$ 113,693
Management and service operations:					
Fees, reimbursements and other	11,689	11,723	13,400	14,310	20,472
Painting services	<u>1,078</u>	<u>1,094</u>	<u>6,147</u>	<u>2,827</u>	<u>1,642</u>
Total revenue	145,761	136,411	135,692	131,462	135,807
Total expenses	(118,505)	(111,071)	(106,627)	(106,600)	(107,619)
Interest income	680	638	309	148	320
Interest expense	<u>(51,991)</u>	<u>(40,070)</u>	<u>(36,846)</u>	<u>(36,990)</u>	<u>(36,851)</u>
(Loss) income before gain on disposition of properties and land, gain on disposition of investment, equity in net loss of joint ventures, gain on sale of partnership interest, minority interest, and income from discontinued operations					
	(24,055)	(14,092)	(7,472)	(11,980)	(8,343)
Gain on disposition of properties and land	-	-	-	-	227
Gain on disposition of investment	-	150	-	-	-
Equity in net loss of joint ventures	(462)	(644)	(923)	(1,157)	(1,627)
Gain on sale of partnership interest	-	-	-	1,314	-
Minority interest in operating partnership	<u>(61)</u>	<u>(63)</u>	<u>(63)</u>	<u>(75)</u>	<u>(324)</u>
<b>(Loss) income from continuing operations</b>	(24,578)	(14,649)	(8,458)	(11,898)	(10,067)
Income from discontinued operations:					
Operating (loss) income	(2,494)	2,319	2,100	985	1,886
Gain on disposition of properties	<u>54,093</u>	<u>48,536</u>	<u>9,682</u>	-	<u>9,660</u>
Income from discontinued operations	<u>51,599</u>	<u>50,855</u>	<u>11,782</u>	<u>985</u>	<u>11,546</u>
<b>Net income (loss)</b>	27,021	36,206	3,324	(10,913)	1,479
Preferred share dividends	(5,046)	(5,130)	(5,805)	(5,484)	(5,485)
Original issuance costs related to redemption of preferred shares	-	<u>(2,163)</u>	-	-	-
<b>Net income (loss) applicable to common shares</b>	\$ 21,975	\$ 28,913	\$ (2,481)	\$ (16,397)	\$ (4,006)

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<b>Earnings per common share - Basic and Diluted:</b>					
(Loss) income from continuing operations applicable to					
common shares	\$ (1.74)	\$ (1.14)	\$ (.73)	\$ (.90)	\$ (.80)
Income from discontinued operations	<u>3.03</u>	<u>2.65</u>	<u>.60</u>	<u>.05</u>	<u>.59</u>
Net income (loss) applicable to common shares	\$ 1.29	\$ 1.51	\$ (.13)	\$ (.85)	\$ (.21)
Weighted average number of common shares outstanding	17,023	19,162	19,519	19,401	19,343
<b>Dividends declared per common share</b>	\$ .68	\$ .68	\$ .68	\$ .68	\$ .92

	<u>2006</u>	<u>2005</u>	<u>2004</u>	<u>2003</u>	<u>2002</u>
<b>Cash flow data:</b>					
Cash flow provided by operations	\$ 17,912	\$ 24,376	\$ 32,935	\$ 30,758	\$ 32,897
Cash flow provided by (used for) investing activity	73,935	4,421	(12,745)	(11,509)	13,260
Cash flow (used for) provided by financing activity	(101,570)	(50,798)	37,332	(15,937)	(48,421)

<b>Balance Sheet Data at December 31:</b>					
Real estate assets, net	\$ 591,520	\$ 645,937	\$ 665,268	\$ 661,585	\$ 683,058
Total assets	<b>648,829</b>	719,242	762,917	704,793	735,303
Total debt	<b>498,634</b>	573,570	557,279	543,496	540,498
Total shareholders' equity	<b>112,051</b>	108,980	163,590	121,428	150,865

<b>Other Data:</b>					
Net operating income (a) (c)	\$ 68,613	\$ 64,645	\$ 64,880	\$ 60,117	\$ 63,974
Total properties (at end of period) - includes joint ventures	66	74	76	78	79
Total multifamily units (at end of period) - includes joint ventures	15,355	17,395	17,854	18,313	18,313
Average monthly net collected rent per unit	\$ 750	\$ 675	\$ 671	\$ 670	\$ 659
Physical occupancy (b)	94.5%	92.9%	91.7%	92.7%	87.4%

(a) We evaluate the performance of our reportable segments based on net operating income ("NOI"). NOI is determined by deducting property operating and maintenance expenses, direct property management and service company expenses and painting service expense from total revenue. We consider NOI to be an appropriate supplemental measure of our performance because it reflects the operating performance of our real estate portfolio and management and service companies at the property and management and service company level and is used to assess regional property and management and service company level performance. NOI should not be considered (i) as an alternative to net income determined in accordance with accounting principles generally accepted in the United States ("GAAP"), (ii) as an indicator of financial performance, (iii) as cash flow from operating activities (determined in accordance with GAAP) or (iv) as a measure of liquidity; nor is it necessarily indicative of sufficient cash flow to fund all of our needs. Other real estate companies may define NOI in a different manner.

(b) Physical occupancy represents the actual number of units leased divided by the total number of units available at the end of the period.

(c) Reconciliation of NOI to net income (loss):

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	<u>2006</u>	<u>2005</u>	<u>2004</u>	<u>2003</u>	<u>2002</u>
Net operating income	\$ 68,613	\$ 64,645	\$ 64,880	\$ 60,117	\$ 63,974
Depreciation and amortization	(31,517)	(31,306)	(28,044)	(29,171)	(28,770)
General and administrative expense	(9,840)	(7,999)	(7,771)	(6,084)	(7,016)
Interest income	680	638	309	148	320
Interest expense	(51,991)	(40,070)	(36,846)	(36,990)	(36,851)
Gain on disposition of properties and land	-	-	-	-	227
Gain on disposition of investment	-	150	-	-	-
Equity in net loss of joint ventures	(462)	(644)	(923)	(1,157)	(1,627)
Gain on sale of partnership interest	-	-	-	1,314	-
Minority interest in operating partnership	(61)	(63)	(63)	(75)	(324)
Income from discontinued operations:					
Operating (loss) income	(2,494)	2,319	2,100	985	1,886
Gain on disposition of properties	<u>54,093</u>	<u>48,536</u>	<u>9,682</u>	-	<u>9,660</u>
Income from discontinued operations	<u>51,599</u>	<u>50,855</u>	<u>11,782</u>	<u>985</u>	<u>11,546</u>
Net income (loss)	\$ 27,021	\$ 36,206	\$ 3,324	\$ (10,913)	\$ 1,479

**Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations**

The following discussion should be read in conjunction with the consolidated financial statements and notes thereto included in Part II, Item 8 of this report on Form 10-K. This discussion contains forward-looking statements based on current judgments and current knowledge of management, which are subject to certain risks, trends and uncertainties that could cause actual results to vary from those projected, including, but not limited to, preliminary expectations regarding our 2007 performance which is based on certain assumptions. Accordingly, readers are cautioned not to place undue reliance on forward-looking statements which speak only as of the dates of the document. These forward-looking statements are intended to be covered by the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. The words "expects," "projects," "believes," "plans," "anticipates," and similar expressions are intended to identify forward-looking statements. Investors are cautioned that our forward-looking statements involve risks and uncertainty that could cause our actual results to differ from estimates or projections contained in these forward-looking statements. For a discussion of these risks and uncertainties, see "Risk Factors" in Item 1A.

**Overview.** We are engaged primarily in the operation of multifamily residential units that we own. We also provide asset and property management services to third party owners of multifamily residential units for which we are paid fees. Our primary source of cash and revenue from operations is rents from the leasing of owned apartment units. Approximately 91.2% of our consolidated revenue was generated from the leasing of these owned units for the twelve months ended December 31, 2006, and approximately 88.0% of the property revenue generated by these owned properties was related to the Market-Rate properties.

We consider property NOI to be an important indicator of our overall performance. Property NOI (property operating revenue and interest income less property operating and maintenance expenses) is a measure of the profitability of our properties, which has the largest impact of all of our sources of income and expense on our financial condition and operating results. See Note 19 of the Notes to Consolidated Financial Statements presented in Part II, Item 8 of this report on Form 10-K for additional information regarding property NOI and total NOI, in addition to a reconciliation of total NOI to consolidated net income in accordance with accounting principals generally accepted in the United States of America ("GAAP").

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Our four reportable segments are based upon types of property and services and consist of our Market-Rate properties (80.3% of total revenue), properties we acquired or developed within the prior year and properties that have been sold or are classified as held for sale, which segment is referenced as Disposition/Acquisition (4.5% of total revenue), our Affordable Housing properties (6.4% of total revenue) and Management and Service Operations (8.8% of total revenue, which is primarily derived from third party asset and property management operations).

Our Same Community Market-Rate Midwest portfolio, consisting of 41 properties, containing 10,221 units, accounts for 59.8% of our revenue and 64.2% of our NOI. While we achieved growth in net collected rents of 4.8% in our Midwest markets, we face continuing challenges in achieving growth similar to the 9.5% growth realized in net collected rents in our Mid-Atlantic and Southeast markets, primarily due to a sluggish Midwest economy with higher unemployment rates and a lack of job growth, coupled with fewer household formations. In response to these conditions, our strategy has been to reduce our Midwest property exposure by selling certain non-core Midwest properties and acquiring properties in other markets that have a greater potential for growth. During 2006, we sold eight properties containing 2,040 units, seven of which were located in Ohio and one property located in North Carolina, which was the only property that we owned or managed in that market.

In 2007, we intend to continue with our strategy of reducing our Midwest presence by selling properties. We will also continue to evaluate potential property acquisitions in higher growth markets that we have identified. However, strong competition for replacement properties in these markets may hinder our ability to find suitable replacement properties that satisfy our investment criteria. We may also consider selling assets in any market, including the Mid-Atlantic and Southeast markets, where market conditions are such that the reinvestment of cash proceeds derived from a sale are expected to provide a significantly greater return on equity and an increase in cash flow.

We are also focused on reducing overall interest rate charges on our borrowings which, at December 31, 2006, had a weighted average rate of 7.2%. We plan to accomplish this goal by using sale proceeds to pay off debt or refinance existing debt with new debt at lower interest rates.

In order to increase property NOI, we plan to continue to focus our efforts on improving revenue, controlling costs and realizing operational efficiencies at the asset level, both regionally and portfolio-wide.

### **2007 Expectations:**

- **Portfolio performance** - We expect to increase our Market-Rate property NOI by approximately 2.8% to 3.3% in 2007. We expect our Midwest portfolio to deliver NOI of 2.7% to 3.2% driven by property revenue increases of 3.3% to 3.8%. We also expect our Mid-Atlantic and Southeast portfolio to deliver NOI increases of 3.0% to 3.5% as a result of property revenue increases of 2.9% to 3.4%.
- **Property acquisitions and sales** - We plan to acquire approximately \$50.0 million of properties, while disposing of approximately \$50.0 million to \$75.0 million of properties.

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**Defeasance and other prepayment costs** - We expect to incur approximately \$5.0 million in costs to defease/prepay or refinance debt during 2007.

**Federal Income Taxes.** We have elected to be taxed as a Real Estate Investment Trust ("REIT") under Sections 856 through 860 of the Internal Revenue Code of 1986, as amended, commencing with our taxable year ending December 31, 1993. REITs are subject to a number of organizational and operational requirements including a requirement that 90.0% of the income that would otherwise be considered as taxable income be distributed to shareholders. Providing we continue to qualify as a REIT, we will generally not be subject to federal income tax on net income. However, our Service Companies are subject to federal income tax.

A REIT is precluded from owning more than 10.0% of the outstanding voting securities of any one issuer, other than a wholly owned subsidiary or another REIT, and more than 10.0% of the value of all securities of any one issuer. As an exception to this prohibition, a REIT is allowed to own up to 100% of the securities of a Taxable REIT Subsidiary ("TRS") that can provide non-customary services to REIT tenants and others without disqualifying the rents that a REIT receives from its tenants. However, no more than 20.0% of the value of a REIT's total assets can be represented by securities of one or more TRS's. The amount of intercompany interest and other expenses between a TRS and a REIT are subject to arms length allocations. We have elected TRS status for all of our Service Companies.

### LIQUIDITY AND CAPITAL RESOURCES

**Cash Flows and Liquidity.** Significant sources and uses of cash in the past three years are summarized as follows:

*Significant Cash Sources (Uses):*

(In thousands)	For the year ended December 31,		
	<u>2006</u>	<u>2005</u>	<u>2004</u>
Net cash provided by operating activities	\$ 17,912	\$ 24,376	\$ 32,935
Property acquisition and capital expenditures	(12,782)	(74,318)	(22,338)
Property disposition proceeds, net	87,038	78,739	9,593
(Decreases) increases related to debt - net	(74,937)	42,787	(1,399)
Redemption of Class A Preferred Shares	-	(56,250)	-
Issuance of 8.7% Class B Cumulative			
Redeemable Preferred Shares	-	-	56,793
Cash dividends and operating partnership			
distributions paid	(16,872)	(18,742)	(18,863)
Purchase of treasury shares under repurchase plan	(10,185)	(17,382)	-

Our primary sources of liquidity are cash flow provided by operations, short term borrowings on the lines of credit and proceeds from property sales. The decrease in cash provided by operations in 2006 compared to 2005 was primarily due to the payment of \$14.4 million of defeasance and other prepayment costs, which were funded by property sales and secured borrowings. Excluding these costs, cash flow from operations



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would have increased \$7.9 million primarily due to changes in accounts payable and accounts receivable resulting from the timing of cash payments.

During 2006, funds received from the sale of properties were primarily used to reduce debt, including the payment of associated defeasance and other prepayment costs. Sale proceeds were also used to repurchase our common shares and partially fund capital expenditures.

The decrease in cash provided by operations in 2005 compared to 2004 was primarily due to an increase in property operating and maintenance expenses, an increase in interest expense and a reduction in net painting service revenue. These factors were partially offset by increases in property revenue. See the discussion of our results of operations below for additional information regarding these fluctuations. Additionally, in April 2005, our CEO repaid two notes to us totaling \$3.4 million, which were scheduled to mature May 1, 2005.

**Lines of Credit.** We have a \$14.0 million line of credit that is available for regular borrowings and letter of credit transactions. This line of credit is secured by one of our properties. There were no regular borrowings outstanding under this line at December 31, 2006 and 2005. At December 31, 2006, a letter of credit in the amount of \$63,000 had been issued against this line. The interest rate on this line is LIBOR plus 1.8% or the one month reference rate and it matures December 31, 2007.

We also have a \$17.0 million secured line of credit that is available for regular borrowings which is secured by one of our properties. This line was unavailable at December 31, 2005, because the property securing that credit line had been sold. In February 2006, we identified a replacement property to serve as security for this credit line and amended the loan terms by increasing the credit line to \$17.0 million from \$15.0 million with interest calculated at LIBOR plus 1.5%. This line matures March 1, 2008. Borrowings under the line may be restricted based upon the operating performance of the property. There were no borrowings outstanding under this line at December 31, 2006 and 2005.

**Shelf Availability.** We have a shelf registration statement on file with the Securities and Exchange Commission relating to a possible offering, from time to time, of debt securities, preferred shares, depositary shares, common shares and common share warrants. In December 2004, we issued \$58.0 million of 8.7% Class B Series II Cumulative Redeemable Preferred Shares under this registration statement. The remaining availability under the shelf registration at December 31, 2006 is \$214.7 million. Currently, we do not have access to issue debt securities under this shelf registration.

**Liquidity: Normal Business Operations.** We anticipate that we will meet our business operations and liquidity requirements for the upcoming year generally through net cash provided by operations. We believe that if net cash provided by operations is below projections, other sources, such as secured borrowings (primarily the lines of credit), unsecured borrowings, and property sales proceeds are available and should be sufficient to meet operating requirements, capital additions, mortgage amortization payments and the payment of dividends in accordance with REIT requirements.

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**Liquidity: Non-Operational Activities.** Sources of cash available for paying down debt, acquiring properties or buying back our shares include the net proceeds from the sale of properties and the issuance of shares. Although we intend to sell between \$50.0 million and \$75.0 million of properties in 2007, market conditions and other factors may adversely impact our ability to execute such sales.

**Long Term Contractual Obligations.** The following table summarizes our long term contractual obligations at December 31, 2006, as defined by Item 303(a)5 of Regulation S-K of the Securities and Exchange Act of 1934.

(In thousands)	Payments Due In				
	Total	2007	2008 - 2009	2010 - 2011	2012 and Later Years
Mortgages payable-principal	\$ 498,634	\$ 57,139	\$ 94,186	\$ 145,476	\$ 201,833
Mortgages payable-interest	209,053	38,903	60,024	43,093	67,033
Operating leases	1,109	177	202	118	612
Purchase obligations	9,881	8,676	1,175	24	6
Total	\$ 718,677	\$ 104,895	\$ 155,587	\$ 188,711	\$ 269,484

**Mortgages Payable-Principal.** Mortgages payable-principal includes principal payments on all property specific mortgages and lines of credit. For detailed information about our debt, see Note 6 of the Notes to Consolidated Financial Statements presented in Part II, Item 8 of this report on Form 10-K.

**Mortgages Payable-Interest.** Mortgages payable-interest includes accrued interest at December 31, 2006 and interest payments as required based upon the terms of the mortgages in existence at December 31, 2006. Interest related to floating rate debt is calculated based on applicable rates as of December 31, 2006.

**Operating Leases.** We lease certain equipment and facilities under operating leases. For detailed information about our lease obligations, see Note 10 of the Notes to Consolidated Financial Statements presented in Part II, Item 8 of this report on Form 10-K.

**Purchase Obligations.** Purchase obligations represent agreements to purchase goods or services that are legally binding and enforceable and that specify all significant terms of the agreement. Our purchase obligations include, but are not limited to, contracts that individual properties have entered into in the normal course of operations, such as landscaping, snow removal, elevator maintenance, security, etc, as well as obligations entered into at the corporate level. Obligations included in the above table represent agreements dated December 31, 2006 or earlier.

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**Dividends.** On December 13, 2006, we declared a dividend of \$0.17 per common share which was paid on February 1, 2007 to shareholders of record on January 12, 2007. We anticipate that we will continue paying quarterly dividends and that we will sustain our current dividend rate. Additionally, on January 22, 2007, we declared a quarterly dividend of \$0.54375 per Depositary Share on our Class B Cumulative Redeemable Preferred Shares, which will be paid on March 15, 2007, to shareholders of record on March 1, 2007.

**Capital Expenditures.** We anticipate incurring approximately \$13.9 million in capital expenditures for 2007. This includes replacement of worn carpet and appliances, parking lots, roofs and similar items in accordance with our current property expenditure plan, as well as commitments for investment/revenue enhancing and non-recurring expenditures. These commitments are expected to be funded largely with cash provided by operating activities and proceeds from property sales.

**Financing and Other Commitments.** The following table identifies our total debt outstanding and weighted average interest rates as of December 31, 2006 and 2005:

	Balance	Weighted Average	Balance	Weighted Average
	Outstanding	Interest	Outstanding	Interest
	<u>December 31, 2006</u>	<u>Rate</u>	<u>December 31, 2005</u>	<u>Rate</u>
<b>Fixed rate debt</b>				
Mortgages payable - CMBS	\$ 303,945	7.7%	\$ 455,166	7.7%
Mortgages payable - other	132,209	6.1%	-	-
Unsecured borrowing	<u>25,780</u>	<u>7.9%</u>	<u>25,780</u>	<u>7.9%</u>
<b>Total fixed rate debt</b>	461,934	7.3%	480,946	7.7%
<b>Variable rate debt</b>				
Mortgages payable	36,700	6.6%	92,624	5.9%
Lines of credit borrowings	-	-	-	-
<b>Total variable rate debt</b>	<u>36,700</u>	<u>6.6%</u>	<u>92,624</u>	<u>5.9%</u>
<b>Total debt</b>	\$ 498,634	7.2%	\$ 573,570	7.4%

During 2006, we defeased/prepaid 19 mortgage loans totaling \$201.8 million. Of these 19 loans, ten fixed rate loans and one variable rate loan were prepaid with the proceeds received from property sales; and five fixed rate loans and three variable rate loans were prepaid with the proceeds of a \$132.2 million mortgage refinancing involving five properties. The new loans are structured as five separate loans; however, each loan is cross-collateralized, cross-defaulted, and includes a collateral substitution feature.

At December 31, 2006, we had 21 unencumbered properties, 11 of which are Affordable Housing properties. These 21 properties had net income of \$2.1 million for the year ended December 31, 2006, and a net book value of \$115.0 million at December 31, 2006. We believe that we would be able to obtain financing on these properties should the need arise; however, financing may be restricted on ground leased properties and the property subject to a right of reverter because of their finite remaining terms (see discussion below). Five of these unencumbered properties are scheduled for disposition during 2007. Additionally, in January 2007, we unencumbered one additional asset by defeasing/prepaying the mortgage secured by that property.

We lease certain equipment and facilities under operating leases. Future minimum lease payments under all noncancellable operating leases in which we are the lessee, principally for ground leases, are included in the previous table of contractual obligations.

The ground lease agreements contain provisions which, upon expiration of the lease, require reversion of the land and building to the lessor. Such provisions exist for seven properties at December 31, 2006. These ground leases expire at various dates from 2021 to 2036. In September 2006, we sold one property that was subject to a ground lease with a term expiring in 2021. Total revenue derived from such properties were \$6.4 million, \$8.8 million and \$10.3 million for the years ended December 31, 2006, 2005 and 2004, respectively. Furthermore, at the end of the term of each lease, any remaining replacement reserves revert to the lessor. Such cash reserves included in restricted cash were \$565,000 and \$773,000 at December 31, 2006 and 2005, respectively. With respect to such leases, we paid ground rent of \$50,000, \$85,000 and \$101,000 for the years ended December 31, 2006, 2005 and 2004, respectively.

We own one property which is subject to a right of reverter. This provision requires that the land and real estate assets revert at expiration back to the original grantor from whom we acquired this property or its successors and assignees, which is in September 2037. The net book value of this property was \$774,000 at December 31, 2006. This property generated revenue and net income of \$997,000 and \$318,000 for 2006, \$934,000 and \$344,000 for 2005, \$988,000 and \$377,000 for 2004.

**Guarantees.** We routinely guaranty mortgage debt of our wholly owned subsidiaries. Additionally, we had one guaranty at December 31, 2006, related to a mortgage loan secured by one of our joint venture properties. For further information on this guaranty, see Note 11 of the Notes to the Consolidated Financial Statements presented in Part II, Item 8 of this report on Form 10-K. In the normal course of business, we may enter into contractual arrangements under which we may agree to indemnify the third party to such arrangement from any losses incurred relating to the services they perform on behalf of AERC or for losses arising from certain events as defined within the particular contract, which may include, for example, litigation or claims relating to past performance. Such indemnification obligations may not be subject to maximum loss clauses. Historically, payments made related to these indemnifications have not been material.

**Off-Balance Sheet Investments and Financing Commitments.** We have investments in two joint ventures that each own one multifamily apartment community. One of these properties is a Market-Rate property and the other property is an Affordable Housing property. The operations of these properties are similar to the operations of our wholly owned portfolio. These investments enable us to exercise influence over the operations of the properties and share in their profits, while earning additional fee income. We account for our investments in unconsolidated joint ventures under the equity method of accounting as we exercise significant influence, but do not control these entities and are not required to consolidate them in accordance with FASB Interpretation No. 46, "Consolidation of Variable Interest Entities" or under EITF 04-05, "Investor's Accounting for an Investment in a Limited Partnership When the Investor Is the Sole General Partner and the Limited Partners Have Certain Rights". These investments are initially recorded at cost, as investments in joint ventures and subsequently adjusted for equity in earnings and cash contributions and distributions.

The Affordable Housing joint venture property had negative cash flow during 2006 and is expected to have negative cash flow during 2007 as a result of operating expenses exceeding the housing assistance payments from HUD. We are pursuing a request for an increase in housing assistance payments in order to address the deficit. The joint venture partnership that owns this property intends to sell it. Additional cash contributions that may be required of us to pay deficits, if any, are not expected to be material.

We have one guaranty obligation related to our joint ventures which was previously discussed under Guarantees. Both of these joint venture properties were encumbered by debt at December 31, 2006. Our proportionate share of this debt was \$22.7 million.

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For summarized financial information for these joint ventures, see Note 7 of the Notes to the Consolidated Financial Statements presented in Part II, Item 8 of this report on Form 10-K.

**Operating Partnership.** As provided in the AERC HP Investors Limited Partnership Agreement ("DownREIT Partnership"), we, as general partner, have guaranteed the obligation of the DownREIT Partnership to redeem OP units held by the limited partners. The DownREIT Partnership was formed in 1998. Under the terms of the DownREIT Partnership Agreement, the DownREIT Partnership is obligated to redeem OP units for our common shares or cash, at our discretion, at a price per OP unit equal to the 20 day trailing price of our common shares for the immediate 20 day period preceding a limited partner's redemption notice. During 2006, we redeemed 13,746 OP units. As of December 31, 2006, there were 79,277 OP units remaining having a carrying value of \$1.9 million, and 442,755 of the original 522,032 OP units had been redeemed. These transactions had the effect of increasing our interest in the DownREIT Partnership from 85.0% to 97.4%. In January 2007, we redeemed an additional 942 units. For additional information regarding the OP units, see Note 1 of the Notes to the Consolidated Financial Statements presented in Part II, Item 8 of this report on Form 10-K.

**Acquisitions and Development.** We intend to continue to evaluate potential property acquisitions in higher growth markets that we previously identified. Any future property acquisitions or developments would be financed with the most appropriate sources of capital, which may include the assumption of mortgage indebtedness, bank and other institutional borrowings, the exchange of properties, undistributed earnings, secured or unsecured debt financings, or the issuance of shares or units exchangeable into common shares.

During 2005, we acquired a 168-unit Market-Rate property located in Atlanta, Georgia, and a 316-unit Market-Rate property located in West Palm Beach, Florida. The purchases were funded primarily by mortgage financing on the acquired properties, mortgage funding on another Market-Rate property, by cash received from property dispositions, and cash previously received through the issuance of trust preferred securities.

**Dispositions.** During 2006, we sold eight properties (seven Market-Rate properties and one Affordable Housing property) for net cash proceeds of \$87.0 million. These proceeds were used primarily to defease/prepay debt, repurchase \$10.2 million of our common shares and partially fund capital expenditures. The operating results of these properties, along with the gains of \$54.1 million that we recognized, are included in "Income from discontinued operations".

During 2005, we sold three Market-Rate properties for net cash proceeds of \$78.7 million. These proceeds were used primarily in the acquisition of two properties in 2005, to repay borrowings on our line of credit and to defease/prepay debt during the first quarter of 2006.

Additionally, we classified one property as held for sale at December 31, 2006. This property was sold on February 20, 2007. We tested this property for impairment under SFAS 144 and determined that it was not impaired. The results of operations for this property are included in

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"Income from discontinued operations" in the Consolidated Statements of Operations for all periods presented. Additionally, the major classes of assets and liabilities related to this property have been reclassified as such in the accompanying Consolidated Balance Sheets at December 31, 2006.

**Management and Service Operations.** Concurrently with the sale of an Affordable Housing property in September 2006, we entered into a management contract with the buyer of the property to provide property management services for that property. We anticipate a total of approximately \$30,000 in annual fee revenue related to this property. Additionally, in January 2007, we entered into a management contract for a property located in Pennsylvania for which we anticipate receiving a total of approximately \$64,000 in annual fee revenue.

During 2006, the following management contracts were canceled:

Effective	Property	Approximate
Date of	and/or Asset	Property and/or
<u>Termination</u>	<u>Management Contract Canceled</u>	<u>Asset Management</u>
	<u>Earned During 2006</u>	<u>Fees Lost in 2006</u>
(In thousands)		
3/3/06	Hillwood II <sup>(1)</sup>	\$ 20
5/1/06	University Circle	27
7/19/06	Advised Asset <sup>(1)(2)</sup>	184
7/24/06	St. Andrews <sup>(1)</sup>	35
9/1/06	Advised Asset	78

(1) Properties that were sold by the owners.

(2) A disposition fee of \$198,000 was received in relation to this sale.

During 2007, our management services on the following properties may no longer be required due to the potential sale of the properties:

Effective	Property	Approximate
Date of	and/or Asset	Property and/or
<u>Termination</u>	<u>Management Contract</u>	<u>Asset Management</u>
		<u>Earned During 2006</u>
(In thousands)		
Unknown	Lakeshore Village (50% joint venture)	\$ 21 <sup>(1)</sup>
Unknown	Stow-Kent Gardens	35

(1) Represents net fees.

**RESULTS OF OPERATIONS FOR 2006 COMPARED WITH 2005 AND 2005 COMPARED WITH 2004**

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In the following discussion of the comparison of the year ended December 31, 2006 to the year ended December 31, 2005 and the year ended December 31, 2005 to the year ended December 31, 2004, Market-Rate properties refers to the Same Community Market-Rate property portfolio. Market-Rate properties represent 50 wholly owned properties. Acquired/Disposed properties represent two acquired properties. The results of operations for the property designated as held for sale at December 31, 2006, have been recorded in "Income from discontinued operations". Affordable Housing properties represent 11 properties subject to HUD regulations.

During the 2006 to 2005 comparison period, operating income increased \$1.9 million primarily as a result of increased property revenue. Interest expense during this comparison period, however, increased due to \$12.7 million in costs recognized related to the defeasement/prepayment of debt (\$2.8 million of additional prepayments costs were recognized in "Income from discontinued operations"), which was partially offset by reduced mortgage interest costs. The increased interest expense resulted in an increase in the loss from continuing operations during this comparison period. During the 2005 to 2004 comparison period, increases in real estate taxes and insurance expense, utilities expense, and amortization costs related to property acquisitions were greater than increases in property revenue, resulting in a decrease in operating income and an increase in the loss from continuing operations.

The following chart reflects the amount and percentage change in line items that are relevant to the changes in overall operating performance when comparing the years ended December 31, 2006 to 2005 and 2005 to 2004:

	Increase (decrease) when comparing the years ended December 31,			
	2006 to 2005		2005 to 2004	
(Amounts in thousands)				
Property revenue	\$ 9,400	7.6%	\$ 7,449	6.4%
Fees, reimbursements and other	(34)	(0.3)%	(1,677)	(12.5)%
Painting service revenue and expenses, net	(233)	(416.1)%	(1,439)	(104.0)%
Property operating and maintenance expenses:				
Repairs and maintenance	993	9.2%	525	5.1%
Personnel	1,296	8.6%	661	4.6%
Real estate taxes and insurance	1,621	9.4%	2,393	16.0%
Utilities	432	5.0%	1,036	13.6%
Property operating and maintenance expenses	4,973	8.6%	5,084	9.6%
Interest expense	11,921	29.8%	3,224	8.8%
Depreciation and amortization	211	0.7%	3,262	11.6%
General and administrative	1,841	23.0%	228	2.9%

**Property Revenue.** Property revenue is primarily impacted by a combination of rental rates, rent concessions and occupancy levels. We measure these factors using indicators such as physical occupancy (number of units occupied divided by total number of units), and average monthly net collected rent per unit (gross potential rents less vacancies and concessions divided by total number of units). This information is presented in the following table for the years ended December 31, 2006, 2005 and 2004 (information for the years ended December 31, 2005 and 2004 reflect results based upon the operating properties and their respective segments as of December 31, 2006):

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	For the year ended December 31, 2006	
		Average Monthly
	Physical	Net Collected
	<u>Occupancy</u>	<u>Rent Per Unit</u>
Acquisitions/Dispositions	91.7%	\$ 1,115
Market-Rate	94.5%	748
Affordable Housing	99.6%	648

	For the year ended December 31, 2005	
		Average Monthly
	Physical	Net Collected
	<u>Occupancy</u>	<u>Rent Per Unit</u>
Acquisitions/Dispositions	-	-
Market-Rate	92.9%	\$ 706
Affordable Housing	99.2%	640

	For the year ended December 31, 2004	
		Average Monthly
	Physical	Net Collected
	<u>Occupancy</u>	<u>Rent Per Unit</u>
Acquisitions/Dispositions	-	-
Market-Rate	91.4%	\$694
Affordable Housing	99.7%	631

Property revenue increased in 2006 compared to 2005 primarily as a result of increased rental revenue of \$8.0 million, \$5.4 million of which was contributed by the Market-Rate properties. The increase in Market-Rate property rental revenue was primarily due to increased occupancy, increased rental rates and a reduction in concessions during 2006. Additionally, the two properties acquired in 2005 contributed \$2.5 million in rental revenue during 2006. Other property revenue increased \$1.4 million in 2006 compared to 2005 primarily as a result of our utility and refuse reimbursement programs, which increased a total of \$1.2 million. These programs were initiated in late 2004 and 2005, and provided increasing revenue during their phase-in period, leveling off in late 2005. Other property revenue increased \$1.8 million in 2005 compared to 2004 primarily as a result of \$1.5 million of increases related to the utility and refuse reimbursement programs.

Property revenue for the Affordable Housing properties increased \$183,000 in 2006 compared to 2005 and \$121,000 in 2005 compared to 2004 primarily as a result of HUD approved rent increases during 2006 and 2005. The revenue is primarily dependent upon the receipt of rental assistance subsidies from HUD via monthly housing assistance payments ("HAP Payments"). The amount of each monthly HAP Payment is equal to the rent amount (the "Contract Rent") stated in the HAP Contract with HUD, less the amount payable by the Eligible Resident for such month.

Below is a table setting forth the expiration dates of the HAP Contracts and the HAP Payments revenue recognized for our Affordable Housing properties as of December 31, 2006:



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(In thousands)		Final	Revenue Recognized During		
	<u>Property</u>	<u>Expiration Date</u>	<u>2006</u>	<u>2005</u>	<u>2004</u>
	Ellet	December 2017	\$ 401	\$ 415	\$ 425
	Lakeshore Village (50.0% joint venture) <sup>(1)</sup>	July 2024	585	581	597
	Puritas Place	September 2011	673	692	703
	St. James (Riverview)	November 2009	454	466	471
	Shaker Park Gardens II	June 2007	718	716	670
	State Road Apartments	December 2016	440	413	426
	Statesman II	November 2007	318	320	318
	Sutliff Apartments	November 2019	758	767	779
	Tallmadge Acres	March 2008	812	796	762
	Twinsburg Apartments	June 2009	437	439	431
	Village Towers	November 2009	416	427	434
	West High Apartments	November 2007	608	596	567

(1) Amounts shown represent 100% payment.

The eleven wholly owned properties shown in the above table had positive cash flow during 2006 and are anticipated to have positive cash flow for the remaining contract terms. Therefore, none of these HAP contracts are considered to be loss contracts. Lakeshore Village had negative cash flow during 2006 as a result of increased operating expenditures related to increased repairs and maintenance expenses that exceeded the mark-to-market modeled expectations. We intend to continue to pursue a request for a budget-based increase in monthly HAP payments sufficient to support a positive cash flow at this property. We anticipate that additional cash requirements resulting from the negative cash flow, if any, will be funded by us and our joint venture partner. Such funding requirements are not expected to be material obligations. Due to the increase in cash requirements resulting from negative cash flow coupled with the uncertainty of increased HAP funding, the partnership that owns this property is marketing it for sale.

Contract Rents may be adjusted at least annually in accordance with the annual adjustment factor method for some of the properties. Generally, these types of adjustments are only permitted if current rents are below the HUD published Fair Market Rent ("FMR") threshold. If current rents exceed FMRs, a rent comparability study must be completed to demonstrate that the property's rents are below "market."

"Contract Renewal Request Forms" must be submitted to HUD (or its corresponding contract agent) not less than 120 days prior to the applicable HAP anniversary date in order to renew an existing HAP contract. We understand that the following options are available to us for expiring HAP contracts: (i) for properties without mortgages, we may renew at current rents plus an operating cost adjustment factor ("OCAF") that is set by HUD on an annual basis; (ii) for properties encumbered by a mortgage, we may renew at the lesser of (x) current rents plus an OCAF or (y) comparable market rents; or, (iii) opt out of the Section 8 program. Opting out of the Section 8 program requires an additional one-year notice to HUD (or the contract agent) and the affected residents.

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We believe, that upon expiration of the contracts, the contracts will be renewed, or we will enter into another government subsidized or mortgage restructuring program.

The following represents our current expectations concerning those HAP contracts that expire in 2007 and 2008.

*Shaker Park Gardens II.* In April 2006, we requested a renewal of the current contract for a one-year term with a budget based rent increase of 19.2%. HUD denied our request. Subsequently we applied for a 3.9% increase, as calculated using the OCAF published on October 21, 2005. Our request for an OCAF increase was granted and the contract was renewed for a one-year term through June 30, 2007. We intend to request a renewal in March 2007 for an additional one year period.

*Statesman II.* In July 2006, we requested a renewal of the current contract for a one-year term with an increase in rents of 3.9%, as calculated using the OCAF published on October 21, 2005. Our request for an OCAF increase was granted and the contract was renewed for a one-year term through November 30, 2007. Prior to expiration of the current contract, we intend to request a renewal for an additional one year period.

*Tallmadge Acres.* In November 2006, we requested a renewal of the current contract for a one-year term with an increase in rents of 4.7%, as calculated using the OCAF published on October 2, 2006. Our request for an OCAF increase was granted and the contract will be renewed for a one-year term effective March 17, 2007. Prior to expiration of the current contract, we intend to request a renewal for an additional one year period.

*West High Apartments.* In July 2006, we requested a renewal of the current contract for a one-year term with an increase in rents of 3.9%, as calculated using the OCAF published on October 21, 2005. Our request for an OCAF increase was granted and the contract was renewed for a one-year term through November 30, 2007. Prior to expiration of the current contract, we intend to request a renewal for an additional one year period.

***Fees, Reimbursements and Other.*** Fee revenue for the management and service operations decreased \$812,000 during 2005 compared to 2004 primarily as a result of a reduction in the number of properties that we manage for clients. In 2005, four managed properties were sold, one property was transferred to another advisor, and we purchased our joint venture partners' share of one property. Disposition fees were recognized in 2004 related to two of these property sales. Management and advisory fees attributed to properties owned by non-affiliated third party owners and advisory clients are earned pursuant to contracts that are generally terminable upon 30 days notice.

***Painting Service Revenue and Expenses.*** Painting service revenue and expenses both decreased in 2005 compared to 2004 primarily as a result of contracts that were entered into by our subsidiary, Merit Painting Services in 2003 and 2004. Work related to these contracts was completed during 2004.

**Property Operating and Maintenance Expenses.** Property operating and maintenance expenses increased when comparing 2006 to 2005 primarily as a result of real estate tax expense, personnel expense, and repairs and maintenance expense. The increase in real estate taxes was primarily due to assessed property value and millage rate increases and a decrease in refunds received related to prior year taxes. The increase in repairs and maintenance expense was primarily due to increases in maintenance project costs, unit preparation costs, landscaping costs, and trash removal costs. Property operating and maintenance expenses increased when comparing 2005 to 2004 primarily as a result of real estate tax expense, utilities expense, and personnel expense. The increase in real estate taxes was primarily due to assessed property value and millage rate increases that resulted in \$1.4 million in additional expense in 2005 and an Ohio tax law change that resulted in an increase of approximately \$805,000 in 2005. This law was signed June 30, 2005, and became effective July 1, 2005, retroactive to January 1, 2005. Utilities increased primarily due to increased consumption and cost per unit of natural gas and an increase in water and sewer rates in 2005 compared to 2004.

**Interest Expense.** Interest expense increased in 2006 compared to 2005 primarily due to \$12.7 million in costs recognized related to the prepayment, primarily through defeasance, of 14 mortgage loans (the costs related to four additional loan prepayments are included in "Income from discontinued operations" below). Interest expense increased in 2005 compared to 2004 primarily due to increased borrowings, primarily the \$25.8 million of unsecured debt obtained in March 2005, and mortgage loans obtained on the two properties acquired during 2005.

**Depreciation and Amortization.** Depreciation and amortization expenses increased in 2005 compared to 2004 primarily as a result of the acquisition of one property in July 2004, one property in March 2005, and one property in October 2005 and the completion of major renovation work at one of our properties in late 2004.

**General and Administrative Expenses.** General and administrative expenses increased when comparing 2006 to 2005 primarily due to salary, benefit and share-based payment costs and an increase of \$585,000 in Directors' compensation, primarily as a result of valuation adjustments in deferred compensation based on common share units which are valued using the closing price of our common shares at the end of each period. Additionally, we recorded an estimated loss contingency in connection with the out of court settlement reached with Montgomery County, Maryland. See Note 10 of the Notes to the Consolidated Financial Statements presented in Part II, Item 8 of this report on Form 10-K.

**Income From Discontinued Operations.** Included in discontinued operations for the years ended December 31, 2006, 2005, and 2004, are the operating results and the gains related to eight wholly owned properties that were sold in 2006, three wholly owned properties that were sold in 2005 and one wholly owned property that was sold in 2004. The decrease in operating income from discontinued operations in 2006 compared to 2005 was primarily due to costs incurred to defease four loans that were secured by the properties that were sold. For further details on "Income from discontinued operations," see Note 2 of the Notes to the Consolidated Financial Statements presented in Part II, Item 8 of this report on Form 10-K.

**Inflation.** It is our belief that the effects of inflation would be minimal on the operational performance of our portfolio as a result of the short term nature of our leases which are typically for terms of one year or less.

### Critical Accounting Estimates

Our consolidated financial statements include accounts of all subsidiaries, the Service Companies and the Operating Partnership structured as a DownREIT. The preparation of the consolidated financial statements in conformity with GAAP requires us to make estimates and assumptions in certain circumstances that affect amounts reported in the consolidated financial statements and related notes. In preparing these consolidated financial statements, we have utilized information available including industry practice and our own past history in forming estimates and judgments of certain amounts included in the consolidated financial statements, giving due consideration to materiality. It is possible that the ultimate outcome that we anticipated in formulating the estimates inherent in these consolidated financial statements may not materialize. However, application of the accounting policies below involves the exercise of judgment and use of assumptions as to future uncertainties and, as a result, actual results could differ from these estimates. In addition, other companies may utilize different estimates, which may impact comparability of our results of operations to those of companies in similar businesses.

SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets," requires us to assess the recoverability of the carrying value of long-lived assets when an event of impairment has occurred. In performing this analysis, we estimate holding periods of the assets, changes in fair market value of the assets and cash flows related to the operations of the assets to determine the range of potential alternatives and assign a probability to the various alternatives under consideration by management. Should the estimates used to determine alternatives or the probabilities of the occurrence thereof change, an impairment may result which could materially impact our results of operations.

SFAS No. 142, "Goodwill and Other Intangible Assets," requires us to review goodwill annually and whenever there is an impairment indicator. In performing this analysis, we use a multiple of revenues to the range of potential alternatives and assign a probability to the various alternatives we consider. Should estimates used to determine the alternatives considered or the probabilities of the occurrence thereof change, an impairment may result which could materially impact our results of operations.

SFAS No. 123(R), "Share-Based Payment," requires us to estimate the fair value of stock options awarded. We use the Black-Scholes option pricing model to estimate the fair value of the stock options, which requires the use of judgement and/or estimates in determining certain of the assumptions used by this model. If we had used different judgement and/or estimates, a different valuation would have been produced that may have resulted in a material change to our results of operations. SFAS No. 123(R) also requires us to estimate future performance results related to certain share-based awards. If the results vary from our estimate it may require us to make a material adjustment to our results of operations.

We estimate the amount of real estate taxes for which we will be liable based upon assumptions relating to possible changes in millage rates and property value reassessments. In certain circumstances, it is possible that the actual millage rates or reassessment values are not available until the following reporting period and that these rates or values could differ from assumptions and require material adjustments to the liabilities recorded.

### Quantitative and Qualitative Disclosures About Market Risk

**Interest Rate Risk.** At December 31, 2006, we had \$36.7 million of variable rate mortgage debt. Additionally, we have interest rate risk associated with fixed rate debt at maturity. We have and will continue to manage interest rate risk as follows: (i) maintain what we believe to be a conservative ratio of fixed rate, long term debt to total debt such that variable rate exposure is kept at an acceptable level; (ii) consider hedges

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for certain long term variable and/or fixed rate debt through the use of interest rate swaps or interest rate caps; and (iii) consider the use of treasury locks where appropriate to hedge rates on anticipated debt transactions. We use various financial models and advisors to assist us in analyzing opportunities to achieve those objectives. For additional information related to interest rate hedge agreements, see "Derivative Instruments and Hedging Activities" in Note 1 of the Notes to Consolidated Financial Statements presented in Part II, Item 8 of this report on Form 10-K. The table below provides information about our financial instruments that are sensitive to changes in interest rates. For debt obligations, the table below presents principal cash flows and related weighted average interest rates by expected maturity dates.

(In thousands)	December 31, 2006							December 31, 2005		
								Fair Market	Fair Market	
<u>Long term debt</u>	<u>2007</u>	<u>2008</u>	<u>2009</u>	<u>2010</u>	<u>2011</u>	<u>Thereafter</u>	<u>Total</u>	<u>Value</u>	<u>Total</u>	<u>Value</u>
<b>Fixed:</b>										
Fixed rate mortgage debt	\$ 57,139	\$ 39,056	\$ 55,130	\$ 43,977	\$ 64,799	\$ 201,833	\$ 461,934	\$ 504,182	\$ 480,946	\$ 504,506
Weighted average interest rate	7.6%	7.8%	7.5%	7.8%	7.6%	6.7%	7.3%			
<b>Variable:</b>										
Variable rate mortgage debt	-	-	-	32,800	3,900	-	36,700	36,700	92,624	92,624
Weighted average interest rate	-	-	-	6.5%	7.2%	-	6.6%			
LIBOR based credit facilities*	=	=	=	=	=	=	=	=	=	=
Total variable rate debt	-	-	-	<u>32,800</u>	<u>3,900</u>	-	<u>36,700</u>	<u>36,700</u>	<u>92,624</u>	<u>92,624</u>
Total long term debt	\$ 57,139	\$ 39,056	\$ 55,130	\$ 76,777	\$ 68,699	\$ 201,833	\$ 498,634	\$ 540,882	\$ 573,570	\$ 597,130

\*One LIBOR based credit facility matures December 31, 2007, and the second LIBOR based credit facility matures March 1, 2008. At December 31, 2006 and 2005, there were no

borrowings outstanding on either facility.

## CONTINGENCIES

**Environmental.** We have reviewed tangible long-lived assets and other agreements for associated asset retirement obligations ("AROs"), in accordance with FASB Statement No. 143, "Accounting for Asset Retirement Obligations" and FIN 47 "Accounting for Conditional Asset Retirement Obligations". Based on that analysis, we do not have any material AROs that would require recognition as a liability or disclosure in our financial statements at December 31, 2006. Phase I environmental audits were obtained at the time of the IPO, property acquisition, or property refinancing, as the case may be, on all of our wholly owned and joint venture properties.

Future claims for environmental liabilities are not measurable given the uncertainties surrounding whether there exists a basis for any such claims to be asserted and, if so, whether any claims will, in fact, be asserted.

*Pending Litigation.* For a discussion of the pending litigation, see Note 10 of the Notes to the Consolidated Financial Statements presented in Part II, Item 8 of this report on Form 10-K.

**Item 7A. Quantitative and Qualitative Disclosures About Market Risk**

For a discussion of the Quantitative and Qualitative Disclosure about Market Risk, reference Management's Discussion and Analysis.

**Item 8. Consolidated Financial Statements and Supplementary Data**

The response to this item is included in Item 15 of this report.

**Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure**

None.

**Item 9A. Controls and Procedures**

*Disclosure Controls and Procedures.* We have evaluated the design and operation of our disclosure controls and procedures to determine whether they are effective in ensuring that the disclosure of required information is timely made in accordance with the Securities Exchange Act of 1934 ("Exchange Act") and the rules and forms of the Securities and Exchange Commission. This evaluation was made under the supervision and with the participation of management, including our Chief Executive Officer ("CEO") and Chief Financial Officer ("CFO") as of the end of the period covered by this annual report on Form 10-K. The CEO and CFO have concluded, based on their review, that our disclosure controls and procedures, as defined in Exchange Act Rules 13a-15(e) and 15d-15(e), are effective to ensure that information required to be disclosed by us in reports that we file under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms.

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*Management's Report on Internal Control over Financial Reporting.* We are responsible for establishing and maintaining adequate internal control over financial reporting as defined in Rule 13a-15(f) under the Exchange Act. We assessed the effectiveness of our internal control over financial reporting using the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in "Internal Control - Integrated Framework". Based on that assessment and those criteria, we concluded that our internal control over financial reporting is effective as of December 31, 2006. Our independent registered public accounting firm, PricewaterhouseCoopers LLP, has issued an audit report on management's assessment of our internal control over financial reporting, which is included in the "Report of Independent Registered Public Accounting Firm" in Part II, Item 8 of this report on Form 10-K.

*Changes in Internal Control over Financial Reporting.* There were no changes in our internal control over financial reporting during the fourth quarter of 2006 that materially affected or are reasonably likely to materially affect our internal control over financial reporting.

We believe that because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

### **Item 9B. Other Information**

None.

## **PART III**

### **Item 10. Directors, Executive Officers and Corporate Governance**

The information regarding our Directors, including information regarding the audit committee's financial expert, contained in the Notice of Annual Meeting and Proxy Statement for the Annual Meeting of Shareholders to be held on May 2, 2007, is incorporated by reference in this report on Form 10-K. Such information will be filed with the SEC no later than 120 days after the year covered by this report.

The information regarding executive officers and other key employees is set forth in Part I of this report on Form 10-K under the heading "Executive Officers of the Registrant and Other Key Employees."

We adopted a formal Code of Ethics that applies to our Chief Executive Officer, Chief Financial Officer and Director of Financial Reporting. The Code of Ethics is posted on our website, [www.aecrealty.com](http://www.aecrealty.com). Any future amendments to, or waivers from, the Code of Ethics that apply to these individuals will be posted on the website also.

**Item 11. Executive Compensation**

The information on Executive Compensation contained in the Notice of Annual Meeting and Proxy Statement for the Annual Meeting of Shareholders to be held on May 2, 2007 is incorporated by reference in this report on Form 10-K. Such information will be filed with the SEC no later than 120 days after the year covered by this report.

**Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Shareholder Matters**

The following table summarizes information about our common stock that may be issued upon exercise of options outstanding and the total number of securities available for future issuance under all the existing compensation plans as of December 31, 2006. On May 4, 2005, our shareholders approved the Amended and Restated 2001 Equity-Based Award Plan which is currently the only plan under which grants of options to employees and directors can be made. Also, certain options previously granted to outside Directors, which were not made under any of those plans, were not approved by shareholders as shareholder approval for these grants was not required at the time the grants were made. For more information regarding all of our plans, see Note 17 in the Notes to the Consolidated Financial Statements presented in Part II, Item 8 of this report on Form 10-K.

Previously, we had three equity compensation plans, two of which, the AERC Share Option Plan and the Equity-Based Incentive Compensation Plan had been approved by shareholders and one, the Year 2001 Equity Incentive Plan which had not been approved by shareholders, as there was no requirement for this plan to be approved by shareholders when it was formed. As previously stated, this plan was amended and approved by shareholders in 2005.

	Number of	Weighted Average	Number of Securities Remaining
			Available for Future Issuance
	Securities to be	Exercise Price of	Under Equity Compensation
	Issued Upon Exercise	Outstanding Options	Plans [Excluding Securities
<u>Plan Category</u>	<u>of Outstanding Options</u>		<u>Reflected in the First Column]</u>
Equity compensation plans			
approved by security holders	1,454,772	\$12.49	764,127



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Equity compensation plans not approved by security holders	45,000	\$13.26	=
Total	1,499,772		764,127

Additionally, the information on Security Ownership of Certain Beneficial Owners and Management contained in the Notice of Annual Meeting and Proxy Statement for the Annual Meeting of Shareholders to be held on May 2, 2007 is incorporated by reference in this report on Form 10-K. Such information will be filed with the SEC no later than 120 days after the year covered by this report.

**Item 13. Certain Relationships and Related Transactions, and Director Independence**

The information on Certain Relationships and Related Transactions contained in the Notice of Annual Meeting and Proxy Statement for the Annual Meeting of Shareholders to be held on May 2, 2007, is incorporated by reference in this report on Form 10-K. Such information will be filed with the SEC no later than 120 days after the year covered by this report.

**Item 14. Principal Accountant Fees and Services**

The information on Principal Accountant Fees and Services contained in the Notice of Annual Meeting and Proxy Statement for the Annual Meeting of Shareholders to be held on May 2, 2007, is incorporated by reference in this report on Form 10-K. Such information will be filed with the SEC no later than 120 days after the year covered by this report.

**PART IV**

**Item 15. Exhibits and Financial Statement Schedules**

The following documents are filed as part of this Report.

1. Consolidated Financial Statements: The following documents are filed as part of this report.

Report of Independent Registered Public Accounting Firm

Consolidated Balance Sheets at December 31, 2006 and 2005.

Consolidated Statements of Operations for the years ended December 31, 2006, 2005 and 2004.

Consolidated Statements of Shareholders' Equity for the years ended December 31, 2006, 2005 and 2004.

Consolidated Statements of Cash Flows for the years ended December 31, 2006, 2005 and 2004.

Notes to Consolidated Financial Statements.

2. Financial Statement Schedules: The following financial statement schedules of Associated Estates Realty Corporation are filed as part of this Report and should be read in conjunction with the Consolidated Financial Statements of Associated Estates Realty Corporation.

Schedules Page

II Valuation and Qualifying Accounts F-38

III Real Estate and Accumulated Depreciation F-39

Schedules not listed above have been omitted because they are not applicable or are not required or the information required to be set forth therein is included in the Consolidated Financial Statements or Notes thereto.

3. Exhibits: The Exhibits listed on the accompanying Index to Exhibits are filed as part of, or incorporated by reference into, this Report.

**SIGNATURES**

Pursuant to the requirements of Section 13 or 15(d) 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, on the 28th day of February, 2007.

**ASSOCIATED ESTATES REALTY CORPORATION**

By /s/ Jeffrey I. Friedman

Jeffrey I. Friedman, Chairman of the Board,  
and Chief Executive Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities indicated on the 28th day of February, 2007.

<u>Signature</u>	<u>Title</u>	<u>Date</u>
<u>/s/ Jeffrey I. Friedman</u>	Chairman of the Board and Chief Executive	<u>February 28, 2007</u>
Jeffrey I. Friedman	Officer (Principal Executive Officer)	
<u>/s/ Lou Fatica</u>	Chief Financial Officer (Principal Financial	<u>February 28, 2007</u>

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Lou Fatica	Officer and Principal Accounting Officer)	
<u>/s/ Albert T. Adams</u>	Director	<u>February 28, 2007</u>
Albert T. Adams		
<u>/s/ James M. Delaney</u>	Director	<u>February 28, 2007</u>
James M. Delaney		
<u>/s/ Michael E. Gibbons</u>	Director	<u>February 28, 2007</u>
Michael E. Gibbons		
<u>/s/ Mark L. Milstein</u>	Director	<u>February 28, 2007</u>
Mark L. Milstein		
<u>/s/ James A. Schoff</u>	Director	<u>February 28, 2007</u>
James A. Schoff		
<u>/s/ Richard T. Schwarz</u>	Director	<u>February 28, 2007</u>
Richard T. Schwarz		

INDEX TO EXHIBITS

<u>Number</u>	<u>Title</u>	<u>Filed herewith or incorporated herein by reference</u>
3.1	Amendment to Second Amended and Restated Articles of Incorporation.	Exhibit 3.1 to Form 8-K filed December 8, 2004.
3.2	Second Amended and Restated Articles of Incorporation, as amended by the Company.	Exhibit 3.2 to Form 8-K filed December 8, 2004.
3.3	Amended and Restated Code of Regulations of the Company.	Exhibit 3.3 to Form 10-Q filed August 1, 2006
4.1	Specimen Common Share Certificate.	Exhibit 3.1 to Form S-11 filed September 2, 1993 (File No. 33-68276 as amended).
4.2	Specimen 8.70% Class B Series II Cumulative Redeemable Preferred Shares.	Exhibit 4.3 to Form 8-A filed December 8, 2004.
4.3	Deposit Agreement by and among Associated Estates Realty Corporation and National City Bank and Depositary Receipts.	Exhibit 4.5 to Form 8-A filed December 8, 2004
4.4	Form of Indemnification Agreement.	Exhibit 4.2 to Form S-11 filed September 2, 1993 (File No. 33-68276 as amended).
4.5	Form of Promissory Note and Form of Mortgage and Security Agreement dated May 10, 1999 from AERC to The Chase Manhattan Bank.	Exhibit 4.5 to Form 10-Q filed August 13, 1999.
4.5a	Form of Promissory Note and Form of Mortgage and Security Agreement dated September 10, 1999 from AERC to The Chase Manhattan Bank.	Exhibit 4.5a to Form 10-Q filed November 12, 1999.
4.5b	Form of Promissory Note and Form of Mortgage and Security Agreement dated November 18, 1999 from AERC to The Chase Manhattan Bank.	Exhibit 4.5b to Form 10-K filed March 15, 2000.

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4.9	Second Amended and Restated Loan Agreement dated April 19, 2002 between Associated Estates Realty Corporation and National City Bank.	Exhibit 4.13a to Form 10-Q filed August 13, 2002.
4.9a	Third Amended and Restated Loan Agreement dated November 1, 2005 between Associated Estates Realty Corporation and National City Bank.	Exhibit 4.9a to Form 10-K filed March 1, 2006.
4.9a(i)	Amendment No. 1 to Third Amended and Restated Loan Agreement dated May 15, 2006 between Associated Estates Realty Corporation and National City Bank.	Exhibit 4.9a(i) to Form 10-Q filed August 1, 2006.
4.9b	First Amendment to Second Amended and Restated Loan Agreement dated May 14, 2002 between Associated Estates Realty Corporation and National City Bank.	Exhibit 4.13b to Form 10-Q filed August 13, 2002.
4.9c	Second Amendment to Second Amended and Restated Loan Agreement dated April 17, 2003 between Associated Estates Realty Corporation and National City Bank.	Exhibit 4.13c to Form 10-Q filed August 1, 2003.
4.9d	Third Amendment to Second Amended and Restated Loan Agreement dated July 15, 2003 between Associated Estates Realty Corporation and National City Bank.	Exhibit 4.13d to Form 10-Q filed November 20, 2003.
4.9e	Fourth Amendment to Second Amended and Restated Loan Agreement dated September 7, 2004 between Associated Estates Realty Corporation and National City Bank.	Exhibit 4.13e to Form 10-Q filed November 2, 2004.
4.11	Loan Agreement dated July 22, 2003 between The Huntington National Bank and MIG/Orlando Development, Ltd.	Exhibit 4.15 to Form 10-Q filed November 20, 2003.
4.12	Amended and Restated Loan Agreement dated February 20, 2006 between The Huntington National Bank and MIG/Orlando Development Ltd.	Exhibit 4.12 to Form 10-Q filed May 2, 2006
	<p>Certain of the Registrant's assets are subject to mortgage obligations each of which individually relates to indebtedness totaling less than 10.0% of the total assets of the Registrant. The Registrant hereby agrees to furnish a copy of such agreements to the Commission upon its request.</p> <p>The Registrant issued unsecured debt in the form of Trust Preferred Securities on March 15, 2005 in a private placement in an amount less than 10.0% of the total assets of the Registrant. The Registrant hereby agrees to furnish a copy of the Purchase Agreement dated March 15, 2005 between Associated Estates Realty Corporation, AERC Delaware Trust and Taberna Preferred Funding 1, Ltd. and a specimen Preferred Securities Certificate to the Commission upon its request.</p>	
10	Associated Estates Realty Corporation Directors' Deferred Compensation Plan.	Exhibit 10 to Form 10-Q filed November 14, 1996.
10.1	Stock Option Plan.	Exhibit 10.2 to Form S-11 filed September 2, 1993 (File No. 33-68276 as amended).
10.2	Amended and Restated Employment Agreement between the Company and Jeffrey I. Friedman.	Exhibit 10.1 to Form 10-Q filed May 13, 1996.
10.3	Equity-Based Incentive Compensation Plan.	Exhibit 10.4 to Form 10-K filed March 29, 1995.
10.4	Form of Restricted Agreement dated by and among the Company and Its Independent Directors.	Exhibit 10.9 to Form 10-K filed March 28, 1996.
10.8	Form of Share Option Agreement by and among the Company and Its Independent Directors.	Exhibit 10.14 to Form 10-K filed March 30, 1993.
10.9	Partnership Interests Purchase Agreement dated July 17, 2004 by and among Jeffrey I. Friedman and JIFCO, an Ohio Corporation and Winchester, Inc., an Ohio Corporation.	Exhibit 10.21 to Form 10-K filed February 25, 2005.
10.10	Associated Estates Realty Corporation Amended and Restated 2001 Equity-Based Plan (as amended on May 4, 2005). Incorporated by reference to Appendix 1 to the Definitive Proxy Statement filed March 28, 2005.	Exhibit 99.01 to Form S-8 filed May 26, 2005.
10.11	Form of Equity Award Agreement.	Exhibit 10.11 to Form 10-Q filed August 2, 2005.
10.12	Long Term Incentive Compensation Plan.	Exhibit 10.12 to Form 10-Q filed November 1, 2005.
21.1	List of Subsidiaries.	Exhibit 21.1 to Form 10-K filed herewith.
23.1	Consent of Independent Accountants.	Exhibit 23.1 to Form 10-K filed herewith.

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31 Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes Oxley Act.	Exhibit 31 to Form 10-K filed herewith.
31.1 Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes Oxley Act.	Exhibit 31.1 to Form 10-K filed herewith.
32 Certification of Chief Executive Officer and Chief Financial Officer Pursuant to Section 906 of the Sarbanes Oxley Act.	Exhibit 32 to Form 10-K filed herewith.

**INDEX TO CONSOLIDATED FINANCIAL STATEMENTS**

**ASSOCIATED ESTATES REALTY CORPORATION**

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All other schedules are omitted because they are not applicable or the required information is shown in the consolidated financial statements or notes thereto.

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**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

To the Board of Directors and Shareholders of

Associated Estates Realty Corporation:

We have completed integrated audits of Associated Estates Realty Corporation's consolidated financial statements and of its internal control over financial reporting as of December 31, 2006, in accordance with the standards of the Public Company Accounting Oversight Board (United States). Our opinions, based on our audits, are presented below.

Consolidated financial statements and financial statement schedules

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In our opinion, the consolidated financial statements listed in the index appearing under item 15(a)(1) present fairly, in all material respects, the financial position of Associated Estates Realty Corporation and its subsidiaries at December 31, 2006 and 2005, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2006 in conformity with accounting principles generally accepted in the United States of America. In addition, in our opinion, the financial statement schedules listed in the index appearing under item 15(a)(2) present fairly, in all material respects, the information set forth therein when read in conjunction with the related consolidated financial statements. These financial statements and financial statement schedules are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and financial statement schedules based on our audits. We conducted our audits of these statements in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit of financial statements includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As discussed in Note 17 to the consolidated financial statements, the Company changed the manner in which it accounts for share-based compensation in 2006 in accordance with guidance provided in Statement of Financial Accounting Standards No. 123(R), "Share-Based Payment".

### Internal control over financial reporting

Also, in our opinion, management's assessment, included in Management's Report on Internal Control Over Financial Reporting appearing under item 9A, that the Company maintained effective internal control over financial reporting as of December 31, 2006 based on criteria established in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), is fairly stated, in all material respects, based on those criteria. Furthermore, in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2006, based on criteria established in *Internal Control - Integrated Framework* issued by the COSO. The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express opinions on management's assessment and on the effectiveness of the Company's internal control over financial reporting based on our audit. We conducted our audit of internal control over financial reporting in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. An audit of internal control over financial reporting includes obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we consider necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinions.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.



Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

/s/ PricewaterhouseCoopers LLP

Cleveland, Ohio

February 28, 2007

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**ASSOCIATED ESTATES REALTY CORPORATION**  
**CONSOLIDATED BALANCE SHEETS**

(In thousands, except share amounts)	December 31,	
	2006	2005
<b>ASSETS</b>		
Real estate assets		
Land	\$ 92,341	\$ 98,070
Buildings and improvements	751,393	809,967
Furniture and fixtures	<u>28,126</u>	<u>31,112</u>
	871,860	939,149
Less: accumulated depreciation	<u>(281,994)</u>	<u>(294,505)</u>
	589,866	644,644
Construction in progress	1,323	1,020
Real estate associated with property held for sale, net	<u>331</u>	<u>273</u>
Real estate, net	591,520	645,937
Cash and cash equivalents	30,010	39,733
Restricted cash	7,279	8,497
Accounts and notes receivable, net		
Rents	1,582	1,277
Affiliates and joint ventures	322	1,909
Other	1,955	3,674
Investments in joint ventures, net	5,247	5,890
Goodwill	1,725	1,725
Other assets, net	9,155	10,584
Other assets associated with property held for sale, net	<u>34</u>	<u>16</u>
<b>Total assets</b>	<b>\$ 648,829</b>	<b>\$ 719,242</b>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
Mortgage notes payable	\$ 472,854	\$ 547,790
Unsecured debt	<u>25,780</u>	<u>25,780</u>
Total debt	498,634	573,570
Accounts payable, accrued expenses and other liabilities	24,568	22,465
Dividends payable	2,934	3,052
Resident security deposits	3,601	4,121
Funds held on behalf of managed properties		
Affiliates and joint ventures	200	959
Other	1,978	1,101

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Accrued interest	2,992	2,800
Other liabilities associated with property held for sale	<u>20</u>	<u>22</u>
<b>Total liabilities</b>	534,927	608,090
Operating partnership minority interest	1,851	2,172
Shareholders' equity		
Preferred shares, without par value; 9,000,000 shares authorized: 8.70% Class B Series II cumulative redeemable, \$250 per share liquidation preference, 232,000 issued and outstanding	58,000	58,000
Common shares, without par value, \$.10 stated value; 41,000,000 authorized; 22,995,763 issued and 17,261,224 and 17,950,326 outstanding at December 31, 2006 and 2005, respectively	2,300	2,300
Paid-in capital	280,369	278,885
Accumulated distributions in excess of accumulated net income	(173,962)	(184,303)
Accumulated other comprehensive loss	(71)	(25)
Less: Treasury shares, at cost, 5,734,539 and 5,045,437 shares at December 31, 2006 and 2005, respectively	<u>(54,585)</u>	<u>(45,877)</u>
<b>Total shareholders' equity</b>	112,051	108,980
<b>Total liabilities and shareholders' equity</b>	\$ 648,829	\$ 719,242

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

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**ASSOCIATED ESTATES REALTY CORPORATION**

**CONSOLIDATED STATEMENTS OF OPERATIONS**

(In thousands, except per share amounts)	For the year ended December 31,		
	2006	2005	2004
Revenue			
Property revenue	\$ 132,994	\$ 123,594	\$ 116,145
Management and service company revenue:			
Fees, reimbursements and other	11,689	11,723	13,400
Painting services	<u>1,078</u>	<u>1,094</u>	<u>6,147</u>
Total revenue	145,761	136,411	135,692
Expenses			
Property operating and maintenance	63,086	58,113	53,029

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Depreciation and amortization	31,517	31,306	28,044
Direct property management and service company expenses	12,695	12,503	13,019
Painting services	1,367	1,150	4,764
General and administrative	9,840	7,999	7,771
Total expenses	118,505	111,071	106,627
Operating income	27,256	25,340	29,065
Interest income	680	638	309
Interest expense	(51,991)	(40,070)	(36,846)
(Loss) income before gain on disposition of investment, equity in net loss of joint ventures, minority interest and income from discontinued operations	(24,055)	(14,092)	(7,472)
Gain on disposition of investment	-	150	-
Equity in net loss of joint ventures	(462)	(644)	(923)
Minority interest in operating partnership	(61)	(63)	(63)
(Loss) income from continuing operations	(24,578)	(14,649)	(8,458)
Income from discontinued operations:			
Operating (loss) income	(2,494)	2,319	2,100
Gain on disposition of properties	54,093	48,536	9,682
Income from discontinued operations	51,599	50,855	11,782
<b>Net income</b>	27,021	36,206	3,324
Preferred share dividends	(5,046)	(5,130)	(5,805)
Original issuance costs related to redemption of preferred shares	-	(2,163)	-
<b>Net income (loss) applicable to common shares</b>	\$ 21,975	\$ 28,913	\$ (2,481)
<b>Earnings per common share - basic and diluted:</b>			
(Loss) income from continuing operations applicable to common shares	(1.74)	(1.14)	(.73)
Income from discontinued operations	3.03	2.65	.60
Net income (loss) applicable to common shares	\$ 1.29	\$ 1.51	\$ (.13)
<b>Dividends declared per common share</b>	\$ .68	\$ .68	\$ .68
<b>Weighted average number of common shares outstanding - basic and diluted</b>	17,023	19,162	19,519

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

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**ASSOCIATED ESTATES REALTY CORPORATION**

**CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY**

Class A      Class B  
Cumulative   Cumulative

Accumulated  
Distributions   Accumulated

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(In thousands, except share amounts)	Total	Redeemable	Redeemable	Common	Total Paid-In Capital		in Excess of	Other	Treasury
		Preferred Shares	Preferred Shares	Shares (at \$.10 stated value)	Paid-In Capital	Unearned Compensation	Accumulated Net Income	Comprehensive Loss	Shares (at cost)
Balance, December 31, 2003	\$ 121,428	\$ 56,250	\$ -	\$ 2,300	\$ 279,354	\$ (267)	\$ (184,436)	\$ -	\$ (31,773)
Comprehensive income-net income	3,324	-	-	-	-	-	3,324	-	-
Issuance of Class B Cumulative Preferred Shares	56,793	-	58,000	-	(1,207)	-	-	-	-
Amortization of unearned compensation	318	-	-	-	-	318	-	-	-
Forfeiture of 4,083 restricted common shares to treasury	(7)	-	-	-	14	25	-	-	(46)
Issuance of 74,451 restricted common shares from treasury shares	66	-	-	-	(215)	(555)	-	-	836
Purchase of 8,862 common shares	(74)	-	-	-	-	-	-	-	(74)
Issuance of 113,000 common shares for stock option exercises from treasury shares	928	-	-	-	(329)	-	-	-	1,257
Other	(21)	-	-	-	(21)	-	-	-	-
Common share dividends declared	(13,360)	-	-	-	-	-	(13,360)	-	-
Preferred share dividends declared	<u>(5,805)</u>	=	=	=	=	=	<u>(5,805)</u>	=	=
Balance, December 31, 2004	163,590	56,250	58,000	2,300	277,596	(479)	(200,277)	-	(29,800)
Comprehensive income:									
Net income	36,206	-	-	-	-	-	36,206	-	-
Other comprehensive income (loss):									
Change in fair value of hedge instruments	<u>(25)</u>	=	=	=	=	=	=	<u>(25)</u>	=
Total comprehensive income	36,181	-	-	-	-	-	36,206	(25)	-
Amortization of unearned compensation	326	-	-	-	-	326	-	-	-
Forfeiture of 18,063 restricted common shares to treasury	(22)	-	-	-	28	141	-	-	(191)
Issuance of 77,167 restricted common shares from treasury shares	144	-	-	-	(128)	(587)	-	-	859
Purchase of 1,823,265 common shares	(17,427)	-	-	-	-	-	-	-	(17,427)
Issuance of 61,300 common shares for stock option exercises from treasury shares	493	-	-	-	(189)	-	-	-	682
Adjustment to December 2004 issuance of 8.70% Class B Series II Cumulative Redeemable Preferred Shares	14	-	-	-	14	-	-	-	-
Redemption of Class A Cumulative Redeemable Preferred Shares	(56,250)	(56,250)	-	-	2,163	-	(2,163)	-	-
Common share dividends declared	(12,939)	-	-	-	-	-	(12,939)	-	-
Preferred share dividends declared	<u>(5,130)</u>	=	=	=	=	=	<u>(5,130)</u>	=	=
Balance, December 31, 2005	108,980	-	58,000	2,300	279,484	(599)	(184,303)	(25)	(45,877)
Comprehensive income:									
Net income	27,021	-	-	-	-	-	27,021	-	-
Other comprehensive income (loss):									
Change in fair value of hedge instruments	<u>(46)</u>	=	=	=	=	=	=	<u>(46)</u>	=
Total comprehensive income	26,975	-	-	-	-	-	27,021	(46)	-
Share-based compensation	1,022	-	-	-	1,500	599	14	-	(1,091)

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Purchase of 992,423 common shares	(10,269)	-	-	-	-	-	-	-	(10,269)
Issuance of 236,599 common shares for stock option exercises from treasury shares	2,037	-	-	-	(615)	-	-	-	2,652
Common share dividends declared	(11,648)	-	-	-	-	-	(11,648)	-	-
Preferred share dividends declared	(5,046)	=	=	=	=	=	(5,046)	=	=
Balance, December 31, 2006	\$ 112,051	\$ -	\$ 58,000	\$ 2,300	\$ 280,369	\$ -	\$ (173,962)	\$ (71)	\$ (54,585)

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

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ASSOCIATED ESTATES REALTY CORPORATION

CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)	For the year ended December 31,		
	2006	2005	2004
Cash flow from operating activities:			
Net income	\$ 27,021	\$ 36,206	\$ 3,324
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization (including discontinued operations)	33,389	35,465	33,754
Loss on fixed asset replacements write-off	163	80	278
Minority interest in operating partnership	61	63	63
Amortization of deferred financing costs and other	2,163	826	1,067
Amortization of swap termination payments received	(497)	(727)	(1,165)
Gain on disposition of properties, land and investment, net	(54,093)	(48,686)	(9,682)
Share-based compensation	965	303	324
Equity in net loss of joint ventures	462	644	923
Earnings distributed from joint ventures	318	-	418
Net change in assets and liabilities:			
- Accounts and notes receivable	1,414	(2,601)	(804)
- Accounts and notes receivable from affiliates and joint ventures	1,081	3,148	310
- Accounts payable and accrued expenses	4,215	(83)	3,561
- Other operating assets and liabilities	(86)	1,510	(407)
- Restricted cash	1,218	243	150
- Funds held for non-owned managed properties	877	(640)	675
- Funds held for non-owned managed properties of affiliates	(759)	(1,375)	146
Total adjustments	(9,109)	(11,830)	29,611
Net cash flow provided by operations	17,912	24,376	32,935
Cash flow from investing activities:			
Recurring fixed asset additions	(11,049)	(8,127)	(9,011)
Revenue enhancing/non-recurring fixed asset additions	(1,477)	(871)	(5,450)
Acquisition/development fixed asset additions	(256)	(65,320)	(7,877)
Purchase of operating partnership units	(184)	-	-

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Net proceeds received from sale of properties, land and investment	87,038	78,739	9,593
Contributions to joint ventures	(137)	-	-
Net cash flow provided by (used for) investing activities	73,935	4,421	(12,745)
Cash flow from financing activities:			
Principal payments on mortgage notes payable	(207,146)	(60,933)	(26,294)
Payment of debt procurement costs	(1,540)	(1,659)	(53)
Proceeds from mortgage notes obtained	132,209	87,940	20,000
Proceeds from issuance of unsecured trust preferred securities	-	25,780	-
Principal payment on Medium Term Notes	-	-	(105)
Line of credit borrowings	96,300	60,250	59,300
Line of credit repayments	(96,300)	(70,250)	(54,300)
Redemption of Class A preferred shares	-	(56,250)	-
Exercise of stock options	2,037	493	928
Common share dividends paid	(11,765)	(13,229)	(13,331)
Preferred share dividends paid	(5,046)	(5,450)	(5,484)
Operating partnership distributions paid	(61)	(63)	(48)
Issuance of Class B Cumulative Redeemable Preferred Shares, net	-	-	56,793
Purchase of treasury shares	(10,185)	(17,382)	-
Other financing activities, net	(73)	(45)	(74)
Net cash flow (used for) provided by financing activities	(101,570)	(50,798)	37,332
(Decrease) increase in cash and cash equivalents	(9,723)	(22,001)	57,522
Cash and cash equivalents, beginning of year	39,733	61,734	4,212
Cash and cash equivalents, end of year	\$ 30,010	\$ 39,733	\$ 61,734

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

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**ASSOCIATED ESTATES REALTY CORPORATION**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**1. BASIS OF PRESENTATION AND SIGNIFICANT ACCOUNTING POLICIES**

**Business**

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We are a self-administered and self-managed equity real estate investment trust ("REIT") specializing in multifamily property management, advisory, development, acquisition, disposition, operation and ownership activities. In addition to rental revenue, we receive certain property, asset management and disposition fees. Our MIG subsidiary is a registered investment advisor and serves as a real estate advisor to pension funds. We own three taxable REIT subsidiaries (the "Service Companies") that provide management and other services to us and to third parties.

As of December 31, 2006, we owned or managed 99 apartment communities in nine states consisting of 20,558 units. We own, either directly or indirectly through subsidiaries, or hold ownership interests in 66 of the 99 apartment communities containing 15,355 units in eight states. Twelve of those owned or partially owned apartment communities, consisting of 1,254 units, are Affordable Housing communities. We property manage 33 communities in which we do not have an ownership interest consisting of 5,203 units. We asset manage a 186-unit apartment community and one commercial property containing approximately 145,000 square feet. In January 2007, we assumed property management responsibilities for a 200-unit Affordable Housing property located in Pennsylvania.

### Principles of Consolidation

The accompanying consolidated financial statements include the accounts of all subsidiaries and qualified REIT subsidiaries, which include but are not limited to:

- separate legal entities that were formed in connection with project specific, nonrecourse mortgage refinancing for which records, books of accounts and depository accounts must be maintained that are separate and apart from any other person or entity;

the Service Companies (which are taxed as Taxable REIT Subsidiaries ("TRS") under the REIT Modernization Act ("RMA") implemented in 1999);

certain variable interest entities in which we have a controlling interest, including where we have been determined to be a primary beneficiary of a variable interest entity in accordance with the provisions of Interpretation No. 46(R), "Consolidation of Variable Interest Entities", or meet certain criteria of a sole general partner or managing member in accordance with EITF 04-05, "Investor's Accounting for an Investment in a Limited Partnership When the Investor Is the Sole General Partner and the Limited Partners Have Certain Rights"; and

an Operating Partnership structured as a DownREIT in which we own an aggregate 97.4% as of December 31, 2006.

Limited partnership interests held by others in real estate partnerships controlled by us are reflected as "Operating partnership minority interest" in the Consolidated Balance Sheets. Capital contributions, distributions and profits and losses are allocated to minority interests in accordance with the terms of the Operating Partnership agreement. The DownREIT structure enabled us to acquire multifamily real estate assets in an operating partnership entity that is separate from other properties that we own. In the DownREIT structure, the limited partners originally contributed two real estate assets to the operating partnership and, in return, received partnership units entitling them to a share of the profits, based on the number of operating partnership units. One of the properties was sold in October 2005. The operating partnership units entitle the holder to exchange their partnership units at some future time for common shares or to redeem partnership units for cash (at our option). We are the DownREIT general partner. All significant intercompany balances and transactions have been eliminated in consolidation.



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We own 100% of the common stock of all qualified REIT subsidiaries included in our consolidated financial statements.

### **Use of Estimates**

The preparation of the consolidated financial statements in accordance with accounting principles generally accepted in the United States of America ("GAAP") requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities at the date of the consolidated financial statements and reported amounts of revenues and expenses during the reporting periods. Actual results could differ from these estimates.

### **Cash Equivalents**

Highly liquid investments with an original maturity of three months or less when purchased are considered to be cash equivalents.

### **Real Estate and Depreciation**

Real estate assets are stated at cost less accumulated depreciation. Depreciation is provided on a straight-line basis over the estimated useful lives of the assets as follows:

Buildings and improvements 5 - 30 years

Furniture, fixtures and equipment 5 - 10 years

We capitalize replacements and improvements, such as HVAC equipment, structural replacements, windows, appliances, flooring, carpeting and kitchen/bath replacements and renovations. Ordinary repairs and maintenance, such as unit cleaning and painting and appliance repairs are expensed when incurred.

We capitalize interest costs on funds used in construction, real estate taxes and insurance from the commencement of development activity through the time the property is ready for leasing.

In accordance with SFAS 144, we discontinue the depreciation of assets that we have specifically identified as held for sale. There was one property classified as held for sale at December 31, 2006 and 2005.

#### **Classification of Fixed Asset Additions**

We consider recurring fixed asset additions to a property to be capital expenditures made to replace worn out assets necessary to maintain or enhance the property's value. We consider investment/revenue enhancing and/or non-recurring fixed assets to be capital expenditures if such improvements increase the value of the property and/or enable us to increase rents. We consider acquisition and development fixed asset additions to be for the purchase of, or construction of, new properties to be added to our portfolio, or fixed asset additions identified at the time of purchase that are not made until subsequent periods.

#### **Impairment of Long-Lived Assets**

We evaluate the recoverability of the carrying value of our real estate assets using the methodology prescribed in Statement of Financial Accounting Standards ("SFAS") No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets." Factors we consider in evaluating impairment of existing real estate assets held for investment include significant declines in property operating profits, recurring property operating losses and other significant adverse changes in general market conditions that are considered permanent in nature. Under SFAS No. 144, a real estate asset held for investment is not considered impaired if the undiscounted, estimated future cash flows of the asset (both the annual estimated cash flow from future operations and the estimated cash flow from the theoretical sale of the asset) over its estimated holding period are in excess of the asset's net book value at the balance sheet date. If any real estate asset held for investment is considered impaired, a loss is provided to reduce the carrying value of the asset to its fair value. We periodically classify real estate assets as held for sale. See Note 2 for a discussion of our policy regarding classification of a property as held for sale. Upon the classification of a real estate asset as held for sale, the carrying value of the asset is reduced to the lower of its net book value or its fair value, less costs to sell the asset. Subsequent to the classification of assets as held for sale, no further depreciation expense is recorded. No impairment was recorded in connection with our owned real estate assets for the years ended December 31, 2006, 2005 and 2004.

Investments in joint ventures that we own 50.0% or less are presented using the equity method of accounting as we have the ability to exercise significant influence over, but we do not have financial or operating control over such entities. Since we intend to fulfill our obligations as a partner in the joint ventures, we have recognized our share of losses and distributions in excess of our investment. Our investment in unconsolidated entities is periodically reviewed for other than temporary declines in market value. Any decline that is not expected to recover in the next 12 months is considered other than temporary and an impairment is recorded as a reduction in the carrying value of the investment. Estimated fair values are based on our projections of cash flows and market capitalization rates. As of December 31, 2006, no impairment has been recorded in connection with any of our joint venture investments. For additional information concerning our activity in connection with our joint venture investments, see Note 7. Also, we have guaranteed certain debt obligations at one joint venture property that may require us to incur fundings above our prorata share. This guaranty is detailed in Note 11.

### **Deferred Leasing and Financing Costs**

Costs incurred in obtaining long-term financing are deferred and amortized over the life of the associated instrument on a straight-line basis, which approximates the effective interest method.

### **Intangible Assets and Goodwill**

SFAS 142, "Goodwill and Other Intangible Assets," requires that intangible assets not subject to amortization and goodwill are tested for impairment annually, or more frequently if events or changes in circumstances indicate that the carrying value may not be recoverable. See Note 4 for additional information related to intangible assets and goodwill.

### **Revenue Recognition**

Our residential property leases are for terms of generally one year or less. Rental income is recognized on the straight-line basis. Retroactive revenue increases related to budget based Affordable Housing properties are generally recognized based on rental increase applications that are approved by HUD.

Acquisition, management and disposition fees and other fees are recognized when the related services are performed and the earnings process is complete.

Rent concessions, including free rent, incurred in connection with residential property leases, are capitalized and amortized on a straight-line basis over the terms of the related leases (generally one year) and are charged as a reduction of rental revenue.

### **Property Management**

We are reimbursed for expenses incurred in connection with the management of properties for third parties, joint ventures and other affiliates. We are the primary obligor for these expenses, which are primarily salaries and benefits relating to employees at these properties, and therefore

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we record these reimbursements as management and service company revenue (included in "Fees, reimbursements and other") and as expenses (included in "Direct property management and service company expenses"). For the years ended December 31, 2006, 2005 and 2004, the reimbursements shown as revenue were equivalent to the expenses, which were \$8.3 million, \$8.6 million and \$9.2 million, respectively.

### Advertising Costs

We recognize advertising costs as expense when incurred. The total amount charged to advertising expense was \$2.0 million for the years ended December 31, 2006 and 2005, and \$1.9 million for the year ended December 31, 2004. There were no advertising costs reported as assets for the years ended December 31, 2006 and 2005.

### Share-Based Compensation

Effective January 1, 2006, we adopted the provisions of Statement of Financial Accounting Standards No. 123 (revised), "Share-Based Payment" ("SFAS 123(R)") using the modified prospective application method. Prior to the adoption of SFAS 123(R), we accounted for share-based compensation using the intrinsic value method in accordance with Accounting Principles Board Opinion No. 25 ("APB No. 25"), and accordingly, we recognized no compensation expense for stock option awards. For information about our equity based award plans, see Note 17.

Under the modified prospective method of SFAS 123(R), share-based compensation cost is recognized on (i) all awards granted on or after January 1, 2006 using the fair-value method, (ii) nonvested stock option awards granted prior to January 1, 2006 based on their grant date fair value as previously calculated under the pro-forma disclosure provisions of SFAS 123 over the remaining requisite service periods, and (iii) nonvested restricted share awards based on their grant date fair value over the remaining service periods. Prior periods were not restated to reflect the impact of adopting this Statement. Additionally, SFAS 123(R) requires us to estimate the amount of expected forfeitures when calculating compensation costs, instead of accounting for forfeitures as they occur, which was our previous method. Forfeiture rates were calculated based on our historical forfeiture activity, which was adjusted for activity that we believe is not representative of future expectations. The following table reflects the effect on operating results and per share information if we had accounted for share-based compensation in accordance with SFAS 123(R) for the twelve months ended December 31, 2005 and 2004:

(In thousands, except per share data)	<u>2005</u>	<u>2004</u>
Net income	\$ 36,206	\$ 3,324
Total stock compensation cost recognized	358	339
Total stock compensation cost had SFAS 123(R) been adopted	(663)	(502)
Proforma net income had SFAS 123(R) been adopted	\$ 35,901	\$ 3,161
Net income (loss) applicable to common shares:		

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Net income (loss) as reported	\$ 28,913	\$ (2,481)
Total stock compensation cost recognized	358	339
Total stock compensation cost had SFAS 123(R) been adopted	(663)	(502)
Pro forma net income (loss) had SFAS 123(R) been adopted	\$ 28,608	\$ (2,644)
Income (loss) per common share - basic and diluted		
Net income (loss) as reported	\$ 1.51	\$ (.13)
Total stock compensation cost recognized	.02	.02
Total stock compensation cost had SFAS 123(R) been adopted	(.04)	(.03)
Pro forma net income (loss) had SFAS 123(R) been adopted	\$ 1.49	\$ (.14)

**Operating Partnership Minority Interest**

In 1998, in conjunction with the acquisition of an operating partnership that owned two apartment communities, one of which was sold in October 2005, we issued a total of 522,032 operating partnership units ("OP units"). If and when the OP units are presented for redemption, we have the option to redeem, in certain circumstances, the OP units for common shares exchangeable on a one-for-one basis, or the cash equivalent amount. The OP unitholders are entitled to receive cumulative distributions per OP unit equal to the per share distributions on our common shares. We charged \$61,000, \$63,000 and \$63,000 to "Minority interest in operating partnership" in the Consolidated Statements of Operations relating to the OP unitholders allocated share of net income for the years ended December 31, 2006, 2005 and 2004, respectively. There were 79,277 OP units remaining as of December 31, 2006.

The following table identifies the number of OP units redeemed, the cash paid to redeem the units, the recorded value of the units when issued and the difference between the cash paid and the recorded value which reduced the recorded amount of the underlying real estate (in thousands, except units redeemed):

Year	Units Redeemed	Cash Paid	Recorded	Reduction
			Value At Issuance	in Underlying Real Estate
2000	19,662	\$ 144	\$ 436	\$ 292
2001	39,314	393	929	536
2002	335,000	3,100	7,600	4,500
2003	35,033	211	800	589
2004	-	-	-	-
2005	-	-	-	-
2006	13,746	184	321	137
	442,755	\$ 4,032	\$ 10,086	\$ 6,054

**Income Taxes**

We have elected to be taxed as a REIT under the Internal Revenue Code of 1986 (the "Code"), as amended. As a REIT, we are entitled to a tax deduction for dividends paid to shareholders, thereby effectively subjecting the distributed net income to taxation at the shareholder level only, provided we distribute at least 90.0% of our taxable income and meet certain other qualifications.

The Service Companies operate as taxable C-corporations under the Code and have accounted for income taxes in accordance with the provisions of SFAS No. 109, "Accounting for Income Taxes". The Service Companies have elected to be treated as Taxable REIT Subsidiaries. Taxes are provided for those Service Companies having net profits for both financial statement and income tax purposes. The 2006, 2005 and 2004 net operating loss carryforwards for the Service Companies, in the aggregate, are approximately \$8.0 million, \$7.0 million and \$5.9 million, respectively, and expire during the years 2018 to 2026.

The gross deferred tax assets were \$4.5 million, \$4.3 million and \$4.0 million at December 31, 2006, 2005 and 2004, respectively, and relate principally to net operating losses of the Service Companies. Gross deferred tax liabilities of \$166,000, \$150,000 and \$154,000 at December 31, 2006, 2005 and 2004, respectively, relate primarily to tax basis differences in fixed assets and intangibles. The deferred tax valuation allowance was \$4.3 million, \$4.2 million and \$3.8 million at December 31, 2006, 2005 and 2004, respectively. We reserve for net deferred tax assets when we believe it is more likely than not that they will not be realized. The deferred tax assets and the deferred tax valuation allowance are recorded in "Other assets, net" and the deferred tax liabilities are recorded in "Accounts payable, accrued expenses and other liabilities" in the Consolidated Balance Sheets.

At December 31, 2006 and 2005, our net tax basis of properties exceeds the amount set forth in the Consolidated Balance Sheets by \$66.5 million and \$99.0 million, respectively.

**Reconciliation Between GAAP Net Income and Taxable (Loss) Income**

The following reconciles GAAP net income to taxable (loss) income:

(In thousands)	Year ended December 31,		
	<u>2006</u>	<u>2005</u>	<u>2004</u>

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GAAP net income	\$ 27,021	\$ 36,206	\$ 3,324
Add: GAAP net loss (income) of taxable REIT subsidiaries and minority interest in joint venture, net	748	(340)	(1,024)
GAAP net income from REIT operations <sup>(1)</sup>	27,769	35,866	2,300
Add: Book depreciation and amortization	35,388	37,639	35,688
Less: Tax depreciation and amortization	(27,058)	(28,522)	(28,368)
Book/tax differences on (losses) gains from capital transactions	(27,106)	(22,105)	(4,180)
Other book/tax differences, net	1,496	(796)	(911)
Taxable income before adjustments	10,489	22,082	4,529
Less: Capital gains	(26,986)	(25,769)	(5,502)
Taxable (loss) income subject to dividend requirement	\$ (16,497)	\$ (3,687)	\$ (973)

(1) All adjustments to GAAP net income from REIT operations are net of amounts attributable to taxable REIT subsidiaries and minority interests.

**Reconciliation Between Cash Dividends Paid and Dividends Paid Deduction**

(In thousands)	Year ended December 31,		
	2006	2005	2004
Cash dividends paid	\$ 16,691	\$ 18,279	\$ 19,135
Plus: Dividends designated (to prior) from following year	(1,252)	1,252	-
Less: Portion designated capital gain distribution	(11,169)	(19,531)	(5,502)
Less: Return of capital	(4,270)	-	(13,633)
Dividends paid deduction	\$ -	\$ -	\$ -

**Dividends Per Share**

Total dividends per common share and the related components for the years ended December 31, 2006, 2005 and 2004, as reported for income tax purposes, were as follows:

For the year ended December 31, 2006					
	Ordinary	Non-Taxable	20% Rate	Unrecaptured	
Date Paid	Income	Return of	Capital	Section 1250	Dividends
		Capital	Gain	Gain	
1/23/06 <sup>(1)</sup>	\$ -	\$ 0.040981	\$ 0.058761	\$ 0.047265	\$ 0.099742

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5/1/06	-	0.069847	0.100153	0.080559	0.170000
8/1/06	-	0.069847	0.100153	0.080559	0.170000
11/1/06	-	<u>0.069847</u>	<u>0.100153</u>	<u>0.080559</u>	<u>0.170000</u>
	\$ -	\$ 0.250522	\$ 0.359220	\$ 0.288942	\$ 0.609742

(1) Represents a portion of the dividend paid on January 23, 2006. The remaining portion of this dividend was reported for the year ended December 31, 2005, for income tax purposes.

<u>For the year ended December 31, 2005</u>					
	Ordinary	Non-Taxable	20% Rate	Unrecaptured	
	Income	Return of	Capital	Section 1250	
<u>Date Paid</u>	<u>Income</u>	<u>Capital</u>	<u>Gain</u>	<u>Gain</u>	<u>Dividends</u>
2/1/05	\$ -	\$ -	\$ .170000	\$ .066019	\$ .170000
5/2/05	-	-	.170000	.066019	.170000
8/1/05	-	-	.170000	.066019	.170000
11/1/05	-	-	.170000	.066019	.170000
1/23/06 <sup>(1)</sup>	-	-	<u>.070258</u>	<u>.027285</u>	<u>.070258</u>
	\$ -	\$ -	\$ .750258	\$ .291361	\$ .750258

(1) Represents a portion of the dividend paid on January 23, 2006. The remaining portion of this dividend was reported for the year ended December 31, 2006, for income tax purposes.

<u>For the year ended December 31, 2004</u>					
	Ordinary	Non-Taxable	20% Rate	Unrecaptured	
	Income	Return of	Capital	Section 1250	
<u>Date Paid</u>	<u>Income</u>	<u>Capital</u>	<u>Gain</u>	<u>Gain</u>	<u>Dividends</u>
2/1/2004	\$ .0001	\$ .1688	\$ .0011	\$ .0003	\$ .1700
5/1/2004	.0001	.1688	.0011	.0003	.1700
8/1/2004	.0001	.1688	.0011	.0003	.1700
11/1/2004	<u>.0001</u>	<u>.1688</u>	<u>.0011</u>	<u>.0003</u>	<u>.1700</u>
	\$ .0004	\$ .6752	\$ .0044	\$ .0012	\$ .6800

Preferred dividends of \$5.0 million, \$5.1 million and \$5.8 million were paid for the years ended December 31, 2006, 2005 and 2004, respectively of which \$5.0 million, \$5.1 million and \$5.4 million were designated as a capital gain dividend for the years ended December 31, 2006, 2005 and 2004, respectively.



## Derivative Instruments and Hedging Activities

Statement of Financial Accounting Standards No. 133, "Accounting for Derivative Instruments and Hedging Activities" ("SFAS 133"), as amended and interpreted, establishes accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts and for hedging activities. As required by SFAS 133, we record all derivatives on the balance sheet at fair value. The accounting for changes in the fair value of derivatives depends on the intended use of the derivative and the resulting designation. Derivatives used to hedge the exposure to changes in the fair value of an asset, liability or firm commitment attributable to a particular risk, such as interest rate risk, are considered fair value hedges. Derivatives used to hedge the exposure to variability in expected future cash flows or other types of forecasted transactions, are considered cash flow hedges.

For derivatives designated as fair value hedges, changes in the fair value of the derivative and the hedged item related to the hedged risk are recognized in earnings. For derivatives designated as cash flow hedges, the effective portion of changes in the fair value of the derivative is initially reported in other comprehensive income (outside of earnings) and subsequently reclassified to earnings when the hedged transaction affects earnings and the ineffective portion of changes in the fair value of the derivative is recognized directly in earnings. Hedge effectiveness is assessed by comparing the changes in fair value or cash flows of the derivative hedging instrument with the changes in fair value or cash flows of the designated hedged item or transaction. For derivatives not designated as hedges, changes in fair value are recognized in earnings.

We do not use derivatives for trading or speculative purposes. Further, we have a policy of only entering into contracts with major financial institutions based upon their credit ratings and other factors. When viewed in conjunction with the underlying and offsetting exposure that the derivatives are designed to hedge, we have not sustained a material loss from those instruments and we do not anticipate any material adverse effect on our net income or financial position in the future from the use of derivatives.

During 2006, we utilized forward contracts with respect to forecasted probable purchases of natural gas used in heating certain properties that we own or manage. We utilize the gas forwards to limit the market price risk associated with the forecasted gas purchase. Identification of a forward contract as a qualifying cash-flow hedge requires us to determine that the forecasted transaction(s) is probable, and the hedging relationship between the gas contract and the expected future purchase is expected to be highly effective at the initiation of the hedge and throughout the hedging relationship. We reassess this hedge on a quarterly basis to determine if it continues to be effective and the forecasted transactions are probable. The changes in fair value of the contracts will be recorded in other comprehensive income ("OCI"). The amount in OCI will be reclassified into earnings when the cost of the gas affects earnings. If any portion of the hedge is determined to be ineffective, that amount will also be recorded into earnings. As of December 31, 2006, this hedge was reported at fair value on the Consolidated Balance Sheets as "Accounts payable, accrued expenses and other liabilities" in the amount of \$80,000. The unrealized gain/loss in the fair value of this hedge is deferred in OCI and will be recognized in earnings as the hedged transaction occurs. The change in net unrealized gain/loss on this hedge reflects a reclassification of net unrealized gain/loss from accumulated OCI to earnings of \$143,000 during the year ended December 31, 2006. We estimate the \$71,000 unrealized loss in OCI will be reclassified into earnings during the first quarter of 2007.

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The forward contracts related to properties that we manage are accounted for as derivatives and are not designated as hedges. Therefore, these forwards are recognized at fair value with the changes in fair value recorded in earnings. Additionally, we have contracts with certain of the owners of the managed properties involved in the forward contracts. These contracts create a reverse derivative, in which we are the seller, and are also recognized at fair value with the changes in fair value recorded in earnings. The changes in fair value of the reverse derivatives are exactly opposite the changes in fair value of the initial derivative for contracts with identical critical terms, and therefore result in a net impact of zero to our (loss) income from continuing operations.

We have utilized interest rate swaps to add stability to interest expense as part of our hedging strategy. Interest rate swaps designated as fair value hedges involve the payment of variable-rate amounts in exchange for fixed-rate payments over the life of the agreements without exchange of the underlying principal amount. At December 31, 2006 and 2005, there were no interest rate swap derivatives included on the Consolidated Balance Sheet.

*Interest Rate Hedge Activity:* On June 30, 2004, we terminated an interest rate swap with a notional amount of \$17.2 million (which was entered into in May, 2002) as a result of the refinancing of the related fixed rate loan. We recorded a credit to interest expense of \$270,000 for the twelve months ended December 31, 2004 with regards to this swap.

On April 19, 2002, we executed an interest rate swap with a notional amount of \$14.0 million (which commenced on May 15, 2002) to hedge the fair market value of a fixed rate loan. This swap expired in November 2005 upon the maturity of the related loan. We recorded a credit to interest expense of \$147,000, and \$418,000 for the years ended December 31, 2005, and 2004, respectively, with regards to this swap.

On February 25, 2000, we executed two interest rate swaps. The notional amounts of the swaps were approximately \$10.6 million (which commenced March 1, 2000) and \$54.8 million (which commenced March 10, 2000). The swaps amortized monthly in accordance with the amortization of the hedged loans and were to expire upon maturity of the loans. These swaps were executed to hedge the fair market value of five fixed rate loans. On December 11, 2000, we executed termination agreements for both swaps, and received a total termination payment of \$3.2 million. This termination payment is being amortized, as a credit to interest expense, through the maturity dates of the related loans in 2007. If a loan is extinguished prior to the original maturity date, any unamortized termination payment related to such loan is immediately credited to interest expense. Total amortization related to the termination payments was \$497,000, \$727,000, and \$1.2 million for the twelve months ended December 31, 2006, 2005, and 2004.

### Treasury Shares

We record the purchase of Treasury shares at cost. From time to time, we may reissue these shares. When shares are reissued, we account for the issuance based on the "First in, first out" method. For additional information regarding treasury shares, see Note 14.

## Recent Accounting Pronouncements

In September 2005, the EITF issued Issue 04-05, Investor's Accounting for an Investment in a Limited Partnership. When the Investor is the Sole General Partner and the Limited Partners Have Certain Rights, ("EITF 04-05"). At issue is what rights held by the limited partner(s) preclude consolidation in circumstances in which the sole general partner would consolidate the limited partnership in accordance with GAAP. The assessment of limited partners' rights and their impact on the presumption of control of the limited partnership by the sole general partner should be made when an investor becomes the sole general partner and should be reassessed if (i) there is a change to the terms or in the exercisability of the rights of the limited partners, (ii) the sole general partner increases or decreases its ownership of limited partnership interests, or (iii) there is an increase or decrease in the number of outstanding limited partnership interests. This issue was effective no later than for fiscal years beginning after December 15, 2005, and as of September 29, 2005, for new or modified arrangements. The impact of adopting EITF 04-05 did not have a material impact on our financial position, results of operations or cash flows.

In May 2005, the Financial Accounting Standards Board ("FASB") issued SFAS No. 154, "Accounting Changes and Error Corrections" ("SFAS 154"), which replaces APB Opinion No. 20, "Accounting Changes," and SFAS No. 3, "Reporting Accounting Changes in Interim Financial Statements-An Amendment of APB Opinion No. 28." SFAS 154 provides guidance on the accounting for and reporting of accounting changes and error corrections. It establishes retrospective application, on the latest practicable date, as the required method for reporting a change in accounting principle and the reporting of a correction of an error. SFAS 154 was effective for us in the first quarter of 2006. The adoption of this standard did not have a material impact on our financial position, results of operations or cash flows.

In June 2006, the Financial Accounting Standards Board ("FASB") issued Interpretation No. 48, "Accounting for Uncertainty in Income Taxes" - an interpretation of FASB Statement No. 109, "Accounting for Income Taxes" ("FIN 48"). This Interpretation clarifies the accounting for uncertain tax positions and provides guidance for the recognition and measurement of a tax position taken or expected to be taken in a tax return. This Interpretation will become effective for us on January 1, 2007. We do not anticipate that the adoption of FIN 48 will have a material impact on our financial position, results of operations or cash flows.

In September 2006, the FASB issued SFAS 157, Fair Value Measurements, which upon adoption will replace various definitions of fair value in existing accounting literature with a single definition, will establish a framework for measuring fair value, and will require additional disclosures about fair value measurements. The statement clarifies that fair value is the price that would be received to sell an asset or the price paid to transfer a liability in the most advantageous market available to the entity and emphasizes that fair value is a market-based measurement and should be based on the assumptions market participants would use. The statement also creates a three-level hierarchy under which individual fair value estimates are to be ranked based on the relative reliability of the inputs used in the valuation. This hierarchy is the basis for the disclosure requirements, with fair value estimates based on the least reliable inputs requiring more extensive disclosures about the valuation method used and the gains and losses associated with those estimates. SFAS 157 is required to be applied whenever another financial accounting standard requires or permits an asset or liability to be measured at fair value. The statement does not expand the use of fair value to any new circumstances. We will be required to apply the new guidance beginning January 1, 2008. We are currently evaluating the impact that this statement will have on our financial condition, results of operations and cash flows.

In September 2006, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 108 ("SAB 108") "Considering the Effects of Prior Year Misstatements in Current Year Financial Statements." SAB 108 provides guidance on quantifying financial statement misstatements, including the effects of prior year errors on current year financial statements. SAB 108 is effective for

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fiscal years ending after November 15, 2006. The adoption of SAB 108 did not have a material impact on our financial position, results of operations or cash flows.

### Reclassifications

Certain reclassifications have been made to the 2005 and 2004 consolidated financial statements to conform to the 2006 presentation.

## 2. ACQUISITION AND DISPOSITION ACTIVITY

### Acquisition Activity

On October 11, 2005, we acquired a 168-unit Market-Rate property located in Atlanta, Georgia. The purchase was funded primarily by mortgage financing on the acquired property, by cash received from the disposition of a Market-Rate property on June 29, 2005, which had previously been placed in escrow in accordance with Section 1031 of the Internal Revenue Code, and cash previously received through the March 15, 2005 issuance of trust preferred securities. See Note 6 for further information on the trust preferred securities.

On March 9, 2005, we acquired a 316-unit Market-Rate property located in West Palm Beach, Florida. The purchase was funded primarily by mortgage financing on the acquired property and on a previously unencumbered Market-Rate property. See Note 6 for further information concerning these mortgage notes. Additionally, this property was part of a reverse Like-Kind Exchange under Section 1031 of the Internal Revenue Code.

On July 16, 2004, we acquired our joint venture partner's interest in Courtney Chase Apartments, a Market-Rate property located in Orlando, Florida. We previously had a 24.0% ownership interest in this partnership and had accounted for this investment under the equity method of accounting. We paid \$7.9 million in cash and assumed the existing debt on the property of \$15.6 million. Funding for this acquisition was derived from net proceeds received from the sale of a Market-Rate property located in Northeast Ohio. Consequently, commencing July 16, 2004, the results of operations, financial condition and cash flows of this property are included in our consolidated financial statements.

### Disposition Activity

We report the results of operations and gain/loss related to the sale of real estate assets as discontinued operations in accordance with SFAS 144, "Accounting for the Impairment or Disposal of Long-Lived Assets." Real estate assets that are classified as held for sale are also reported as discontinued operations. We generally classify properties as held for sale when all significant contingencies surrounding the closing have been resolved. In many transactions, these contingencies are not satisfied until the actual closing of the transaction. Interest expense included in discontinued operations is limited to interest and related prepayment costs on mortgage debt specifically associated with properties sold or classified as held for sale.

During 2006, we completed the sale of eight properties containing a total of 2,040 units for a total sales price of \$92.5 million. Seven of these properties were located in Ohio (six Market-rate properties and one Affordable Housing property) and one was a Market-Rate property located in North Carolina. We recognized total gains of \$54.1 million related to these sales, which are included in "Income from discontinued operations".

Additionally, we classified one property as held for sale at December 31, 2006. We tested this property for impairment under SFAS 144 and determined that it was not impaired. The major classes of assets and liabilities related to this property have been reclassified as such in the accompanying Consolidated Balance Sheet at December 31, 2006.

During 2005, we completed the sale of three Market-Rate properties containing a total of 943 units for a total sales price of \$108.5 million. One of these properties was located in Cleveland, Ohio, one was located in Orlando, Florida, and one was located in Phoenix, Arizona. We recognized total gains of \$48.5 million related to these sales, which are included in "Income from discontinued operations".

During 2004, we completed the sale of one Market-Rate property containing 459 units with a sales price of \$10.0 million. We recognized a gain of \$9.7 million related to this sale, which is included in "Income from discontinued operations".

The following chart summarizes the "Income from discontinued operations" for the years ended December 31, 2006, 2005, and 2004, respectively:

	<u>2006</u>	<u>2005</u>	<u>2004</u>
(In thousands)			
Property revenue	\$ 10,239	\$ 22,723	\$ 25,532
Property operating and maintenance expense	(7,046)	(13,175)	(14,239)
Real estate asset depreciation and amortization	(1,872)	(4,158)	(5,710)
Interest income	16	8	5

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Interest expense <sup>(1)</sup>	(3,831)	(3,079)	(3,488)
Operating (loss) income	(2,494)	2,319	2,100
Gain on disposition of properties	54,093	48,536	9,682
<b>Income from discontinued operations</b>	<b>\$ 51,599</b>	<b>\$ 50,855</b>	<b>\$ 11,782</b>

(1) Includes \$2.8 million of defeasance/prepayment costs associated with the prepayment of four mortgage loans in 2006.

### 3. RESTRICTED CASH

Restricted cash, some of which is required by HUD for certain government subsidized properties and some of which is required by our lenders, includes residents' security deposits, reserve funds for replacements and other escrows held for the future payment of real estate taxes and insurance. The reserve funds for replacements are intended to provide cash to defray future costs that may be incurred to maintain the associated property. In addition, certain escrows are maintained in connection with mortgage servicing operations.

Restricted cash is comprised of the following:

	December 31,	
	2006	2005
(In thousands)		
Resident security deposits	\$ 1,423	\$ 1,462
Investor's escrow	86	175
Escrows and reserve funds for replacements required by mortgages	5,770	6,860
	\$ 7,279	\$ 8,497

Restricted resident security deposits are held in separate bank accounts in the name of the properties for which the funds are being held. Investor's escrow represent funds held primarily for the payment of operating expenses associated with properties we manage on behalf of our advisory clients. These funds are held in short term investments. Certain reserve funds for replacements are invested in a combination of money market funds and U.S. treasury bills with maturities less than 18 months.

### 4. GOODWILL AND OTHER ASSETS

**Goodwill**

*MIG Realty Advisors, Inc.* In June 1998, we recorded goodwill in connection with the MIG Realty Advisors, Inc. merger. The goodwill was allocated fully to the Management and Service Operations Segment.

We completed our annual review of goodwill during 2006. In performing this analysis, we use a multiple of revenues to the range of potential alternatives and assign a probability to the various alternatives we consider. Based on this analysis, we determined that goodwill was not impaired as of December 31, 2006 and 2005. Should the estimates used to determine alternatives or the probabilities of the occurrence thereof change, an impairment may result which could materially impact our results of operations for the period in which it is recorded.

**Other Assets, Net**

Other assets, net, consist of the following:

(In thousands)	December 31,	
	<u>2006</u>	<u>2005</u>
Intangible assets	\$ 1,945	\$ 1,945
Deferred financing and leasing costs	8,112	10,194
Less: Accumulated amortization	<u>(5,976)</u>	<u>(6,688)</u>
	4,081	5,451
Prepaid expenses	4,712	4,717
Other assets	<u>362</u>	<u>416</u>
	\$ 9,155	\$ 10,584

**Intangible assets**

*Property Acquisitions.* In accordance with SFAS 141, "Business Combinations", we allocate a portion of the total purchase price of a property acquisition to any intangible assets identified, such as existing leases and tenant relationships. The intangible assets are amortized over the remaining lease terms or estimated life of the tenant relationship, which is approximately twelve to sixteen months. Due to the short term nature of residential leases, we believe that existing lease rates approximate market rates, and therefore, no allocation is made for above/below market leases.

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In connection with the October 2005 property acquisition discussed in Note 2, we recorded intangible assets in the amount of \$540,000 related to existing leases, which had been amortized over twelve months, and \$148,000 related to tenant relationships, which are being amortized over sixteen months. These intangible assets have been fully allocated to the Acquisition/Disposition segment.

In connection with the March 2005 property acquisition discussed in Note 2, we recorded intangible assets in the amount of \$975,000 related to existing leases, which had been amortized over thirteen months, and \$282,000 related to tenant relationships, which had been amortized over sixteen months. These intangible assets were fully allocated to the Acquisition/Disposition segment.

In connection with the July 2004 property acquisition discussed in Note 2, we recorded intangible assets in the amount of \$539,000 related to existing leases, which had been amortized over thirteen months, and \$142,000 related to tenant relationships, which had been amortized over sixteen months. These intangible assets were allocated to the Acquisition/Disposition segment.

Information on the intangible assets at December 31, 2006 is as follows:

(In thousands)	In Place	Tenant
	<u>Leases</u>	<u>Relationships</u>
Gross carrying amount	\$ 1,515	\$ 430
Less: Accumulated amortization	(1,515)	(421)
Balance as of December 31, 2006	\$ -	\$ 9

The aggregate amortization expense for the years ended December 31, 2006, 2005 and 2004 was \$847,000, \$1.5 million and \$434,000, respectively. The estimated amortization expense related to intangible assets existing at December 31, 2006, is \$9,000 for the twelve months ended December 31, 2007.

### Deferred financing and leasing costs

Amortization expense for deferred financing and leasing costs, including amortization classified in income from discontinued operations, was \$1.0 million, \$1.2 million, and \$1.1 million for the years ended December 31, 2006, 2005 and 2004, respectively.

### 5. GAIN ON DISPOSITION OF INVESTMENT



During the year ended December 31, 2005, a property in which we had a \$5,000 limited partnership interest was sold. We recorded a net gain of \$150,000 related to this sale in "Gain on disposition of investment". We had previously recorded the investment at cost in "Other assets" in the Consolidated Balance Sheets.

## 6. DEBT

Our debt at December 31, 2006 and 2005, consists of the following:

(In thousands)	December 31,	
	2006	2005
Conventional mortgage debt, maturing at various dates to 2012	\$ 340,645	\$ 546,486
Other mortgage debt, maturing 2013	132,209	-
Federally insured mortgage debt	-	1,304
Unsecured debt, maturing 2035	25,780	25,780
	\$ 498,634	\$ 573,570
Weighted average interest rate - fixed rate debt	7.3%	7.7%
Weighted average interest rate - variable rate debt	6.6%	5.9%

Real estate assets pledged as collateral for all debt had a net book value of \$439.2 million and \$603.6 at December 31, 2006 and 2005, respectively.

As of December 31, 2006, the scheduled debt maturities for each of the next five years and thereafter, are as follows (in thousands):

2007	\$ 53,469
2008	36,186
2009	54,167
2010	76,590

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2011	72,515
Thereafter	205,707
	\$ 498,634

Cash paid for interest was \$54.6 million, \$41.9 million, and \$39.2 million for the years ended December 31, 2006, 2005 and 2004, respectively. Included in the cash paid for interest of \$54.6 million during 2006 is \$14.4 million of defeasance and other prepayment costs.

### Conventional Mortgage Debt

During 2006, we prepaid a total of 18 conventional mortgage loans totaling \$200.6 million. Of these 18 loans, ten fixed rate loans were prepaid with the proceeds received from property sales, and five fixed rate loans and three variable rate loans were prepaid with the proceeds of a \$132.2 million mortgage refinancing involving five properties. The new loans are structured as five separate loans; however each loan is cross-collateralized, cross-defaulted, and includes a collateral substitution feature. These loans mature in October 2013 and accrue interest at a fixed rate of 6.09%. The fifteen fixed rate loans that were prepaid totaled \$146.0 million and had a weighted average interest rate of 7.6%. In relation to the loan defeasances/prepayments, we recognized in interest expense defeasement/prepayment costs totaling \$15.5 million, of which \$14.4 million were paid during 2006 and \$1.1 million were deferred financing costs that had been charged to expense. A total of \$12.7 million of these costs were included in "Income from continuing operations", and \$2.8 million were included in "Income from discontinued operations".

During 2005, we repaid a total of \$49.9 million of mortgage loans upon maturity, we prepaid a total of \$21.4 million mortgage loans, and a \$10.1 million mortgage loan was assumed by the buyer of the Market-Rate property that secured the loan. We recorded a discount of \$330,000 as a reduction to interest expense in relation to the prepayment of a \$5.3 million, zero percent Urban Development Action Grant loan.

Conventional mortgages payable are comprised of 36 loans at December 31, 2006 and 54 loans at December 31, 2005, each of which is a project specific loan collateralized by the respective real estate and resident leases. Mortgages payable are generally due in monthly installments of principal and/or interest and mature at various dates through June 2012. Under certain of the mortgage agreements, we are required to make escrow deposits for taxes, insurance and replacement of project assets.

### Other Mortgage Debt

Other mortgages payable are comprised of 5 loans at December 31, 2006 that are cross-collateralized, cross-defaulted, and include a collateral substitution feature. These loans are payable in monthly payments of interest only and mature in October 2013.

### **Federally Insured Mortgage Debt**

During 2006, we prepaid the \$1.2 million federally insured mortgage which previously encumbered one of our properties with the proceeds from the sale of this property. This loan was insured by HUD pursuant to one of the mortgage insurance programs administered under the National Housing Act of 1934.

### **Line of Credit**

We have a \$14.0 million line of credit that is available for regular borrowings and letter of credit transactions. This line of credit is secured by one of our properties. There were no regular borrowings outstanding under this line at December 31, 2006 and 2005. At December 31, 2006, a letter of credit in the amount of \$63,000 had been issued against this line. In November 2005, we completed an agreement that reduced the interest rate on this line to LIBOR plus 1.8% or the one month reference rate from LIBOR plus 2.0% or the prime rate and extended the maturity date for two years to December 2007.

We have a \$17.0 million secured line of credit that is available for regular borrowings which is secured by one of our properties. This line was unavailable at December 31, 2005, because the property securing that credit line had been sold. In February 2006, we identified a replacement property to serve as security for this credit line and amended the loan terms by increasing the credit line to \$17.0 million from \$15.0 million with interest calculated at LIBOR plus 1.5%. This line matures March 1, 2008. Borrowings under the line may be restricted based upon the operating performance of the property. There were no borrowings outstanding under this line at December 31, 2006 and 2005.

### **Unsecured Debt**

On March 15, 2005, AERC Delaware Trust (the "Trust"), a newly formed wholly owned subsidiary, sold trust preferred securities for an aggregate amount of \$25.8 million. Associated Estates Realty Corporation ("AERC") owns all of the common securities of the Trust. The Trust used the proceeds to purchase AERC's junior subordinated note due March 30, 2035, which represents all of the Trust's assets. The terms of the trust preferred securities are substantially the same as the terms of the junior subordinated note. Interest on the junior subordinate note is payable at a fixed rate equal to 7.9% per annum through the interest rate payment date in March 2015 and thereafter at a variable rate equal to LIBOR plus 3.25% per annum. AERC may redeem the junior subordinated note at par at any time on and after March 30, 2010. To the extent that AERC redeems the junior subordinated note, the Trust is required to redeem a corresponding amount of trust preferred securities.

**7. INVESTMENTS IN AND ADVANCES TO JOINT VENTURES**

At December 31, 2006, our interests in joint venture properties were as follows:

	<u>Ownership</u>
Lakeshore Village	50.0%
Idlewylde	49.0%

The following tables represent summarized financial information at 100% for all joint ventures in which we have been an investor during the years presented.

<b>Balance sheet data</b>	December 31,	
	<u>2006</u>	<u>2005</u>
(In thousands)		
Real estate, net	\$ 51,865	\$ 54,057
Other assets	<u>3,446</u>	<u>2,249</u>
	\$ 55,311	\$ 56,306
Amounts payable to us	\$ 11	\$ 69
Mortgages payable	46,149	46,173
Other liabilities	1,059	902
Equity	<u>8,092</u>	<u>9,162</u>
	\$ 55,311	\$ 56,306
Investments in joint ventures, net	\$ 5,247	\$ 5,890

<b>Operating data</b>	For the year ended December 31,		
	<u>2006</u>	<u>2005</u>	<u>2004</u>
(In thousands)			
Property revenue	\$ 8,602	\$ 7,685	\$ 9,059
Operating and maintenance expenses	(4,353)	(4,261)	(5,257)
Depreciation and amortization	(2,329)	(2,314)	(2,776)
Interest expense	<u>(2,784)</u>	<u>(2,346)</u>	<u>(2,866)</u>
(Loss) income from continuing operations	(864)	(1,236)	(1,840)
Income from discontinued operations:			
Operating income	-	-	46

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Gain on disposition of property	-	-	-
Income from discontinued operations	-	-	46
Net (loss) income	\$ (864)	\$ (1,236)	\$ (1,794)
Equity in net loss of joint ventures	\$ (462)	\$ (644)	\$ (923)

Of the \$46.1 million of mortgages payable at December 31, 2006, \$42.0 million matures in 2010 and \$4.1 million matures in 2031.

On July 16, 2004, we acquired our joint venture partner's interest in Courtney Chase Apartments, a 288-unit Market-Rate multifamily community located in Orlando, Florida. We previously had a 24.0% ownership interest in this partnership and had accounted for this investment under the equity method of accounting. We paid \$7.9 million in cash and assumed the existing debt on the property of \$15.6 million. Consequently, commencing July 16, 2004, the results of operations, financial condition and cash flows of this property are included in our consolidated financial statements.

We received distributions of \$318,000 and \$418,000 for the twelve months ended December 31, 2006 and 2004, respectively. There were no distributions received during 2005. Revenue from property and asset management fees charged to joint ventures aggregated \$281,000, \$245,000, and \$334,000 for the years ended December 31, 2006, 2005, and 2004, respectively. The corresponding expenses are included in the operating and maintenance expenses of the joint ventures, as set forth above.

We capitalize interest costs in accordance with SFAS No. 58 "Capitalization of Interest Cost in Financial Statements That Include Investments Accounted for by the Equity Method" related to our investment in certain joint venture properties during their construction period. The remaining amount of capitalized interest was \$874,000 and \$908,000 at December 31, 2006 and December 31, 2005, respectively. This excess investment over equity in the underlying net assets of the joint ventures is included in "Investment in joint ventures, net" in the Consolidated Balance Sheets, and is amortized as a reduction to earnings on a straight-line basis over the lives of the related assets.

Lakeshore Village is governed by regulations pursuant to the property's HUD rent subsidy and mortgage insurance programs, which contain provisions governing certain aspects of the operations of the property (See Note 10). Rent subsidies of \$585,000, \$581,000 and \$597,000 for the years ended December 31, 2006, 2005 and 2004, respectively, were received by the property.

## 8. TRANSACTIONS WITH AFFILIATES AND JOINT VENTURES

We provide management and other services to (and are reimbursed for certain expenses incurred on behalf of) certain non-owned properties in which our Chief Executive Officer ("CEO") and/or other related parties have varying ownership interests. The entities which own these properties, as well as other related parties, are referred to as "affiliates". We also provide similar services to joint venture properties.

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Accounts and notes receivable from affiliates and joint ventures primarily consists of funds advanced, property management fees and other miscellaneous receivables.

In the normal course of business, we have advanced funds on behalf of affiliates and joint ventures and held funds for the benefit of affiliates and joint ventures.

We held two notes of equal amounts payable by our CEO aggregating \$3.4 million, both of which were to mature May 1, 2005. These notes were paid in full on April 25, 2005. For the years ended December 2005 and 2004, the interest rate charged on these notes was approximately 3.1% and 3.3%, respectively.

Merit Painting Services ("Merit"), a subsidiary of ours, has provided services to JAS Construction, Inc. ("JAS") related to property rehabilitation and other work from time to time. JAS is owned by a son of our CEO. Reported revenue related to work performed by Merit for JAS is included in the table below. Accounts receivable from affiliates and joint ventures related to JAS at December 31, 2006 and 2005 respectively were \$33,000 and \$392,000.

Summarized affiliate and joint venture transaction activity was as follows:

(In thousands)	For the year ended December 31,		
	<u>2006</u>	<u>2005</u>	<u>2004</u>
Property management fee and other			
miscellaneous service revenue	\$ 587	\$ 892	\$ 918
Painting service revenue related to JAS Construction	265	368	5,512
Other affiliate and joint venture painting service revenue	11	82	88
Expenses incurred on behalf of and reimbursed by <sup>(1)</sup>	1,055	1,204	1,407
Interest income on Notes due from CEO	-	47	111

(1) Primarily payroll and employee benefits, reimbursed at cost.

**9. NOTEHOLDER INTEREST**

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On May 15, 2006, we completed the sale of a Market-Rate property located in Northeast Ohio. The sale price was a net \$28.4 million and we recorded a gain of \$23.4 million. In connection with our IPO in 1993, we acquired a Noteholder Interest which was secured by a limited partnership interest in one-half of this property. We had declared the notes to be in default because of nonpayment of interest and principal. On July 16, 2004, we accepted a 98.999% limited partnership interest in the limited partnership that owned the property in full satisfaction of all obligations under the notes. In addition, one of our subsidiaries acquired the remaining 1.001% general partnership interest in that limited partnership held by our President and CEO Jeffrey I. Friedman and a company controlled by him. The subsidiary acquired such partnership interest in return for a promise to pay Mr. Friedman and his controlled company 1.001% of the net sale proceeds derived from any future sale of the property. Pursuant to the terms of the buyout, Mr. Friedman and his controlled company were paid a total of \$127,000 from the proceeds of this sale. The independent members of the Board of Directors approved the terms of the buyout.

### 10. COMMITMENTS AND CONTINGENCIES

#### *Leases*

At December 31, 2006, we had no equipment leased under capital leases and at December 31, 2005, we had an immaterial amount of equipment leased under capital leases, which were included in property, plant and equipment. We lease certain equipment and facilities under operating leases. Future minimum lease payments under all noncancellable operating leases in which we are the lessee, principally for ground leases, for each of the next five years and thereafter, are as follows (in thousands):

	<u>Operating leases</u>
2007	\$ 177
2008	136
2009	66
2010	65
2011	53
Thereafter	<u>612</u>
	\$ 1,109

The ground lease agreements contain provisions which, upon expiration of the lease, require reversion of the land and building to the lessor. Such provisions exist for seven properties at December 31, 2006 and expire at various dates from 2021 to 2036. In September 2006, we sold one property that was subject to a ground lease expiring in 2021. Total revenue derived from such properties were \$6.4 million, \$8.8 million and \$10.3 million for the years ended December 31, 2006, 2005 and 2004, respectively. Furthermore, at the end of the term of each lease, any remaining replacement reserves revert to the lessor. Such cash reserves included in restricted cash were \$565,000 and \$773,000 at December 31, 2006, and 2005, respectively. With respect to such leases, we incurred ground rent expense of \$50,000, \$85,000 and \$101,000 for the years ended December 31, 2006, 2005 and 2004, respectively.

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We own one property which is subject to a right of reverter. This provision requires that the land and real estate assets revert at expiration back to the original grantor from whom we acquired this property or its successors and assignees, which is in September 2037. The net book value of this property was \$774,000 at December 31, 2006. This property generated revenue and net income of \$997,000 and \$318,000 for 2006, \$939,000 and \$344,000 for 2005, \$988,000 and \$377,000 for 2004.

### ***Affordable Housing***

Certain of our Affordable Housing properties are governed by rent subsidies which contain provisions governing certain aspects of the operations of these properties. Among other matters, such provisions may include a requirement to maintain a reserve fund for replacements, the renting of properties to qualifying residents, and the requirement to make distributions in accordance with certain regulations. Certain approvals may be required to encumber properties having rental subsidies.

The rent subsidy program provides that HUD will make monthly housing assistance payments to our subsidiary on behalf of persons who reside in approved properties and who meet the eligibility criteria. The amount of the total monthly rental and the subsidy is determined at least annually by HUD. This arrangement is evidenced by a contract between HUD and the applicable subsidiary. Such contracts have scheduled expiration dates between June 2007 and November 2019 for the properties that we own. HUD may abate subsidy payments if the applicable subsidiary defaults on any obligations under such contracts and fails to cure each default after receiving notice thereof. Federal rent subsidies recognized in income were \$6.0 million, \$6.5 million and \$6.5 million for the years ended December 31, 2006, 2005 and 2004, respectively.

### ***Legal Proceedings***

We are subject to legal proceedings, lawsuits and other claims, including proceedings by government authorities (collectively "Litigation"). Litigation is subject to uncertainties and outcomes are difficult to predict. Consequently, we are unable to estimate ultimate aggregate monetary liability or financial impact with respect to the Litigation matters described in the following paragraphs as of December 31, 2006, and no accruals have been made for these matters other than those identified in the following paragraphs. We believe that other Litigation will not have a material adverse impact on us after final disposition. However, because of the uncertainties of litigation, one or more lawsuits could ultimately result in a material obligation.

### ***Pending Lawsuits***

On or about April 14, 2002, Melanie and Kyle Kopp commenced an action against us in the Franklin County, Ohio Court of Common Pleas seeking undetermined damages, injunctive relief and class action certification. This case arose out of our Suredeposit program. This program allows cash short prospective residents to purchase a bond in lieu of paying a security deposit. The bond serves as a fund to pay those resident obligations that would otherwise have been funded by the security deposit.



Plaintiffs allege that the non-refundable premium paid for the bond is a disguised form of security deposit, which is otherwise required to be refundable in accordance with Ohio's Landlord-Tenant Act. Plaintiffs further allege that certain pet deposits and other nonrefundable deposits required by us are similarly security deposits that must be refundable in accordance with Ohio's Landlord-Tenant Act. On or about January 15, 2004, the plaintiffs filed a motion for class certification. We subsequently filed a motion for summary judgment. Both motions are pending before the Court. We intend to vigorously defend ourselves against these claims.

### ***Government Investigations***

On or about August 7, 2002, the Maryland Attorney General served us with a subpoena seeking information concerning certain of our leasing practices in connection with our Maryland properties. The subpoena sought extensive information going back a number of years, including information about our Suredeposit programs and certain non-refundable deposits. The Maryland Attorney General completed its review of the information we furnished and based upon that information contends that certain of our leasing practices are in violation of Maryland's landlord tenant laws. We have reached an out of court settlement with the Maryland Attorney General for the purpose of resolving this matter and we have recorded an estimated loss contingency for that purpose, which is included in "Accounts payable, accrued expenses and other liabilities" in the Consolidated Balance Sheets and "General and administrative expense" in the Consolidated Statements of Operations.

On or about December 22, 2003, the Montgomery County, Maryland Office of Landlord Tenant Affairs commenced an investigation into possible violations of state and county Landlord-Tenant laws involving two properties operated by us located in Montgomery County, Maryland. The matters that were the subject of this investigation were for the most part the same leasing practices being investigated by the Maryland Attorney General. Although these Montgomery County charges were never formally withdrawn, we believe that Montgomery County will not pursue these matters based upon our settlement with the Maryland Attorney General.

Montgomery County recently commenced additional investigations concerning the charging of trash fees. We have reached an out of court settlement with Montgomery concerning this matter and we have recorded an estimated loss contingency for that purpose which is included in "Accounts payable, accrued expenses and other liabilities" in the Consolidated Balance Sheets and "General and administrative expense" in the Consolidated Statements of Operations.

## **11. GUARANTEES**

We are a 49.0% partner in the joint venture partnership that owns Idlewylde Apartments, an 843-unit multifamily community, located in Atlanta, Georgia. In connection with the \$42.0 million mortgage loan encumbering this property, we have guaranteed certain obligations of the partnership including environmental indemnification obligations and typical non-recourse carveouts. Although we have not recorded a liability for a potential loss, we are required by GAAP to estimate the fair value of this guaranty. We have estimated the fair value of the guaranty to be \$290,000, and this amount is included as an asset in "Investments in joint ventures, net" and as a liability in "Accounts payable, accrued expenses and other liabilities" in the accompanying Consolidated Balance Sheets. In addition, we routinely guaranty mortgage debt of our wholly owned subsidiaries. In the normal course of business, we may enter into contractual arrangements under which we may agree to indemnify the third party to such arrangement from any losses incurred relating to the services they perform on behalf of AERC or for losses

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arising from certain events as defined within the particular contract, which may include, for example, litigation or claims relating to past performance. Such indemnification obligations may not be subject to maximum loss clauses. Historically, payments made related to these indemnifications have not been material.

### 12. DISCLOSURE ABOUT FAIR VALUE OF FINANCIAL INSTRUMENTS

In the following disclosures, we determined estimated fair value by using available market information and appropriate valuation methodologies. Considerable judgment is necessary to interpret market data and develop estimated fair values. Accordingly, the estimates presented herein are not necessarily indicative of the amounts we could realize on disposition of the financial instruments. The use of different market assumptions and/or estimation methodologies may have a material effect on the estimated fair value amounts.

Rents, accounts and notes receivable, accounts payable, accrued expenses and other liabilities are carried at amounts that reasonably approximate corresponding fair values.

Mortgages and notes payable with an aggregate carrying value of \$498.6 million and \$573.6 million at December 31, 2006 and 2005, respectively, have an estimated aggregate fair value of approximately \$540.9 million and \$597.1 million, respectively. Estimated fair value is based on interest rates currently available to us for issuance of debt with similar terms and remaining maturities.

We may, from time to time, enter into interest rate agreements to manage interest costs and risks associated with changing rates. We do not utilize these agreements for trading or speculative purposes. See "Derivative instruments and hedging activities" in Note 1 for further information.

Disclosure about the fair value of financial instruments is based on pertinent information available to us as of December 31, 2006 and 2005. Although we are not aware of any factors that would significantly affect the fair value amounts, such amounts have not been comprehensively revalued for purposes of these consolidated financial statements since these dates and current estimates of fair value may differ significantly from the amounts presented herein.

### 13. SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION

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The following summarizes our non-cash investing and financing activities which are not reflected in the Consolidated Statements of Cash Flows:

(In thousands)	For the year ended		
	December 31,		
	2006	2005	2004
Dividends declared but not paid	\$ 2,934	\$ 3,052	\$ 3,661
Assumption of debt by purchaser of property	-	10,065	-
Assumption of debt in connection with operating property acquisition	-	-	15,619
Reclassification of original issuance costs related to redemption of preferred shares	-	2,163	-
Fixed asset replacement and other write-offs	2,842	2,435	4,757
Net change in accounts payable related to recurring fixed asset additions	859	-	-
Fixed asset adjustment for purchase of minority interest	137	-	-
Final fixed asset adjustment related to 2002 non-monetary joint venture exchange	506	-	-

**14. COMMON, TREASURY AND PREFERRED SHARES**

***Treasury Shares***

On July 27, 2005, our Board of Directors ("Board") authorized the repurchase of up to \$50.0 million of our common shares. On October 20, 2006, our Board expanded this authorization to include the repurchase of our Class B Series II Preferred Shares. As of December 31, 2006, we had repurchased 2,803,925 common shares under this plan at a cost of \$27.6 million and no preferred shares.

During the twelve months ended December 31, 2006, a total of 39,795 restricted shares had vested and were issued from treasury shares. Effective January 1, 2006, we adopted SFAS 123(R). This Statement requires that restricted shares are recorded as issued shares when they become vested. In accordance with previous guidance under GAAP, we had recorded restricted shares as issued shares when they were initially granted. As a result of the adoption of this Statement, the 144,582 restricted shares which were nonvested at January 1, 2006, were recorded as though they were returned to treasury. See Note 17 for additional information related to the adoption of SFAS 123(R).

***Preferred Shares***

We are authorized to issue a total of 9,000,000 Preferred Shares, designated as follows:

- 3,000,000 Class A Cumulative Preferred Shares, of which 225,000 have been designated as 9.75% Class A Cumulative Redeemable Preferred Shares and are discussed below.

3,000,000 Class B Cumulative Preferred Shares, of which 400,000 have been designated as Class B Series I Cumulative Preferred Shares and 232,000 have been designated as 8.7% Class B Series II Cumulative Redeemable Preferred Shares and are discussed below.

3,000,000 Noncumulative Preferred Shares.

*8.7% Class B Series II Cumulative Redeemable Preferred Shares.* In December 2004, we issued 2,320,000 depositary shares, each representing 1/10th of a share of our 8.7% Class B Series II Cumulative Redeemable Preferred Shares, for \$58.0 million and incurred costs of approximately \$1.2 million related to the issuance. The liquidation preference for each Class B Preferred Share is \$250.00 (equivalent to \$25.00 per depositary share), plus accrued and unpaid dividends. Dividends on the Class B Preferred Shares are cumulative from the date of issue and are payable quarterly. Except in certain circumstances relating to the preservation of our status as a REIT, the Class B Preferred Shares are not redeemable prior to December 15, 2009. On and after December 15, 2009, the Class B Preferred Shares are redeemable for cash at our option. The net proceeds from this offering were used to redeem the outstanding 9.75% Class A Cumulative Redeemable Preferred Shares as discussed below.

*9.75% Class A Cumulative Redeemable Preferred Shares.* On January 6, 2005, we redeemed all of our outstanding 9.75% Class A Cumulative Redeemable Preferred Shares at a cost of \$56.6 million. In connection with the issuance of the 9.75% Class A Cumulative Redeemable Preferred Shares in July 1995, we incurred issuance costs of \$2.2 million which were recorded as a reduction in shareholders' equity. In accordance with GAAP, we recognized the \$2.2 million of issuance costs as a reduction in net earnings to arrive at net income applicable to common shares for the year ended December 31, 2005.

## **Shareholder Rights Plan**

In January 1999, we adopted a Shareholder Rights Plan. To implement the Plan, the Board of Directors declared a distribution of one Right for each of our outstanding common shares. Each Right entitles the holder to purchase from us 1/1,000th of a Class B Series I Cumulative Preferred Share (a "Preferred Share") at a purchase price of \$40 per Right, subject to adjustment. One one-thousandth of a Preferred Share is intended to be approximately the economic equivalent of one common share. The Rights will expire on January 6, 2009, unless redeemed by us as described below.

The Rights are not currently exercisable and are traded with our common shares. The Rights will become exercisable if a person or group becomes the beneficial owner of, or announces an offer to acquire 15.0% or more of the then outstanding common shares.

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If a person or group acquires 15.0% or more of our outstanding common shares, then each Right now owned by the acquiring person or its affiliates will entitle its holder to purchase, at the Right's then-current exercise price, fractional preferred shares that are approximately the economic equivalent of common shares (or, in certain circumstances, common shares, cash, property or other securities) having a market value equal to twice the then-current exercise price. In addition, if, after the Rights become exercisable, we are acquired in a merger or other business combination transaction with an acquiring person or its affiliates or sell 50.0% or more of its assets or earnings power to an acquiring person or its affiliates, each Right will entitle its holder to purchase, at the Right's then-current exercise price, a number of the acquiring common shares having a market value of twice the Right's exercise price. The Board of Directors may redeem the Rights, in whole, but not in part, at a price of \$.01 per Right.

The distribution was made on January 29, 1999 to shareholders of record on that date. The initial distribution of Rights was not taxable to shareholders.

### **15. EARNINGS PER SHARE**

Earnings per share ("EPS") has been computed pursuant to the provisions of SFAS No. 128.

There were 1.9 million, 2.0 million and 2.0 million options to purchase common shares outstanding at December 31, 2006, 2005 and 2004, respectively. None of the options were included in the calculation of diluted earnings per share for the years presented as their inclusion would be antidilutive to the net loss from continuing operations applicable to common shares.

The exchange of operating partnership minority interests into common shares was not included in the computation of diluted EPS because we plan to settle these OP units in cash.

### **16. EMPLOYEE BENEFIT PLANS**

We offer medical, dental and life insurance benefits to those employees who have completed their 90-day introductory period. Employees who have completed six months of service are eligible for educational assistance program and to participate in the 401(k) plan and employees who have completed one year of service are provided with long-term disability coverage. Additionally, we offer a variety of supplemental benefits to employees at their own cost.

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We sponsor a defined contribution plan pursuant to Section 401(k) of the Internal Revenue Code, whereby eligible employees may elect to contribute up to 25.0% of their gross wages. After one year of participation, we match such contributions at a rate of 25.0% up to a maximum participant contribution of 6.0%. We recorded expense in relation to this plan of approximately \$148,000, \$141,000, and \$132,000 for the years ended December 31, 2006, 2005 and 2004, respectively.

### Supplemental Executive Retirement Plan

Our Supplemental Executive Retirement Plan (the "SERP") was adopted by the Board of Directors on January 1, 1997. This Plan was implemented to provide competitive retirement benefits for officers and to act as a retention incentive. This non-qualified, unfunded, defined contribution plan extends to certain named officers nominated by the Chief Executive Officer and approved by the Executive Compensation Committee of the Board. The SERP provides for us to make a contribution to the account of each of the participating officers at the end of each plan year. The contribution, which is a percentage of eligible earnings (including base salary and payments under the Annual Incentive Plan), is set by the Committee at the beginning of each SERP year. Contributions will not be taxable to the participant (other than social security and federal unemployment taxes once vested) until distribution. The account balances earn interest each year at a rate determined by the Executive Compensation Committee of the Board. The Executive Compensation Committee approves the interest rate at the beginning of each year. The following table summarizes the changes in SERP balances for the twelve months ended December 31, 2006, 2005, and 2004:

(In thousands)	Supplemental Executive Retirement Plan Benefit		
	for the year ending December 31,		
	<u>2006</u>	<u>2005</u>	<u>2004</u>
Balance at beginning of period	\$ 1,035	\$ 933	\$ 778
Service cost	99	105	82
Forfeiture of prior period service cost	(52)	(74)	-
Interest cost	<u>82</u>	<u>71</u>	<u>73</u>
Balance at end of period	\$ 1,164	\$ 1,035	\$ 933

### 17. EQUITY BASED AWARD PLANS

#### AERC Share Option Plan

The AERC Share Option Plan expired September 30, 2003, and therefore no additional options will be granted under this plan. On December 31, 2006, there were 87,000 options outstanding and exercisable under this plan. These options will remain in effect according to the original terms and conditions of the plan. This plan was provided as an incentive and non-qualified stock option

plan under which 543,093 of our common shares had been reserved for awards of share options to eligible key employees. Options were granted at per share prices not less than fair market value at the date of grant and must be exercised within ten years thereof.

### **Equity-Based Incentive Compensation Plan**

The Equity-Based Incentive Compensation Plan ("the Omnibus Equity Plan") expired February 20, 2005, and therefore no additional shares/awards will be granted under this plan. On December 31, 2006, there were 743,500 shares outstanding and 581,501 shares exercisable under this plan. These awards will remain in effect according to the original terms and conditions of the plan. This plan provided key employees equity or equity based incentives under which 1.4 million of our common shares had been reserved for awards of share options and restricted shares. Options were granted at per share prices not less than fair market value at the date of grant and must be exercised within ten years thereof.

### **Year 2001 Equity Incentive Plan**

Our Year 2001 Equity Incentive Plan (the "EIP") was adopted by the Board on December 8, 2000. At our 2005 Annual Meeting of Shareholders held on May 4, 2005, our shareholders approved the Amended and Restated 2001 Equity-Based Award Plan (the "Plan"). The Plan was amended to (i) allow for the shares reserved for issuance to be listed on the New York Stock Exchange pursuant to the rules of the exchange, (ii) allow us to grant options that qualify as incentive stock options under the Internal Revenue Code of 1986, as amended, (iii) allow compensation attributable to equity based awards under the Plan to qualify as "performance-based compensation", as defined in the Internal Revenue Code, and (iv) increase the number of common shares available for awards by 750,000 common shares. The Plan provides for equity award grants to our officers, employees, and directors. Equity awards available under the Plan include stock options, share appreciation rights, restricted shares, deferred shares, and other awards based on common shares. The aggregate number of common shares subject to awards under the Plan was increased to 2,250,000 from 1,500,000. At December 31, 2006, there were 764,127 common shares available for awards under the amended and restated Plan and 1,045,364, shares outstanding under this plan, of which 786,271 were exercisable.

### **Options Granted to Outside Directors**

We have granted options to outside directors on a periodic basis since the initial public offering ("IPO"). The option awards are determined and approved by the Board of Directors. Option awards vested either one year from the date of grant or three years from the date of grant. At December 31, 2006, there were 45,000 options outstanding and exercisable that had been awarded to outside directors.

### **Share-Based Compensation**

Our share-based compensation awards consist primarily of restricted shares. We award share-based compensation to our officers and employees as a performance incentive and to align individual goals with those of the Company. We grant share-based awards that vest either at the end of a specified service period, or in equal increments during the service period on each anniversary of the grant date. In accordance with SFAS 123(R), we have elected to recognize compensation cost on these awards on a straight-line basis. In addition to awards containing only service conditions, we issue certain grants in which the number of shares that will ultimately vest and the date at which they will vest is dependant upon the achievement of specified performance goals. Compensation cost for awards with performance conditions is recognized based on our best estimate of the number of awards that will vest and the period of time in which they will vest.

During the twelve months ended December 31, 2006, we recognized total share-based compensation cost of \$928,000 in "General and administrative expense". Additionally, we allocated an immaterial amount of equity compensation expense to individual properties which is included in "Property operating and maintenance expense" in the Consolidated Statements of Operations.

*Stock Options.* We use the Black-Scholes option pricing model to estimate the fair value of share-based awards. The weighted average Black-Scholes assumptions and fair value for the twelve months ended December 31, 2006, 2005, and 2004 were as follows:

	For the twelve months		
	ended December 31,		
	<u>2006</u>	<u>2005</u>	<u>2004</u>
Expected volatility	27.7%	30.7%	29.2%
Risk-free interest rate	4.6%	4.1%	3.3%
Expected life of options (in years)	6.0	7.1	5.6
Dividend yield	6.0%	7.0%	7.6%
Grant-date fair value	\$ 1.85	\$ 1.50	\$ 1.13

The expected volatility was based upon the historical volatility of our weekly share closing prices over a period equal to the expected life of the options granted. The risk-free interest rate used was the yield from U.S. Treasury zero-coupon bonds on the date of grant with a maturity equal to the expected life of the options. We use the "simplified" method as allowed under the provisions of the Securities and Exchange Commission's Staff Accounting Bulletin No. 107 to derive the expected life of the options. The dividend yield was derived using our annual dividend rate as a percentage of the price of our shares on the date of grant.

The following table represents stock option activity for the twelve months ended December 31, 2006:

	Number of	Weighted-Average	Weighted-Average
	Stock Options	Exercise Price	Remaining Contract Life



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Outstanding at beginning of period	1,996,308	\$ 11.89	
Granted	237,155	\$ 11.30	
Exercised	236,599	\$ 8.61	
Forfeited	13,750	\$ 12.11	
Expired	62,250	\$ 16.36	
Outstanding at end of period	1,920,864	\$ 12.08	5.0 years
Exercisable at end of period	1,499,772	\$ 12.51	4.3 years

The aggregate intrinsic value of stock options outstanding and stock options exercisable at December 31, 2006, was \$6.7 million and \$5.3 million, respectively. The aggregate intrinsic value of stock options exercised during the twelve months ended December 31, 2006, 2005 and 2004 was \$1.5 million, \$98,000 and \$64,000, respectively. We generally issue shares from treasury upon the exercise of stock options.

*Restricted Shares.* Restricted shares generally have the same rights as our common shares, except for transfer restrictions and forfeiture provisions. Cash distributions paid during the period of restriction on shares that are expected to vest are recorded as a charge to "Accumulated distributions in excess of accumulated net income." Cash distributions paid during the period of restriction on shares that are expected to be forfeited are recorded as a charge to expense. Prior to January 1, 2006, restricted share awards were recorded in shareholders' equity as deferred compensation on the grant date based upon the price of our common shares on the grant date and amortized into expense over the requisite service period based on the straight line method. We generally issue restricted share awards from treasury shares. Upon adoption of SFAS 123(R), we returned the nonvested shares to treasury shares from unearned compensation at their original cost, totaling \$1.5 million. We recorded an immaterial cumulative effect of a change in accounting principle as a result of our change in policy from recognizing forfeitures as they occur to one where we recognize cost after the application of an estimated forfeiture rate. This amount was recorded in "General and administrative expense" in the Consolidated Statements of Operations. Accrued compensation cost of \$561,000 related to nonvested restricted shares at January 1, 2006 was transferred to additional paid in capital from deferred compensation.

The following table represents restricted share activity for the twelve months ended December 31, 2006:

	Number of <u>Shares</u>	Weighted Average <u>Grant-Date Fair Value</u>
Nonvested at beginning of period	144,582	\$ 8.96
Granted	76,940	\$ 11.64
Vested	39,795	\$ 8.36
Forfeited	10,218	\$ 9.71
Nonvested at end of period	171,509	\$ 10.26

The weighted average grant-date fair value of restricted shares granted during the twelve months ended December 31, 2006, 2005 and 2004 was \$11.64, \$9.72 and \$8.35, respectively. The total fair value of restricted shares vested during the twelve months ended December 31, 2006, 2005 and 2004 was \$482,000, \$139,000 and \$359,000, respectively. At December 31, 2006, there was \$589,000 of unrecognized compensation cost related to nonvested restricted share awards that we expect to recognize over a weighted average period of 1.8 years.

## **18. DIRECTOR/EXECUTIVE COMPENSATION**

### **Director's Deferred Compensation Plan**

The Directors' Deferred Compensation Plan was adopted by our Board of Directors on August 22, 1996. The Plan was implemented to allow persons serving as Independent Directors the option of deferring receipt of compensation otherwise payable to them for their services as Directors and to create an opportunity for appreciation of the amount deferred based upon appreciation of our Common Shares.

Prior to January 1 of each year, any eligible Director may elect to defer all or a portion of the fees otherwise payable to that Director for that year and such amount will be credited to a deferral account maintained on behalf of the Director. Fees for each period are credited to the deferral account as they are earned. Amounts credited to the deferral account are converted to "share units" which are valued based upon the closing price of our common shares at the end of each reporting period. Each deferral account is increased when we pay a dividend on our common shares by the number of share units that represent the dividend paid per share multiplied by the number of share units in the account on the date of record for the related dividend payment. At the end of each reporting period, the total value of the deferred compensation is adjusted for increases in share units and for changes in our common share price. The total amount of deferred compensation relating to this plan is included in "Accounts payable and accrued expenses" in the Consolidated Balance Sheets. Adjustments to the total value of the Plan are reflected in "General and administrative expenses" in the Consolidated Statements of Operations. Distributions of \$64,000 and \$66,000 were made from this account during 2006 and 2005, respectively. At December 31, 2006 and 2005, deferred Director compensation totaled \$1.4 million and \$763,000, respectively. The deferral account is vested at all times.

### **Executive Compensation and Employment Agreements**

We have a three year employment agreement with the Chairman, President and Chief Executive Officer dated January 1, 1996, that is automatically extended for an additional year at the end of each year of the agreement, subject to the right of either party to terminate by giving one year's prior written notice. Additionally, we have severance arrangements with certain other executive officers.

### **Annual Incentive Plan**

Annual incentives emphasize pay for performance and serve as a key means of driving current objectives and priorities. Officers are rewarded for accomplishing our short-term financial objectives. In 2006 and 2005, annual incentive opportunities for the officers were linked to Property Net Operating Income, as defined. Participants' awards are paid in a combination of cash and restricted shares. For 2006, the officers have earned an award of approximately \$1.1 and will be subject to Federal income tax on the same amount and in the same manner and at the same times as would have been the case if such deposit and defeasance had not occurred (and, in the case of legal defeasance only, such Opinion of Counsel must be based on a ruling of the Internal Revenue Service or other change in applicable Federal income tax law since the Issue Date).

### **Satisfaction and Discharge**

The Indenture will be discharged and cease to be of further effect (except as to surviving rights of registration of transfer or exchange of the Notes, as expressly provided for in the Indenture) as to all outstanding Notes when (i) either (a) all Notes previously authenticated and delivered (other than certain lost, stolen or destroyed Notes, and certain Notes for which provision for payment was previously made and thereafter the funds have been released to the Company) have been delivered to the Trustee for cancellation or (b) all Notes not previously delivered to the Trustee for cancellation (x) have become due and payable, (y) will become due and payable at their Stated Maturity within one year or (z) have been or are to be called for redemption within one year under arrangements reasonably satisfactory to the Trustee for the giving of notice of redemption by the Trustee in the name, and at the expense, of the Company; (ii) the Company has irrevocably deposited or caused to be deposited with the Trustee money, U.S. Government Obligations, or a combination thereof, sufficient (without reinvestment) to pay and discharge the entire indebtedness on the Notes not previously delivered to the Trustee for cancellation, for principal, premium, if any, and interest to the date of deposit; (iii) the Company has paid or caused to be paid all other sums payable under the Indenture by the Company; and (iv) the Company has delivered to the Trustee an Officer's Certificate and an Opinion of Counsel each to the effect that all conditions precedent under the Satisfaction and Discharge section of the Indenture relating to the satisfaction and discharge of the Indenture have been complied with, *provided* that any such counsel may rely on any Officer's Certificate as to matters of fact (including as to compliance with the foregoing clauses (i), (ii) and (iii)).

### **No Personal Liability of Directors, Officers, Employees, Incorporators and Stockholders**

No director, officer, employee, incorporator or stockholder of the Company, any Note Guarantor or any Subsidiary of any thereof shall have any liability for any obligation of the Company or any Note Guarantor under the Indenture, the Notes or any Note Guarantee, or for any claim based on, in respect of, or by reason of, any such obligation or its creation. Each Holder, by accepting the Notes, waives and releases all such liability. The waiver and release are part of the consideration for issuance of the Notes.

### **Concerning the Trustee**

U.S. Bank National Association will be the Trustee under the Indenture and will be appointed by the Company as Registrar and Paying Agent with regard to the Notes.

The Indenture will provide that, except during the continuance of an Event of Default, the Trustee will perform only such duties as are set forth specifically in the Indenture. During the existence of an Event of

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Default, the Trustee will exercise such of the rights and powers vested in it under the Indenture and use the same degree of care and skill in its exercise as a prudent person would exercise under the circumstances in the conduct of such person's own affairs.

The Indenture and the TIA will impose certain limitations on the rights of the Trustee, should it become a creditor of the Company, to obtain payment of claims in certain cases or to realize on certain property received by it in respect of any such claims, as security or otherwise. The Trustee will be permitted to engage in other transactions; *provided* that if it acquires any conflicting interest as described in the TIA, it must eliminate such conflict, apply to the SEC for permission to continue as Trustee with such conflict, or resign.

## **Transfer and Exchange**

A Holder may transfer or exchange Notes in accordance with the Indenture. Upon any transfer or exchange, the registrar and the Trustee may require such Holder, among other things, to furnish appropriate endorsements and transfer documents and the Company may require such Holder to pay any taxes or other governmental charges required by law or permitted by the Indenture. The Company is not required to transfer or exchange any Note selected for redemption or purchase or to transfer or exchange any Note for a period of 15 Business Days prior to the day of the mailing of the notice of redemption or purchase. The Notes will be issued in registered form and the registered holder of a Note will be treated as the owner of such Note for all purposes.

## **Governing Law**

The Indenture will provide that it and the Notes will be governed by, and construed in accordance with, the laws of the State of New York.

## **Certain Definitions**

*Acquired Indebtedness* means Indebtedness of a Person (i) existing at the time such Person becomes a Subsidiary or (ii) assumed in connection with the acquisition of assets from such Person, in each case other than Indebtedness Incurred in connection with, or in contemplation of, such Person becoming a Subsidiary or such acquisition. Acquired Indebtedness shall be deemed to be Incurred on the date of the related acquisition of assets from any Person or the date the acquired Person becomes a Subsidiary.

*Additional Assets* means (i) any property or assets that replace the property or assets that are the subject of an Asset Disposition; (ii) any property or assets (other than Indebtedness and Capital Stock) to be used by the Company or a Restricted Subsidiary in a Related Business; (iii) the Capital Stock of a Person that is engaged in a Related Business and becomes a Restricted Subsidiary as a result of the acquisition of such Capital Stock by the Company or another Restricted Subsidiary; or (iv) Capital Stock of any Person that at such time is a Restricted Subsidiary acquired from a third party.

*Affiliate* of any specified Person means any other Person, directly or indirectly, controlling or controlled by or under direct or indirect common control with such specified Person. For the purposes of this definition, control when used with respect to any Person means the power to direct the management and policies of such Person, directly or indirectly, whether through the ownership of voting securities, by contract or otherwise; and the terms controlling and controlled have meanings correlative to the foregoing.

*Asset Disposition* means any sale, lease, transfer or other disposition of shares of Capital Stock of a Restricted Subsidiary (other than directors' qualifying shares, or (in the case of a Foreign Subsidiary) to the extent required by applicable law), property or other assets (each referred to for the purposes of this definition as a disposition) by the

Company or any of its Restricted Subsidiaries (including any disposition by means of a merger, consolidation or similar transaction), other than (i) a disposition to the Company or a Restricted

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Subsidiary, (ii) a disposition in the ordinary course of business, (iii) the sale or discount (with or without recourse, and on customary or commercially reasonable terms) of accounts receivable or notes receivable arising in the ordinary course of business, or the conversion or exchange of accounts receivable for notes receivable, (iv) any Restricted Payment Transaction, (v) a disposition that is governed by the provisions described under Merger and Consolidation, (vi) any Financing Disposition, (vii) any fee in lieu or other disposition of assets to any governmental authority or agency that continue in use by the Company or any Restricted Subsidiary, so long as the Company or any Restricted Subsidiary may obtain title to such assets upon reasonable notice by paying a nominal fee, (viii) any exchange of like property pursuant to Section 1031 (or any successor section) of the Code, or any exchange of equipment to be used in a Related Business, (ix) any financing transaction with respect to property built or acquired by the Company or any Restricted Subsidiary after the Issue Date, including without limitation any sale/leaseback transaction or asset securitization, (x) any disposition arising from foreclosure, condemnation or similar action with respect to any property or other assets, (xi) any disposition of Capital Stock, Indebtedness or other securities of an Unrestricted Subsidiary, (xii) a disposition of Capital Stock of a Restricted Subsidiary pursuant to an agreement or other obligation with or to a Person (other than the Company or a Restricted Subsidiary) from whom such Restricted Subsidiary was acquired, or from whom such Restricted Subsidiary acquired its business and assets (having been newly formed in connection with such acquisition), entered into in connection with such acquisition, (xiii) a disposition of not more than 5% of the outstanding Capital Stock of a Foreign Subsidiary that has been approved by the Board of Directors, or (xiv) any disposition or series of related dispositions for aggregate consideration not to exceed \$5.0 million.

*Bank Indebtedness* means any and all amounts, whether outstanding on the Issue Date or thereafter incurred, payable under or in respect of any Credit Facility, including without limitation principal, premium (if any), interest (including interest accruing on or after the filing of any petition in bankruptcy or for reorganization relating to the Company or any Restricted Subsidiary whether or not a claim for post-filing interest is allowed in such proceedings), fees, charges, expenses, reimbursement obligations, guarantees, other monetary obligations of any nature and all other amounts payable thereunder or in respect thereof.

*Board of Directors* means the board of directors or other governing body of the Company or, if the Company is owned or managed by a single entity, the board of directors or other governing body of such entity, or, in either case, any committee thereof duly authorized to act on behalf of such board or governing body.

*Borrowing Base* means the sum (determined as of the end of the most recently ended fiscal quarter for which consolidated financial statements of the Company are available) of (1) 60% of Inventory of the Company and its Restricted Subsidiaries and (2) 85% of Receivables of the Company and its Restricted Subsidiaries.

*Business Day* means a day other than a Saturday, Sunday or other day on which commercial banking institutions are authorized or required by law to close in New York City.

*Capital Stock* of any Person means any and all shares of, rights to purchase, warrants or options for, or other equivalents of or interests in (however designated) equity of such Person, including any Preferred Stock, but excluding any debt securities convertible into such equity.

*Capitalized Lease Obligation* means an obligation that is required to be classified and accounted for as a capitalized lease for financial reporting purposes in accordance with GAAP. The Stated Maturity of any Capitalized Lease Obligation shall be the date of the last payment of rent or any other amount due under the related lease.

*Cash Equivalents* means any of the following: (a) securities issued or fully guaranteed or insured by the United States Government or any agency or instrumentality thereof, (b) time deposits, certificates of deposit or bankers' acceptances of (i) any lender under the Senior Credit Agreement or (ii) any commercial



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bank having capital and surplus in excess of \$500,000,000 and the commercial paper of the holding company of which is rated at least A-1 or the equivalent thereof by S&P or at least P-1 or the equivalent thereof by Moody's (or if at such time neither is issuing ratings, then a comparable rating of another nationally recognized rating agency), (c) commercial paper rated at least A-1 or the equivalent thereof by S&P or at least P-1 or the equivalent thereof by Moody's (or if at such time neither is issuing ratings, then a comparable rating of another nationally recognized rating agency), (d) investments in money market funds complying with the risk limiting conditions of Rule 2a-7 or any successor rule of the SEC under the Investment Company Act of 1940, as amended and (e) investments similar to any of the foregoing denominated in foreign currencies approved by the Board of Directors.

*CDR* means Clayton, Dubilier & Rice, Inc.

*CDR Fund V* means Clayton, Dubilier & Rice Fund V Limited Partnership, a Cayman Islands exempted limited partnership, and any successor in interest thereto.

*Code* means the Internal Revenue Code of 1986, as amended.

*Commodities Agreements* means, in respect of a Person, any commodity futures contract, forward contract, option or similar agreement or arrangement (including derivative agreements or arrangements), as to which such Person is a party or beneficiary.

*Company* means Graphic Packaging International, Inc., a Delaware corporation, and any successor in interest thereto.

*Consolidated Coverage Ratio* as of any date of determination means the ratio of (i) the aggregate amount of Consolidated EBITDA of the Company and its Restricted Subsidiaries for the period of the most recent four consecutive fiscal quarters ending prior to the date of such determination for which consolidated financial statements of the Company are available to (ii) Consolidated Interest Expense for such four fiscal quarters; *provided*, that

- (1) if since the beginning of such period the Company or any Restricted Subsidiary has Incurred any Indebtedness that remains outstanding on such date of determination or if the transaction giving rise to the need to calculate the Consolidated Coverage Ratio is an Incurrence of Indebtedness, Consolidated EBITDA and Consolidated Interest Expense for such period shall be calculated after giving effect on a pro forma basis to such Indebtedness as if such Indebtedness had been Incurred on the first day of such period (except that in making such computation, the amount of Indebtedness under any revolving credit facility outstanding on the date of such calculation shall be computed based on (A) the average daily balance of such Indebtedness during such four fiscal quarters or such shorter period for which such facility was outstanding or (B) if such facility was created after the end of such four fiscal quarters, the average daily balance of such Indebtedness during the period from the date of creation of such facility to the date of such calculation),
- (2) if since the beginning of such period the Company or any Restricted Subsidiary has repaid, repurchased, redeemed, defeased or otherwise acquired, retired or discharged any Indebtedness that is no longer outstanding on such date of determination (each, a Discharge) or if the transaction giving rise to the need to calculate the Consolidated Coverage Ratio involves a Discharge of Indebtedness (in each case other than Indebtedness Incurred under any revolving credit facility unless such Indebtedness has been permanently repaid), Consolidated EBITDA and Consolidated Interest Expense for such period shall be calculated after giving effect on a pro forma basis to such Discharge of such Indebtedness, including with the proceeds of such new Indebtedness, as if such Discharge had occurred on the first day of such period,





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- (3) if since the beginning of such period the Company or any Restricted Subsidiary shall have disposed of any company, any business or any group of assets constituting an operating unit of a business (any such disposition, a Sale ), the Consolidated EBITDA for such period shall be reduced by an amount equal to the Consolidated EBITDA (if positive) attributable to the assets that are the subject of such Sale for such period or increased by an amount equal to the Consolidated EBITDA (if negative) attributable thereto for such period and Consolidated Interest Expense for such period shall be reduced by an amount equal to (A) the Consolidated Interest Expense attributable to any Indebtedness of the Company or any Restricted Subsidiary repaid, repurchased, redeemed, defeased or otherwise acquired, retired or discharged with respect to the Company and its continuing Restricted Subsidiaries in connection with such Sale for such period (including but not limited to through the assumption of such Indebtedness by another Person) *plus* (B) if the Capital Stock of any Restricted Subsidiary is sold, the Consolidated Interest Expense for such period attributable to the Indebtedness of such Restricted Subsidiary to the extent the Company and its continuing Restricted Subsidiaries are no longer liable for such Indebtedness after such Sale,
- (4) if since the beginning of such period the Company or any Restricted Subsidiary (by merger, consolidation or otherwise) shall have made an Investment in any Person that thereby becomes a Restricted Subsidiary, or otherwise acquired any company, any business or any group of assets constituting an operating unit of a business, including any such Investment or acquisition occurring in connection with a transaction causing a calculation to be made hereunder (any such Investment or acquisition, a Purchase ), Consolidated EBITDA and Consolidated Interest Expense for such period shall be calculated after giving pro forma effect thereto (including the Incurrence of any related Indebtedness) as if such Purchase occurred on the first day of such period, and
- (5) if since the beginning of such period any Person who became a Restricted Subsidiary was merged or consolidated with or into the Company or any Restricted Subsidiary, and since the beginning of such period such Person shall have Discharged any Indebtedness or made any Sale or Purchase that would have required an adjustment pursuant to clause (2), (3) or (4) above if made by the Company or a Restricted Subsidiary during such period, Consolidated EBITDA and Consolidated Interest Expense for such period shall be calculated after giving pro forma effect thereto as if such Discharge, Sale or Purchase occurred on the first day of such period.

For purposes of this definition, whenever pro forma effect is to be given to any Sale, Purchase or other transaction, or the amount of income or earnings relating thereto and the amount of Consolidated Interest Expense associated with any Indebtedness Incurred or repaid, repurchased, redeemed, defeased or otherwise acquired, retired or discharged in connection therewith, the pro forma calculations in respect thereof (including without limitation in respect of anticipated cost savings or synergies relating to any such Sale, Purchase or other transaction) shall be as determined in good faith by a responsible financial or accounting Officer of the Company. If any Indebtedness bears a floating rate of interest and is being given pro forma effect, the interest expense on such Indebtedness shall be calculated as if the rate in effect on the date of determination had been the applicable rate for the entire period (taking into account any Interest Rate Agreement applicable to such Indebtedness). If any Indebtedness bears, at the option of the Company or a Restricted Subsidiary, a rate of interest based on a prime or similar rate, a eurocurrency interbank offered rate or other fixed or floating rate, and such Indebtedness is being given pro forma effect, the interest expense on such Indebtedness shall be calculated by applying such optional rate as the Company or such Restricted Subsidiary may designate. If any Indebtedness that is being given pro forma effect was Incurred under a revolving credit facility, the interest expense on such Indebtedness shall be computed based upon the average daily balance of such Indebtedness during the applicable period. Interest on a Capitalized Lease Obligation shall be deemed to accrue at an interest rate determined in good faith by a responsible financial or accounting officer of the Company to be the rate of interest implicit in such Capitalized Lease Obligation in accordance with GAAP.



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*Consolidated EBITDA* means, for any period, the Consolidated Net Income for such period, plus the following to the extent deducted in calculating such Consolidated Net Income: (i) provision for all taxes (whether or not paid, estimated or accrued) based on income, profits or capital, (ii) Consolidated Interest Expense and any Receivables Fees, (iii) depreciation, amortization (including but not limited to amortization of goodwill and intangibles and amortization and write-off of financing costs) and all other non-cash charges or non-cash losses, (iv) any expenses or charges related to any Equity Offering, Investment or Indebtedness permitted by the Indenture (whether or not consummated or incurred) and (v) the amount of any minority interest expense.

*Consolidated Interest Expense* means, for any period, (i) the total interest expense of the Company and its Restricted Subsidiaries to the extent deducted in calculating Consolidated Net Income, net of any interest income of the Company and its Restricted Subsidiaries, including without limitation any such interest expense consisting of (a) interest expense attributable to Capitalized Lease Obligations, (b) amortization of debt discount, (c) interest in respect of Indebtedness of any other Person that has been Guaranteed by the Company or any Restricted Subsidiary, but only to the extent that such interest is actually paid by the Company or any Restricted Subsidiary, (d) non-cash interest expense, (e) the interest portion of any deferred payment obligation and (f) commissions, discounts and other fees and charges owed with respect to letters of credit and bankers acceptance financing, plus (ii) Preferred Stock dividends paid in cash in respect of Disqualified Stock of the Company held by Persons other than the Company or a Restricted Subsidiary and minus (iii) to the extent otherwise included in such interest expense referred to in clause (i) above, Receivables Fees and amortization or write-off of financing costs, in each case under clauses (i) through (iii) as determined on a Consolidated basis in accordance with GAAP; *provided* that gross interest expense shall be determined after giving effect to any net payments made or received by the Company and its Restricted Subsidiaries with respect to Interest Rate Agreements.

*Consolidated Net Income* means, for any period, the net income (loss) of the Company and its Restricted Subsidiaries, determined on a consolidated basis in accordance with GAAP and before any reduction in respect of Preferred Stock dividends; *provided* that there shall not be included in such Consolidated Net Income:

- (i) any net income (loss) of any Person if such Person is not a Restricted Subsidiary, except that (A) subject to the limitations contained in clause (iii) below, the Company's equity in the net income of any such Person for such period shall be included in such Consolidated Net Income up to the aggregate amount actually distributed by such Person during such period to the Company or a Restricted Subsidiary as a dividend or other distribution (subject, in the case of a dividend or other distribution to a Restricted Subsidiary, to the limitations contained in clause (ii) below) and (B) the Company's equity in the net loss of such Person shall be included to the extent of the aggregate Investment of the Company or any of its Restricted Subsidiaries in such Person,
- (ii) any net income (loss) of any Restricted Subsidiary that is not a Note Guarantor if such Restricted Subsidiary is subject to restrictions, directly or indirectly, on the payment of dividends or the making of similar distributions by such Restricted Subsidiary, directly or indirectly, to the Company by operation of the terms of such Restricted Subsidiary's charter or any agreement, instrument, judgment, decree, order, statute or governmental rule or regulation applicable to such Restricted Subsidiary or its stockholders (other than (x) restrictions that have been waived or otherwise released, (y) restrictions pursuant to the Existing Notes, the Notes, the Existing Indentures or the Indenture and (z) restrictions in effect on the Issue Date with respect to a Restricted Subsidiary and other restrictions with respect to such Restricted Subsidiary that taken as a whole are not materially less favorable to the Holders than such restrictions in effect on the Issue Date), except that (A) subject to the limitations contained in

clause (iii) below, the Company's equity in the net income of any such Restricted Subsidiary for such period

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shall be included in such Consolidated Net Income up to the aggregate amount of any dividend or distribution that was or that could have been made by such Restricted Subsidiary during such period to the Company or another Restricted Subsidiary (subject, in the case of a dividend that could have been made to another Restricted Subsidiary, to the limitation contained in this clause) and (B) the net loss of such Restricted Subsidiary shall be included to the extent of the aggregate Investment of the Company or any of its other Restricted Subsidiaries in such Restricted Subsidiary,

- (iii) any gain or loss realized upon the sale or other disposition of any asset of the Company or any Restricted Subsidiary (including pursuant to any sale/leaseback transaction) that is not sold or otherwise disposed of in the ordinary course of business (as determined in good faith by the Board of Directors),
- (iv) any item classified as an extraordinary, unusual or nonrecurring gain, loss or charge (including fees, expenses and charges associated with the Transactions and any acquisition, merger or consolidation after the Issue Date),
- (v) the cumulative effect of a change in accounting principles,
- (vi) all deferred financing costs written off and premiums paid in connection with any early extinguishment of Indebtedness,
- (vii) any unrealized gains or losses in respect of Currency Agreements,
- (viii) any unrealized foreign currency transaction gains or losses in respect of Indebtedness of any Person denominated in a currency other than the functional currency of such Person,
- (ix) any non-cash compensation charge arising from any grant of stock, stock options or other equity based awards, and
- (x) to the extent otherwise included in Consolidated Net Income, any unrealized foreign currency translation or transaction gains or losses in respect of Indebtedness or other obligations of the Company or any Restricted Subsidiary owing to the Company or any Restricted Subsidiary.

In the case of any unusual or nonrecurring gain, loss or charge not included in Consolidated Net Income pursuant to clause (iv) above in any determination thereof, the Company will deliver an Officer's Certificate to the Trustee promptly after the date on which Consolidated Net Income is so determined, setting forth the nature and amount of such unusual or nonrecurring gain, loss or charge. Notwithstanding the foregoing, for the purpose of clause (a)(iii)(A) of the covenant described under Certain Covenants Limitation on Restricted Payments only, there shall be excluded from Consolidated Net Income, without duplication, any dividends, repayments of loans or advances or other transfers of assets from Unrestricted Subsidiaries to the Company or a Restricted Subsidiary to the extent such dividends, repayments or transfers are applied by the Company to increase the amount of Restricted Payments permitted under such covenant pursuant to clause (a)(iii)(C) or (D) thereof.

*Consolidated Tangible Assets* means, as of any date of determination, the total assets less the total intangible assets (including, without limitation, goodwill), in each case shown on the consolidated balance sheet of the Company and its Restricted Subsidiaries as of the most recent date for which such a balance sheet is available, determined on a consolidated basis in accordance with GAAP (and, in the case of any determination relating to any Incurrence of Indebtedness or any Investment, on a pro forma basis including any property or assets being acquired in connection

therewith); *provided* that for purposes of paragraph (b) of

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the covenant described in Certain Covenants Limitation on Indebtedness, the covenant described under Certain Covenants Limitation on Sale of Assets and Subsidiary Stock and the definition of Permitted Investment, Consolidated Tangible Assets shall not be less than \$2,409.0 million.

*Consolidation* means the consolidation of the accounts of each of the Restricted Subsidiaries with those of the Company in accordance with GAAP; *provided that* Consolidation will not include consolidation of the accounts of any Unrestricted Subsidiary, but the interest of the Company or any Restricted Subsidiary in any Unrestricted Subsidiary will be accounted for as an investment. The term Consolidated has a correlative meaning.

*Consolidated Total Debt* means, as of any date of determination, the total Indebtedness shown on the consolidated balance sheet of the Company and its Restricted Subsidiaries as of such date, determined on a consolidated basis in accordance with GAAP.

*Consolidated Total Leverage Ratio* means, as of any date of determination, the ratio of (i) Consolidated Total Debt as of the last day of the most recent fiscal quarter of the Company ending prior to the date of such determination for which consolidated financial statements of the Company are available to (ii) the aggregate amount of Consolidated EBITDA of the Company and its Restricted Subsidiaries for the period of the most recent four consecutive fiscal quarters ending prior to the date of such determination for which consolidated financial statements of the Company are available; *provided, that*

- (1) if since the beginning of the period for which the Consolidated Total Leverage Ratio is being calculated the Company or any Restricted Subsidiary has Incurred any Indebtedness that remains outstanding on such date of determination, then the Consolidated Total Leverage Ratio shall be calculated after giving effect on a pro forma basis to such Indebtedness as if such Indebtedness had been Incurred immediately prior to the last day of such period (except that in making such computation, the amount of Indebtedness under any revolving credit facility outstanding on the date of such calculation shall be computed based on (A) the average daily balance of such Indebtedness during such four fiscal quarters or such shorter period for which such facility was outstanding or (B) if such facility was created after the end of such four fiscal quarters, the average daily balance of such Indebtedness during the period from the date of creation of such facility to the date of such calculation),
- (2) if since the beginning of the period for which the Consolidated Total Leverage Ratio is being calculated the Company or any Restricted Subsidiary has repaid, repurchased, redeemed, defeased or otherwise acquired, retired or discharged any Indebtedness that is no longer outstanding on such date of determination (each, a Discharge ) (in each case other than Indebtedness Incurred under any revolving credit facility unless such Indebtedness has been permanently repaid), then the Consolidated Total Leverage Ratio shall be calculated after giving effect on a pro forma basis to such Discharge of such Indebtedness as if such Discharge had occurred immediately prior to the last day of such period,
- (3) if since the beginning of the period for which the Consolidated Total Leverage Ratio is being calculated the Company or any Restricted Subsidiary shall have disposed of any company, any business or any group of assets constituting an operating unit of a business (any such disposition, a Sale ), then the Consolidated EBITDA for such period shall be reduced by an amount equal to the Consolidated EBITDA (if positive) attributable to the assets that are the subject of such Sale for such period or increased by an amount equal to the Consolidated EBITDA (if negative) attributable thereto for such period,
- (4) if since the beginning of the period for which the Consolidated Total Leverage Ratio is being calculated the Company or any Restricted Subsidiary (by merger, consolidation or otherwise) shall have made an Investment in any Person that thereby becomes a Restricted Subsidiary, or





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otherwise acquired any company, any business or any group of assets constituting an operating unit of a business, including any such Investment or acquisition occurring in connection with a transaction causing a calculation to be made hereunder (any such Investment or acquisition, a Purchase ), Consolidated EBITDA for such period shall be calculated after giving pro forma effect thereto (including the Incurrence of any related Indebtedness) as if such Purchase occurred on the first day of such period, and

- (5) if since the beginning of the period for which the Consolidated Total Leverage Ratio is being calculated any Person who became a Restricted Subsidiary was merged or consolidated with or into the Company or any Restricted Subsidiary, and since the beginning of such period such Person shall have Discharged any Indebtedness or made any Sale or Purchase that would have required an adjustment pursuant to clause (2), (3) or (4) above if made by the Company or a Restricted Subsidiary during such period, Consolidated EBITDA for such period shall be calculated after giving pro forma effect thereto as if such Discharge, Sale or Purchase occurred on the first day of such period.

For purposes of this definition, whenever pro forma effect is to be given to any Sale, Purchase or other transaction, or the amount of income or earnings relating thereto, the pro forma calculations in respect thereof (including without limitation in respect of anticipated cost savings or synergies relating to any such Sale, Purchase or other transaction) shall be determined on a basis consistent with Article 11 of Regulation S-X promulgated under the Securities Act.

*Coors Stockholders* means (i) Adolph Coors, Jr. Trust dated September 12, 1969; Augusta Coors Collbran Trust dated July 5, 1946; Bertha Coors Munroe Trust dated July 5, 1946; Grover C. Coors Trust dated August 7, 1952; Herman F. Coors Trust dated July 5, 1946; Janet H. Coors Irrevocable Trust FBO Frances M. Baker dated July 27, 1976; Janet H. Coors Irrevocable Trust FBO Frank E. Ferrin dated July 27, 1976; Janet H. Coors Irrevocable Trust FBO Joseph J. Ferrin dated July 27, 1976; Joseph Coors Trust dated December 14, 1988; Louise Coors Porter Trust dated July 5, 1946; May Kistler Coors Trust dated September 24, 1965; and Adolph Coors Foundation; (ii) a spouse or lineal descendant (whether natural or adopted), sibling, parent, heir, executor, administrator, testamentary trustee, lifetime trustee or legatee of Adolph Coors, Jr. or the Persons named in clause (i) above; (iii) any trust, the primary beneficiaries of which are named in clause (i) or (ii) above; (iv) the trustees or any Affiliates of any trust named in clause (i) or (iii) above; (v) the beneficiary or beneficiaries authorized or entitled to receive distributions from any trust named in clause (i) or (iii) above; or (vi) any corporation, limited liability company or partnership, the stockholders, members or general or limited partners of which include only the Persons named in clause (i) or (ii) above; and any of their respective successors in interest.

*Credit Facilities* means one or more of (i) the Senior Credit Facility and (ii) other facilities or arrangements designated by the Company, in each case with one or more banks or other institutions providing for revolving credit loans, term loans, receivables financings (including without limitation through the sale of receivables to such institutions or to special purpose entities formed to borrow from such institutions against such receivables), letters of credit or other Indebtedness, in each case, including all agreements, instruments and documents executed and delivered pursuant to or in connection with any of the foregoing, including but not limited to any notes and letters of credit issued pursuant thereto and any guarantee and collateral agreement, patent and trademark security agreement, mortgages or letter of credit applications and other guarantees, pledge agreements, security agreements and collateral documents, in each case as the same may be amended, supplemented, waived or otherwise modified from time to time, or refunded, refinanced, restructured, replaced, renewed, repaid, increased or extended from time to time (whether in whole or in part, whether with the original banks or other institutions or other banks or other institutions or otherwise, and whether provided under any original Credit Facility or one or more other credit agreements, indentures, financing agreements or other Credit Facilities or otherwise). Without limiting the generality of the foregoing, the term Credit Facility shall include any agreement (i) changing the maturity of any Indebtedness Incurred thereunder or contemplated thereby, (ii) adding Subsidiaries as additional borrowers or guarantors thereunder,



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(iii) increasing the amount of Indebtedness Incurred thereunder or available to be borrowed thereunder or  
(iv) otherwise altering the terms and conditions thereof.

*Currency Agreement* means, in respect of a Person, any foreign exchange contract, currency swap agreement or other similar agreement or arrangements (including derivative agreements or arrangements), as to which such Person is a party or a beneficiary.

*Default* means any event or condition that is, or after notice or passage of time or both would be, an Event of Default.

*Designated Noncash Consideration* means the Fair Market Value of noncash consideration received by the Company or one of its Restricted Subsidiaries in connection with an Asset Disposition that is so designated as Designated Noncash Consideration pursuant to an Officer's Certificate, setting forth the basis of such valuation.

*Disinterested Director* means, with respect to any Affiliate Transaction, a member of the Board of Directors having no material direct or indirect financial interest in or with respect to such Affiliate Transaction. A member of the Board of Directors shall not be deemed to have such a financial interest by reason of such member's holding Capital Stock of the Company or Holding or any options, warrants or other rights in respect of such Capital Stock.

*Disqualified Stock* means, with respect to any Person, any Capital Stock (other than Management Stock) that by its terms (or by the terms of any security into which it is convertible or for which it is exchangeable or exercisable) or upon the happening of any event (other than following the occurrence of a Change of Control or other similar event described under such terms as a change of control, or an Asset Disposition) (i) matures or is mandatorily redeemable pursuant to a sinking fund obligation or otherwise, (ii) is convertible or exchangeable for Indebtedness or Disqualified Stock or (iii) is redeemable at the option of the holder thereof (other than following the occurrence of a Change of Control or other similar event described under such terms as a change of control, or an Asset Disposition), in whole or in part, in each case on or prior to the final Stated Maturity of the Notes.

*Domestic Subsidiary* means any Restricted Subsidiary of the Company other than a Foreign Subsidiary.

*Equity Agreements* means, collectively, (1) the Stockholders Agreement, dated as of July 9, 2007, among Holding, the Coors Stockholders, CDR Fund V, EXOR Group S.A., Field Holdings, Inc., and the TPG Entities, (2) the Registration Rights Agreement, dated as of July 9, 2007, among Holding, the Coors Stockholders, CDR Fund V, EXOR Group S.A., Field Holdings, Inc., the TPG Entities, and the other stockholders of Holding party thereto, and (3) the Indemnification Agreement, dated as of March 27, 1996, among the Company, Holding, GPC, CDR and CDR Fund V, in each case as may be amended, supplemented, waived or otherwise modified from time to time in accordance with the terms thereof and of the Indenture.

*Exchange Act* means the Securities Exchange Act of 1934, as amended.

*Excluded Contribution* means Net Cash Proceeds, or the Fair Market Value of property or assets, received by the Company as capital contributions to the Company after the Issue Date or from the issuance or sale (other than to a Restricted Subsidiary) of Capital Stock (other than Disqualified Stock) of the Company, in each case to the extent designated as an Excluded Contribution pursuant to an Officer's Certificate of the Company and not previously included in the calculation set forth in subparagraph (a)(iii)(B)(x) of the covenant described under Certain Covenants Limitation on Restricted Payments for purposes of determining whether a Restricted Payment may be made.

*Existing Indentures* means (a) the Indenture dated as of June 16, 2009 among the Company, U.S. Bank National Association, as Trustee, and the other parties thereto relating to the Existing Senior Notes



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and (b) the Indenture dated as of August 8, 2003 among the Company, Wells Fargo Bank, National Association, as Trustee, and the other parties thereto relating to the Company's 9.50% Senior Subordinated Notes due 2013.

*Existing Notes* means the Existing Senior Notes and the Company's 9.50% Senior Subordinated Notes due 2013, in each case, outstanding on the Issue Date.

*Existing Senior Notes* means the Company's 9 1/2% Senior Notes due 2017 outstanding on the Issue Date.

*Fair Market Value* means, with respect to any asset or property, the fair market value of such asset or property as determined in good faith by the Board of Directors, whose determination will be conclusive.

*Financing Disposition* means any sale, transfer, conveyance or other disposition of property or assets by the Company or any Subsidiary thereof to any Receivables Entity, or by any Receivables Subsidiary, in each case in connection with the Incurrence by a Receivables Entity of Indebtedness, or obligations to make payments to the obligor on Indebtedness, which may be secured by a Lien in respect of such property or assets.

*Foreign Subsidiary* means (a) any Restricted Subsidiary of the Company that is not organized under the laws of the United States of America or any state thereof or the District of Columbia and (b) any Restricted Subsidiary of the Company that has no material assets other than securities of one or more Foreign Subsidiaries, and other assets relating to an ownership interest in any such securities or Subsidiaries.

*GAAP* means generally accepted accounting principles in the United States of America as in effect on the Issue Date (for purposes of the definitions of the terms Consolidated Coverage Ratio, Consolidated EBITDA, Consolidated Interest Expense, Consolidated Net Income and Consolidated Tangible Assets, all defined terms in the Indenture to the extent used in or relating to any of the foregoing definitions, and all ratios and computations based on any of the foregoing definitions) and as in effect from time to time (for all other purposes of the Indenture), including those set forth in the opinions and pronouncements of the Accounting Principles Board of the American Institute of Certified Public Accountants and statements and pronouncements of the Financial Accounting Standards Board or in such other statements by such other entity as approved by a significant segment of the accounting profession. All ratios and computations based on GAAP contained in the Indenture shall be computed in conformity with GAAP.

*GPC* means Graphic Packaging Corporation, a Delaware corporation, and any successor in interest thereto.

*Guarantee* means any obligation, contingent or otherwise, of any Person directly or indirectly guaranteeing any Indebtedness or other obligation of any other Person; *provided* that the term *Guarantee* shall not include endorsements for collection or deposit in the ordinary course of business. The term *Guarantee* used as a verb has a corresponding meaning.

*Guarantor Subordinated Obligations* means, with respect to a Note Guarantor, any Indebtedness of such Note Guarantor (whether outstanding on the Issue Date or thereafter Incurred) that is expressly subordinated in right of payment to the obligations of such Note Guarantor under its Note Guarantee pursuant to a written agreement.

*Hedging Obligations* of any Person means the obligations of such Person pursuant to any Interest Rate Agreement, Currency Agreement or Commodities Agreement.

*Holder* means the Person in whose name a Note is registered in the Note Register.

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*Holding* means Graphic Packaging Holding Company, a Delaware corporation, and any successor in interest thereto.

*Holding Expenses* means (i) costs (including all professional fees and expenses) incurred by Holding or GPC in connection with its reporting obligations under, or in connection with compliance with, applicable laws or applicable rules of any governmental, regulatory or self-regulatory body or stock exchange, the Indenture or any other agreement or instrument relating to Indebtedness of the Company or any Restricted Subsidiary, including in respect of any reports filed with respect to the Securities Act, Exchange Act or the respective rules and regulations promulgated thereunder, (ii) expenses incurred by GPC or Holding in connection with the acquisition, development, maintenance, ownership, prosecution, protection and defense of its intellectual property and associated rights (including but not limited to trademarks, service marks, trade names, trade dress, patents, copyrights and similar rights, including registrations and registration or renewal applications in respect thereof, inventions, processes, designs, formulae, trade secrets, know-how, confidential information, computer software, data and documentation, and any other intellectual property rights; and licenses of any of the foregoing) to the extent such intellectual property and associated rights relate to the business of the Company or any of its Subsidiaries, (iii) indemnification obligations of Holding or GPC owing to directors, officers, employees or other Persons under its charter or by-laws or pursuant to written agreements with any such Person, or obligations in respect of director and officer insurance (including premiums therefor), (iv) other operational expenses of Holding or GPC incurred in the ordinary course of business, and (v) fees and expenses incurred by Holding or GPC in connection with any offering of Capital Stock or Indebtedness, (x) where the net proceeds of such offering are intended to be received by or contributed or loaned to the Company or a Restricted Subsidiary, or (y) in a prorated amount of such expenses in proportion to the amount of such net proceeds intended to be so received, contributed or loaned, or (z) otherwise on an interim basis prior to completion of such offering so long as Holding or GPC shall cause the amount of such expenses to be repaid to the Company or the relevant Restricted Subsidiary out of the proceeds of such offering promptly if completed.

*Incur* means issue, assume, enter into any Guarantee of, incur or otherwise become liable for; *provided, however*, that any Indebtedness or Capital Stock of a Person existing at the time such Person becomes a Subsidiary (whether by merger, consolidation, acquisition or otherwise) shall be deemed to be Incurred by such Subsidiary at the time it becomes a Subsidiary. Accrual of interest, the accretion of accreted value and the payment of interest in the form of additional Indebtedness will not be deemed to be an Incurrence of Indebtedness. Any Indebtedness issued at a discount (including Indebtedness on which interest is payable through the issuance of additional Indebtedness) shall be deemed Incurred at the time of original issuance of the Indebtedness at the initial accreted amount thereof.

*Indebtedness* means, with respect to any Person on any date of determination (without duplication):

- (i) the principal of indebtedness of such Person for borrowed money,
- (ii) the principal of obligations of such Person evidenced by bonds, debentures, notes or other similar instruments,
- (iii) all reimbursement obligations of such Person in respect of letters of credit or other similar instruments (the amount of such obligations being equal at any time to the aggregate then undrawn and unexpired amount of such letters of credit or other instruments plus the aggregate amount of drawings thereunder that have not then been reimbursed),
- (iv) all obligations of such Person to pay the deferred and unpaid purchase price of property (except Trade Payables), which purchase price is due more than one year after the date of placing such property in final service or taking final delivery and title thereto,

(v) all Capitalized Lease Obligations of such Person,

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- (vi) the redemption, repayment or other repurchase amount of such Person with respect to any Disqualified Stock of such Person or (if such Person is a Subsidiary of the Company other than a Note Guarantor) any Preferred Stock of such Subsidiary, but excluding, in each case, any accrued dividends (the amount of such obligation to be equal at any time to the maximum fixed involuntary redemption, repayment or repurchase price for such Capital Stock, or if less (or if such Capital Stock has no such fixed price), to the involuntary redemption, repayment or repurchase price therefor calculated in accordance with the terms thereof as if then redeemed, repaid or repurchased, and if such price is based upon or measured by the fair market value of such Capital Stock, such fair market value shall be as determined in good faith by the Board of Directors or the board of directors or other governing body of the issuer of such Capital Stock),
- (vii) all Indebtedness of other Persons secured by a Lien on any asset of such Person, whether or not such Indebtedness is assumed by such Person; *provided* that the amount of Indebtedness of such Person shall be the lesser of (A) the fair market value of such asset at such date of determination (as determined in good faith by the Company) and (B) the amount of such Indebtedness of such other Persons,
- (viii) all Guarantees by such Person of Indebtedness of other Persons, to the extent so Guaranteed by such Person, and
- (ix) to the extent not otherwise included in this definition, net Hedging Obligations of such Person (the amount of any such obligation to be equal at any time to the termination value of such agreement or arrangement giving rise to such Hedging Obligation that would be payable by such Person at such time).

The amount of Indebtedness of any Person at any date shall be determined as set forth above or otherwise provided in the Indenture, or otherwise shall equal the amount thereof that would appear on a balance sheet of such Person (excluding any notes thereto) prepared in accordance with GAAP.

*Interest Rate Agreement* means, with respect to any Person, any interest rate protection agreement, future agreement, option agreement, swap agreement, cap agreement, collar agreement, hedge agreement or other similar agreement or arrangement (including derivative agreements or arrangements), as to which such Person is party or a beneficiary.

*Inventory* means goods held for sale or lease by a Person in the ordinary course of business, net of any reserve for goods that have been segregated by such Person to be returned to the applicable vendor for credit, as determined in accordance with GAAP.

*Investment* in any Person by any other Person means any direct or indirect advance, loan or other extension of credit (other than to customers, suppliers, directors, officers or employees of any Person in the ordinary course of business) or capital contribution (by means of any transfer of cash or other property to others or any payment for property or services for the account or use of others) to, or any purchase or acquisition of Capital Stock, Indebtedness or other similar instruments issued by, such Person. For purposes of the definition of *Unrestricted Subsidiary* and the covenant described under *Certain Covenants Limitation on Restricted Payments* only, (i) *Investment* shall include the portion (proportionate to the Company's equity interest in such Subsidiary) of the fair market value of the net assets of any Subsidiary of the Company at the time that such Subsidiary is designated an *Unrestricted Subsidiary*, provided that upon a redesignation of such Subsidiary as a *Restricted Subsidiary*, the Company shall be deemed to continue to have a permanent *Investment* in an *Unrestricted Subsidiary* in an amount (if positive) equal to (x) the Company's *Investment* in such Subsidiary at the time of such redesignation less (y) the portion (proportionate to the Company's equity interest

in such Subsidiary) of the fair market value of the net assets of such Subsidiary at the time of such redesignation,  
(ii) any property transferred to or from an Unrestricted Subsidiary shall be

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valued at its fair market value at the time of such transfer, and (iii) in each case under clause (i) or (ii) above, fair market value shall be as determined in good faith by the Board of Directors. Guarantees shall not be deemed to be Investments. The amount of any Investment outstanding at any time shall be the original cost of such Investment, reduced (at the Company's option) by any dividend, distribution, interest payment, return of capital, repayment or other amount or value received in respect of such Investment; *provided* that to the extent that the amount of Restricted Payments outstanding at any time is so reduced by any portion of any such amount or value that would otherwise be included in the calculation of Consolidated Net Income, such portion of such amount or value shall not be so included for purposes of calculating the amount of Restricted Payments that may be made pursuant to paragraph (a) of the covenant described under Certain Covenants Limitation on Restricted Payments.

*Investors* means CDR Fund V, EXOR Group S.A., Field Holdings, Inc., the Coors Stockholders, the TPG Entities and any of their respective successors in interest.

*Issue Date* means September , 2010.

*Lien* means any mortgage, pledge, security interest, encumbrance, lien or charge of any kind (including any conditional sale or other title retention agreement or lease in the nature thereof).

*Management Advances* means (1) loans or advances made to directors, officers or employees of GPC, the Company or any Restricted Subsidiary (x) in respect of travel, entertainment or moving-related expenses incurred in the ordinary course of business, (y) in respect of moving-related expenses incurred in connection with any closing or consolidation of any facility, or (z) in the ordinary course of business and (in the case of this clause (z)) not exceeding \$5.0 million in the aggregate outstanding at any time, (2) promissory notes of Management Investors acquired in connection with the issuance of Management Stock to such Management Investors, (3) Management Guarantees, or (4) other Guarantees of borrowings by Management Investors in connection with the purchase of Management Stock, which Guarantees are permitted under the covenant described under Certain Covenants Limitation on Indebtedness.

*Management Guarantees* means guarantees (x) of up to an aggregate principal amount of \$10.0 million of borrowings by Management Investors in connection with their purchase of Management Stock or (y) made on behalf of, or in respect of loans or advances made to, directors, officers or employees of GPC, Holding, the Company or any Restricted Subsidiary (1) in respect of travel, entertainment and moving-related expenses incurred in the ordinary course of business, or (2) in the ordinary course of business and (in the case of this clause (2)) not exceeding \$5.0 million in the aggregate outstanding at any time.

*Management Investors* means the officers, directors, employees and other members of the management of Holding, GPC, the Company or any of their respective Subsidiaries, or family members or relatives thereof, or trusts or partnerships for the benefit of any of the foregoing, or any of their heirs, executors, successors and legal representatives, who at any date beneficially own or have the right to acquire, directly or indirectly, Capital Stock of the Company, Holding or GPC.

*Management Stock* means Capital Stock of the Company or GPC (including any options, warrants or other rights in respect thereof) held by any of the Management Investors.

*Moody's* means Moody's Investors Service, Inc., and its successors.

*Net Available Cash* from an Asset Disposition means cash payments received (including any cash payments received by way of deferred payment of principal pursuant to a note or installment receivable or otherwise, but only as and when received, but excluding any other consideration received in the form of assumption by the acquiring person of Indebtedness or other obligations relating to the properties or assets that are the subject of such Asset Disposition or

received in any other non-cash form) therefrom, in each case net

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of (i) all legal, title and recording tax expenses, commissions and other fees and expenses incurred, and all Federal, state, provincial, foreign and local taxes required to be paid or accrued as a liability under GAAP, as a consequence of such Asset Disposition (including as a consequence of any transfer of funds in connection with the application thereof in accordance with the covenant described under Certain Covenants Limitation on Sales of Assets and Subsidiary Stock ), (ii) all payments made, and all installment payments required to be made, on any Indebtedness that is secured by any assets subject to such Asset Disposition, in accordance with the terms of any Lien upon such assets, or that must by its terms, or in order to obtain a necessary consent to such Asset Disposition, or by applicable law, be repaid out of the proceeds from such Asset Disposition, (iii) all distributions and other payments required to be made to minority interest holders in Subsidiaries or joint ventures as a result of such Asset Disposition, or to any other Person (other than the Company or a Restricted Subsidiary) owning a beneficial interest in the assets disposed of in such Asset Disposition and (iv) any liabilities or obligations associated with the assets disposed of in such Asset Disposition and retained by the Company or any Restricted Subsidiary after such Asset Disposition, including without limitation pension and other post-employment benefit liabilities, liabilities related to environmental matters, and liabilities relating to any indemnification obligations associated with such Asset Disposition.

*Net Cash Proceeds*, with respect to any issuance or sale of any securities of the Company or any Subsidiary by the Company or any Subsidiary, or any capital contribution, means the cash proceeds of such issuance, sale or contribution net of attorneys fees, accountants fees, underwriters or placement agents fees, discounts or commissions and brokerage, consultant and other fees actually incurred in connection with such issuance, sale or contribution and net of taxes paid or payable as a result thereof.

*Notes* means the promissory notes issued pursuant to the Indenture.

*Note Guarantee* means a Parent Guarantee or a Subsidiary Guarantee.

*Note Guarantor* means a Parent Guarantor or a Subsidiary Guarantor.

*Officer* means, with respect to the Company or any other obligor upon the Notes, the Chairman of the Board, the President, the Chief Executive Officer, the Chief Financial Officer, any Vice President, the Controller, the Treasurer or the Secretary (a) of such Person or (b) if such Person is owned or managed by a single entity, of such entity (or any other individual designated as an Officer for the purposes of the Indenture by the Board of Directors).

*Officer's Certificate* means, with respect to the Company or any other obligor upon the Notes, a certificate signed by one Officer of such Person.

*Opinion of Counsel* means a written opinion from legal counsel who is reasonably acceptable to the Trustee. The counsel may be an employee of or counsel to the Company or the Trustee.

*Permitted Holder* means any of the following: (i) any of the Investors, Management Investors, CDR, the TPG Entities and their respective Affiliates; (ii) any investment fund or vehicle managed, sponsored or advised by CDR, TPG or any Investor or Affiliate thereof, and any Affiliate of or successor to any such investment fund or vehicle; and (iii) any Person acting in the capacity of an underwriter in connection with a public or private offering of Capital Stock of Holding or the Company.

*Permitted Investment* means an Investment by the Company or any Restricted Subsidiary in, or consisting of, any of the following:

- (i) a Restricted Subsidiary, the Company, or a Person that will, upon the making of such Investment, become a Restricted Subsidiary;



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- (ii) another Person if as a result of such Investment such other Person is merged or consolidated with or into, or transfers or conveys all or substantially all its assets to, or is liquidated into, the Company or a Restricted Subsidiary;
- (iii) Temporary Cash Investments or Cash Equivalents;
- (iv) receivables owing to the Company or any Restricted Subsidiary, if created or acquired in the ordinary course of business;
- (v) any securities or other Investments received as consideration in, or retained in connection with, sales or other dispositions of property or assets, including Asset Dispositions made in compliance with the covenant described under Certain Covenants Limitation on Sales of Assets and Subsidiary Stock ;
- (vi) securities or other Investments received in settlement of debts created in the ordinary course of business and owing to the Company or any Restricted Subsidiary, or as a result of foreclosure, perfection or enforcement of any Lien, or in satisfaction of judgments, including in connection with any bankruptcy proceeding or other reorganization of another Person;
- (vii) Investments in existence or made pursuant to legally binding written commitments in existence on the Issue Date;
- (viii) Currency Agreements, Interest Rate Agreements, Commodities Agreements and related Hedging Obligations, which obligations are Incurred in compliance with the covenant described under Certain Covenants Limitation on Indebtedness ;
- (ix) pledges or deposits (x) with respect to leases or utilities provided to third parties in the ordinary course of business or (y) otherwise described in the definition of Permitted Liens or made in connection with Liens permitted under the covenant described under Certain Covenants Limitation on Liens ;
- (x) (1) Investments in any Receivables Subsidiary, or in connection with a Financing Disposition by or to any Receivables Entity, including Investments of funds held in accounts permitted or required by the arrangements governing such Financing Disposition or any related Indebtedness, or (2) any promissory note issued by the Company, GPC or Holding, provided that if Holding or GPC receives cash from the relevant Receivables Entity in exchange for such note, an equal cash amount is contributed by Holding or GPC to the Company;
- (xi) bonds secured by assets leased to and operated by the Company or any Restricted Subsidiary that were issued in connection with the financing of such assets so long as the Company or any Restricted Subsidiary may obtain title to such assets at any time by paying a nominal fee, canceling such bonds and terminating the transaction;
- (xii) Notes;
- (xiii) any Investment to the extent made using Capital Stock of the Company (other than Disqualified Stock), or Capital Stock of Holding or GPC, as consideration;

(xiv) Management Advances;

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- (xv) joint ventures in an aggregate amount outstanding at any time not to exceed \$150.0 million; and
- (xvi) other Investments in an aggregate amount outstanding at any time not to exceed 10% of Consolidated Tangible Assets.

*Permitted Liens* means:

- (i) Liens for taxes, assessments or other governmental charges not yet delinquent or the nonpayment of which in the aggregate would not reasonably be expected to have a material adverse effect on the Company and its Restricted Subsidiaries or that are being contested in good faith and by appropriate proceedings if adequate reserves with respect thereto are maintained on the books of the Company or a Subsidiary thereof, as the case may be, in accordance with GAAP;
- (ii) carriers, warehousemen, mechanics, landlords, materialmen, repairmen or other like Liens arising in the ordinary course of business in respect of obligations that are not overdue for a period of more than 60 days or that are bonded or that are being contested in good faith and by appropriate proceedings;
- (iii) pledges, deposits or Liens in connection with workers' compensation, unemployment insurance and other social security and other similar legislation or other insurance-related obligations (including, without limitation, pledges or deposits securing liability to insurance carriers under insurance or self-insurance arrangements);
- (iv) pledges, deposits or Liens to secure the performance of bids, tenders, trade, government or other contracts (other than for borrowed money), obligations for utilities, leases, licenses, statutory obligations, completion guarantees, surety, judgment, appeal or performance bonds, other similar bonds, instruments or obligations, and other obligations of a like nature incurred in the ordinary course of business;
- (v) easements (including reciprocal easement agreements), rights-of-way, building, zoning and similar restrictions, utility agreements, covenants, reservations, restrictions, encroachments, charges, and other similar encumbrances or title defects incurred, or leases or subleases granted to others, in the ordinary course of business, which do not in the aggregate materially interfere with the ordinary conduct of the business of the Company and its Subsidiaries, taken as a whole;
- (vi) Liens existing on, or provided for under written arrangements existing on, the Issue Date, or (in the case of any such Liens securing Indebtedness of the Company or any of its Subsidiaries existing or arising under written arrangements existing on the Issue Date) securing any Refinancing Indebtedness in respect of such Indebtedness so long as the Lien securing such Refinancing Indebtedness is limited to all or part of the same property or assets (plus improvements, accessions, proceeds or dividends or distributions in respect thereof) that secured (or under such written arrangements could secure) the original Indebtedness;
- (vii) (a) mortgages, liens, security interests, restrictions, encumbrances or any other matters of record that have been placed by any developer, landlord or other third party on property over

which the Company or any Restricted Subsidiary of the Company has easement rights or on any leased property and subordination or similar agreements relating thereto and (b) any condemnation or eminent domain proceedings affecting any real property;

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- (viii) Liens securing Hedging Obligations, Purchase Money Obligations or Capitalized Lease Obligations Incurred in compliance with the covenant described under Certain Covenants Limitation on Indebtedness ;
- (ix) Liens arising out of judgments, decrees, orders or awards in respect of which the Company shall in good faith be prosecuting an appeal or proceedings for review, which appeal or proceedings shall not have been finally terminated, or if the period within which such appeal or proceedings may be initiated shall not have expired;
- (x) Leases, subleases, licenses or sublicenses to third parties;
- (xi) Liens securing (1) Indebtedness Incurred in compliance with clause (b)(i), (b)(iv), (b)(vii), (b)(viii)(E), (b)(x) or (b)(xi) of the covenant described under Certain Covenants Limitation on Indebtedness, or clause (b)(iii) thereof (other than Refinancing Indebtedness Incurred in respect of Indebtedness described in paragraph (a) thereof), (2) Bank Indebtedness, (3) the Existing Notes (but only to the extent to the Notes are secured equally and ratably with the Existing Notes) and the Notes, (4) Indebtedness of any Restricted Subsidiary that is not a Note Guarantor, (5) Indebtedness or other obligations of any Receivables Entity or (6) obligations in respect of Management Advances or Management Guarantees;
- (xii) Liens existing on property or assets of a Person at the time such Person becomes a Subsidiary of the Company (or at the time the Company or a Restricted Subsidiary acquires such property or assets, including any acquisition by means of a merger or consolidation with or into the Company or any Restricted Subsidiary); *provided, however*, that such Liens are not created in connection with, or in contemplation of, such other Person becoming such a Subsidiary (or such acquisition of such property or assets), and that such Liens are limited to all or part of the same property or assets (plus improvements, accessions, proceeds or dividends or distributions in respect thereof) that secured (or, under the written arrangements under which such Liens arose, could secure) the obligations to which such Liens relate;
- (xiii) Liens on Capital Stock or other securities of an Unrestricted Subsidiary that secure Indebtedness or other obligations of such Unrestricted Subsidiary;
- (xiv) any encumbrance or restriction (including, but not limited to, put and call agreements) with respect to Capital Stock of any joint venture or similar arrangement pursuant to any joint venture or similar agreement;
- (xv) Liens securing Refinancing Indebtedness Incurred in respect of any Indebtedness secured by, or securing any refinancing, refunding, extension, renewal or replacement (in whole or in part) of any other obligation secured by, any other Permitted Liens, provided that any such new Lien is limited to all or part of the same property or assets (plus improvements, accessions, proceeds or dividends or distributions in respect thereof) that secured (or, under the written arrangements under which the original Lien arose, could secure) the obligations to which such Liens relate; and
- (xvi) Liens (a) arising by operation of law (or by agreement to the same effect) in the ordinary course of business, (b) on property or assets under construction (and related rights) in favor of a contractor or developer or arising from progress or partial payments by a third party

relating to such property or assets, (c) on receivables (including related rights), (d) on cash set aside at the time of the incurrence of any Indebtedness or government securities purchased with such cash, in either case to the

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extent that such cash or government securities prefund the payment of interest on such Indebtedness and are held in an escrow account or similar arrangement to be applied for such purpose, (e) securing or arising by reason of any netting or set-off arrangement entered into in the ordinary course of banking or other trading activities, (f) in favor of the Company or any Subsidiary (other than Liens on property or assets of the Company in favor of any Subsidiary that is not a Note Guarantor) or (g) arising out of conditional sale, title retention, consignment or similar arrangements for the sale of goods entered into in the ordinary course of business.

*Person* means any individual, corporation, partnership, joint venture, association, joint-stock company, limited liability company, trust, unincorporated organization, government or any agency or political subdivision thereof or any other entity.

*Preferred Stock* as applied to the Capital Stock of any corporation means Capital Stock of any class or classes (however designated) that by its terms is preferred as to the payment of dividends, or as to the distribution of assets upon any voluntary or involuntary liquidation or dissolution of such corporation, over shares of Capital Stock of any other class of such corporation.

*Purchase Money Obligations* means any Indebtedness Incurred to finance or refinance the acquisition, leasing, construction or improvement of property (real or personal) or assets, and whether acquired through the direct acquisition of such property or assets or the acquisition of the Capital Stock of any Person owning such property or assets, or otherwise.

*Receivable* means a right to receive payment arising from a sale or lease of goods or services by a Person pursuant to an arrangement with another Person pursuant to which such other Person is obligated to pay for goods or services under terms that permit the purchase of such goods and services on credit, as determined in accordance with GAAP.

*Receivables Entity* means (x) any Receivables Subsidiary or (y) any other Person that is engaged in the business of acquiring, selling, collecting, financing or refinancing Receivables, accounts (as defined in the Uniform Commercial Code as in effect in any jurisdiction from time to time), other accounts and/or other receivables, and/or related assets.

*Receivables Fees* means distributions or payments made directly or by means of discounts with respect to any participation interest issued or sold in connection with, and other fees paid to a Person that is not a Restricted Subsidiary in connection with, any Receivables Financing.

*Receivables Financing* means any financing of Receivables of the Company or any Restricted Subsidiary that have been transferred to a Receivables Entity in a Financing Disposition.

*Receivables Subsidiary* means a Subsidiary of the Company that (a) is engaged solely in the business of acquiring, selling, collecting, financing or refinancing Receivables, accounts (as defined in the Uniform Commercial Code as in effect in any jurisdiction from time to time) and other accounts and receivables (including any thereof constituting or evidenced by chattel paper, instruments or general intangibles), all proceeds thereof and all rights (contractual and other), collateral and other assets relating thereto, and any business or activities incidental or related to such business, and (b) is designated as a Receivables Subsidiary by the Board of Directors.

*Refinance* means refinance, refund, replace, renew, repay, modify, restate, defer, substitute, supplement, reissue, resell or extend (including pursuant to any defeasance or discharge mechanism); and the terms refinances, refinanced and refinancing as used for any purpose in the Indenture shall have a correlative meaning.



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*Refinancing Indebtedness* means Indebtedness that is Incurred to refinance any Indebtedness existing on the date of the Indenture or Incurred in compliance with the Indenture (including Indebtedness of the Company that refinances Indebtedness of any Restricted Subsidiary (to the extent permitted in the Indenture) and Indebtedness of any Restricted Subsidiary that refinances Indebtedness of another Restricted Subsidiary) including Indebtedness that refinances Refinancing Indebtedness; *provided*, that (1) if the Indebtedness being refinanced is Subordinated Obligations or Guarantor Subordinated Obligations, the Refinancing Indebtedness has a final Stated Maturity at the time such Refinancing Indebtedness is Incurred that is equal to or greater than the final Stated Maturity of the Indebtedness being refinanced (or if shorter, the Notes), (2) such Refinancing Indebtedness is Incurred in an aggregate principal amount (or if issued with original issue discount, an aggregate issue price) that is equal to or less than the sum of (x) the aggregate principal amount (or if issued with original issue discount, the aggregate accreted value) then outstanding of the Indebtedness being refinanced, plus (y) fees, underwriting discounts, premiums and other costs and expenses incurred in connection with such Refinancing Indebtedness and (3) Refinancing Indebtedness shall not include (x) Indebtedness of a Restricted Subsidiary that is not a Note Guarantor that refinances Indebtedness of the Company that could not have been initially Incurred by such Restricted Subsidiary pursuant to the covenant described under *Certain Covenants Limitation on Indebtedness* or (y) Indebtedness of the Company or a Restricted Subsidiary that refinances Indebtedness of an Unrestricted Subsidiary.

*Related Business* means those businesses in which the Company or any of its Subsidiaries is engaged on the date of the Indenture, or that are related, complementary, incidental or ancillary thereto or extensions, developments or expansions thereof.

*Related Taxes* means (x) any taxes, charges or assessments, including but not limited to sales, use, transfer, rental, ad valorem, value-added, stamp, property, consumption, franchise, license, capital, net worth, gross receipts, excise, occupancy, intangibles or similar taxes, charges or assessments (other than (i) federal, state, local, foreign or provincial taxes measured by income and (ii) federal, state, local, foreign or provincial withholding imposed on payments made by or to Holding or GPC), required to be paid by Holding or GPC by virtue of its being incorporated or having Capital Stock outstanding (but not by virtue of owning stock or other equity interests of any corporation or other entity other than the Company or any of its Subsidiaries), or being a holding company parent of the Company or receiving dividends from or other distributions in respect of the Capital Stock of the Company or any of its Subsidiaries, or having guaranteed any obligations of the Company or any Subsidiary thereof, or having made any payment in respect of any of the items for which the Company or any of its Subsidiaries is permitted to make payments to Holding or GPC pursuant to the covenant described under *Certain Covenants Limitation on Restricted Payments*, or acquiring, developing, maintaining, owning, prosecuting, protecting or defending its intellectual property and associated rights (including but not limited to receiving or paying royalties for the use thereof) relating to the business or businesses of the Company or any Subsidiary thereof, or (y) any consolidated, combined or similar federal, state, foreign, provincial or local taxes measured by income for which Holding or GPC is liable up to an amount not to exceed, with respect to any such tax, the amount of any such tax that the Company and its Subsidiaries would have been required to pay on a separate company basis, or on a consolidated basis as if the Company had filed a consolidated, combined or similar return on behalf of an affiliated group (as defined in Section 1504 of the Code or an analogous provision of state, local, foreign or provincial law) of which it were the common parent; provided that this definition of *Related Taxes* shall not include any taxes, charges or assessments that are directly paid to the appropriate taxing authority by the Company or any of its Subsidiaries.

*Restricted Payment Transaction* means any Restricted Payment permitted pursuant to the covenant described under *Certain Covenants Limitation on Restricted Payments*, any Permitted Payment, any Permitted Investment, or any transaction specifically excluded from the definition of the term *Restricted Payment*.

*Restricted Subsidiary* means any Subsidiary of the Company other than an Unrestricted Subsidiary.





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*SEC* means the United States Securities and Exchange Commission.

*Senior Credit Agreement* means the Credit Agreement, dated as of May 16, 2007, among the Company, the guarantors party thereto, the banks and other financial institutions party thereto as lenders from time to time, Bank of America, N.A., as administrative agent, and the other parties thereto, as such agreement may be amended, supplemented, waived or otherwise modified from time to time or refunded, refinanced, restructured, replaced, renewed, repaid, increased or extended from time to time (whether in whole or in part, whether with the original administrative agent and lenders or other agents and lenders or otherwise, and whether provided under the original Senior Credit Agreement or other credit agreements or otherwise).

*Senior Credit Facility* means the collective reference to the Senior Credit Agreement, any Loan Documents (as defined therein), any notes and letters of credit issued pursuant thereto and any guarantee and collateral agreement, patent and trademark security agreement, mortgages, letter of credit applications and other guarantees, pledge agreements, security agreements and collateral documents, and other instruments and documents, executed and delivered pursuant to or in connection with any of the foregoing, in each case as the same may be amended, supplemented, waived or otherwise modified from time to time, or refunded, refinanced, restructured, replaced, renewed, repaid, increased or extended from time to time (whether in whole or in part, whether with the original agent and lenders or other agents and lenders or otherwise, and whether provided under the original Senior Credit Agreement or one or more other credit agreements, indentures (including the Indenture) or financing agreements or otherwise). Without limiting the generality of the foregoing, the term *Senior Credit Facility* shall include any agreement (i) changing the maturity of any Indebtedness Incurred thereunder or contemplated thereby, (ii) adding Subsidiaries of the Company as additional borrowers or guarantors thereunder, (iii) increasing the amount of Indebtedness Incurred thereunder or available to be borrowed thereunder or (iv) otherwise altering the terms and conditions thereof.

*Senior Indebtedness* means any Indebtedness of the Company or any Restricted Subsidiary other than, in the case of the Company, Subordinated Obligations and, in the case of any Note Guarantor, Guarantor Subordinated Obligations.

*Significant Domestic Subsidiary* means any Domestic Subsidiary that is a Significant Subsidiary.

*Significant Subsidiary* means any Restricted Subsidiary that would be a significant subsidiary of the Company within the meaning of Rule 1-02 under Regulation S-X promulgated by the SEC, as in effect on the Issue Date.

*S&P* means Standard & Poor's Ratings Group, a division of The McGraw-Hill Companies, Inc., and its successors.

*Stated Maturity* means, with respect to any security, the date specified in such security as the fixed date on which the payment of principal of such security is due and payable, including pursuant to any mandatory redemption provision (but excluding any provision providing for the repurchase of such security at the option of the holder thereof upon the happening of any contingency).

*Subordinated Obligations* means any Indebtedness of the Company (whether outstanding on the date of the Indenture or thereafter Incurred) that is expressly subordinated in right of payment to the Notes pursuant to a written agreement.

*Subsidiary* of any Person means any corporation, association, partnership or other business entity of which more than 50% of the total voting power of shares of Capital Stock or other equity interests (including partnership interests) entitled (without regard to the occurrence of any contingency) to vote in the election of directors, managers or trustees thereof is at the time owned or controlled, directly or indirectly, by (i) such Person or (ii) one or more Subsidiaries of such Person.



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*Subsidiary Guarantee* means any guarantee that may from time to time be entered into by a Restricted Subsidiary of the Company pursuant to the covenant described under *Certain Covenants Future Note Guarantors*.

*Subsidiary Guarantor* means any Restricted Subsidiary of the Company that enters into a Subsidiary Guarantee.

*Successor Company* shall have the meaning assigned thereto in clause (i) under *Merger and Consolidation*.

*Temporary Cash Investments* means any of the following: (i) any investment in (x) direct obligations of the United States of America or any agency or instrumentality thereof or obligations Guaranteed by the United States of America or any agency or instrumentality thereof or (y) direct obligations of any foreign country recognized by the United States of America rated at least *A* by S&P or *A-1* by Moody's (or, in either case, the equivalent of such rating by such organization or, if no rating of S&P or Moody's then exists, the equivalent of such rating by any nationally recognized rating organization), (ii) overnight bank deposits, and investments in time deposit accounts, certificates of deposit, bankers' acceptances and money market deposits (or, with respect to foreign banks, similar instruments) maturing not more than one year after the date of acquisition thereof issued by (x) any lender under the Senior Credit Agreement or (y) a bank or trust company that is organized under the laws of the United States of America, any state thereof or any foreign country recognized by the United States of America having capital and surplus aggregating in excess of \$250 million (or the foreign currency equivalent thereof) and whose long term debt is rated at least *A* by S&P or *A-1* by Moody's (or, in either case, the equivalent of such rating by such organization or, if no rating of S&P or Moody's then exists, the equivalent of such rating by any nationally recognized rating organization) at the time such Investment is made, (iii) repurchase obligations with a term of not more than 30 days for underlying securities of the types described in clause (i) or (ii) above entered into with a bank meeting the qualifications described in clause (ii) above, (iv) Investments in commercial paper, maturing not more than 270 days after the date of acquisition, issued by a Person (other than of the Company or any of its Subsidiaries), with a rating at the time as of which any Investment therein is made of *P-2* (or higher) according to Moody's or *A-2* (or higher) according to S&P (or, in either case, the equivalent of such rating by such organization or, if no rating of S&P or Moody's then exists, the equivalent of such rating by any nationally recognized rating organization), (v) Investments in securities maturing not more than one year after the date of acquisition issued or fully guaranteed by any state, commonwealth or territory of the United States of America, or by any political subdivision or taxing authority thereof, and rated at least *A* by S&P or *A* by Moody's (or, in either case, the equivalent of such rating by such organization or, if no rating of S&P or Moody's then exists, the equivalent of such rating by any nationally recognized rating organization), (vi) Preferred Stock (other than of the Company or any of its Subsidiaries) having a rating of *A* or higher by S&P or *A2* or higher by Moody's (or, in either case, the equivalent of such rating by such organization or, if no rating of S&P or Moody's then exists, the equivalent of such rating by any nationally recognized rating organization), (vii) investment funds investing 95% of their assets in securities of the type described in clauses (i)-(vi) above (which funds may also hold reasonable amounts of cash pending investment and/or distribution), (viii) any money market deposit accounts issued or offered by a domestic commercial bank or a commercial bank organized and located in a country recognized by the United States of America, in each case, having capital and surplus in excess of \$250 million (or the foreign currency equivalent thereof), or investments in money market funds complying with the risk limiting conditions of Rule 2a-7 (or any successor rule) of the SEC under the Investment Company Act of 1940, as amended, and (ix) similar investments approved by the Board of Directors in the ordinary course of business.

*TIA* means the Trust Indenture Act of 1939 (15 U.S.C. §§ 77aaa-7bbbb) as in effect on the date of the Indenture.

*TPG* means TPG Capital, LP.

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*TPG Entities* means TPG Bluegrass IV AIV 1, LP, TPG Bluegrass IV AIV 2, LP, TPG FOF V-A, LP, TPG FOF V-B, LP, TPG Bluegrass V AIV 1, LP, and TPG Bluegrass V AIV 2, LP.

*Trade Payables* means, with respect to any Person, any accounts payable or any indebtedness or monetary obligation to trade creditors created, assumed or guaranteed by such Person arising in the ordinary course of business in connection with the acquisition of goods or services.

*Transactions* means, collectively, any or all of the following:

- (a) the entry into the Indenture, the offer and issuance of the Notes, and the provision of the Parent Guarantees by the Parent Guarantors and the Subsidiary Guarantees by the Subsidiary Guarantors;
- (b) the consummation of any tender offer for, or redemption and/or other acquisition or retirement of, the Company's existing 9.50% senior subordinated notes due 2013; and
- (c) all other transactions relating to any of the foregoing (including payment of fees and expenses related to any of the foregoing).

*Trustee* means the party named as such in the Indenture until a successor replaces it and, thereafter, means the successor.

*Trust Officer* means the Chairman of the Board, the President or any other officer or assistant officer of the Trustee assigned by the Trustee to administer its corporate trust matters.

*Unrestricted Subsidiary* means (i) any Subsidiary of the Company that at the time of determination is an Unrestricted Subsidiary, as designated by the Board of Directors in the manner provided below, and (ii) any Subsidiary of an Unrestricted Subsidiary. The Board of Directors may designate any Subsidiary of the Company (including any newly acquired or newly formed Subsidiary of the Company) to be an Unrestricted Subsidiary unless such Subsidiary or any of its Subsidiaries owns any Capital Stock or Indebtedness of, or owns or holds any Lien on any property of, the Company or any other Restricted Subsidiary of the Company that is not a Subsidiary of the Subsidiary to be so designated; *provided*, that (A) such designation was made at or prior to the Issue Date, or (B) the Subsidiary to be so designated has total consolidated assets of \$1,000 or less or (C) if such Subsidiary has consolidated assets greater than \$1,000, then such designation would be permitted under the covenant described under *Certain Covenants Limitation on Restricted Payments*. The Board of Directors may designate any Unrestricted Subsidiary to be a Restricted Subsidiary; *provided*, that immediately after giving effect to such designation either the Company could incur at least \$1.00 of additional Indebtedness under paragraph (a) in the covenant described under *Certain Covenants Limitation on Indebtedness* or (y) the Consolidated Coverage Ratio would be greater than it was immediately prior to giving effect to such designation. Any such designation by the Board of Directors shall be evidenced to the Trustee by promptly filing with the Trustee a copy of the resolution of the Company's Board of Directors giving effect to such designation and an Officer's Certificate of the Company certifying that such designation complied with the foregoing provisions.

*U.S. Government Obligation* means (x) any security that is (i) a direct obligation of the United States of America for the payment of which the full faith and credit of the United States of America is pledged or (ii) an obligation of a Person controlled or supervised by and acting as an agency or instrumentality of the United States of America the payment of which is unconditionally guaranteed as a full faith and credit obligation by the United States of America, which, in either case under the preceding clause (i) or (ii), is not callable or redeemable at the option of the issuer thereof, and any depositary receipt issued by a bank (as defined in Section 3(a)(2) of the Securities Act) as custodian

with respect to any U.S. Government Obligation that is specified in clause (x) above and held by such bank for the account of the holder of such depository receipt, or with respect to any specific payment of principal of or interest on any U.S. Government Obligation

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that is so specified and held, provided that (except as required by law) such custodian is not authorized to make any deduction from the amount payable to the holder of such depositary receipt from any amount received by the custodian in respect of the U.S. Government Obligation or the specific payment of principal or interest evidenced by such depositary receipt.

*Voting Stock* of an entity means all classes of Capital Stock of such entity then outstanding and normally entitled to vote in the election of directors or all interests in such entity with the ability to control the management or actions of such entity.

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**CERTAIN U.S. FEDERAL TAX CONSIDERATIONS**

The following is a summary of certain U.S. federal income tax consequences and, in the case of a Non-U.S. Holder (as defined below), certain estate tax consequences to a holder with respect to the purchase, ownership and disposition of the notes, but does not purport to be a complete analysis of all the potential U.S. federal income and estate tax consequences of such purchase, ownership and disposition. This summary deals only with holders who will hold the notes as capital assets for U.S. federal income tax purposes and, who acquire the notes in this offering at the public offering price. This summary does not address the U.S. federal income or estate tax consequences to any particular holder of notes and does not deal with persons who may be subject to special treatment under U.S. federal income tax laws, such as financial institutions, insurance companies, regulated investment companies, real estate investment trusts, partnerships or other pass-through entities for U.S. federal income tax purposes or investors in such entities, controlled foreign corporations, passive foreign investment companies, former residents or citizens of the United States, tax-exempt organizations, individual retirement and other tax-deferred accounts, dealers in securities or currencies, holders that hold the notes as a position in a hedge, straddle, constructive sale transaction, conversion transaction, synthetic security or other integrated transaction for U.S. federal income tax purposes and U.S. Holders (defined below) whose functional currency is not the U.S. dollar. Further, this summary does not discuss any alternative minimum tax consequences, any consequences resulting from the newly enacted Medicare tax on investment income, U.S. federal gift tax laws or the tax laws of any state, local or foreign government that may be applicable to the notes.

As used in this prospectus supplement, the term U.S. Holder means a beneficial owner of the notes that is, for U.S. federal income tax purposes:

an individual who is a citizen or resident of the United States;

a corporation, or other entity treated as a corporation for U.S. federal income tax purposes, created or organized in or under the laws of the United States, any state thereof or the District of Columbia;

an estate, the income of which is subject to U.S. federal income taxation regardless of its source; or

a trust, if (1) a court within the United States is able to exercise primary supervision over the administration of the 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 effect under applicable United States Treasury Regulations to be treated as a United States person.

Except as modified for estate tax purposes, a Non-U.S. Holder is a beneficial owner of notes that is, for U.S. federal income tax purposes, an individual, corporation, estate or trust and is not a U.S. Holder.

If any entity treated as a partnership for U.S. federal income tax purposes is a beneficial owner of notes, the treatment of a partner in the partnership will generally depend upon the status of the partner and upon the activities of the partnership. A holder of notes that is a partnership and partners in such partnership should consult their tax advisors.

This summary is based on the Internal Revenue Code of 1986, as amended (the Code), Treasury Regulations promulgated thereunder, and judicial and administrative interpretations thereof, all as in effect on the date hereof and all of which are subject to change, which change may be retroactive and may affect the tax consequences described herein. We have not and will not seek any rulings from the Internal Revenue Service (IRS) regarding the matters discussed below. There can be no assurance that the IRS will not take positions concerning the tax consequences of

the purchase, ownership or disposition of the notes that are different from those discussed below.

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We urge prospective investors to consult their tax advisors with respect to the U.S. federal income and estate tax consequences to them of the purchase, ownership and disposition of notes in light of their own particular circumstances, including the tax consequences under state, local, foreign and other tax laws and the possible effects of changes in U.S. federal income, estate and other tax laws.

**U.S. Holders**

*Payment of Stated Interest*

The stated interest that is payable on the notes will be qualified stated interest (i.e., stated interest that is payable in cash at a single fixed rate at least annually over the entire term of the note) and a U.S. Holder of a note is required to include in ordinary income the stated interest payable on the note generally when received or accrued, in accordance with the holder's method of tax accounting for U.S. federal income tax purposes.

*Disposition*

Upon a redemption, sale, exchange, retirement or other disposition of a note, a U.S. Holder will recognize capital gain or loss measured by the difference, if any, between the amount received in exchange therefor (other than the portion received for accrued but unpaid stated interest, which portion is treated as interest received) and such holder's adjusted tax basis in the note. A U.S. Holder's adjusted tax basis in a note will generally be equal to the price paid for such note. Any gain or loss recognized on the redemption, sale, exchange, retirement or other disposition of a note generally will be long-term capital gain or loss if such note is held for more than one year at the time of such redemption, sale, exchange, retirement or other taxable disposition. For certain non-corporate U.S. Holders, any such long-term capital gain is currently subject to U.S. federal income tax at a reduced rate. The deduction of capital losses is subject to limitation.

*Backup Withholding and Related Information Reporting*

Under the Code and applicable Treasury Regulations, a U.S. Holder of a note may be subject to backup withholding (currently at a rate of 28% and scheduled to increase to 31% in 2011) and relating information reporting on certain amounts paid or deemed paid to the holder unless such holder (1) is a corporation or comes within certain other exempt categories and, when required, provides proof of such exemption; or (2) provides a correct taxpayer identification number, certifies that such holder has not lost exemption from backup withholding, and has met the requirements for the reporting of previous income set forth in the backup withholding rules. U.S. Holders of notes should consult their tax advisors as to their qualification for exemption from withholding and the procedure for obtaining such an exemption. Amounts paid as backup withholding do not constitute an additional tax and may be credited against a U.S. Holder's federal income tax liability and may entitle such holder to a refund provided that the required information is properly and timely submitted to the IRS.

When required, information will be reported to both U.S. Holders and the IRS regarding the amount of interest paid on the notes in each calendar year as well as the corresponding amount of tax withheld, if any exists. This obligation, however, does not apply with respect to payments to certain U.S. Holders, including corporations, provided that they establish entitlement to an exemption.

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### **Non-U.S. Holders**

#### *Payment of Interest*

In general, payments of interest received by a Non-U.S. Holder that is not effectively connected income (as described below) will not be subject to U.S. federal withholding tax, provided that:

- (1) (a) the Non-U.S. Holder does not actually or constructively own 10% or more of the total combined voting power of all classes of our stock entitled to vote;
  - (b) the Non-U.S. Holder is not a controlled foreign corporation that is related to us;
  - (c) the Non-U.S. Holder is not a bank receiving interest on an extension of credit pursuant to a loan arrangement entered into in the ordinary course of its trade or business; and
  - (d) either (i) the Non-U.S. Holder certifies it is not a United States person (within the meaning of the Code) by providing a properly completed and executed Form W-8BEN (or other applicable form) to us or our Paying Agent, or (ii) a financial institution or other intermediary that holds the note on behalf of the Non-U.S. Holder has entered into a withholding agreement with the IRS and submits an IRS Form W-8IMY (or suitable successor or substitute form) and certain other required documentation to us or our Paying Agent; or
- (2) the Non-U.S. Holder is entitled to the benefits of an income tax treaty under which interest on the notes is exempt from U.S. withholding tax and the Non-U.S. Holder or such Non-U.S. Holder's agent provides a Form W-8BEN (or other applicable form) to us or our paying agent demonstrating the exemption.

Payments of interest not exempt from U.S. federal withholding tax as described above will be subject to a 30% withholding tax (subject to reduction under an applicable income tax treaty).

#### *Disposition*

A Non-U.S. Holder generally will not be subject to U.S. federal income tax (and generally no tax will be withheld) with respect to gain realized on the redemption, sale, exchange, retirement or other taxable disposition of a note unless (1) the Non-U.S. Holder is an individual who is present in the United States for a period or periods aggregating 183 or more days in the taxable year of the disposition and certain other conditions are met, in which case the Non-U.S. Holder generally will be subject to a 30% U.S. federal income tax on any gain recognized, which may be offset by certain U.S. source losses; or (2) such gain is effectively connected with the conduct by the Non-U.S. Holder of a U.S. trade or business, as described below.

#### *Effectively Connected Income*

If interest or gain from a disposition (including a retirement or redemption) of notes is effectively connected with a Non-U.S. Holder's conduct of a U.S. trade or business, and if an income tax treaty applies and the Non-U.S. Holder maintains a U.S. permanent establishment or fixed base to which the interest or gain is generally attributable, the Non-U.S. Holder will be subject to U.S. federal income tax on the interest or gain in the same manner as if it were a U.S. Holder. A foreign corporation that is a holder of a note also may be subject to a branch profits tax on its effectively connected earnings and profits for the taxable year, subject to certain adjustments, at a rate of 30% or

lower applicable treaty rate. For this purpose, interest on a note or gain recognized on the disposition of a note will be included in earnings and profits if the interest or gain is effectively connected with the conduct by the foreign corporation of a trade or business in the United States. If

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interest income received with respect to the notes is effectively connected income, the U.S. federal withholding tax described above will not apply (assuming an appropriate certification is provided).

*Backup Withholding and Related Information Reporting*

Backup withholding (currently at a rate of 28% and scheduled to increase to 31% in 2011) and related information reporting requirements do not apply to payments of interest made by us or a Paying Agent to Non-U.S. Holders if the certification described above under Non-U.S. Holders Payment of Interest is received, provided that the payor does not have actual knowledge or reason to know that the holder is a U.S. Holder. Payments of the proceeds from a disposition (including a retirement or redemption) by a Non-U.S. Holder of a note made by or through a foreign office of a broker generally will not be subject to backup withholding and information reporting, except that information reporting (but generally not backup withholding) may apply to those payments if the broker is a United States person; a controlled foreign corporation for U.S. federal income tax purposes; a foreign person 50% or more of whose gross income is effectively connected with the conduct of a U.S. trade or business for a specified three-year period; or a foreign partnership with certain specified connections to the United States unless, in each case, the certification requirements described above are met or the holder otherwise establishes an exemption, and the broker does not have actual knowledge or reason to know the holder is a United States person. Information reporting and backup withholding generally will apply to a payment of disposition proceeds by a U.S. office of a broker, unless the Non-U.S. Holder certifies its nonresident status or otherwise establishes an exemption. Amounts paid as backup withholding do not constitute an additional tax and may be credited against a Non-U.S. Holder's U.S. federal income tax liability and may entitle such holder to a refund, provided that the required information is properly and timely submitted to the IRS. Non-U.S. Holders should consult their tax advisors regarding the filing of a U.S. federal income tax return for claiming a refund of such backup withholding.

*U.S. Federal Estate Taxes*

Subject to applicable estate tax treaty provisions, notes held at the time of death (or notes transferred before death but subject to certain retained rights or powers) by an individual who at the time of death is not a citizen or resident of the United States (as specifically defined for estate tax purposes) will not be included in such individual's gross estate for U.S. federal estate tax purposes provided that the individual does not actually or constructively own 10% or more of the total combined voting power of all classes of our stock entitled to vote or hold the notes in connection with a U.S. trade or business.

**Table of Contents****UNDERWRITING**

Banc of America Securities LLC, J.P. Morgan Securities LLC, Goldman, Sachs & Co. and Deutsche Bank Securities Inc. are acting as underwriters. Subject to the terms and conditions set forth in the underwriting agreement among us and the underwriters, we have agreed to sell to the underwriters, and each of the underwriters listed below has agreed, severally and not jointly, to purchase from us, the principal amount of notes set forth opposite its name below.

<b>Underwriter</b>	<b>Principal Amount of Notes</b>
Banc of America Securities LLC	\$
J.P. Morgan Securities LLC	
Goldman, Sachs & Co.	
Deutsche Bank Securities Inc.	
Total	\$ 250,000,000

Subject to the terms and conditions set forth in the underwriting agreement, the underwriters have agreed, severally and not jointly, to purchase all of the notes sold under the underwriting agreement if any of these notes are purchased. If an underwriter defaults, the underwriting agreement provides that the purchase commitments of the nondefaulting underwriters may be increased or the underwriting agreement may be terminated.

We have agreed to indemnify the several underwriters and their controlling persons against certain liabilities in connection with this offering, including liabilities under the Securities Act, or to contribute to payments the underwriters may be required to make in respect of those liabilities.

The underwriters are offering the notes, subject to prior sale, when, as and if issued to and accepted by them, subject to approval of legal matters by their counsel, including the validity of the notes, and other conditions contained in the underwriting agreement, such as the receipt by the underwriters of officer's certificates and legal opinions. The underwriters reserve the right to withdraw, cancel or modify offers to the public and to reject orders in whole or in part.

**Commissions and Discounts**

The underwriters propose initially to offer the notes to the public at the public offering price set forth on the cover page of this prospectus supplement and to certain dealers at such price less a concession not in excess of % of the principal amount of the notes. After the initial offering, the public offering price, concession or any other term of the offering may be changed.

The expenses of the offering, not including the underwriting discount, are estimated at \$ and are payable by us.

**New Issue of Notes**

The notes are a new issue of securities with no established trading market. We do not intend to apply for listing of the notes on any national securities exchange or for inclusion of the notes on any automated dealer quotation system. We

have been advised by the underwriters that they presently intend to make a market in the notes after completion of the offering. However, they are under no obligation to do so and may discontinue any market-making activities at any time without any notice. We cannot assure the liquidity of the trading market for the notes or that an active public market for the notes will develop. If an active public trading market for the notes does not develop, the market price and liquidity of the notes may be adversely affected. If the notes are traded, they may trade at a discount from their initial offering price, depending on

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prevailing interest rates, the market for similar securities, our operating performance and financial condition, general economic conditions and other factors.

### **No Sales of Similar Securities**

We have agreed that, for a period of 30 days as of the date of this prospectus supplement, we will not without first obtaining the prior written consent of Banc of America Securities LLC, directly or indirectly, issue, sell, offer to contract or grant any option to sell, pledge, transfer or otherwise dispose of, any debt securities or securities exchangeable for or convertible into debt securities, except for the notes sold to the initial purchasers pursuant to the underwriting agreement.

### **Short Positions**

In connection with the offering, the underwriters may purchase and sell the notes in the open market. These transactions may include short sales and purchases on the open market to cover positions created by short sales. Short sales involve the sale by the underwriters of a greater principal amount of notes than they are required to purchase in the offering. The underwriters must close out any short position by purchasing notes in the open market. A short position is more likely to be created if the underwriters are concerned that there may be downward pressure on the price of the notes in the open market after pricing that could adversely affect investors who purchase in the offering.

Similar to other purchase transactions, the underwriters' purchases to cover the syndicate short sales may have the effect of raising or maintaining the market price of the notes or preventing or retarding a decline in the market price of the notes. As a result, the price of the notes may be higher than the price that might otherwise exist in the open market.

Neither we nor any of the underwriters make any representation or prediction as to the direction or magnitude of any effect that the transactions described above may have on the price of the notes. In addition, neither we nor any of the underwriters make any representation that the representatives will engage in these transactions or that these transactions, once commenced, will not be discontinued without notice.

### **Other Relationships**

The underwriters and their respective affiliates are full service financial institutions engaged in various activities, which may include securities trading, commercial and investment banking, financial advisory, investment management, investment research, principal investment, hedging, financing and brokerage activities. Some of the underwriters and their affiliates have engaged in, and may in the future engage in, investment banking and other commercial dealings in the ordinary course of business with us or our affiliates. They have received, or may in the future receive, customary fees and commissions for these transactions. In addition, in the ordinary course of their various business activities, the underwriters and their respective affiliates may make or hold a broad array of investments and actively trade debt and equity securities (or related derivative securities) and financial instruments (including bank loans) for their own account and for the accounts of their customers, and such investment and securities activities may involve securities and/or instruments of the issuer. The underwriters and their respective affiliates may also make investment recommendations and/or publish or express independent research views in respect of such securities or instruments and may at any time hold, or recommend to clients that they acquire, long and/or short positions in such securities and instruments. Banc of America Securities LLC is acting as Dealer Manager in connection with the tender offer for our 2013 Notes. Bank of America, N.A., an affiliate of Banc of America Securities LLC, is administrative agent and a lender under our Credit Agreement. Affiliates of Deutsche Bank Securities Inc. and J.P. Morgan Securities LLC are lenders under the Credit Agreement. Certain of the underwriters and/or their respective affiliates may hold for their own accounts or for the accounts of clients the 2013 Notes and may thus receive a portion of the proceeds of the offering.





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**Notice to Prospective Investors in the EEA**

In relation to each Member State of the European Economic Area which has implemented the Prospectus Directive (each, a Relevant Member State ) an offer to the public of any notes which are the subject of the offering contemplated by this prospectus supplement may not be made in that Relevant Member State, once the prospectus has been approved by the competent authority in such Relevant Member State and published in accordance with the Prospectus Directive as implemented in such Relevant Member State except that an offer to the public in that Relevant Member State of any notes may be made at any time under the following exemptions under the Prospectus Directive, if they have been implemented in that Relevant Member State:

- (a) to legal entities which are authorized or regulated to operate in the financial markets or, if not so authorized or regulated, whose corporate purpose is solely to invest in securities;
- (b) to any legal entity which has two or more of (1) an average of at least 250 employees during the last financial year; (2) a total balance sheet of more than 43,000,000 and (3) an annual net turnover of more than 50,000,000, as shown in its last annual or consolidated accounts;
- (c) by the underwriters to fewer than 100 natural or legal persons (other than qualified investors as defined in the Prospectus Directive) subject to obtaining the prior consent of the representatives for any such offer; or
- (d) in any other circumstances falling within Article 3(2) of the Prospectus Directive;

provided that no such offer of notes shall result in a requirement for the publication by us or any representative of a prospectus pursuant to Article 3 of the Prospectus Directive.

Any person making or intending to make any offer of notes within the EEA should only do so in circumstances in which no obligation arises for us or any of the underwriters to produce a prospectus for such offer. Neither we nor the underwriters have authorized, nor do they authorize, the making of any offer of notes through any financial intermediary, other than offers made by the underwriters which constitute the final offering of notes contemplated in this prospectus supplement.

For the purposes of this provision, and your representation below, the expression an offer to the public in relation to any notes in any Relevant Member State means the communication in any form and by any means of sufficient information on the terms of the offer and any notes to be offered so as to enable an investor to decide to purchase any notes, as the same may be varied in that Relevant Member State by any measure implementing the Prospectus Directive in that Relevant Member State and the expression Prospectus Directive means Directive 2003/71/EC and includes any relevant implementing measure in each Relevant Member State.

Each person in a Relevant Member State who receives any communication in respect of, or who acquires any notes under, the offer of notes contemplated by this prospectus supplement will be deemed to have represented, warranted and agreed to and with us and each underwriter that:

- (a) it is a qualified investor within the meaning of the law in that Relevant Member State implementing Article 2(1)(e) of the Prospectus Directive; and
- (b) in the case of any notes acquired by it as a financial intermediary, as that term is used in Article 3(2) of the Prospectus Directive, (i) the notes acquired by it in the offering have not been acquired on behalf of, nor have they been acquired with a view to their offer or



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resale to, persons in any Relevant Member State other than qualified investors (as defined in the Prospectus Directive), or in circumstances in which the prior consent of the representatives has been given to the offer or resale; or (ii) where notes have been acquired by it on behalf of persons in any Relevant Member State other than qualified investors, the offer of those notes to it is not treated under the Prospectus Directive as having been made to such persons.

### **Notice to Prospective Investors in Switzerland**

This document, as well as any other material relating to the notes which are the subject of the offering contemplated by this prospectus supplement, do not constitute an issue prospectus pursuant to Article 652a of the Swiss Code of Obligations. The notes will not be listed on the SWX Swiss Exchange and, therefore, the documents relating to the notes, including, but not limited to, this document, do not claim to comply with the disclosure standards of the listing rules of SWX Swiss Exchange and corresponding prospectus schemes annexed to the listing rules of the SWX Swiss Exchange. The notes are being offered in Switzerland by way of a private placement, *i.e.* to a small number of selected investors only, without any public offer and only to investors who do not purchase the notes with the intention to distribute them to the public. The investors will be individually approached by us from time to time. This document, as well as any other material relating to the notes, is personal and confidential and do not constitute an offer to any other person. This document may only be used by those investors to whom it has been handed out in connection with the offering described herein and may neither directly nor indirectly be distributed or made available to other persons without our express consent. It may not be used in connection with any other offer and shall in particular not be copied and/or distributed to the public in (or from) Switzerland.

### **Notice to Prospective Investors in the Dubai International Financial Centre**

This document relates to an exempt offer in accordance with the Offered Securities Rules of the Dubai Financial Services Authority. This document is intended for distribution only to persons of a type specified in those rules. It must not be delivered to, or relied on by, any other person. The Dubai Financial Services Authority has no responsibility for reviewing or verifying any documents in connection with exempt offers. The Dubai Financial Services Authority has not approved this document nor taken steps to verify the information set out in it, and has no responsibility for it. The notes which are the subject of the offering contemplated by this prospectus supplement may be illiquid and/or subject to restrictions on their resale. Prospective purchasers of the notes offered should conduct their own due diligence on the notes. If you do not understand the contents of this document you should consult an authorised financial adviser.

### **Notice to Prospective Investors in Hong Kong, Japan and Singapore**

The notes may not be offered or sold by means of any document other than (i) in circumstances which do not constitute an offer to the public within the meaning of the Companies Ordinance (Cap.32, Laws of Hong Kong), or (ii) to professional investors within the meaning of the Securities and Futures Ordinance (Cap.571, Laws of Hong Kong) and any rules made thereunder, or (iii) in other circumstances which do not result in the document being a prospectus within the meaning of the Companies Ordinance (Cap.32, Laws of Hong Kong), and no advertisement, invitation or document relating to the notes may be issued or may be in the possession of any person for the purpose of issue (in each case whether in Hong Kong or elsewhere), which is directed at, or the contents of which are likely to be accessed or read by, the public in Hong Kong (except if permitted to do so under the laws of Hong Kong) other than with respect to notes which are or are intended to be disposed of only to persons outside Hong Kong or only to professional investors within the meaning of the Securities and Futures Ordinance (Cap. 571, Laws of Hong Kong) and any rules made thereunder.



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The securities have not been and will not be registered under the Financial Instruments and Exchange Law of Japan (the Financial Instruments and Exchange Law) and each underwriter has agreed that it will not offer or sell any securities, directly or indirectly, in Japan or to, or for the benefit of, any resident of Japan (which term as used herein means any person resident in Japan, including any corporation or other entity organized under the laws of Japan), or to others for re-offering or resale, directly or indirectly, in Japan or to a resident of Japan, except pursuant to an exemption from the registration requirements of, and otherwise in compliance with, the Financial Instruments and Exchange Law and any other applicable laws, regulations and ministerial guidelines of Japan.

This prospectus has not been registered as a prospectus with the Monetary Authority of Singapore. Accordingly, this prospectus and any other document or material in connection with the offer or sale, or invitation for subscription or purchase, of the notes may not be circulated or distributed, nor may the notes be offered or sold, or be made the subject of an invitation for subscription or purchase, whether directly or indirectly, to persons in Singapore other than (i) to an institutional investor under Section 274 of the Securities and Futures Act, Chapter 289 of Singapore (the SFA ), (ii) to a relevant person, or any person pursuant to Section 275(1A), and in accordance with the conditions, specified in Section 275 of the SFA or (iii) otherwise pursuant to, and in accordance with the conditions of, any other applicable provision of the SFA.

Where the notes are subscribed or purchased under Section 275 by a relevant person which is: (a) a corporation (which is not an accredited investor) the sole business of which is to hold investments and the entire share capital of which is owned by one or more individuals, each of whom is an accredited investor; or (b) a trust (where the trustee is not an accredited investor) whose sole purpose is to hold investments and each beneficiary is an accredited investor, shares, debentures and units of shares and debentures of that corporation or the beneficiaries' rights and interest in that trust shall not be transferable for 6 months after that corporation or that trust has acquired the notes under Section 275 except: (1) to an institutional investor under Section 274 of the SFA or to a relevant person, or any person pursuant to Section 275(1A), and in accordance with the conditions, specified in Section 275 of the SFA; (2) where no consideration is given for the transfer; or (3) by operation of law.

We expect that the delivery of the notes will be made against payment therefor on or about \_\_\_\_\_, 2010, which will be the tenth business day following the date of pricing of the notes (such settlement cycle being herein referred to as T+10 ). Under Rule 15c6-1 under the Exchange Act, trades in the secondary market generally are required to settle in three business days, unless the parties to any such trade expressly agree otherwise. Accordingly, the purchasers who wish to trade notes on the date of pricing or within the six trading days thereafter will be required, by virtue of the fact that the notes initially will settle T+10, to specify an alternative settlement cycle at the time of any such trade to prevent a failed settlement. Purchasers of notes who wish to trade notes on the date of pricing or within three trading days thereafter should consult their advisor.

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**LEGAL MATTERS**

The validity of the notes offered and sold in this offering will be passed upon for us by Alston & Bird LLP. Alston & Bird LLP has, from time to time, represented, currently represents, and may continue to represent, some or all of the underwriters in connection with various legal matters. Certain legal matters will be passed upon for the underwriters by Cahill Gordon & Reindel llp.

**EXPERTS**

The consolidated financial statements of the Company at December 31, 2008 and 2009 and for the years then ended, incorporated by reference from the Company's Annual Report on Form 10-K for the year ended December 31, 2009, including the schedule appearing therein, have been audited by Ernst & Young LLP, independent registered public accounting firm, as set forth in their report thereon and incorporated herein by reference. Such consolidated financial statements are incorporated herein by reference in reliance upon such reports given on the authority of such firm as experts in accounting and auditing.

The consolidated financial statements for the year ended December 31, 2007 incorporated in this prospectus supplement by reference from the Company's Annual Report on Form 10-K for the year ended December 31, 2009 have been so incorporated in reliance on the report 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**

GPHC files annual, quarterly and current reports, proxy statements and other information with the SEC under the Exchange Act. You may read and copy any reports, statements or other information on file at the SEC's public reference facility located at 100 F Street, N.E., Washington, D.C. 20549. Please call the SEC at 1-800-SEC-0330 for further information regarding its public facilities. GPHC's SEC filings are available to the public from commercial document retrieval services and also available at the Internet website maintained by the SEC at <http://www.sec.gov>. You may also retrieve GPHC's SEC filings at our Internet website at [www.graphicpkg.com](http://www.graphicpkg.com). The information contained on our website is not a part of this prospectus supplement.

We are incorporating by reference information into this prospectus supplement. This means that we are disclosing important information by referring to another document separately filed with the SEC. This information incorporated by reference is deemed to be part of this prospectus supplement, except for any information superseded by information in this prospectus supplement. This prospectus supplement incorporates by reference the documents set forth below that we have previously filed with the SEC. These documents contain important information about us.

Annual Report on Form 10-K of GPHC, as amended, for the year ended December 31, 2009;

Quarterly Reports on Form 10-Q of GPHC for the periods ended March 31, 2010 and June 30, 2010; and

Current Reports on Form 8-K of GPHC filed January 22, 2010, May 24, 2010, July 7, 2010 and August 12, 2010.

We also incorporate by reference into this prospectus supplement any future filings made with the SEC under Sections 13(a), 13(c), 14 or 15(d) of the Exchange Act (other than those made pursuant to Item 2.02 or Item 7.01 of

Form 8-K or any other information furnished to the SEC, unless specifically stated otherwise) after the date of this prospectus supplement and before the end of the offering of the securities pursuant to this prospectus supplement or the offering is otherwise terminated.

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We encourage you to read our periodic and current reports, as they provide additional information about us that prudent investors find important. You may request a copy of these filings without charge by writing to or by telephoning us at the following address:

Graphic Packaging Holding Company  
814 Livingston Court  
Marietta, GA 30067  
(770) 644-3000  
Attention: Investor Relations Department

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**GRAPHIC PACKAGING HOLDING COMPANY**  
**Common Stock, Preferred Stock, Debt Securities, Guarantees of Debt Securities,**  
**Depository Shares, Warrants, Purchase Contracts and Units**

**GRAPHIC PACKAGING INTERNATIONAL, INC.**  
**Debt Securities Guaranteed by Graphic Packaging Holding Company and Guarantees of Debt Securities**

We may offer, issue and sell from time to time, together or separately, up to \$500,000,000 of the securities in one or more offerings.

**Graphic Packaging Holding Company**

Graphic Packaging Holding Company may offer and sell the following securities:

- common stock;
- preferred stock;
- debt securities;
- guarantees of debt securities;
- depository shares;
- warrants to purchase common stock, preferred stock or debt securities;
- purchase contracts; or
- units.

**Graphic Packaging International, Inc.**

Graphic Packaging International, Inc. may offer and sell the following securities:

- debt securities guaranteed by Graphic Packaging Holding Company; or
- guarantees of debt securities.

This prospectus describes some of the general terms that may apply to these securities. The specific terms of any securities to be offered will be described in a supplement to this prospectus. The prospectus supplement may also add, update or change information contained in this prospectus. You should read this prospectus and the applicable prospectus supplement carefully before you make your investment decision. This prospectus may not be used to sell securities unless accompanied by a prospectus supplement.

We may offer and sell these securities to or through one or more underwriters, dealers and agents, or directly to purchasers, on a continuous or delayed basis. The supplements to this prospectus will describe the terms of any offering of these securities, including any underwriting arrangements. See Plan of Distribution.

Our common stock is listed on the New York Stock Exchange under the trading symbol GPK. Each prospectus supplement will indicate if the securities offered thereby will be listed on any securities exchange.

**You should carefully read and consider the risk factors included in our periodic reports and other information that we file with the Securities and Exchange Commission before your invest in our securities.**

**Neither the Securities and Exchange Commission nor any state securities commission has approved or disapproved of these securities or passed upon the accuracy or adequacy of this prospectus. Any representation to the contrary is a criminal offense.**

The date of this prospectus is July 1, 2010.

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We include cross references to captions elsewhere in this prospectus where you can find related additional information. The following table of contents tells you where to find these captions.

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In this prospectus, except as otherwise indicated, the terms Company, we, us or our mean Graphic Packaging Holding Company and all entities included in our consolidated financial statements. GPHC refers to Graphic Packaging Holding Company, GPC refers to Graphic Packaging Corporation, and GPII refers to Graphic Packaging International, Inc.

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**ABOUT THIS PROSPECTUS**

This prospectus is part of a registration statement on Form S-3 that we filed with the Securities and Exchange Commission, or the SEC, using a shelf registration process. Under this shelf registration process, we may, from time to time, sell any combination of the securities described in this prospectus up to a maximum aggregate offering of \$500,000,000. This prospectus provides you with a general description of those securities. Each time we sell securities, we will provide a prospectus supplement that will contain specific information about the terms of that offering, including the specific amounts, prices and terms of the securities offered. The prospectus supplement may also add, update or change information contained in this prospectus. If there is any inconsistency between the information in this prospectus and any prospectus supplement, you should rely on the information in the prospectus supplement. You should read this prospectus and the applicable prospectus supplement together with the additional information described under the heading **Where You Can Find More Information**.

**WHERE YOU CAN FIND MORE INFORMATION**

You may obtain from the SEC, through the SEC's website or at the SEC's offices mentioned in the following paragraph, a copy of the registration statement, including exhibits, that we have filed with the SEC to register the securities offered under this prospectus. This prospectus is part of the registration statement and does not contain all the information in the registration statement on Form S-3. You will find additional information about us in the registration statement. Any statement made in this prospectus concerning a contract or other document of ours is not necessarily complete, and you should read the documents that are filed as exhibits to the registration statement or otherwise filed with the SEC for a more complete understanding of the document or matter. Each such statement is qualified in all respects by reference to the document to which it refers.

We file annual, quarterly and current reports, proxy statements and other information with the SEC. Our SEC filings are available to the public over the Internet at the SEC's website at [www.sec.gov](http://www.sec.gov) and on our corporate website at [www.graphicpkg.com](http://www.graphicpkg.com). Information on our website does not constitute part of this prospectus. You may inspect without charge any documents filed by us at the SEC's Public Reference Room at 100 F Street, N.E., Washington, D.C. 20549. You may obtain copies of all or any part of these materials from the SEC upon the payment of certain fees prescribed by the SEC. Please call the SEC at 1-800-SEC-0330 for further information on the Public Reference Room.

We incorporate by reference into this prospectus documents we file with the SEC, which means that we can disclose important information to you by referring you to those documents. The information incorporated by reference is an important part of this prospectus. Some information contained in this prospectus updates the information incorporated by reference, and information that we file subsequently with the SEC will automatically update this prospectus. In other words, in the case of a conflict or inconsistency between information set forth in this prospectus and information that we file later and incorporate by reference into this prospectus, you should rely on the information contained in the document that was filed later.

We incorporate by reference into this prospectus the documents listed below and any filings we make with the SEC under Sections 13(a), 13(c), 14, or 15(d) of the Securities Exchange Act of 1934, as amended, or the Exchange Act, after the initial filing of the registration statement that contains this prospectus and prior to the time that all the securities offered by this prospectus have been issued as described in this prospectus (other than, in each case, documents or information deemed to have been furnished and not filed in accordance with SEC rules):

our Annual Report on Form 10-K for the year ended December 31, 2009 (filed on February 23, 2010);

our Quarterly Report on Form 10-Q for the quarter ended March 31, 2010 (filed on May 6, 2010);

our Current Reports on Form 8-K filed on January 22, 2010 and May 24, 2010; and

the description of our common stock set forth in our Registration Statement on Form 8-A filed pursuant to Section 12 of the Exchange Act on March 10, 2008 and any amendment or report filed for the purpose of updating that description.

You may request a copy of the registration statement, the above filings and any future filings that are incorporated by reference into this prospectus, other than an exhibit to a filing unless that exhibit is specifically incorporated by reference into that filing, at no cost, by writing or calling us at the following address: Office of the Secretary, Graphic Packaging Holding Company, 814 Livingston Court, Marietta, Georgia 30067; telephone: (770) 644-3000.

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You should rely only on the information contained or incorporated by reference in this prospectus, any accompanying prospectus supplement or any free writing prospectus filed by us with the SEC and any information about the terms of securities offered conveyed to you by us, our underwriters or agents. We have not authorized anyone else to provide you with additional or different information. These securities are only being offered in jurisdictions where the offer is permitted. You should not assume that the information contained in this prospectus, any accompanying prospectus supplement or any free writing prospectus is accurate as of any date other than their respective dates.

### **CAUTIONARY NOTE REGARDING FORWARD-LOOKING STATEMENTS**

Certain statements regarding our expectations, including, but not limited to, statements regarding the effect of deflation of certain input costs, price increases for coated paperboard and cartons, cost savings from the Company's continuous improvement programs, capital investment, depreciation and amortization, interest expense, debt reduction and pension plan contributions in this prospectus constitute forward-looking statements as defined in the Private Securities Litigation Reform Act of 1995. Such statements are based on currently available operating, financial and competitive information and are subject to various risks and uncertainties that could cause actual results to differ materially from the Company's historical experience and present expectations. These risks and uncertainties include, but are not limited to, the Company's substantial amount of debt, inflation of and volatility in raw material and energy costs, continuing pressure for lower cost products, the Company's ability to implement its business strategies, including productivity initiatives and cost reduction plans, currency movements and other risks of conducting business internationally, and the impact of regulatory and litigation matters, including those that could limit the Company's ability to utilize its net operating losses to offset taxable income and those that impact the Company's ability to protect and use its intellectual property. Undue reliance should not be placed on such forward-looking statements, as such statements speak only as of the date on which they are made and the Company undertakes no obligation to update such statements. Additional information regarding these and other risks is contained in the Company's annual report on Form 10-K for the fiscal year ended December 31, 2009 and other reports subsequently filed with the SEC.

### **OUR COMPANY**

We are a leading provider of packaging solutions for a wide variety of products to food, beverage and other consumer products companies. Additionally, we are the largest U.S. producer of folding cartons and hold leading market positions in coated unbleached kraft paperboard, coated-recycled boxboard and multi-wall bags. Our customers include some of the most widely recognized companies in the world. We strive to provide our customers with packaging solutions designed to deliver marketing and performance benefits at a competitive cost by capitalizing on our low-cost paperboard mills and converting plants, proprietary carton and packaging designs and commitment to customer service. We have approximately 13,100 employees.

On March 10, 2008, the business of GPC was combined with the business of Altivity Packaging, LLC ( Altivity ). Altivity was the largest privately-held producer of folding cartons and a market leader in all of its major businesses, including coated-recycled boxboard, multi-wall bag and specialty packaging. The combination brought together two of the most innovative, value-added paperboard packaging companies in the global packaging market with expanded product offerings, market reach and technology capabilities. As part of the integration with Altivity, we have achieved cost synergies and operating efficiencies sooner than expected. We have already implemented steps that we believe will result in at least \$100 million in annual synergies. We believe further opportunities exist to optimize our manufacturing operations.

As a result of the combination with Altivity (the Altivity Transaction ), our business segments were revised. We report our results in three business segments: paperboard packaging, multi-wall bag and specialty packaging. For a more detailed description, see Business and Management's Discussion and Analysis of Financial Condition and Results of Operations included in our annual report on Form 10-K for the fiscal year ended December 31, 2009 and our quarterly

report on Form 10-Q for the quarter ended March 31, 2010.

**Table of Contents****USE OF PROCEEDS**

Except as may be otherwise set forth in the applicable prospectus supplement accompanying this prospectus, the net proceeds from the sale of the securities will be used for general corporate purposes, including:

- repayment of short-term or long-term borrowings;
- acquisitions of or investments in businesses or assets;
- working capital; and
- capital expenditures.

Pending application of the net proceeds, we may temporarily invest the net proceeds in short-term marketable securities.

**RATIOS OF EARNINGS TO FIXED CHARGES**

Our ratios of earnings to fixed charges for the three months ended March 31, 2010 and the five fiscal years ended December 31, 2009 are set forth below:

	<b>Three Months Ended March 31, 2010</b>	<b>2009</b>	<b>Year Ended December 31,</b>			
			<b>2008</b>	<b>2007</b>	<b>2006</b>	<b>2005</b>
Ratio of Earnings to Fixed Charges(1)(2)	1.3x	1.4x	(3)	(3)	(3)	(3)

- (1) For purposes of calculating this ratio, earnings consists of income from continuing operations before income taxes and income from equity affiliates plus (a) fixed charges minus interest capitalized during the period, (b) distributed income from equity affiliates and (c) amortization of previously capitalized interest. Fixed charges consist of interest expense, capitalized interest, amortization of discount on indebtedness and an appropriate portion of rental expense representative of the interest factor.
- (2) Currently, we have no shares of preferred stock outstanding and thus have not paid any dividends on preferred stock in the periods presented. Therefore, the ratio of earnings to combined fixed charges and preference dividends is not shown because it is not different from the ratio of earnings to fixed charges.
- (3) Earnings for the years ended 2008, 2007, 2006 and 2005 were inadequate to cover fixed charges by \$64.1 million, \$24.2 million, \$75.6 million and \$67.9 million respectively.

**DESCRIPTION OF CAPITAL STOCK****Overview**



Our restated certificate of incorporation authorizes 1 billion shares of common stock, par value \$0.01 per share, and 100 million shares of preferred stock, par value \$0.01 per share. Approximately 343.2 million shares of our common stock are issued and outstanding, and no shares of preferred stock are issued and outstanding.

The following descriptions of our capital stock and provisions of our restated certificate of incorporation and amended and restated by-laws are summaries of their material terms and provisions and are qualified by reference to the complete text of our certificate of incorporation and by-laws, which are incorporated by reference in their entirety and filed as exhibits to the registration statement of which this prospectus is a part.

### **Common Stock**

Holders of our common stock are entitled to one vote for each share held on all matters submitted to a vote of stockholders and do not have cumulative voting rights. Holders of common stock are entitled to receive proportionately any dividends that may be declared by our board of directors, subject to the preferences and rights of any shares of preferred stock. In the event of our liquidation, dissolution or winding-up, holders of common stock will be entitled to receive proportionately any of our assets remaining after the payment of debts and liabilities and subject to the preferences and rights of any shares of preferred stock. Holders of common stock have no preemptive, subscription, redemption or conversion rights. The rights and privileges of holders of our common stock will be subject to any series of preferred stock that we may issue in the future, as described below.

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### **Preferred Stock**

Our certificate of incorporation provides that our board of directors has the authority, without further vote or action by our stockholders, to issue up to 100 million shares of preferred stock in one or more series and to fix the number of shares constituting any such series and the preferences, limitations and relative rights, including but not limited to, dividend rights, dividend rate, voting rights, terms of redemption, redemption price or prices, conversion rights and liquidation preferences of the shares constituting any series. The issuance of preferred stock could adversely affect the rights of holders of common stock.

Our certificate of incorporation authorizes shares of preferred stock that may be designated Series A junior participating preferred stock in connection with our stockholder rights plan. See [Stockholder Rights Plan](#) below.

### **Change of Control Related Provisions**

A number of provisions in our certificate of incorporation and by-laws and under the Delaware General Corporation Law, or the DGCL, may make it more difficult for third parties to acquire control of us. These provisions may have the effect of delaying, deferring, discouraging, preventing or rendering more difficult a future takeover attempt which is not approved by our board of directors, but which individual stockholders may deem to be in their best interests or in which stockholders may receive a substantial premium for their shares over then current market prices. As a result, stockholders who might desire to participate in such a transaction may not have an opportunity to do so. In addition, these provisions may adversely affect the prevailing market price of the common stock. These provisions are intended to:

discourage some types of transactions that may involve an actual or threatened change in control;

discourage certain tactics that may be used in proxy fights;

enhance the likelihood of continuity and stability in the composition of our board of directors;

ensure that our board of directors will have sufficient time to act in what the board believes to be in the best interests of us and our stockholders; and

encourage persons seeking to acquire control of us to consult first with our board to negotiate the terms of any proposed business combination or offer.

### ***Unissued Shares of Common Stock***

There are currently outstanding approximately 343.2 million shares of our authorized common stock. The remaining shares of authorized and unissued common stock are available for future issuance without additional stockholder approval, except as may be required by the rules or regulations of the New York Stock Exchange (the NYSE) or other stock exchange on which our common stock may be listed. While the additional shares are not designed to deter or prevent a change of control, under some circumstances we could use the additional shares to create voting impediments or to frustrate persons seeking to effect a takeover or otherwise gain control by, for example, issuing those shares in private placements to purchasers who might side with our board of directors in opposing a hostile takeover bid.

### ***Unissued Shares of Preferred Stock***

Our certificate of incorporation grants our board of directors the authority, without any further vote or action by our stockholders, except as may be required by the rules or regulations of the NYSE or other stock exchange on which our common stock may be listed, to issue preferred stock in one or more series and to fix the number of shares constituting any such series and the preferences, limitations and relative rights, including but not limited to, dividend rights, dividend rate, voting rights, terms of redemption, redemption price or prices, conversion rights and liquidation preferences of the shares constituting any series. The existence of authorized but unissued preferred stock could reduce our attractiveness as a target for an unsolicited takeover bid since we could, for example, issue shares of preferred stock to parties who might oppose such a takeover bid or shares that contain terms the potential acquirer may find unattractive. This may have the effect of delaying or preventing a change in control, may discourage bids for the common stock at a premium over the market price of the common stock, and may adversely affect the market price of, and the voting and other rights of the holders of, common stock.

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***Classified Board of Directors, Vacancies and Removal of Directors***

Our certificate of incorporation and by-laws provide that our board of directors is divided into three classes of even number or nearly even number, with each class elected for staggered three-year terms expiring in successive years. Any effort to obtain control of our board of directors by causing the election of a majority of the board of directors may require more time than would be required without a staggered board structure. Under the DGCL, for companies like us with a classified board of directors, stockholders may remove directors only for cause. Vacancies (including a vacancy created by increasing the size of the board) in our board of directors may only be filled by a majority vote of our directors. Any director elected to fill a vacancy will hold office for the remainder of the full term of the class of directors in which the vacancy occurred (including a vacancy created by increasing the size of the board) and until such director's successor shall have been duly elected and qualified. No decrease in the number of directors will shorten the term of any incumbent director. Our certificate of incorporation and by-laws provide that the number of directors will be fixed and increased or decreased from time to time solely by resolution of the board of directors, but the board of directors will at no time consist of fewer than three directors. These provisions may have the effect of slowing or impeding a third party from initiating a proxy contest, making a tender offer or otherwise attempting a change in the membership of our board of directors that would effect a change of control.

***Advance Notice Requirements for Nomination of Directors and Presentation of New Business at Meetings of Stockholders; Action by Written Consent***

Our by-laws provide for advance notice requirements for stockholder proposals and nominations for director. Generally, to be timely, notice must be delivered to us not fewer than 90 days nor more than 120 days prior to the first anniversary date of the annual meeting for the preceding year. In addition, under the provisions of both our certificate of incorporation and by-laws, action may not be taken by written consent of stockholders; rather, any action taken by the stockholders must be effected at a duly called annual or special meeting. A special meeting may only be called by our board of directors. These provisions make it more procedurally difficult for a stockholder to place a proposal or nomination on the meeting agenda or to take action without a meeting, and therefore may reduce the likelihood that a stockholder will seek to take independent action to replace directors or seek a stockholder vote with respect to other matters that are not supported by management.

***Business Combination under Delaware Law***

We are subject to Section 203 of the DGCL. Subject to specified exceptions, Section 203, as currently in effect, prohibits a publicly held Delaware corporation from engaging in a business combination with an interested stockholder for a period of three years following the date the person became an interested stockholder, unless:

before that date, the board of directors approved either the business combination or the transaction in which such stockholder became an interested stockholder;

upon consummation of the transaction that resulted in the stockholder's becoming an interested stockholder, the interested stockholder owned at least 85% of the voting stock of the corporation outstanding at the time the transaction commenced, other than statutorily excluded shares; or

on or after that date, the business combination is approved by the board of directors and authorized at an annual or special meeting of stockholders, and not by written consent, by the affirmative vote of holders of at least 66<sup>2</sup>/<sub>3</sub>% of the corporation's outstanding voting stock which is not owned by the interested stockholder.

A business combination, as further defined by the DGCL, includes a merger, asset or stock sale, or other transaction resulting in a financial benefit to the interested stockholder. Except as otherwise described in the DGCL, an interested

stockholder is defined to include (1) any person that is the owner of 15% or more of the outstanding voting stock of the corporation, or is an affiliate or associate of the corporation and was the owner of 15% or more of the outstanding voting stock of the corporation at any time within three years immediately before the date of determination, and (2) the affiliates and associates of any such person.

Certain stockholders that are members or affiliates of the Coors family (the Coors Family Stockholders ) as well as certain investment partnerships organized by TPG Capital that became stockholders as a result of the Altivity Transaction (the TPG Entities ) and their respective affiliates or associates are not be subject to the restrictions imposed by Section 203 because our board of directors approved the transactions, i.e., the business combinations, in which those stockholders became interested stockholders.

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***Limitation of Liability of Directors***

Our certificate of incorporation provides that no director will be personally liable to us or our stockholders for monetary damages for breach of fiduciary duty as a director, except to the extent that this limitation on or exemption from liability is not permitted by the DGCL. As currently enacted, the DGCL permits a corporation to provide in its certificate of incorporation that a director of the corporation will not be personally liable to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, except for liability for:

- any breach of the director's duty of loyalty to the corporation or our stockholders;
- acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law;
- payments of unlawful dividends or unlawful stock repurchases or redemptions; or
- any transaction from which the director derived an improper personal benefit.

The principal effect of this limitation on liability provision is that a stockholder will be unable to recover monetary damages against a director for breach of fiduciary duty unless the stockholder can demonstrate that one of the exceptions listed in the DGCL applies. The inclusion of this provision in our certificate of incorporation may discourage or deter stockholders or management from bringing a lawsuit against our directors for a breach of their fiduciary duties, even though such an action, if successful, might otherwise have benefited us and our stockholders. This provision should not affect the availability of equitable remedies such as an injunction or rescission of a transaction based upon a director's breach of his or her fiduciary duties.

The DGCL provides that a corporation may indemnify its directors and officers as well as its other employees and agents against judgments, fines, amounts paid in settlement and expenses, including attorneys' fees, actually and reasonably incurred in connection with various proceedings, other than an action brought by or in the right of the corporation, if such person acted in good faith and in a manner he or she reasonably believed to be in or not opposed to the best interests of the corporation, and, with respect to any criminal action or proceeding, if he or she had no reasonable cause to believe his or her conduct was unlawful. A similar standard applies to actions brought by or in the right of the corporation, except that indemnification in such a case may only extend to expenses, including attorneys' fees, incurred in connection with the defense or settlement of such actions, and the statute requires court approval before there can be any indemnification where the person seeking indemnification has been found liable to the corporation.

Our certificate of incorporation and, with regard to our officers, our by-laws provide that we will indemnify our current and former directors, as well as any person who has agreed to become a director, and officers to the fullest extent permitted by the DGCL. Under these provisions and subject to the DGCL, we are required to indemnify our directors and officers for all judgments, fines, settlements, liabilities, losses, ERISA excise taxes or penalties, legal fees and other expenses actually and reasonably incurred in connection with pending or threatened legal proceedings because of the director's or officer's position with us or another entity that the director or officer serves as a director, officer, employee or agent at our request, subject to various conditions, and to advance funds to our directors and officers before final disposition of such proceedings to enable them to defend against such proceedings. To receive indemnification, the director or officer must have met the applicable standard of conduct required by Delaware law to be indemnified.

Unless otherwise ordered by a court, any indemnification of a present or former director, officer or employee of the Company shall be made by us (and may be made by us in the case of an agent) upon a determination that indemnification of such person is proper because he or she has met the applicable standard of conduct required by

Delaware law to be indemnified. With respect to a person who is a director or officer at the time of such determination, such determination shall be made: (i) by a majority vote of the directors who are not parties to the proceeding, even though less than a quorum, (ii) a committee of such directors designated by a majority vote of such directors, even though less than a quorum, (iii) by independent legal counsel in a written opinion if there are no such directors or if such directors so direct, or (iv) by our stockholders. The by-laws also specifically authorize us to maintain insurance on behalf of any person who is or was or has agreed to become a director, officer, employee or agent, or is or was serving at our request as a director, officer, employee or agent of another entity, against certain liabilities.

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***Supermajority Voting Requirement for Amendment of Certain Provisions of Our Certificate of Incorporation and By-Laws***

The provisions of our certificate of incorporation governing, among other things, the classified board, the liability of directors and the elimination of the ability of stockholders to act by written consent, may not be amended, altered or repealed unless the amendment is approved by the vote of holders of 75% of the combined voting power of the then outstanding shares entitled to vote thereon. This requirement exceeds the majority vote of the outstanding stock that would otherwise be required by the DGCL for the repeal or amendment of such provisions of the certificate of incorporation. Our by-laws may be amended by the board of directors or by the vote of holders of 75% of the combined voting power of the then outstanding shares entitled to vote thereon. These provisions make it more difficult for any person to remove or amend any provisions that may have an anti-takeover effect.

**Stockholder Rights Plan**

We have adopted a stockholder rights plan under which each outstanding share of our common stock will be coupled with a stock purchase right. The description and terms of the rights can be found in a rights agreement between us and Wells Fargo Bank, N.A., as the rights agent. The following is a summary of the material provisions of the rights plan. This summary is qualified in its entirety by reference to the rights plan, which is attached as an exhibit to the registration statement of which this prospectus is a part and incorporated herein by reference in its entirety. This summary may not contain all of the information about the rights plan which is important to you, and we encourage you to read the rights plan in its entirety.

The rights are currently attached to the certificates representing outstanding shares of common stock, and no separate rights certificates will be distributed. The rights are transferable only with the common stock until a distribution date (as described below). Each right entitles the holder to purchase one one-thousandth of a share of our Series A junior participating preferred stock at an exercise price of \$20.00, subject to adjustment. Each one one-thousandth of a share of Series A junior participating preferred stock will have economic and voting terms approximately equivalent to one share of our common stock. Until it is exercised, the right itself will not entitle the holder of the right to any rights as a stockholder, including the right to receive dividends or to vote at stockholder meetings.

The rights are not exercisable until the distribution date and will expire at the close of business on March 10, 2018, unless earlier redeemed or exchanged by us. As soon as practicable after the distribution date, we would issue separate certificates representing the rights which would trade separately from the shares of our common stock. A distribution date would generally occur upon the earlier of:

the tenth day after the first public announcement by or communication to us that a person or group of affiliated or associated persons (referred to as an acquiring person) has acquired beneficial ownership of 15% or more of our outstanding common stock (the date of such announcement or communication is referred to as the stock acquisition time); or

the tenth business day after the commencement or first public announcement of the intention to commence a tender offer or exchange offer that would result in a person or group becoming an acquiring person.

However, an acquiring person will not include us, any of our subsidiaries, any of our employee benefit plans or any person or entity acting under our employee benefit plans. In addition, an acquiring person will not include stockholders, including the Coors Family Stockholders and the TPG Entities, who beneficially owned 15% or more of our outstanding common stock immediately after the completion of the Altiivity Transaction (referred to as grandfathered persons, provided that any such stockholder will cease to be a grandfathered person at such time when such stockholder beneficially owns less than 15% of our outstanding common stock).



If any person becomes an acquiring person, each right will represent, instead of the right to acquire one one-thousandth of a share of Series A junior participating preferred stock, the right to receive upon exercise a number of shares of common stock having a value equal to two times the purchase price of the right, subject to certain exceptions. All rights that are beneficially owned by an acquiring person or its transferee will become null and void.

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If at any time after a public announcement has been made or we have received notice that a person has become an acquiring person and:

we are acquired in a merger or other business combination and we are not the surviving corporation; or

50% or more of our assets, cash flow or earning power (taken as a whole with our subsidiaries) is sold or transferred;

each right, except rights that previously have been voided as described above, will represent the right to receive, upon exercise, common stock of the acquiring company having a value equal to two times the purchase price of the right.

At any time until the earlier of (1) the time we become aware that a person has become an acquiring person or (2) March 10, 2018, we may redeem all the rights at a price of \$0.001 per right. At any time after a person has become an acquiring person and before the acquisition by such person and its affiliates of 50% or more of the outstanding shares of our common stock, we may exchange the rights, in whole or in part, at an exchange ratio of one share of common stock per right.

The purchase price of the rights, the number of thousandths of a share of Series A junior participating preferred stock and the amount of common stock, cash or other securities or property issuable upon exercise of, or exchange for, the rights, and the number of such rights outstanding, are subject to adjustment from time to time to prevent dilution. Except as provided in the rights agreement, no adjustment in the purchase price or the number of shares of Series A junior participating preferred stock issuable upon exercise of a right will be required until the cumulative adjustment would require an increase or decrease of at least 1% in the purchase price or number of shares for which a right is exercisable.

Before the time that a person or group becomes an acquiring person, and subject to specified limitations, the rights agreement may be supplemented or amended by us and the rights agent, without the approval of the holders of the rights.

The stockholder rights plan is designed to protect stockholders in the event of unsolicited offers to acquire us and other coercive takeover tactics which, in the opinion of our board of directors, could impair our ability to represent stockholder interests. The rights will not prevent a takeover of us. However, the provisions of the stockholder rights plan may render an unsolicited takeover more difficult or less likely to occur, even though such takeover may offer our stockholders the opportunity to sell their stock at a price above the prevailing market rate and/or may be favored by a majority of our stockholders.

## **Stockholders Agreement**

The following is a summary of the material provisions of the stockholders agreement. This summary is qualified in its entirety by reference to the stockholders agreement, which is incorporated by reference in its entirety and is included as an exhibit to the registration statement of which this prospectus is a part. This summary may not contain all of the information about the stockholders agreement which is important to you, and we encourage you to read the stockholders agreement in its entirety.

Certain of our significant stockholders, including the Coors Family Stockholders, Clayton, Dubilier & Rice Fund V Limited Partnership (the CDR Fund), Old Town, S.A. (formerly known as EXOR Group S.A.) (Old Town), Field Holdings, Inc. and the TPG Entities, entered into the stockholders agreement in connection with the Altivity Transaction. The parties thereto have made certain agreements regarding matters further described below, that, among other things: (i) provides the covered stockholders certain rights to designate members of our board of directors;

(ii) restricts the ability of the covered stockholders to transfer their shares of our common stock; and (iii) limits the covered stockholders from acquiring additional shares of our common stock and from taking certain other actions with respect to us.

***Designation Rights***

The stockholders agreement provides that each of the Coors Family Stockholders, the CDR Fund, Old Town and the TPG Entities will have the right, subject to requirements related to stock ownership, to designate a certain number of individuals for nomination for election to our board of directors as described below. Each of the Coors Family Stockholders, the CDR Fund and Old Town is entitled to designate one individual for nomination for

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election to the board for so long as each such stockholder owns at least 3% of the fully diluted shares of our common stock.

The TPG Entities, as a group, are entitled to designate the following number of individuals for nomination for election to our board of directors for so long as they meet the requirements related to stock ownership specified below:

three individuals for so long as the TPG Entities own at least 20% of our fully diluted shares common stock in the aggregate;

two individuals for so long as the TPG Entities own at least the lesser of (i) 16% of our fully diluted shares common stock in the aggregate or (ii) the percentage of our common stock then held by the Coors Family Stockholders, so long as that percentage is not less than 10%; and

one individual for so long as the TPG Entities own at least 3% of the fully diluted outstanding shares of our common stock.

The stockholders agreement further provides that each of our other directors, not designated in the manner described above, will be independent directors, as described below, designated for nomination by the nominating and corporate governance committee of our board.

Pursuant to the stockholders agreement, at each meeting of our stockholders at which directors are to be elected, we will recommend that our stockholders elect to the board of directors the designees of the individuals designated by the Coors Family Stockholders, the CDR Fund, Old Town and the TPG Entities. In addition, our then serving Chief Executive Officer shall be nominated for election to the board.

In the event that the Coors Family Stockholders, the CDR Fund, Old Town or the TPG Entities lose the right to designate a person to the board, such designee will resign immediately upon receiving notice from the nominating and corporate governance committee that it has identified a replacement director, and will resign in any event no later than 120 days after the designating person or entity loses the right to designate such designee to the board. The board seat formerly occupied by such designee shall become a seat for an additional independent director to be selected solely by the nominating and corporate governance committee or the board may determine to reduce its size by the number of vacated board seats.

An independent director is a director who: (i) is not an officer or employee of the Company or any of its affiliates, (ii) is not an officer or employee of any covered stockholder or, if such covered stockholder is a trust, a direct or indirect beneficiary of such trust and (iii) meets the standards of independence under applicable law and the requirements applicable to companies listed on the NYSE.

***Agreement to Vote for Directors; Vacancies***

Each covered stockholder is obligated to vote all of the shares owned by such covered stockholder in favor of the CEO director and each of the parties' designees to the board, and to take all other steps within such covered stockholder's power to ensure that the composition of the board is as contemplated by the stockholders agreement.

As long as the Coors Family Stockholders, the CDR Fund, Old Town or the TPG Entities, as the case may be, has the right to designate a person for nomination for election to the board, at any time at which the seat occupied by such party's designee becomes vacant as a result of death, disability, retirement, resignation, removal or otherwise, such party will be entitled to designate for appointment by the remaining directors an individual to fill such vacancy and to serve as a director. We, along with each of the covered stockholders, have agreed to take such actions as will result in

the appointment to the board as soon as practicable of any individual so designated by the Coors Family Representative, the CDR Fund, Old Town or the TPG Entities.

At any time at which a vacancy is created on the board as a result of the death, disability, retirement, resignation, removal or otherwise of one of the independent directors before the expiration of his or her term as director, the nominating and corporate governance committee will notify the board of a replacement who is an independent director. We, along with and the covered stockholders has agreed to take such actions as will result in the appointment of such replacement to the board as soon as practicable.

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***Actions of the Board of Directors; Affiliate Agreements***

The stockholders agreement provides that actions of the board will require the affirmative vote of at least a majority of the directors present in person or by telephone at a duly convened meeting at which a quorum is present, or the unanimous written consent of the board, except that a board decision regarding the merger, consolidation or sale of substantially all our assets will require the affirmative vote of a majority of the directors then in office. In addition, a decision by us to enter into, modify or terminate any agreement with an affiliate of the Coors Family Stockholders, the CDR Fund, Old Town or the TPG Entities will require the affirmative vote of a majority of the directors not nominated by a covered stockholder which, directly or indirectly through an affiliate, has an interest in that agreement.

***Committees of the Board of Directors***

The stockholders agreement provides for the board to have an audit committee, a compensation and benefits committee and a nominating and corporate governance committee as follows:

the audit committee will have at least three members, each of whom will be an independent director;

the compensation and benefits committee will have three members, each of whom will be an independent director; and

the nominating and corporate governance committee will have five members, consisting of the directors designated by the Coors Family Stockholders, the CDR Fund, Old Town and two of the directors designated by the TPG Entities, plus in certain circumstances, a non-voting chairman.

The rights described above of each of the covered stockholders to have its director designee sit as a member of board committees will cease at such time as such stockholder holds less than 3% of the fully diluted shares of our common stock, and in the case of the two TPG Entities designees on the nominating and corporate governance committee, one such designee shall resign from the committee at such time as the TPG Entities have the right to designate only one director for nomination for election to the board. Our board of directors will fill any committee seats that become vacant in the manner provided in the preceding sentence with independent directors. The stockholders agreement prohibits the board from forming an executive committee.

***Transfer Restrictions***

The covered stockholders are restricted from transferring their shares, except:

to us or in a transaction approved by the our board of directors;

to certain affiliated permitted transferees that agree to be bound by the stockholders agreement;

pursuant to a public offering; or

pursuant to a transfer made in accordance with Rule 144 of the Securities Act or that is exempt from the registration requirements of the Securities Act, to any person so long as such transferee would not own in excess of 5% of the fully diluted shares of our common stock.

***Standstill Agreement***

The covered stockholders are also subject to standstill provisions that generally restrict the covered stockholders from acquiring additional equity securities of us (or any rights to purchase equity securities) that would increase such covered stockholder's beneficial ownership of our common stock on a percentage basis greater than the percentage held as of the closing date of the Altivity Transaction, or otherwise take action to increase such covered stockholder's control over us. These restrictions prohibit the covered stockholders from taking the following actions, among other items:

acquiring the beneficial ownership of additional equity securities (or the rights to purchase equity securities) of us, subject to certain exceptions;

making or participating in any solicitation of proxies to vote any of our securities in an election contest;

participating in the formation of a group with respect to shares of our common stock (except to the extent such group is formed with respect to the stockholders agreement or the registration rights agreement);

granting any proxy to any person other than us or our designees to vote at any meeting of our stockholders;

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initiating or soliciting stockholders for the approval of one or more stockholder proposals with respect to us;

seeking to place a representative on our board of directors, except as contemplated by the stockholders agreement;

seeking to publicly call a meeting of our stockholders;

making any public announcement or proposal with respect to any form of business combination involving us; and

disclosing any plan to do any of the foregoing or assist or encouraging any third party to do any of the foregoing.

Once the TPG Entities transfer shares of our common stock such that their aggregate percentage holdings of our outstanding common stock drops below 25%, and then below 15%, respectively, the TPG Entities may not acquire beneficial ownership on a percentage basis of shares greater than 25% or 15%, as the case may be.

***Term of Stockholders Agreement***

The stockholders agreement will terminate under the following circumstances:

by the unanimous consent of us and the covered stockholders;

with respect to any covered stockholder, at such time as such covered stockholder holds less than 3% of the fully diluted shares of our common stock;

except with respect to the standstill provisions, at such time as no more than one of the covered stockholders holds more than 3% of the fully diluted shares of our common stock;

except with respect to the standstill provisions, at such time as approved by each of the covered stockholders who holds in excess of 3% of the fully diluted shares of our common stock; or

upon the fifth anniversary of the effective date of the stockholders agreement; *provided, however*, that the confidentiality provisions of the stockholders agreement shall survive for one year following the termination of the stockholders agreement.

Notwithstanding the foregoing, the standstill provisions of the stockholders agreement will terminate on the earlier of the date on which the TPG Entities or the covered stockholders other than the TPG Entities collectively, beneficially own less than 10% of the fully diluted shares of our common stock and the third anniversary of the closing of the transactions; *provided, however*, that in no event will the standstill provisions of the stockholders agreement terminate prior to the second anniversary of the closing of the transactions.

**Registration Rights**

The holders of an aggregate of 268,821,452 shares of our common stock are entitled to certain rights with respect to registration of such shares under the Securities Act. These shares are referred to as registrable securities.



The holders of registrable securities possess certain registration rights pursuant to the terms of a registration rights agreement, dated as of July 9, 2007, by and among us, the Coors Family Stockholders, Old Town, the CDR Fund, the TPG Entities and certain other stockholders. The registration rights agreement provides, in part, that if we determine to register any of our securities under the Securities Act, these holders are entitled to written notice of the registration and are entitled to include all or portion of their registrable shares in the registration, subject to certain limitations. In addition, these holders will have the right to require us to file a registration statement under the Securities Act to register all or any part of the registrable securities held by such holders, subject to certain conditions and limitations.

This is not a complete description of the registration rights agreement and is qualified by the full text of the registration rights agreement, which is filed as an exhibit to the registration statement of which this prospectus is a part.

**Listing**

Our common stock is listed on the NYSE under the ticker symbol **GPK**.

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### **Transfer Agent and Registrar**

The transfer agent and registrar for our common stock is Wells Fargo Bank, N.A.

## **DESCRIPTION OF THE DEBT SECURITIES**

### **General**

The following description of the terms of our senior debt securities and subordinated debt securities (together, the debt securities ) sets forth certain general terms and provisions of the debt securities to which any prospectus supplement may relate. Unless otherwise noted, the general terms and provisions of our debt securities discussed below apply to both our senior debt securities and our subordinated debt securities. Our debt securities may be issued from time to time in one or more series. The particular terms of any series of debt securities and the extent to which the general provisions may apply to a particular series of debt securities will be described in the prospectus supplement relating to that series.

Debt securities may be issued either by GPHC or GPII. When describing any debt securities, references to we, us and our refer to the issuer of those debt securities.

The senior debt securities will be issued under an indenture between us and U.S. Bank National Association, as Senior Indenture Trustee (the senior indenture ). The subordinated debt securities will be issued under an indenture between us and U.S. Bank National Association, as Subordinated Indenture Trustee (the subordinated indenture and, together with the senior indenture, the indentures ). The Senior Indenture Trustee and the Subordinated Indenture Trustee are both referred to, individually, as the Trustee. The senior debt securities will constitute our unsecured and unsubordinated obligations and the subordinated debt securities will constitute our unsecured and subordinated obligations. A detailed description of the subordination provisions is provided below under the caption Ranking and Subordination Subordination. In general, however, if we declare bankruptcy, holders of the senior debt securities will be paid in full before the holders of subordinated debt securities will receive anything.

The statements set forth below are brief summaries of certain provisions contained in the indentures, which summaries do not purport to be complete and are qualified in their entirety by reference to the indentures, which are filed as exhibits to the registration statement of which this prospectus forms a part. Terms used herein that are otherwise not defined shall have the meanings given to them in the indentures. Such defined terms shall be incorporated herein by reference.

The indentures will not limit the amount of debt securities that may be issued under the applicable indenture, and debt securities may be issued under the applicable indenture up to the aggregate principal amount that may be authorized from time to time by us. Any such limit applicable to a particular series will be specified in the prospectus supplement relating to that series.

The prospectus supplement relating to any series of debt securities in respect of which this prospectus is being delivered will contain the following terms, among others, for each such series of debt securities:

the designation and issue date of the debt securities;

the date or dates on which the principal amount of the debt securities is payable;

the rate or rates (or manner of calculation thereof), if any, per annum at which the debt securities will bear interest, if any, the date or dates from which interest will accrue and the interest payment date or dates for the

debt securities;

any limit upon the aggregate principal amount of the debt securities which may be authenticated and delivered under the applicable indenture;

the period or periods within which, the redemption price or prices or the repayment price or prices, as the case may be, at which, and the terms and conditions upon which, the debt securities may be redeemed at the issuing company's option or the option of the holder of such debt securities;

the obligation, if any, of the issuing company to purchase the debt securities pursuant to any sinking fund or analogous provisions or at the option of a holder of such debt securities and the period or periods within

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which, the price or prices at which and the terms and conditions upon which such debt securities will be purchased, in whole or in part, pursuant to such obligation;

if other than denominations of \$1,000 and any integral multiple thereof, the denominations in which the debt securities will be issuable;

in the case of debt securities issued by GPHC, provisions, if any, with regard to the conversion or exchange of the debt securities, at the option of the holders of such debt securities or GPHC, as the case may be, for or into new securities of a different series, GPHC's common stock or other securities;

if other than U.S. dollars, the currency or currencies or units based on or related to currencies in which the debt securities will be denominated and in which payments of principal of, and any premium and interest on, such debt securities shall or may be payable;

if the principal of (and premium, if any) or interest, if any, on the debt securities are to be payable, at the election of the issuing company or a holder of such debt securities, in a currency (including a composite currency) other than that in which such debt securities are stated to be payable, the period or periods within which, and the terms and conditions upon which, such election may be made;

if the amount of payments of principal of (and premium, if any) or interest, if any, on the debt securities may be determined with reference to an index based on a currency (including a composite currency) other than that in which such debt securities are stated to be payable, the manner in which such amounts shall be determined;

provisions, if any, related to the exchange of the debt securities, at the option of the holders of such debt securities, for other securities of the same series of the same aggregate principal amount or of a different authorized series or different authorized denomination or denominations, or both;

the portion of the principal amount of the debt securities, if other than the principal amount thereof, which shall be payable upon declaration of acceleration of the maturity thereof as more fully described under the section Events of Default, Notice and Waiver below;

whether the debt securities will be issued in the form of global securities and, if so, the identity of the depositary with respect to such global securities;

if the debt securities will be guaranteed, the terms and conditions of such guarantees and provisions for the accession of the guarantors to certain obligations under the applicable indenture;

with respect to subordinated debt securities only, the amendment or modification of the subordination provisions in the subordinated indenture with respect to the debt securities; and

any other specific terms.

We may issue debt securities of any series at various times and we may reopen any series for further issuances from time to time without notice to existing holders of securities of that series.

Some of the debt securities may be issued as original issue discount debt securities. Original issue discount debt securities bear no interest or bear interest at below-market rates. These are sold at a discount below their stated principal amount. If we issue these securities, the prospectus supplement relating to such series of debt securities will describe any special tax, accounting or other information which we think is important. We encourage you to consult

with your own tax and financial advisors on these important matters.

Unless we specify otherwise in the applicable prospectus supplement relating to such series of debt securities, the covenants contained in the indentures will not provide special protection to holders of debt securities if we enter into a highly leveraged transaction, recapitalization or restructuring.

Unless otherwise set forth in the prospectus supplement relating to such series of debt securities, interest on outstanding debt securities will be paid to holders of record on the date that is 15 days prior to the date such interest is to be paid or, if not a business day, the next preceding business day. Unless otherwise specified in the prospectus supplement, debt securities will be issued in fully registered form only. Unless otherwise specified in the prospectus supplement, the principal amount of the debt securities will be payable at the corporate trust office of the Trustee in New York, New York. The debt securities may be presented for transfer or exchange at such office unless otherwise specified in the prospectus supplement, subject to the limitations provided in the applicable indenture, without any

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service charge, but we may require payment of a sum sufficient to cover any tax or other governmental charges payable in connection therewith.

### **Guarantees**

The payment obligations of GPHC under any series of debt securities may be guaranteed by one or more of GPHC's direct or indirect subsidiaries, including GPC, GPII or by other persons. The payment obligations of GPII under any series of debt security will be guaranteed fully and unconditionally by GPHC, and may be guaranteed by one or more of GPHC's other direct or indirect subsidiaries or by other persons. If a series of debt securities is so guaranteed, the guarantors will execute a supplemental indenture or notation of guarantee as further evidence of their guarantee. The applicable prospectus supplement will describe the terms of any guarantee.

The obligations of each guarantor under its guarantee may be limited to the maximum amount that will not result in such guarantee obligations constituting a fraudulent conveyance or fraudulent transfer under federal or state law, after giving effect to all other contingent and fixed liabilities of that subsidiary and any collections from or payments made by or on behalf of any other guarantor in respect to its obligations under its guarantee.

### **Ranking and Subordination**

#### ***General***

The subordinated debt securities and the related guarantees will effectively rank junior in right of payment to any of our or the guarantors' current and future secured obligations to the extent of the value of the assets securing such obligations. The debt securities and the guarantees will be effectively subordinated to all existing and future liabilities, including indebtedness and trade payables, of our non-guarantor subsidiaries. Unless otherwise set forth in the prospectus supplement relating to such series of debt securities, the indentures will not limit the amount of unsecured indebtedness or other liabilities that can be incurred by our non-guarantor subsidiaries.

Furthermore, GPHC is a holding company with no material business operations. GPHC's ability to service its indebtedness and other obligations is dependent primarily upon the earnings and cash flows of its subsidiaries and the distribution or other payment to GPHC of such earnings or cash flows. In addition, certain indebtedness of GPHC's subsidiaries contains, and future agreements relating to any indebtedness of its subsidiaries may contain, significant restrictions on the ability of its subsidiaries to pay dividends or otherwise make distributions to us.

#### ***Ranking of Debt Securities***

The senior debt securities described in this prospectus will be unsecured, senior obligations of the issuing company and will rank equally with the issuing company's other unsecured and unsubordinated obligations. Any guarantees of the senior debt securities will be unsecured and senior obligations of each of the guarantors, and will rank equally with all other unsecured and unsubordinated obligations of such guarantors. The subordinated debt securities will be unsecured, subordinated obligations and the any guarantees of the subordinated debt securities will be unsecured and subordinated obligations of each of the guarantors.

#### ***Subordination***

If issued, the indebtedness evidenced by the subordinated debt securities will be subordinate to the prior payment in full of all our Senior Indebtedness (as defined below). During the continuance beyond any applicable grace period of any default in the payment of principal, premium, interest or any other payment due on any of our Senior Indebtedness, we may not make any payment of principal of, or premium, if any, or interest on the subordinated debt

securities. In addition, upon any payment or distribution of our assets upon any dissolution, winding up, liquidation or reorganization, the payment of the principal of, or premium, if any, and interest on the subordinated debt securities will be subordinated to the extent provided in the subordinated indenture in right of payment to the prior payment in full of all our Senior Indebtedness. Because of this subordination, if we dissolve or otherwise liquidate, holders of our subordinated debt securities may receive less, ratably, than holders of our Senior Indebtedness. The subordination provisions do not prevent the occurrence of an event of default under the subordinated indenture.

The subordination provisions also apply in the same way to each guarantor with respect to the Senior Indebtedness of such guarantor.

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The term **Senior Indebtedness** of a person means with respect to such person the principal of, premium, if any, interest on, and any other payment due pursuant to any of the following, whether outstanding on the date of the subordinated indenture or incurred by that person in the future:

all of the indebtedness of that person for borrowed money, including any indebtedness secured by a mortgage or other lien which is (1) given to secure all or part of the purchase price of property subject to the mortgage or lien, whether given to the vendor of that property or to another lender, or (2) existing on property at the time that person acquires it;

all of the indebtedness of that person evidenced by notes, debentures, bonds or other similar instruments sold by that person for money;

all of the lease obligations which are capitalized on the books of that person in accordance with generally accepted accounting principles;

all indebtedness of others of the kinds described in the first two bullet points above and all lease obligations of others of the kind described in the third bullet point above, in each case, that the person, in any manner, assumes or guarantees or that the person in effect guarantees through an agreement to purchase, whether that agreement is contingent or otherwise; and

all renewals, extensions or refundings of indebtedness of the kinds described in the first, second or fourth bullet point above and all renewals or extensions of leases of the kinds described in the third or fourth bullet point above;

*unless*, in the case of any particular indebtedness, lease, renewal, extension or refunding, the instrument or lease creating or evidencing it or the assumption or guarantee relating to it expressly provides that such indebtedness, lease, renewal, extension or refunding is not superior in right of payment to the subordinated debt securities. Our senior debt securities, and any unsubordinated guarantee obligations of ours or any guarantor to which we and the guarantors are a party, including the guarantors' guarantees of our debt securities and other indebtedness for borrowed money, constitute Senior Indebtedness for purposes of the subordinated indenture.

Pursuant to the subordinated indenture, the subordinated indenture may not be amended, at any time, to alter the subordination provisions of any outstanding subordinated debt securities without the consent of the requisite holders of each outstanding series or class of Senior Indebtedness (as determined in accordance with the instrument governing such Senior Indebtedness) that would be adversely affected thereby.

## **Consolidation, Merger, Conveyance or Transfer on Certain Terms**

Except as described in the applicable prospectus supplement relating to such debt securities, we will not consolidate with or merge into any other entity or convey or transfer our properties and assets substantially as an entirety to any entity, unless:

(1) the entity formed by such consolidation or into which we are merged or the entity that acquires by conveyance or transfer our properties and assets substantially as an entirety shall be organized and existing under the laws of the United States of America or any State or the District of Columbia, and will expressly assume, by supplemental indenture, executed and delivered to the Trustee, in form reasonably satisfactory to the Trustee, the due and punctual payment of the principal of (and premium, if any) and interest on all the debt securities and the performance of every covenant of the applicable indenture (as supplemented from time to time) on our part to be performed or observed;



(2) immediately after giving effect to such transaction, no Event of Default (as defined below), and no event which, after notice or lapse of time, or both, would become an Event of Default, shall have happened and be continuing; and

(3) we have delivered to the Trustee an officers certificate and an opinion of counsel each stating that such consolidation, merger, conveyance or transfer and such supplemental indenture comply with the requirements set forth in paragraphs (1) and (2) above and that all conditions precedent relating to such transaction have been complied with.

Upon any consolidation or merger, or any conveyance or transfer of our properties and assets substantially as an entirety as set forth above, the successor person formed by such consolidation or into which we are merged or to

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which such conveyance or transfer is made shall succeed to, and be substituted for, and may exercise every right and power of ours under the applicable indenture with the same effect as if such successor had been named in the applicable indenture. In the event of any such conveyance or transfer, we, as the predecessor, shall be discharged from all obligations and covenants under the applicable indenture and the debt securities issued under such indenture and may be dissolved, wound up or liquidated at any time thereafter.

## **Certain Covenants**

Any covenants pertaining to a series of debt securities will be set forth in a prospectus supplement relating to such series of debt securities.

Except as described in the prospectus and any applicable prospectus supplement relating to such series of debt securities, the indentures and the debt securities do not contain any covenants or other provisions designed to afford holders of debt securities protection in the event of a recapitalization or highly leveraged transaction involving us.

## **Certain Definitions**

The following are certain of the terms defined in the indentures:

*GAAP* means generally accepted accounting principles as such principles are in effect in the United States as of the date of the applicable indenture.

*Significant Subsidiary* means any Subsidiary which would be a significant subsidiary as defined in Rule 1-02 of Regulation S-X, promulgated pursuant to the Securities Act of 1933 (the Securities Act ), as in effect on the date of the applicable indenture.

*Subsidiary* means, with respect to any person, any corporation more than 50% of the voting stock of which is owned directly or indirectly by such person, and any partnership, association, joint venture or other entity in which such person owns more than 50% of the equity interests or has the power to elect a majority of the board of directors or other governing body.

## **Optional Redemption**

Unless we specify otherwise in the applicable prospectus supplement, we may redeem any of the debt securities as a whole at any time or in part from time to time, at our option, on at least 15 days, but not more than 45 days, prior notice mailed to the registered address of each holder of the debt securities to be redeemed, at respective redemption prices equal to the greater of:

100% of the principal amount of the debt securities to be redeemed, and

the sum of the present values of the Remaining Scheduled Payments, as defined below, discounted to the redemption date, on a semi-annual basis, assuming a 360 day year consisting of twelve 30 day months, at the Treasury Rate, as defined below, plus the number, if any, of basis points specified in the applicable prospectus supplement;

plus, in each case, accrued interest to the date of redemption that has not been paid (such redemption price, the Redemption Price ).

*Comparable Treasury Issue* means, with respect to the debt securities, the U.S. Treasury security selected by an Independent Investment Banker as having a maturity comparable to the remaining term ( *Remaining Life* ) of the debt securities being redeemed that would be utilized, at the time of selection and in accordance with customary financial practice, in pricing new issues of corporate debt securities of comparable maturity to the *Remaining Life* of such debt securities.

*Comparable Treasury Price* means, with respect to any redemption date for the debt securities: (1) the average of two Reference Treasury Dealer Quotations for that redemption date, after excluding the highest and lowest of four such Reference Treasury Dealer Quotations; or (2) if the Trustee obtains fewer than four Reference Treasury Dealer Quotations, the average of all quotations obtained by the Trustee.

*Independent Investment Banker* means one of the Reference Treasury Dealers, to be appointed by us.

*Reference Treasury Dealer* means four primary U.S. Government securities dealers to be selected by us.

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*Reference Treasury Dealer Quotations* means, with respect to each Reference Treasury Dealer and any redemption date, the average, as determined by the Trustee, of the bid and asked prices for the Comparable Treasury Issue, expressed in each case as a percentage of its principal amount, quoted in writing to the Trustee by such Reference Treasury Dealer at 3:00 p.m., New York City time, on the third business day preceding such redemption date.

*Remaining Scheduled Payments* means, with respect to each debt security to be redeemed, the remaining scheduled payments of the principal thereof and interest thereon that would be due after the related redemption date but for such redemption; *provided, however*, that, if such redemption date is not an interest payment date with respect to such debt security, the amount of the next succeeding scheduled interest payment thereon will be deemed to be reduced by the amount of interest accrued thereon to such redemption date.

*Treasury Rate* means, with respect to any redemption date for the debt securities: (1) the yield, under the heading which represents the average for the immediately preceding week, appearing in the most recently published statistical release designated H.15(519) or any successor publication which is published weekly by the Board of Governors of the Federal Reserve System and which establishes yields on actively traded United States Treasury debt securities adjusted to constant maturity under the caption Treasury Constant Maturities, for the maturity corresponding to the Comparable Treasury Issue; *provided* that if no maturity is within three months before or after the maturity date for the debt securities, yields for the two published maturities most closely corresponding to the Comparable Treasury Issue will be determined and the Treasury Rate will be interpolated or extrapolated from those yields on a straight line basis, rounding to the nearest month; or (2) if that release, or any successor release, is not published during the week preceding the calculation date or does not contain such yields, the rate per annum equal to the semiannual equivalent yield to maturity of the Comparable Treasury Issue, calculated using a price for the Comparable Treasury Issue (expressed as a percentage of its principal amount) equal to the Comparable Treasury Price for that redemption date. The Treasury Rate will be calculated on the third business day preceding the redemption date.

On and after the redemption date, interest will cease to accrue on the debt securities or any portion thereof called for redemption, unless we default in the payment of the Redemption Price, and accrued interest. On or before the redemption date, we shall deposit with a paying agent, or the applicable Trustee, money sufficient to pay the Redemption Price of and accrued interest on the debt securities to be redeemed on such date. If we elect to redeem less than all of the debt securities of a series, then the Trustee will select the particular debt securities of such series to be redeemed in a manner it deems appropriate and fair.

## **Defeasance**

Except as otherwise set forth in the prospectus supplement relating to such series of debt securities, each indenture will provide that we, at our option,

(1) will be discharged from any and all obligations in respect of any series of debt securities (except in each case for certain obligations to register the transfer or exchange of debt securities, replace stolen, lost or mutilated debt securities, maintain paying agencies and hold monies for payment in trust), or

(2) need not comply with any restrictive covenants described in a prospectus supplement relating to such series of debt securities, the guarantors will be released from the guarantees and certain Events of Default (other than those arising out of the failure to pay interest or principal on the debt securities of a particular series and certain events of bankruptcy, insolvency and reorganization) will no longer constitute Events of Default with respect to such series of debt securities,

in each case, if we deposit with the Trustee, in trust, money or the equivalent in securities of the government which issued the currency in which the debt securities are denominated or government agencies backed by the full faith and

credit of such government, or a combination thereof, which through the payment of interest thereon and principal thereof in accordance with their terms will provide money in an amount sufficient to pay all the principal (including any mandatory sinking fund payments) of, and interest on, such series on the dates such payments are due in accordance with the terms of such series.

To exercise any such option, we are required, among other things, to deliver to the Trustee an opinion of counsel to the effect that the deposit and related defeasance would not cause the holders of such series to recognize

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income, gain or loss for federal income tax purposes and, in the case of a discharge pursuant to clause (a) above, accompanied by a ruling to such effect received from or published by the U.S. Internal Revenue Service.

In addition, we are required to deliver to the Trustee an officers' certificate stating that such deposit was not made by us with the intent of preferring the holders over other creditors of ours or with the intent of defeating, hindering, delaying or defrauding creditors of ours or others.

## **Events of Default, Notice and Waiver**

Except as otherwise set forth in the prospectus supplement relating to such series of debt securities, each indenture will provide that, if an Event of Default specified therein with respect to any series of debt securities issued thereunder shall have happened and be continuing, either the Trustee thereunder or the holders of 33 1/3% in aggregate principal amount of the outstanding debt securities of such series (or 33 1/3% in aggregate principal amount of all outstanding debt securities under such indenture, in the case of certain Events of Default affecting all series of debt securities issued under such indenture) may declare the principal of all the debt securities of such series to be due and payable.

Except as otherwise set forth in the prospectus supplement relating to such series of debt securities, an *Event of Default* in respect of any series will be defined in the indentures as being any one of the following events:

default for 30 days in payment of any interest installment with respect to such series;

default in payment of principal of, or premium, if any, on, or any sinking or purchase fund or analogous obligation with respect to, debt securities of such series when due at their stated maturity, by declaration or acceleration, when called for redemption or otherwise;

default for 90 days after written notice to us by the Trustee thereunder or by holders of 33 1/3% in aggregate principal amount of the outstanding debt securities of such series in the performance, or breach, of any covenant or warranty pertaining to debt securities of such series; and

certain events of bankruptcy, insolvency and reorganization with respect to us or any Significant Subsidiary of ours which is organized under the laws of the United States or any political sub-division thereof or the entry of an order ordering the winding up or liquidation of our affairs.

Each indenture will provide that the Trustee thereunder will, within 90 days after the occurrence of a default with respect to the debt securities of any series issued under such indenture, give to the holders of the debt securities of such series notice of all uncured and unwaived defaults known to it; *provided, however*, that, except in the case of default in the payment of principal of, premium, if any, or interest, if any, on any of the debt securities of such series, the Trustee will be protected in withholding such notice if it in good faith determines that the withholding of such notice is in the interests of the holders of the debt securities of such series. The term *default* for the purpose of this provision means any event which is, or after notice or lapse of time or both would become, an Event of Default with respect to debt securities of such series.

Each indenture will contain provisions entitling the Trustee under such indenture, subject to the duty of the Trustee during an Event of Default to act with the required standard of care, to be indemnified to its reasonable satisfaction by the holders of the debt securities before proceeding to exercise any right or power under the applicable indenture at the request of holders of such debt securities.

Each indenture will provide that the holders of a majority in aggregate principal amount of the outstanding debt securities of any series issued under such indenture may direct the time, method and place of conducting proceedings

for remedies available to the Trustee or exercising any trust or power conferred on the Trustee in respect of such series, subject to certain conditions.

Except as otherwise set forth in the prospectus supplement relating to the debt securities, in certain cases, the holders of a majority in principal amount of the outstanding debt securities of any series may waive, on behalf of the holders of all debt securities of such series, any past default or Event of Default with respect to the debt securities of such series except, among other things, a default not theretofore cured in payment of the principal of, or premium, if any, or interest, if any, on any of the senior debt securities of such series or payment of any sinking or purchase fund or analogous obligations with respect to such senior debt securities.

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Each indenture will include a covenant that we will file annually with the Trustee a certificate of no default or specifying any default that exists.

### **Modification of the Indentures**

Except as set forth in the prospectus supplement relating to the debt securities, we and the Trustee may, without the consent of the holders of the debt securities issued under the indenture governing such debt securities, enter into indentures supplemental to the applicable indenture for, among others, one or more of the following purposes:

- (1) to evidence the succession of another person to us or to a guarantor, if any, and the assumption by such successor of our or the guarantor's obligations under the applicable indenture and the debt securities of any series;
- (2) to add to our covenants or those of any guarantor, if any, or to surrender any of our rights or powers or those of any guarantor for the benefit of the holders of debt securities of any or all series issued under such indenture;
- (3) to cure any ambiguity, to correct or supplement any provision in the applicable indenture which may be inconsistent with any other provision therein, or to make any other provisions with respect to matters or questions arising under such indenture;
- (4) to add to the applicable indenture any provisions that may be expressly permitted by the Trust Indenture Act of 1939, as amended (the "TIA"), excluding the provisions referred to in Section 316(a)(2) of the TIA as in effect at the date as of which the applicable indenture was executed or any corresponding provision in any similar federal statute hereafter enacted;
- (5) to establish the form or terms of any series of debt securities to be issued under the applicable indenture, to provide for the issuance of any series of debt securities and/or to add to the rights of the holders of debt securities;
- (6) to evidence and provide for the acceptance of any successor Trustee with respect to one or more series of debt securities or to add or change any of the provisions of the applicable indenture as shall be necessary to facilitate the administration of the trusts thereunder by one or more trustees in accordance with the applicable indenture;
- (7) to provide any additional Events of Default;
- (8) to provide for uncertificated securities in addition to or in place of certificated securities; *provided* that the uncertificated securities are issued in registered form for certain federal tax purposes;
- (9) to provide for the terms and conditions of converting those debt securities that are convertible into common stock or another such similar security;
- (10) to secure any series of debt securities;
- (11) to add guarantees in respect of any series or all of the debt securities;
- (12) to make any change necessary to comply with any requirement of the SEC in connection with the qualification of the applicable indenture or any supplemental indenture under the TIA; and
- (13) to make any other change that does not adversely affect the rights of the holders of the debt securities.



No supplemental indenture for the purpose identified in clauses (2), (3) or (5) above may be entered into if to do so would adversely affect the rights of the holders of debt securities of any series issued under the same indenture in any material respect.

Except as set forth in the prospectus supplement relating to such series of debt securities, each indenture will contain provisions permitting us and the Trustee under such indenture, with the consent of the holders of a majority in principal amount of the outstanding debt securities of all series issued under such indenture to be affected voting as a single class, to execute supplemental indentures for the purpose of adding any provisions to or changing or eliminating any of the provisions of the applicable indenture or modifying the rights of the holders of the debt

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securities of such series to be affected, except that no such supplemental indenture may, without the consent of the holders of affected debt securities, among other things:

change the maturity of the principal of, or the maturity of any premium on, or any installment of interest on, any such debt security, or reduce the principal amount or the interest or any premium of any such debt securities, or change the method of computing the amount of principal or interest on any such debt securities on any date or change any place of payment where, or the currency in which, any debt securities or any premium or interest thereon is payable, or impair the right to institute suit for the enforcement of any such payment on or after the maturity of principal or premium, as the case may be;

reduce the percentage in principal amount of any such debt securities the consent of whose holders is required for any supplemental indenture, waiver of compliance with certain provisions of the applicable indenture or certain defaults under the applicable indenture;

modify any of the provisions of the applicable indenture related to (i) the requirement that the holders of debt securities issued under such indenture consent to certain amendments of the applicable indenture, (ii) the waiver of past defaults and (iii) the waiver of certain covenants, except to increase the percentage of holders required to make such amendments or grant such waivers; or

impair or adversely affect the right of any holder to institute suit for the enforcement of any payment on, or with respect to, such senior debt securities on or after the maturity of such debt securities.

In addition, the subordinated indenture will provide that we may not make any change in the terms of the subordination of the subordinated debt securities of any series in a manner adverse in any material respect to the holders of any series of subordinated debt securities without the consent of each holder of subordinated debt securities that would be adversely affected.

## **The Trustee**

U.S. Bank National Association is the Trustee under each indenture. The Trustee and its affiliates may also provide banking, trustee and other services for, and transact other banking business with, us in the normal course of business.

## **Governing Law**

The indentures will be governed by, and construed in accordance with, the laws of the State of New York.

## **Global Securities**

We may issue debt securities through global securities. A global security is a security, typically held by a depository, that represents the beneficial interests of a number of purchasers of the security. If we do issue global securities, the following procedures will apply.

We will deposit global securities with the depository identified in the prospectus supplement. After we issue a global security, the depository will credit on its book-entry registration and transfer system the respective principal amounts of the debt securities represented by the global security to the accounts of persons who have accounts with the depository. These account holders are known as participants. The underwriters or agents participating in the distribution of the debt securities will designate the accounts to be credited. Only a participant or a person who holds an interest through a participant may be the beneficial owner of a global security. Ownership of beneficial interests in the global security will be shown on, and the transfer of that ownership will be effected only through, records

maintained by the depositary and its participants.

We and the Trustee will treat the depositary or its nominee as the sole owner or holder of the debt securities represented by a global security. Except as set forth below, owners of beneficial interests in a global security will not be entitled to have the debt securities represented by the global security registered in their names. They also will not receive or be entitled to receive physical delivery of the debt securities in definitive form and will not be considered the owners or holders of the debt securities.

Principal, any premium and any interest payments on debt securities represented by a global security registered in the name of a depositary or its nominee will be made to the depositary or its nominee as the registered owner of the global security. None of us, the Trustee or any paying agent will have any responsibility or liability for any

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aspect of the records relating to or payments made on account of beneficial ownership interests in the global security or maintaining, supervising or reviewing any records relating to the beneficial ownership interests.

We expect that the depositary, upon receipt of any payments, will immediately credit participants' accounts with payments in amounts proportionate to their respective beneficial interests in the principal amount of the global security as shown on the depositary's records. We also expect that payments by participants to owners of beneficial interests in the global security will be governed by standing instructions and customary practices, as is the case with the securities held for the accounts of customers registered in street names, and will be the responsibility of the participants.

If the depositary is at any time unwilling or unable to continue as depositary and a successor depositary is not appointed by us within 90 days, we will issue registered securities in exchange for the global security. In addition, we may at any time in our sole discretion determine not to have any of the debt securities of a series represented by global securities. In that event, we will issue debt securities of that series in definitive form in exchange for the global securities.

## **DESCRIPTION OF THE DEPOSITARY SHARES**

### **General**

We may, at our option, elect to offer fractional shares rather than full shares of the preferred stock of a series. In the event that we determine to do so, we will issue receipts for depositary shares, each of which will represent a fraction (to be set forth in the prospectus supplement relating to a particular series of preferred stock) of a share of a particular series of preferred stock as more fully described below.

The shares of any series of preferred stock represented by depositary shares will be deposited under one or more deposit agreements among us, a depositary to be named in the applicable prospectus supplement, and the holders from time to time of depositary receipts issued thereunder. Subject to the terms of the applicable deposit agreement, each holder of a depositary share will be entitled, in proportion to the applicable fraction of a share of preferred stock represented by the depositary share, to all the rights and preferences of the preferred stock represented thereby (including, as applicable, dividend, voting, redemption, subscription and liquidation rights).

The depositary shares will be evidenced by depositary receipts issued pursuant to the deposit agreement. Depositary receipts will be distributed to those persons purchasing the fractional shares of the related series of preferred stock.

The following description sets forth certain general terms and provisions of the depositary shares to which any prospectus supplement may relate. The particular terms of the depositary shares to which any prospectus supplement may relate and the extent, if any, to which such general provisions may apply to the depositary shares so offered will be described in the applicable prospectus supplement. To the extent that any particular terms of the depositary shares or the deposit agreement described in a prospectus supplement differ from any of the terms described below, then the terms described below will be deemed to have been superseded by that prospectus supplement relating to such deposited shares. The forms of deposit agreement and depositary receipt will be filed as exhibits to the documents incorporated or deemed to be incorporated by reference in this prospectus.

The following summary of certain provisions of the depositary shares and deposit agreement does not purport to be complete and is subject to, and is qualified in its entirety by express reference to, all the provisions of the deposit agreement and the applicable prospectus supplement, including the definitions.

Immediately following our issuance of shares of a series of preferred stock that will be offered as fractional shares, we will deposit the shares with the depository, which will then issue and deliver the depository receipts to the purchasers thereof. Depository receipts will only be issued evidencing whole depository shares. A depository receipt may evidence any number of whole depository shares.

Pending the preparation of definitive depository receipts, the depository may, upon our written order, issue temporary depository receipts substantially identical to (and entitling the holders thereof to all the rights pertaining to) the definitive depository receipts but not in definitive form. Definitive depository receipts will be prepared thereafter without unreasonable delay, and such temporary depository receipts will be exchangeable for definitive depository receipts at our expense.

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### **Dividends and Other Distributions**

The depositary will distribute all cash dividends or other cash distributions received in respect of the related series of preferred stock to the record holders of depositary shares relating to the series of preferred stock in proportion to the number of the depositary shares owned by the holders.

In the event of a distribution other than in cash, the depositary will distribute property received by it to the record holders of depositary shares entitled thereto in proportion to the number of depositary shares owned by the holders, unless the depositary determines that the distribution cannot be made proportionately among the holders or that it is not feasible to make the distributions, in which case the depositary may, with our approval, adopt any method as it deems equitable and practicable for the purpose of effecting the distribution, including the sale (at public or private sale) of the securities or property thus received, or any part thereof, at the place or places and upon those terms as it may deem proper.

The amount distributed in any of the foregoing cases will be reduced by any amounts required to be withheld by us or the depositary on account of taxes or other governmental charges.

### **Redemption of Depositary Shares**

If any series of the preferred stock underlying the depositary shares is subject to redemption, the depositary shares will be redeemed from the proceeds received by the depositary resulting from any redemption, in whole or in part, of the series of the preferred stock held by the depositary. The redemption price per depositary share will be equal to the applicable fraction of the redemption price per share payable with respect to the series of the preferred stock. If we redeem shares of a series of preferred stock held by the depositary, the depositary will redeem as of the same redemption date the number of depositary shares representing the shares of preferred stock so redeemed. If less than all the depositary shares are to be redeemed, the depositary shares to be redeemed will be selected by lot or substantially equivalent method determined by the depositary.

After the date fixed for redemption, the depositary shares so called for redemption will no longer be deemed to be outstanding and all rights of the holders of the depositary shares will cease, except the right to receive the monies payable upon redemption and any money or other property to which the holders of the depositary shares were entitled upon such redemption, upon surrender to the depositary of the depositary receipts evidencing the depositary shares. Any funds deposited by us with the depositary for any depositary shares that the holders thereof fail to redeem will be returned to us after a period of two years from the date the funds are so deposited.

### **Voting the Underlying Preferred Stock**

Upon receipt of notice of any meeting at which the holders of any series of the preferred stock are entitled to vote, the depositary will mail the information contained in the notice of meeting to the record holders of the depositary shares relating to the series of preferred stock. Each record holder of the depositary shares on the record date (which will be the same date as the record date for the related series of preferred stock) will be entitled to instruct the depositary as to the exercise of the voting rights pertaining to the number of shares of the series of preferred stock represented by that holder's depositary shares. The depositary will endeavor, insofar as practicable, to vote or cause to be voted the number of shares of preferred stock represented by the depositary shares in accordance with the instructions, provided the depositary receives the instructions sufficiently in advance of the meeting to enable it to so vote or cause to be voted the shares of preferred stock, and we will agree to take all reasonable action that may be deemed necessary by the depositary in order to enable the depositary to do so. The depositary will abstain from voting shares of the preferred stock to the extent it does not receive specific instructions from the holders of depositary shares representing the preferred stock.

### **Withdrawal of Stock**

Upon surrender of the depositary receipts at the corporate trust office of the depositary and upon payment of the taxes, charges and fees provided for in the deposit agreement and subject to the terms thereof, the holder of the depositary shares evidenced thereby will be entitled to delivery at such office, to or upon his or her order, of the number of whole shares of the related series of preferred stock and any money or other property, if any, represented by the depositary shares. Holders of depositary shares will be entitled to receive whole shares of the related series of preferred stock, but holders of the whole shares of preferred stock will not thereafter be entitled to deposit the shares of preferred stock with the depositary or to receive depositary shares therefor. If the depositary receipts delivered by

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the holder evidence a number of depositary shares in excess of the number of depositary shares representing the number of whole shares of the related series of preferred stock to be withdrawn, the depositary will deliver to the holder or upon his or her order at the same time a new depositary receipt evidencing the excess number of depositary shares.

### **Amendment and Termination of a Deposit Agreement**

The form of depositary receipt evidencing the depositary shares of any series and any provision of the applicable deposit agreement may at any time and from time to time be amended by agreement between us and the depositary. However, any amendment that materially adversely alters the rights of the holders of depositary shares of any series will not be effective unless the amendment has been approved by the holders of at least a majority of the depositary shares of the series then outstanding. Every holder of a depositary receipt at the time the amendment becomes effective will be deemed, by continuing to hold the depositary receipt, to be bound by the deposit agreement as so amended. Notwithstanding the foregoing, in no event may any amendment impair the right of any holder of any depositary shares, upon surrender of the depositary receipts evidencing the depositary shares and subject to any conditions specified in the deposit agreement, to receive shares of the related series of preferred stock and any money or other property represented thereby, except in order to comply with mandatory provisions of applicable law. The deposit agreement may be terminated by us at any time upon not less than 60 days prior written notice to the depositary, in which case, on a date that is not later than 30 days after the date of the notice, the depositary shall deliver or make available for delivery to holders of depositary shares, upon surrender of the depositary receipts evidencing the depositary shares, the number of whole or fractional shares of the related series of preferred stock as are represented by the depositary shares. The deposit agreement shall automatically terminate after all outstanding depositary shares have been redeemed or there has been a final distribution in respect of the related series of preferred stock in connection with any liquidation, dissolution or winding up of us and the distribution has been distributed to the holders of depositary shares.

### **Charges of Depositary**

We will pay all transfer and other taxes and the governmental charges arising solely from the existence of the depositary arrangements. We will pay the charges of the depositary, including charges in connection with the initial deposit of the related series of preferred stock and the initial issuance of the depositary shares and all withdrawals of shares of the related series of preferred stock, except that holders of depositary shares will pay transfer and other taxes and governmental charges and any other charges as are expressly provided in the deposit agreement to be for their accounts.

### **Resignation and Removal of Depositary**

The depositary may resign at any time by delivering to us written notice of its election to do so, and we may at any time remove the depositary. Any resignation or removal will take effect upon the appointment of a successor depositary, which successor depositary must be appointed within 60 days after delivery of the notice of resignation or removal and must be a bank or trust company having its principal office in the United States and having a combined capital and surplus of at least \$50,000,000.

### **Miscellaneous**

The depositary will forward to the holders of depositary shares all reports and communications from us that are delivered to the depositary and which we are required to furnish to the holders of the related preferred stock.



The depositary's corporate trust office will be identified in the applicable prospectus supplement. Unless otherwise set forth in the applicable prospectus supplement, the depositary will act as transfer agent and registrar for depositary receipts and if shares of a series of preferred stock are redeemable, the depositary will also act as redemption agent for the corresponding depositary receipts.

### **DESCRIPTION OF THE WARRANTS**

The following description of the terms of the warrants sets forth certain general terms and provisions of the warrants to which any prospectus supplement may relate. GPHC may issue warrants for the purchase of common stock, preferred stock, debt securities, or depositary shares. Warrants may be issued independently or together with

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common stock, preferred stock, debt securities or depositary shares offered by any prospectus supplement and may be attached to or separate from any such offered securities. Each series of warrants will be issued under a separate warrant agreement to be entered into between us and a bank or trust company, as warrant agent. The warrant agent will act solely as our agent in connection with the warrants and will not assume any obligation or relationship of agency or trust for or with any holders or beneficial owners of warrants. The following summary of certain provisions of the warrants does not purport to be complete and is subject to, and qualified in its entirety by reference to, the provisions of the warrant agreement that will be filed with the SEC in connection with the offering of such warrants.

**Debt Warrants**

The prospectus supplement relating to a particular issue of debt warrants will describe the terms of such debt warrants, including the following:

the title of such debt warrants;

the offering price for such debt warrants, if any;

the aggregate number of such debt warrants;

the designation and terms of the debt securities purchasable upon exercise of such debt warrants;

if applicable, the designation and terms of the debt securities with which such debt warrants are issued and the number of such debt warrants issued with each such debt security;

if applicable, the date from and after which such debt warrants and any debt securities issued therewith will be separately transferable;

the principal amount of debt securities purchasable upon exercise of a debt warrant and the price at which such principal amount of debt securities may be purchased upon exercise (which price may be payable in cash, securities or other property);

the date on which the right to exercise such debt warrants shall commence and the date on which such right shall expire;

if applicable, the minimum or maximum amount of such debt warrants that may be exercised at any one time;

whether the debt warrants represented by the debt warrant certificates or debt securities that may be issued upon exercise of the debt warrants will be issued in registered or bearer form;

information with respect to book-entry procedures, if any;

the currency or currency units in which the offering price, if any, and the exercise price are payable;

if applicable, a discussion of material United States federal income tax considerations;

the antidilution or adjustment provisions of such debt warrants, if any;

the redemption or call provisions, if any, applicable to such debt warrants; and

any additional terms of such debt warrants, including terms, procedures, and limitations relating to the exchange and exercise of such debt warrants.

**Stock Warrants**

The prospectus supplement relating to any particular issue of common stock warrants, preferred stock warrants or depositary share warrants will describe the terms of such warrants, including the following:

the title of such warrants;

the offering price for such warrants, if any;

the aggregate number of such warrants;

the designation and terms of the offered securities purchasable upon exercise of such warrants;

if applicable, the designation and terms of the offered securities with which such warrants are issued and the number of such warrants issued with each such offered security;

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if applicable, the date from and after which such warrants and any offered securities issued therewith will be separately transferable;

the number of shares of common stock, preferred stock or depositary shares purchasable upon exercise of a warrant and the price at which such shares may be purchased upon exercise;

the date on which the right to exercise such warrants shall commence and the date on which such right shall expire;

if applicable, the minimum or maximum amount of such warrants that may be exercised at any one time;

the currency or currency units in which the offering price, if any, and the exercise price are payable;

if applicable, a discussion of material United States federal income tax considerations;

the antidilution provisions of such warrants, if any;

the redemption or call provisions, if any, applicable to such warrants; and

any additional terms of such warrants, including terms, procedures and limitations relating to the exchange and exercise of such warrants.

**DESCRIPTION OF THE PURCHASE CONTRACTS**

We may issue, from time to time, purchase contracts, including contracts obligating holders to purchase from us and us to sell to the holders, a specified principal amount of senior debt securities, subordinated debt securities, shares of common stock or preferred stock, depositary shares, government securities, or any of the other securities that we may sell under this prospectus at a future date or dates. The consideration payable upon settlement of the purchase contracts may be fixed at the time the purchase contracts are issued or may be determined by a specific reference to a formula set forth in the purchase contracts. The purchase contracts may be issued separately or as part of units consisting of a purchase contract and other securities or obligations issued by us or third parties, including United States treasury securities, securing the holders' obligations to purchase the relevant securities under the purchase contracts. The purchase contracts may require us to make periodic payments to the holders of the purchase contracts or units or vice versa, and the payments may be unsecured or prefunded on some basis. The purchase contracts may require holders to secure their obligations under the purchase contracts.

The prospectus supplement related to any particular purchase contracts will describe, among other things, the material terms of the purchase contracts and of the securities being sold pursuant to such purchase contracts, a discussion, if appropriate, of any special United States federal income tax considerations applicable to the purchase contracts and any material provisions governing the purchase contracts that differ from those described above. The description in the prospectus supplement will not necessarily be complete and will be qualified in its entirety by reference to the purchase contracts, and, if applicable, collateral arrangements and depositary arrangements, relating to the purchase contracts.

**DESCRIPTION OF THE UNITS**

We may, from time to time, issue units comprised of one or more of the other securities that may be offered under this prospectus, in any combination. Each unit may also include debt obligations of third parties, such as U.S. Treasury

securities. Each unit will be issued so that the holder of the unit is also the holder of each security included in the unit. Thus, the holder of a unit will have the rights and obligations of a holder of each included security. The unit agreement under which a unit is issued may provide that the securities included in the unit may not be held or transferred separately at any time, or at any time before a specified date.

Any prospectus supplement related to any particular units will describe, among other things:

the material terms of the units and of the securities comprising the units, including whether and under what circumstances those securities may be held or transferred separately;

any material provisions relating to the issuance, payment, settlement, transfer or exchange of the units or of the securities comprising the units;

if appropriate, any special United States federal income tax considerations applicable to the units; and

any material provisions of the governing unit agreement that differ from those described above.

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**PLAN OF DISTRIBUTION**

We may sell the securities being offered hereby in one or more of the following ways from time to time:

to underwriters or dealers for resale to the public or to institutional investors;

directly to institutional investors;

directly to a limited number of purchasers or to a single purchaser;

through agents to the public or to institutional investors; or

through a combination of any of these methods of sale.

If we use underwriters or dealers in the sale, the securities will be acquired by the underwriters or dealers for their own account and may be resold from time to time in one or more transactions, including:

at a fixed price or prices, which may be changed from time to time;

in at the market offerings within the meaning of the SEC's Rule 415(a)(4);

at prices related to such prevailing market prices; or

at negotiated prices.

For each series of securities, the prospectus supplement will set forth the terms of the offering of the securities, including:

the initial public offering price;

the method of distribution, including the names of any underwriters, dealers or agents;

the purchase price of the securities;

our net proceeds from the sale of the securities;

any underwriting discounts, agency fees, or other compensation payable to underwriters or agents;

any discounts or concessions allowed or reallocated or repaid to dealers; and

the securities exchanges on which the securities will be listed, if any.

If we use underwriters in the sale, they will buy the securities for their own account. The underwriters may then resell the securities in one or more transactions at a fixed public offering price or at varying prices determined at the time of sale or thereafter. The obligations of the underwriters to purchase the securities will be subject to certain conditions. The underwriters will be obligated to purchase all the securities offered if they purchase any securities. Any initial public offering price and any discounts or concessions allowed or re-allowed or paid to dealers may be changed from

time to time. In connection with an offering, underwriters and selling group members and their affiliates may engage in transactions to stabilize, maintain or otherwise affect the market price of the securities in accordance with applicable law.

If we use dealers in the sale, we will sell securities to such dealers as principals. The dealers may then resell the securities to the public at varying prices to be determined by such dealers at the time of resale. If we use agents in the sale, they will use their reasonable best efforts to solicit purchases for the period of their appointment. If we sell directly, no underwriters or agents would be involved. We are not making an offer of securities in any jurisdiction that does not permit such an offer.

Underwriters, dealers and agents that participate in the securities distribution may be deemed to be underwriters as defined in the Securities Act. Any discounts, commissions or profit they receive when they resell the securities may be treated as underwriting discounts and commissions under the Securities Act. We may have agreements with underwriters, dealers and agents to indemnify them against certain civil liabilities, including certain liabilities under the Securities Act, or to contribute with respect to payments that they may be required to make. Underwriters, dealers and agents may engage in transactions with, or perform services for, us or our subsidiaries in the ordinary course of their business.

It has not presently been established whether the underwriters, if any, of any of the securities will make a market in the securities. If the underwriters make a market in the securities, such market making may be

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discontinued at any time without notice. No assurance can be given as to the liquidity of the trading market for the securities.

**LEGAL MATTERS**

The validity of the securities offered by this prospectus will be passed upon for us by Alston & Bird LLP, Atlanta, Georgia, and for any underwriters or agents by counsel named in the applicable prospectus supplement.

**EXPERTS**

The consolidated financial statements of the Company at December 31, 2008 and 2009 and for the years then ended, incorporated by reference from the Company's Annual Report on Form 10-K for the year ended December 31, 2009, including the schedule appearing therein, have been audited by Ernst & Young LLP, independent registered public accounting firm, as set forth in their report thereon and incorporated herein by reference. Such consolidated financial statements are incorporated herein by reference in reliance upon such reports given on the authority of such firm as experts in accounting and auditing.

The consolidated financial statements for the year ended December 31, 2007 incorporated in this registration statement by reference from the Company's Annual Report on Form 10-K for the year ended December 31, 2009 have been so incorporated in reliance on the report of PricewaterhouseCoopers LLP, an independent registered public accounting firm, given on the authority of said firm as experts in auditing and accounting.



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**Graphic Packaging International, Inc.**

**% Senior Notes due 2018**

**PROSPECTUS SUPPLEMENT**

**BofA Merrill Lynch**

**J.P. Morgan**

**Goldman, Sachs & Co.**

**Deutsche Bank Securities**

**, 2010**