FERRO CORP
Form 10-Q
April 24, 2013
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended March 31, 2013

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 1-584

FERRO CORPORATION

(Exact name of registrant as specified in its charter)

Ohio	**34-0217820**
(State or other jurisdiction of	**(I.R.S. Employer**
incorporation or organization)	**Identification No.)**
6060 Parkland Boulevard	
Mayfield Heights, OH	**44124**
(Address of principal executive offices)	**(Zip Code)**

216-875-5600

(Registrant s telephone number, including area code)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). YES x NO ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer	¨	Accelerated filer	x
Non-accelerated filer	¨ (Do not check if a smaller reporting company)	Smaller reporting company	¨

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). YES ¨ NO x

At March 31, 2013, there were 86,568,385 shares of Ferro Common Stock, par value $1.00, outstanding.

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PART I FINANCIAL INFORMATION

Item 1. Financial Statements (Unaudited)

Ferro Corporation and Subsidiaries

Condensed Consolidated Statements of Operations

	Three months ended March 31, 2013	Three months ended March 31, As adjusted 2012
	(Dollars in thousands, except per share amounts)	
Net sales	$ 417,524	$ 460,425
Cost of sales	338,287	374,704
Gross profit	79,237	85,721
Selling, general and administrative expenses	61,592	72,508
Restructuring and impairment charges	9,454	311
Other expense (income):		
Interest expense	7,297	6,374
Interest earned	(53)	(84)
Foreign currency losses, net	1,506	144
Miscellaneous (income) expense, net	(10,516)	396
Income before income taxes	9,957	6,072
Income tax expense	1,016	2,809
Income from continuing operations	8,941	3,263
(Loss) income from discontinued operations, net of income taxes	(8,421)	707
Net income	520	3,970
Less: Net (loss) income attributable to noncontrolling interests	(363)	124
Net income attributable to Ferro Corporation common shareholders	$ 883	$ 3,846
Earnings (loss) per share attributable to Ferro Corporation common shareholders:		
Basic earnings (loss):		
From continuing operations	$ 0.11	$ 0.03
From discontinued operations	(0.10)	0.01
	$ 0.01	$ 0.04
Diluted earnings (loss):		
From continuing operations	$ 0.11	$ 0.03
From discontinued operations	(0.10)	0.01
	$ 0.01	$ 0.04

See accompanying notes to condensed consolidated financial statements.

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Ferro Corporation and Subsidiaries

Condensed Consolidated Statements of Comprehensive (Loss) Income

	Three months ended March 31, 2013	As adjusted 2012
	(Dollars in thousands)	
Net income	$ 520	$ 3,970
Other comprehensive (loss) income, net of tax:		
Foreign currency translation	(2,982)	24
Postretirement benefit liabilities	(68)	(664)
Total comprehensive (loss) income	(2,530)	3,330
Less: Comprehensive (loss) income attributable to noncontrolling interests	(342)	122
Comprehensive (loss) income attributable to Ferro Corporation	$ (2,188)	$ 3,208

See accompanying notes to condensed consolidated financial statements.

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Ferro Corporation and Subsidiaries

Condensed Consolidated Balance Sheets

	March 31, 2013	December 31, 2012
	(Dollars in thousands)	
ASSETS		
Current assets		
Cash and cash equivalents	$ 32,897	$ 29,576
Accounts receivable, net	314,017	306,463
Inventories	210,232	200,824
Deferred income taxes	8,413	7,995
Other receivables	30,323	31,554
Other current assets	13,938	10,802
Current assets of discontinued operations		6,289
Total current assets	609,820	593,503
Other assets		
Property, plant and equipment, net	298,434	309,374
Goodwill	62,413	62,975
Amortizable intangible assets, net	13,165	14,410
Deferred income taxes	21,246	21,554
Other non-current assets	55,608	61,941
Other assets of discontinued operations		15,346
Total assets	$ 1,060,686	$ 1,079,103
LIABILITIES AND EQUITY		
Current liabilities		
Loans payable and current portion of long-term debt	$ 75,178	$ 85,152
Accounts payable	191,554	182,024
Accrued payrolls	32,375	31,643
Accrued expenses and other current liabilities	65,679	76,384
Current liabilities of discontinued operations		1,300
Total current liabilities	364,786	376,503
Other liabilities		
Long-term debt, less current portion	265,526	261,624
Postretirement and pension liabilities	208,594	216,167
Other non-current liabilities	16,969	18,135
Total liabilities	855,875	872,429
Equity		
Ferro Corporation shareholders equity:		
Common stock, par value $1 per share; 300.0 million shares authorized; 93.4 million shares issued; 86.6 million shares outstanding in 2013 and 2012	93,436	93,436
Paid-in capital	319,267	321,652
Retained deficit	(85,723)	(86,606)
Accumulated other comprehensive income	13,579	16,650
Common shares in treasury, at cost	(148,553)	(151,605)
Total Ferro Corporation shareholders equity	192,006	193,527
Noncontrolling interests	12,805	13,147

Total equity	204,811	206,674
Total liabilities and equity	$ 1,060,686	$ 1,079,103

See accompanying notes to condensed consolidated financial statements.

Ferro Corporation and Subsidiaries

Condensed Consolidated Statements of Equity

	Ferro Corporation Shareholders								
	Common Shares in Treasury		Common	Paid-in	Retained Earnings	Accumulated Other Comprehensive (Loss)	Non-controlling	
	Shares	Amount	Stock	Capital	(Deficit)	Income	Interests	Total Equity
	(In thousands)							
Balances at December 31, 2011	6,865	$ (153,617)	$ 93,436	$ 320,882	$ 287,662	$ 23,899	$ 10,232	$ 582,494
Net income					3,846		124	3,970
Other comprehensive (loss) income						(638)	(2)	(640)
Stock-based compensation transactions	3	637		1,081				1,718
Distributions to noncontrolling interests							(44)	(44)
Balances at March 31, 2012	6,868	$ (152,980)	$ 93,436	$ 321,963	$ 291,508	$ 23,261	$ 10,310	$ 587,498
Balances at December 31, 2012	6,962	$ (151,605)	$ 93,436	$ 321,652	$ (86,606)	$ 16,650	$ 13,147	$ 206,674
Net income (loss)					883		(363)	520
Other comprehensive (loss) income						(3,071)	21	(3,050)
Stock-based compensation transactions	(95)	3,052		(2,385)				667
Balances at March 31, 2013	6,867	$ (148,553)	$ 93,436	$ 319,267	$ (85,723)	$ 13,579	$ 12,805	$ 204,811

See accompanying notes to condensed consolidated financial statements.

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Ferro Corporation and Subsidiaries

Condensed Consolidated Statements of Cash Flows

	Three months ended March 31, 2013	Three months ended March 31, 2012
	(Dollars in thousands)	
Cash flows from operating activities		
Net cash used for operating activities	$ (17,106)	$ (10,975)
Cash flows from investing activities		
Capital expenditures for property, plant and equipment	(8,178)	(22,579)
Proceeds from sale of assets	15,109	368
Proceeds from sale of stock of Ferro Pfanstiehl Laboratories, Inc.	16,912	
Dividends received from affiliates	1,119	
Net cash provided by (used for) investing activities	24,962	(22,211)
Cash flows from financing activities		
Net (repayments) borrowings under loans payable	(9,635)	31,684
Proceeds from long-term debt	110,133	97,918
Principal payments on long-term debt	(106,094)	(95,673)
Other financing activities	1,409	(440)
Net cash (used for) provided by financing activities	(4,187)	33,489
Effect of exchange rate changes on cash and cash equivalents	(348)	(23)
Increase in cash and cash equivalents	3,321	280
Cash and cash equivalents at beginning of period	29,576	22,991
Cash and cash equivalents at end of period	$ 32,897	$ 23,271
Cash paid during the period for:		
Interest	$ 12,308	$ 12,059
Income taxes	1,548	1,229

See accompanying notes to condensed consolidated financial statements.

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Ferro Corporation and Subsidiaries

Notes to Condensed Consolidated Financial Statements

1. Basis of Presentation

The accompanying unaudited condensed consolidated financial statements of Ferro Corporation (Ferro, we, us or the Company) have been prepared in accordance with accounting principles generally accepted in the United States of America (U.S. GAAP) for interim financial information, the instructions to Form 10-Q, and Article 10 of Regulation S-X. These statements reflect all normal and recurring adjustments which are, in the opinion of management, necessary to present fairly the financial position, results of operations and cash flows for the periods presented. The preparation of financial statements in conformity with U.S. GAAP requires us to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. These interim condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and related notes included in our Annual Report on Form 10-K for the year ended December 31, 2012.

Operating results for the three months ended March 31, 2013, are not necessarily indicative of the results expected in subsequent quarters or for the full year ending December 31, 2013.

2. Recent Accounting Pronouncements and Change in Accounting Principle

Accounting Standards Adopted in the Three Months Ended March 31, 2013

On January 1, 2013, we adopted Financial Accounting Standards Board (FASB) Accounting Standards Update (ASU) 2011-11, *Disclosures about Offsetting Assets and Liabilities*, (ASU 2011-11) and ASU 2013-01, *Clarifying the Scope of Disclosures about Offsetting Assets and Liabilities*, (ASU 2013-01). These pronouncements are codified in Accounting Standards Codification (ASC) Topic 210, Balance Sheet, and contain new disclosure requirements about a company s right of setoff and related arrangements associated with its financial and derivative instruments. Adoption of this pronouncement did not have a material effect on our consolidated financial statements.

On January 1, 2013, we adopted FASB ASU 2013-02, *Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income*, (ASU 2013-02), which is codified in ASC Topic 220, Comprehensive Income. This pronouncement adds new disclosure requirements for items reclassified out of accumulated other comprehensive income. Adoption of this pronouncement did not have a material effect on our consolidated financial statements.

Change in Accounting Principle

During the third quarter of 2012, we elected to change our method of recognizing defined benefit pension and other postretirement benefit expense. Historically, we recognized actuarial gains and losses in accumulated other comprehensive income within equity on our consolidated balance sheets annually, and these gains and losses were amortized into our operating results over the average remaining service period of plan participants, to the extent such gains and losses were in excess of a corridor.

Under our new method, we recognize actuarial gains and losses in our operating results in the year in which the gains or losses occur. These gains and losses are generally measured annually as of December 31 and recorded during the fourth quarter, unless an interim remeasurement is required. The remaining components of benefit expense, primarily service and interest costs and the expected return on plan assets, will be recorded quarterly as ongoing expense or benefit. While the historical method of recognizing expense was acceptable, we believe the new method is preferable because it results in recognition in our operating results of actuarial gains and losses as they arise. In accordance with ASC Topic 250, Accounting Changes and Error Corrections, all prior periods have been adjusted to apply the new method retrospectively. The effect of the change on retained earnings as of January 1, 2012, was a reduction of $106.0 million with a corresponding offset to accumulated other comprehensive loss.

We have presented the effects of the change in accounting principle on our condensed consolidated financial statements for the three months ended March 31, 2012 below. The following tables present the significant effects of the change on our historical condensed consolidated statement of operations and statement of comprehensive income. There was no effect on our historical condensed consolidated statement of cash flows.

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Condensed Consolidated Statement of Operations Information

	Three months ended March 31, 2012		
	As reported [1]	Effect of accounting change	As adjusted
	(Dollars in thousands, except per share amounts)		
Net sales	$ 460,425	$	$ 460,425
Cost of sales	374,704		374,704
Gross profit	85,721		85,721
Selling, general and administrative expenses	76,487	(3,979)	72,508
Restructuring and impairment charges	311		311
Other expense (income):			
Interest expense	6,374		6,374
Interest earned	(84)		(84)
Foreign currency losses, net	144		144
Miscellaneous expense, net	396		396
Income before income taxes	2,093	3,979	6,072
Income tax expense	1,386	1,423	2,809
Income from continuing operations	707	2,556	3,263
Income from discontinued operations, net of income taxes	707		707
Net income	1,414	2,556	3,970
Less: Net income attributable to noncontrolling interests	124		124
Net income attributable to Ferro Corporation common shareholders	$ 1,290	$ 2,556	$ 3,846
Earnings per share attributable to Ferro Corporation common shareholders:			
Basic earnings:			
From continuing operations	$	$ 0.03	$ 0.03
From discontinued operations	0.01		0.01
	$ 0.01	$ 0.03	$ 0.04
Diluted earnings:			
From continuing operations	$	$ 0.03	$ 0.03
From discontinued operations	0.01		0.01
	$ 0.01	$ 0.03	$ 0.04

(1) Adjusted to reflect the impact of discontinued operations (see Note 12).

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Condensed Consolidated Statement of Comprehensive Income Information

	Three months ended March 31, 2012		
	As reported	Effect of accounting change	As adjusted
	(Dollars in thousands)		
Net income	$ 1,414	$ 2,556	$ 3,970
Other comprehensive income (loss), net of tax:			
Foreign currency translation	24		24
Postretirement benefit liabilities	1,892	(2,556)	(664)
Total comprehensive income	3,330		3,330
Less: Comprehensive income attributable to noncontrolling interests	122		122
Comprehensive income attributable to Ferro Corporation	$ 3,208	$	$ 3,208

3. Inventories

	March 31, 2013	December 31, 2012
	(Dollars in thousands)	
Raw materials	$ 63,718	$ 64,923
Work in process	35,819	35,028
Finished goods	110,695	100,873
Total inventories	$ 210,232	$ 200,824

In the production of some of our products, we use precious metals, some of which we obtain from financial institutions under consignment agreements with terms of one year or less. The financial institutions retain ownership of the precious metals and charge us fees based on the amounts we consign. These fees were $1.0 million and $1.9 million for the three months ended March 31, 2013 and 2012, respectively. We had on hand precious metals owned by participants in our precious metals consignment program of $93.4 million at March 31, 2013, and $112.2 million at December 31, 2012, measured at fair value based on market prices for identical assets and net of credits.

4. Property, Plant and Equipment

Property, plant and equipment is reported net of accumulated depreciation of $662.4 million at March 31, 2013, and $658.1 million at December 31, 2012. Unpaid capital expenditure liabilities, which are noncash investing activities, were $2.4 million at March 31, 2013, and $7.8 million at March 31, 2012. During the first quarter of 2013, the Nules, Spain and Casiglie, Italy properties classified as held for sale with a net book value of approximately $3.0 million as of December 31, 2012, were disposed of through sale. Total consideration received for the properties was approximately $3.3 million.

During the first quarter of 2013, we sold assets related to our solar pastes product line to Heraeus Precious Metals North America Conshocken LLC (Heraeus LLC). The assets sold included, among other things, certain machinery and equipment, certain open orders, raw materials and silver paste required for purchased open orders, and intellectual property. The consideration for the assets sold was $10.9 million, and resulted in a gain on the transaction of $9.0 million and is included within miscellaneous income within the condensed consolidated statement of operations. In addition, Heraeus LLC provided Ferro with approximately $12.0 million of precious metals, which was used to reduce amounts outstanding under our precious metals consignment program.

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5. Debt

Loans payable and current portion of long-term debt consisted of the following:

	March 31, 2013	December 31, 2012
	(Dollars in thousands)	
Loans payable to banks	$ 3,123	$ 2,477
Domestic accounts receivable asset securitization program	30,000	40,000
International accounts receivable sales programs	5,531	6,122
Current portion of long-term debt	36,524	36,553
Loans payable and current portion of long-term debt	$ 75,178	$ 85,152

Long-term debt consisted of the following:

	March 31, 2013	December 31, 2012
	(Dollars in thousands)	
7.875% Senior Notes	$ 250,000	$ 250,000
6.50% Convertible Senior Notes, net of unamortized discounts	34,662	34,417
Revolving credit facility	6,635	2,596
Capital lease obligations	6,126	6,433
Other notes	4,627	4,731
Total long-term debt	302,050	298,177
Current portion of long-term debt	(36,524)	(36,553)
Long-term debt, less current portion	$ 265,526	$ 261,624

Receivable Sales Programs

We have an asset securitization program for Ferro s U.S. trade accounts receivable. We sell interests in our domestic receivables to various purchasers, and we may obtain up to $50.0 million in the form of cash or letters of credit. Advances received under this program are accounted for as borrowings secured by the receivables and included in net cash provided by financing activities. At March 31, 2013, advances received of $30.0 million were secured by $88.2 million of accounts receivable, and based on available and qualifying receivables, $20.0 million of additional borrowings were available under the program. The interest rate under this program is the sum of (A) either (1) commercial paper rates, (2) LIBOR rates, or (3) the federal funds rate plus 0.5% or the prime rate and (B) a fixed margin. At March 31, 2013, the interest rate was 0.6%.

We also have several international programs to sell with recourse trade accounts receivable to financial institutions. Advances received under these programs are accounted for as borrowings secured by the receivables and included in net cash provided by financing activities. At March 31, 2013, the commitments supporting these programs totaled $17.9 million, the advances received of $5.5 million were secured by $8.3 million of accounts receivable, and based on available and qualifying receivables, $0.3 million of additional borrowings were available under the programs. The interest rates under these programs are based on EURIBOR rates plus 1.75%. At March 31, 2013, the weighted-average interest rate was 1.9%.

7.875% Senior Notes

The 7.875% Senior Notes (the Senior Notes) were issued in 2010 at par, bear interest at a rate of 7.875% per year, payable semi-annually in arrears on February 15th and August 15th, and mature on August 15, 2018. Through August 15, 2013, we may redeem up to 35% of the Senior Notes at a price equal to 107.875% of the principal amount using proceeds of certain equity offerings. We may also redeem some or all of the Senior Notes prior to August 15, 2014, at a price equal to the principal amount plus a defined applicable premium. The applicable premium on any redemption date is the greater of 1% of the principal amount of the note or the excess of (1) the present value at such redemption date of the redemption price of the note at August 15, 2014, plus all required interest payments due on the note through August 15, 2014, computed using a discount rate equal to the Treasury Rate as of the redemption date plus 50 basis points; over (2) the principal amount of the note. In addition, we may redeem some or all of the Senior Notes beginning August 15, 2014, at prices ranging from 100% to 103.938% of the principal amount.

The Senior Notes are unsecured obligations and rank equally in right of payment with any other unsecured, unsubordinated obligations. The Senior Notes contain certain affirmative and negative covenants customary for high-yield debt securities, including, but not limited to, restrictions on our ability to incur additional debt, create liens, pay dividends or make other distributions or repurchase our common stock and sell assets outside the ordinary course of business. At March 31, 2013, we were in compliance with the covenants under the Senior Notes indenture.

6.5% Convertible Senior Notes

The 6.5% Convertible Senior Notes (the Convertible Notes) were issued in 2008, bear interest at a rate of 6.5% per year, payable semi-annually in arrears on February 15th and August 15th, and mature on August 15, 2013. We separately account for the liability and equity components of the Convertible Notes in a manner that, when interest cost is recognized in subsequent periods, will reflect our nonconvertible debt borrowing rate at the time the Convertible Notes were issued. The effective interest rate on the liability component is 9.5%. Under certain circumstances, holders of the Convertible Notes may convert their notes prior to maturity. The Convertible Notes are unsecured obligations and rank equally in right of payment with any other unsecured, unsubordinated obligations. The principal amount outstanding was $35.1 million at March 31, 2013, and $35.1 million at December 31, 2012. At March 31, 2013, we were in compliance with the covenants under the Convertible Notes indenture.

Revolving Credit Facility

In 2010, we entered into the Third Amended and Restated Credit Agreement with a group of lenders for a five-year, $350 million multi-currency senior revolving credit facility (the 2010 Credit Facility). In March 2013, we amended the 2010 Credit Facility (the 2013 Amended Credit Facility) to provide additional operating flexibility. The primary effects of the 2013 Amended Credit Facility were to:

- Decrease the Revolving Loan Commitment Amount from $350.0 million to $250.0 million;
- Amend the calculation of EBITDA to provide for a restructuring expense add-back attributable to the Company s restructuring programs of $30.0 million in 2013, $20.0 million in 2014 and $10.0 million in 2015, with no aggregate limit on restructuring expense;
- Increase the maximum permitted leverage ratio such that for (i) the first, second and third quarters of 2013, it shall increase from 3.50 to 4.25; (ii) the fourth quarter of 2013 and first quarter of 2014, it shall increase from 3.50 to 4.00; (iii) the second and third quarters of 2014, it shall increase from 3.50 to 3.75; and (iv) the fourth quarter of 2014 and thereafter, it will be 3.50; and
- Amend the requirements for Permitted Acquisitions such that for the Company to consummate a Permitted Acquisition the Company must have minimum liquidity of $100.0 million and the Company s Secured Leverage Ratio must be less than 1.50.

The 2013 Amended Credit Facility matures on August 24, 2015, and is secured by substantially all of Ferro s assets. After reductions for outstanding letters of credit, we had $239.2 million of additional borrowings available at March 31, 2013. The interest rate under the 2013 Amended Credit Facility is the sum of (A) either (1) LIBOR or (2) the higher of the Federal Funds Rate plus 0.5%, the Prime Rate, or LIBOR plus 1.0% and (B) a variable margin based on the Company s leverage. At March 31, 2013, the interest rate was 3.7%.

Under the 2013 Amended Credit Facility, we are subject to a number of financial covenants, including limitations on the payment of common stock dividends. At March 31, 2013, we were in compliance with the covenants of the 2013 Amended Credit Facility.

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6. Financial Instruments

The following financial instrument assets (liabilities) are presented at their respective carrying amount, fair value and classification within the fair value hierarchy:

	March 31, 2013				
	Carrying Amount	Fair Value Total	Level 1	Level 2	Level 3
	(Dollars in thousands)				
Cash and cash equivalents	$ 32,897	$ 32,897	$ 32,897	$	$
Loans payable	(38,654)	(38,654)		(38,654)	
7.875% Senior Notes	(250,000)	(261,540)		(261,540)	
6.50% Convertible Senior Notes, net of unamortized discounts	(34,662)	(35,241)		(35,241)	
Revolving credit facility	(6,635)	(6,760)		(6,760)	
Other long-term notes payable	(4,627)	(3,850)		(3,850)	
Foreign currency forward contracts, net	2,715	2,715		2,715	

	December 31, 2012				
	Carrying Amount	Fair Value Total	Level 1	Level 2	Level 3
	(Dollars in thousands)				
Cash and cash equivalents	$ 29,576	$ 29,576	$ 29,576	$	$
Loans payable	(48,599)	(48,599)		(48,599)	
7.875% Senior Notes	(250,000)	(231,500)		(231,500)	
6.50% Convertible Senior Notes, net of unamortized discounts	(34,417)	(34,803)		(34,803)	
Revolving credit facility	(2,596)	(2,634)		(2,634)	
Other long-term notes payable	(4,731)	(3,937)		(3,937)	
Foreign currency forward contracts, net	(4,758)	(4,758)		(4,758)	

The fair values of cash and cash equivalents are based on the fair values of identical assets. The fair values of short-term loans payable are based on the present value of expected future cash flows and approximate their carrying amounts due to the short periods to maturity. The fair values of the Senior Notes and the Convertible Notes are based on third-party estimated bid prices. The fair values of the revolving credit facility and the other long-term notes are based on the present value of expected future cash flows and assumptions about current interest rates and the creditworthiness of the Company that market participants would use in pricing the debt.

Foreign currency forward contracts. We manage foreign currency risks principally by entering into forward contracts to mitigate the impact of currency fluctuations on transactions. These forward contracts are not designated as hedging instruments. Gains and losses on these foreign currency forward contracts are netted with gains and losses from currency fluctuations on transactions arising from international trade and reported as foreign currency (gains) losses, net in the condensed consolidated statements of operations. The fair values of these contracts are based on market prices for comparable contracts. We had foreign currency forward contracts with notional amounts of $249.1 million at March 31, 2013, and $250.7 million at December 31, 2012.

The following table presents the effect on our consolidated statements of operations for the three months ended March 31, 2013 and 2012, respectively, of our foreign currency forward contracts:

	Amount of Gain (Loss) Recognized in Earnings 2013	2012	Location of Gain (Loss) in Earnings
	(Dollars in thousands)		
Foreign currency forward contracts	$ 964	$ (5,653)	Foreign currency losses, net

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The following table presents the fair values on our consolidated balance sheets of foreign currency forward contracts:

	March 31, 2013	December 31, 2012	Balance Sheet Location
	(Dollars in thousands)		
Asset derivatives:			
Foreign currency forward contracts	$ 3,640	$	Other current assets
Foreign currency forward contracts		213	Accrued expenses and other current liabilities
Total	$ 3,640	$ 213	
Liability derivatives:			
Foreign currency forward contracts	$ (925)	$	Other current assets
Foreign currency forward contracts		(4,971)	Accrued expenses and other current liabilities
Total	$ (925)	$ (4,971)	

7. Income Taxes

Income tax expense for the three months ended March 31, 2013, was $1.0 million, or 10.2% of pre-tax income. In the first three months of 2012, we recorded income tax expense of $2.8 million, or 46.3% of pre-tax income. The decrease in the effective tax rate was primarily the result of differences in pre-tax loss or income in loss jurisdictions with full valuation allowances for which no tax benefit or expense is recognized.

8. Contingent Liabilities

We have recorded environmental liabilities of $9.4 million at March 31, 2013, and $9.6 million at December 31, 2012, for costs associated with the remediation of certain of our properties that have been contaminated, primarily a non-operating facility in Brazil. The costs include legal and consulting fees, site studies, the design and implementation of remediation plans, post-remediation monitoring and related activities. The ultimate liability could be affected by numerous uncertainties, including the extent of contamination found, the required period of monitoring and the ultimate cost of required remediation.

There are various lawsuits and claims pending against the Company and its subsidiaries. We do not currently expect the ultimate liabilities, if any, and expenses related to such lawsuits and claims to materially affect the consolidated financial position, results of operations, or cash flows of the Company.

9. Retirement Benefits

Net periodic benefit (credit) cost of our U.S. pension plans (including our unfunded nonqualified plans), non-U.S. pension plans, and postretirement health care and life insurance benefit plans have been adjusted for our change in accounting principle as described in Note 2, Recent Accounting Pronouncements and Change in Accounting Principle. Net periodic benefit (credit) cost for the three months ended March 31, 2013 and 2012, respectively, follow:

	U.S. Pension Plans		Non-U.S. Pension Plans		Other Benefit Plans	
	2013	2012	2013	2012	2013	2012
	(Dollars in thousands)					
Service cost	$ 4	$ 4	$ 533	$ 577	$	$
Interest cost	4,485	4,869	1,230	1,375	285	396
Expected return on plan assets	(6,181)	(5,096)	(748)	(753)		
Amortization of prior service cost (credit)	3	12	6	(33)	(29)	(33)
Net periodic benefit (credit) cost	$ (1,689)	$ (211)	$ 1,021	$ 1,166	$ 256	$ 363

Net periodic benefit credit for our U.S. pension plans for the three months ended March 31, 2013 increased from the effects of a lower discount rate and larger plan asset balances resulting in increased expected returns.

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10. Stock-Based Compensation

Our Board of Directors granted 0.5 million stock options, 0.4 million performance share units and 0.3 million deferred stock units during the first quarter of 2013 under our 2010 Long Term Incentive Plan. The following table details the weighted-average grant-date fair values and the assumptions used for estimating the fair values of stock option grants made during the three months ended March 31, 2013:

	Stock Options
Weighted-average grant-date fair value	$ 3.79
Expected life, in years	6.0
Risk-free interest rate	1.4%
Expected volatility	85.6%

The weighted average grant date fair value of our performance share units was $5.29. These shares are currently expensed at target and are evaluated each reporting period for likelihood of achieving the performance criteria.

We measure the fair value of deferred stock units based on the closing market price of our common stock on the date of the grant. The weighted-average fair value per unit for grants made during the three months ended March 31, 2013, was $5.44.

We recognized stock-based compensation expense of $1.3 million for the three months ended March 31, 2013, and $2.0 million for the three months ended March 31, 2012. At March 31, 2013, unearned compensation cost related to the unvested portion of all stock-based awards was approximately $10.2 million and is expected to be recognized over the remaining vesting period of the respective grants, through the first quarter of 2016.

11. Restructuring and Cost Reduction Programs

In the first quarter of 2013, we developed and initiated restructuring programs across the organization with the objectives of realigning the business and lowering our cost structure. Specifically, the programs relate to our European operations, certain corporate functions, improvement of operational efficiencies, and the exit of the solar pastes product line. As a result of the restructuring actions, the Company expects to incur charges of approximately $26 million, substantially all of which will be for severance costs and require future cash expenditures. The programs are subject to required consultations with employee representatives at the affected sites and other local legal requirements. Charges associated with these programs were $9.5 million for the three months ended March 31, 2013.

The activities and accruals related to our restructuring and cost reduction programs are summarized below:

	Employee Severance	Other Costs	Asset Impairment	Total
	(Dollars in thousands)			
Balance at December 31, 2012	$ 4,093	$ 6,139	$	$ 10,232
Restructuring charges	8,170	1,284		9,454
Cash payments	(2,902)	(4,699)		(7,601)
Non-cash items	(204)	(77)		(281)
Balance at March 31, 2013	$ 9,157	$ 2,647	$	$ 11,804

We expect to make cash payments to settle the remaining liability for employee termination benefits and other costs over the next twelve months, except where legal or contractual restrictions prevent us from doing so.

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12. Discontinued Operations

During the first quarter of 2013, we completed the sale of the stock of our pharmaceuticals business, Ferro Pfanstiehl Laboratories, Inc. (FPL), which was previously reported within the Pharmaceuticals reportable segment. Consideration was comprised of a $16.9 million cash payment, and the transaction also included an earn-out incentive of up to $8.0 million based on achieving certain earnings targets over a two-year period. In March 2013, prior to the sale, an impairment loss of $8.7 million associated with the long lived assets of FPL was recorded under ASC Topic 360 Property, Plant and Equipment. The write down was determined by estimating the fair value of the assets less cost to sell of $14.8 million using the market approach considering a bona fide purchase offer, a level three measurement within the fair value hierarchy.

The operations of FPL have been segregated from continuing operations and are included in discontinued operations in our condensed consolidated statements of operations. Interest expense has been allocated to the discontinued operation based on the ratio of net assets of FPL to consolidated net assets excluding debt.

	Three months ended March 31,	
	2013	2012
	(Dollars in thousands)	
Net sales	$ 4,791	$ 5,965
Cost of sales	2,762	3,363
Gross profit	2,029	2,602
Selling, general and administrative expenses	1,181	1,198
Impairment	8,682	
Interest expense	589	366
Miscellaneous expense (income), net	(2)	(2)
(Loss) income from discontinued operations before income taxes	(8,421)	1,040
Income tax expense		333
(Loss) income from discontinued operations, net of income taxes	$ (8,421)	$ 707

The following is a summary of the assets and liabilities of FPL at December 31, 2012, which are presented separately on the condensed consolidated balance sheet:

	(Dollars in thousands)
Inventories	$ 6,267
Other current assets	22
Current assets of discontinued operations	6,289
Property, plant and equipment, net	15,346
Other assets of discontinued operations	15,346
Accounts payable	880
Accrued payrolls	47
Accrued expenses and other current liabilities	373
Current liabilities of discontinued operations	$ 1,300

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13. Earnings Per Share

Details of the calculation of basic and diluted earnings per share are shown below:

	Three months ended March 31, 2013	Three months ended March 31, As adjusted 2012
	(In thousands, except per share amounts)	
Basic earnings per share computation:		
Net income attributable to Ferro Corporation common shareholders	$ 883	$ 3,846
Adjustment for loss (income) from discontinued operations	8,421	(707)
Total	$ 9,304	$ 3,139
Weighted-average common shares outstanding	86,439	86,233
Basic earnings per share from continuing operations attributable to Ferro Corporation common shareholders	$ 0.11	$ 0.03
Diluted earnings per share computation:		
Net income attributable to Ferro Corporation common shareholders	$ 883	$ 3,846
Adjustment for loss (income) from discontinued operations	8,421	(707)
Total	$ 9,304	$ 3,139
Weighted-average common shares outstanding	86,439	86,233
Assumed exercise of stock options	98	191
Assumed satisfaction of deferred stock unit conditions	62	23
Assumed satisfaction of restricted stock unit conditions	35	
Assumed satisfaction of performance stock unit conditions	45	
Assumed satisfaction of restricted share conditions	97	248
Weighted-average diluted shares outstanding	86,776	86,695
Diluted earnings per share from continuing operations attributable to Ferro Corporation common shareholders	$ 0.11	$ 0.03

The number of anti-dilutive or unearned shares, including shares related to contingently convertible debt, was 5.3 million for the three months ended March 31, 2013, and 6.9 million for the three months ended March 31, 2012.

14. Accumulated Other Comprehensive Income

Changes in accumulated other comprehensive income (loss) by component, net of tax, for the three months ended March 31, 2013, were as follows:

Postretirement Benefit Liability Adjustments

CERTAIN PROVISIONS OF MARYLAND LAW AND OF THE COMPANY'S DECLARATION OF TRUST AND BYLAWS

The following summary of certain provisions of Maryland law and of the Declaration of Trust and Bylaws does not purport to be complete and is subject to and qualified in its entirety by reference to Maryland law and to the Declaration of Trust and Bylaws of the Company, as amended, which are incorporated by reference into this Registration Statement.

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Duration

Under the Company□s Declaration of Trust, the Company has a perpetual term and will continue perpetually subject to the authority of the Board of Trustees to terminate the Company□s existence and liquidate its assets and subject to termination pursuant to the Maryland REIT Law.

Board of Trustees

The Company□s Declaration of Trust provides that the number of Trustees of the Company shall not be less than three nor more than 15. Any vacancy (including a vacancy created by an increase in the number of Trustees) will be filled, at any regular meeting or at any special meeting called for that purpose, by a majority of the Trustees (although less than a quorum). The Trustees will each serve for a term of one year (except that an individual who has been elected to fill a vacancy will hold office only until the next annual meeting of shareholders and until his successor has been duly elected and qualified).

The Declaration of Trust provides that a Trustee may be removed from office only at a meeting of the shareholders called for that purpose, by the affirmative vote of the holders of not less than a majority of the Shares entitled to vote in the election of Trustees; provided, however, that in the case of any Trustees elected solely by holders of a series of Preferred Shares, such Trustees may be removed by the affirmative vote of a majority of the Preferred Shares of that series then outstanding and entitled to vote in the election of Trustees, voting together as a single class.

Meetings of Shareholders

The Declaration of Trust requires the Company to hold an annual meeting of shareholders for the election of Trustees and the transaction of any other proper business. Special meetings of shareholders may be called upon the written request of shareholders holding at least 10% of the Common Shares. Special meetings of shareholders may also be called by the holders of Preferred

Shares to the extent, if any, determined by the Board of Trustees in connection with the establishment of a class or series of Preferred Shares. Any action required or permitted to be taken by shareholders must be taken at a duly called annual or special meeting of shareholders and may not be effected by any consent in writing of shareholders.

Business Combinations

Under the MGCL, as applicable to Maryland real estate investment trusts, certain "business combinations" (including certain mergers, consolidations, share exchanges, or, in certain circumstances, asset transfers or issuances or reclassifications of equity securities) between a Maryland real estate investment trust and an "interested shareholder" or an affiliate of the interested shareholder are prohibited for five (5) years after the most recent date on which the interested shareholder becomes an interested shareholder. An interested shareholder includes a person who beneficially owns, and an affiliate or associate of the trust who, at any time within the two-year period prior to the date in question, was the beneficial owner of, ten percent or more of the voting power of our then-outstanding voting shares. Thereafter, any such business combination must be: (a) recommended by the trustees of such trust and (b) approved by the affirmative vote of at least: (i) 80% of the votes entitled to be cast by holders of outstanding voting shares of beneficial interest of the trust; and (ii) two-thirds of the votes entitled to be cast by holders of outstanding voting shares of beneficial interest other than shares held by the interested shareholder with whom (or with whose affiliate or associate) the business combination is to be effected, unless, among other conditions, the trust's common shareholders receive a minimum price (as defined in the MGCL) for their shares and the consideration is received in cash or in the same form as previously paid by the interested shareholder for its shares. These provisions of the MGCL do not apply, however, to business combinations that are approved or exempted by the board of trustees of the trust prior to the time that the interested shareholder becomes an interested shareholder. An amendment to a Maryland REIT's declaration of trust electing not to be subject to the foregoing requirements must be approved by the affirmative vote of at least 80% of the votes entitled to be cast by holders of outstanding voting shares of beneficial interest of the trust, voting together as a single voting group, and two-thirds of the votes entitled to be cast by holders of outstanding voting shares of beneficial interest other than shares of beneficial interest held by interested shareholders. Any such amendment shall not be effective until 18 months after the vote of shareholders and does not apply to any business combination of the trust with an interested shareholder on the date of the shareholder vote. The Board of Trustees has exempted any business combinations involving SSI, TNC, SERS, the SERS Voting Trust, Morgan Stanley Asset Management Inc., the Morgan Stanley Funds, Lazard, Gerard H. Sweeney and their respective affiliates and associates from the business combination provisions of the MGCL and, consequently, the five-year prohibition and the super-majority vote requirements will not apply to business combinations between any of them and the Company. As a result, they may be able to enter into business combinations that may not be in the best interest of the shareholders without compliance by the Company with the super-majority vote requirements and the other provisions of the statute.

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The business combination statute could have the effect of delaying, deferring or preventing offers to acquire the Company and of increasing the difficulty of consummating any such offer.

Control Share Acquisitions

The MGCL, as applicable to Maryland real estate investment trusts, provides that “control shares” of a Maryland real estate investment trust acquired in a “control share acquisition” have no voting rights except to the extent approved by a vote of two-thirds of the votes entitled to be cast on the matter by shareholders, excluding shares owned by the acquiror, by officers or by trustees who are employees of the trust in question. “Control shares” are voting shares of beneficial interest which, if aggregated with all other shares previously acquired by such acquiror or in respect of which the acquiror is able to exercise or direct the exercise of voting power (except solely by virtue of a revocable proxy), would entitle the acquiror to exercise the voting power in the election of trustees within one of the following ranges of voting power: (a) one-fifth or more but less than one-third, (b) one-third or more but less than a majority, or (c) a majority or more of all voting power. Control shares do not include shares the acquiring person is then entitled to vote as a result of having previously obtained shareholder approval. A “control share acquisition” means the acquisition of control shares, subject to certain exceptions.

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

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

The control share acquisition statute does not apply to shares acquired in a merger, consolidation or share exchange if the trust is a party to the transaction, or to acquisitions approved or exempted by the declaration of trust or bylaws of the trust. Pursuant to the statute, the Company has exempted any and all acquisitions of Shares by SSI, TNC, SERS, SERS Voting Trust, Morgan Stanley Asset Management, Inc., the Morgan Stanley Funds and any current or future affiliate or associate of theirs from the control share provisions of the MGCL. As a result, they will be able to possess voting power not generally available to other persons and the effect may be to further enhance their ability to control the Company.

The control share acquisition statute could have the effect of delaying, deferring or preventing offers to acquire the Company and of increasing the difficulty of consummating any such offer.

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Amendment to the Declaration of Trust

The Company□s Declaration of Trust may be amended only by the affirmative vote of the holders of not less than a majority of the Shares then outstanding and entitled to vote thereon, except for the provisions of the Declaration of Trust relating to (i) increases or decreases in the aggregate number of Shares of any class (other than the Series A Preferred Shares,) which may be made by the Board of Trustees without shareholder approval and (ii) the MGCL provisions on business combinations, amendment of which requires the affirmative vote of the holders of not less than 80% of the Shares then outstanding and entitled to vote. In addition, in the event that the Board of Trustees shall have determined, with the advice of counsel, that any one or more of the provisions of the Company□s Declaration of Trust (the □Conflicting Provisions□) are in conflict with the Maryland REIT Law, the Code or other applicable Federal or state law(s), the Conflicting Provisions shall be deemed never to have constituted a part of the Declaration of Trust, even without any amendment thereof.

Termination of the Company and REIT Status

Subject to the rights of any outstanding Preferred Shares and to the provisions of the Maryland REIT Law, the Company□s Declaration of Trust permits the Board of Trustees to terminate the Company and to discontinue the election of the Company to be taxed as a REIT.

Transactions Between the Company and its Trustees or Officers

The Company□s Declaration of Trust provides that any contract or transaction between the Company and one or more Trustees, officers, employees or agents of the Company must be approved by a majority of the Trustees who have no interest in the contract or transaction.

Limitation of Liability and Indemnification

The Maryland REIT Law permits a Maryland real estate investment trust to include in its Declaration of Trust a provision limiting the liability of its trustees and officers to the trust and its shareholders for money damages except for liability resulting from (a) actual receipt of an improper benefit or profit in money, property or services or (b) active and deliberate dishonesty established by a final judgment as being material to the cause of action. The Declaration of Trust of the Company contains such a provision which eliminates such liability to the maximum extent permitted by the Maryland REIT Law.

The Company's Bylaws require it to indemnify, without requiring a preliminary determination of the ultimate entitlement to indemnification, (a) any present or former Trustee, officer or shareholder who has been successful, on the merits or otherwise, in the defense of a proceeding to which he was made a party by reason of such status, against reasonable expenses incurred by him in connection with the proceeding; (b) any present or former Trustee or officer against any claim or liability to which he may become subject by reason of such status unless it is established that (i) his act or omission was committed in bad faith or was the result of active and deliberate dishonesty, (ii) he actually received an improper personal benefit in money, property or services or (iii) in the case of a criminal proceeding, he had reasonable cause to believe that his act or omission was unlawful; and (c) each shareholder or former shareholder against any claim or liability to which he may be subject by reason of such status as a shareholder or former shareholder. However, under the MGCL, a Maryland corporation may not indemnify for an adverse judgment in a suit by or in the right of the corporation or for a judgment of liability on the basis that personal benefit was improperly received, unless in either case a court orders indemnification and then only for expenses. In addition, the Company's Bylaws require it to pay or reimburse, in advance of final disposition of a proceeding, reasonable expenses incurred by a present or former Trustee, officer or shareholder made a party to a proceeding by reason of his status as a Trustee, officer or shareholder provided that, in the case of a Trustee or officer, the Company shall have received (i) a written affirmation by the Trustee or officer of his good faith belief that he has met the applicable standard of conduct necessary for indemnification by the Company as authorized by the Bylaws and (ii) a written undertaking by him or on his behalf to repay the amount paid or reimbursed by the Company if it shall ultimately be determined that the applicable standard of conduct was not met. The Company's Bylaws also (i) permit the Company, with the approval of its Trustees, to provide indemnification and payment or reimbursement of expenses to a present or former Trustee, officer or shareholder who served a predecessor of the Company in such capacity, and to any employee or agent of the Company or a predecessor of the Company, (ii) provide that any indemnification or payment or reimbursement of the expenses permitted by the Bylaws shall be furnished in accordance with the procedures provided for indemnification and payment or reimbursement of expenses under Section 2-418 of the MGCL for directors of Maryland corporations and (iii) permit the Company to provide such other and further indemnification or payment or reimbursement of expenses as may be permitted by the MGCL for directors of Maryland corporations.

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The limited partnership agreement of the Operating Partnership also provides for indemnification by the Operating Partnership of the Company, as general partner, and its Trustees and officers for any costs, expenses or liabilities incurred by them by reason of any act performed by them for or on behalf of the Operating Partnership or the Company; provided that such person□s actions were taken in good faith and in the belief that such conduct was in the best interests of the Operating Partnership and that such person was not guilty of fraud, willful misconduct or gross negligence.

Insofar as indemnification for liabilities arising under the Securities Act may be permitted to Trustees and officers of the Company pursuant to the foregoing provisions or otherwise, the Company has been advised that, although the validity and scope of the governing statute has not been tested in court, in the opinion of the Securities and Exchange Commission, such indemnification is against public policy as expressed in the Securities Act and is, therefore, unenforceable. In addition, indemnification may be limited by state securities laws.

Maryland Asset Requirements

To maintain its qualification as a Maryland real estate investment trust, the Maryland REIT Law requires that the Company hold, either directly or indirectly, at least 75% of the value of its assets in real estate assets, mortgages or mortgage related securities, government securities, cash and cash equivalent items, including high-grade short-term securities and receivables. The Maryland REIT Law also prohibits using or applying land for farming, agricultural, horticultural or similar purposes.

POLICIES WITH RESPECT TO CERTAIN ACTIVITIES

The following is a discussion of certain investment, financing and other policies of the Company. These policies have been determined by the Company□s Board of Trustees and may be amended or revised from time to time by the Board of Trustees without a vote of shareholders. No assurance can be given that the Company's investment objectives will be attained or that the value of the Company will not decrease.

Investment Policies

Investments in Real Estate or Interests in Real Estate. The Company's business objective is to increase cash available for distribution and to maximize shareholder value by: (i) maximizing cash flow through leasing strategies designed to capture potential rental growth as rental rates increase and as below-market leases are renewed; (ii) ensuring a high tenant retention rate through an aggressive tenant services program responsive to the varying needs of the Company's diverse base of tenants; (iii) broadening its geographic and economic diversification while maximizing economies of scale; (iv) acquiring high-quality office and industrial properties and portfolios of such properties at attractive yields in selected submarkets within the Mid-Atlantic region (including Delaware, Maryland, New Jersey, New York, Pennsylvania, Virginia and the District of Columbia), which management expects will experience economic growth; (v) capitalizing on management's redevelopment expertise to selectively acquire, redevelop and reposition underperforming properties in desirable locations; (vi) acquiring land in anticipation of developing office or industrial properties on a build-to-suit basis, under circumstances where significant pre-leasing can be arranged or as otherwise warranted by market conditions; (vii) enhancing the Company's investment strategy through the pursuit of joint venture opportunities with high quality partners having attractive real estate holdings or significant financial resources; and (viii) optimizing the use of debt and equity financing to create a flexible and conservative capital structure that will enable the Company to continue its aggressive growth strategy.

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In pursuit of its business objective of increasing cash available for distribution and maximizing shareholder value, the Company has recently experienced rapid growth. Between January 1, 1997 and December 1, 1998 the Company has acquired 163 office properties containing approximately 12.5 million net rentable square feet, 66 industrial facilities containing approximately 3.7 million net rentable square feet and one mixed use property containing approximately 167,760 net rentable square feet and, together with the Real Estate Ventures, has acquired ownership of, or rights to acquire, approximately 503.8 acres of undeveloped land. The aggregate purchase price for the 230 Properties acquired by the Company between January 1, 1997 and December 1, 1998 was approximately $1.7 billion. During such period, the Company also completed the development of two office properties and one industrial facility containing an aggregate of approximately 288,177 net rentable square feet for aggregate development costs of approximately $19.2 million. The Company believes that, through the expertise and extensive relationships of its management, it will continue to identify and capitalize on substantial opportunities for additional real estate investments from a variety of sources, including institutional and private holders of real estate seeking liquidity or reduction in their holdings or tax-deferred dispositions.

The Company expects to continue to concentrate its real estate activities in submarkets within the Mid-Atlantic region where it believes that: (i) barriers to entry (such as zoning restrictions, utility availability, infrastructure limitations, development moratoriums, and limited developable land) are likely to create supply constraints on office and industrial space; (ii) current market rents do not justify new construction; (iii) it can maximize market penetration by accumulating a critical mass of properties and thereby enhance operating efficiencies; and (iv) there is potential for economic growth.

The Company may develop, purchase or lease income-producing properties for long-term investment, expand and improve the Properties presently owned or other properties purchased, or sell such properties, in whole or in part, when circumstances warrant. Although there is no limitation on the types of development activities that the Company may undertake, the Company expects that its development activities will generally be on a build-to-suit basis for particular tenants, or where a significant portion of the building is pre-leased before construction begins. The Company may also participate with other entities in property ownership and development through joint ventures, such as the Real Estate Ventures, or other types of co-ownership. Equity investments may be subject to existing or future mortgage financing and other indebtedness that will have priority over the equity interests in the Company.

Securities of or Interests in Entities Primarily Engaged in Real Estate Activities and Other Issuers. Subject to the percentage of ownership limitations and gross income tests necessary for REIT qualification, the Company also may invest in securities of other REITS, other entities engaged in real estate activities or securities of other issuers. The Company may enter into additional joint ventures or partnerships for the purpose of obtaining an equity interest in a particular property in accordance with the Company's investment policies.

Investments in Real Estate Mortgages. While the Company's current portfolio consists of, and the Company's business objectives emphasize, equity investments in commercial real estate, the Company may, in the discretion of the Board of Trustees, invest in other types of equity real estate investments, mortgages and other real estate interests. The Company may also invest in participating or convertible mortgages if the Company concludes that it may benefit from the cash flow or any appreciation in the value of the property.

Investment through the Operating Partnership. The Company has made no determination to conduct all of its activities through the Operating Partnership. As of the date of this Prospectus, the Company owns all of the Properties or the economic interest therein indirectly through the Operating Partnership. Although the Partnership

Agreement of the Operating Partnership contains no provision restricting the Company's ability to acquire additional properties outside the Operating Partnership, the Partnership Agreement provides that if the Company acquires additional properties outside the Operating Partnership, the percentage of administrative fees of the Company allocated to the Operating Partnership will be reduced to an amount that is fair and equitable under the circumstances.

Dispositions

The Company may sell properties in its portfolio if, based upon management's periodic review of the Company's portfolio, the Board of Trustees determines that such action would be in the best interests of the Company.

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Financing Policies

The Company has adopted a policy to operate with a long-term average debt-to-total market capitalization ratio (i.e., the total consolidated debt of the Company as a percentage of the market value of issued and outstanding Shares and Units plus total consolidated debt) of not more than 50%. As of December 1, 1998, the Company's debt-to-market capitalization ratio was approximately 54.5%. The Company's Declaration of Trust and Bylaws do not, however, limit the amount or percentage of indebtedness that the Company may incur. In addition, the Company may, from time to time, modify its debt policy in light of current economic conditions, relative costs of debt and equity capital, market values of its properties, general conditions in the market for debt and equity securities, fluctuations in the market price of its Common Shares, growth opportunities and other factors. Accordingly, the Company may increase or decrease its debt-to-market capitalization ratio beyond the limit described above. To the extent that the Board of Trustees decides to obtain additional capital, the Company may raise such capital through additional equity offerings (including offerings of senior or convertible securities), debt financings or retention of cash flow (subject to provisions in the Code concerning taxability of undistributed REIT income), or a combination of these methods. Borrowing may be unsecured or secured by any or all of the assets of the Company, the Operating Partnership or any existing or new property-owning partnership and may have full or limited recourse to all or any portion of the assets of the Company, the Operating Partnership or any existing or new property-owning partnership. Indebtedness incurred by the Company may be in the form of bank borrowing, purchase money obligations to sellers of the properties, publicly or privately placed debt instruments or financing from institutional investors or other lenders. The proceeds from any borrowing by the Company may be used for working capital, to refinance existing indebtedness, to finance acquisition, expansion or development of new properties and for the payment of distributions. The Company has not established any limit on the number or amount of mortgages that may be placed on any single property or on its portfolio as a whole. In making decisions regarding the incurrence of indebtedness, the Company considers such factors as the ability of particular properties and the Company as a whole to generate cash flow to cover expected debt service, the purchase price of properties to be acquired with debt financing, the estimated market value of properties upon refinancing and the impact of the debt financing on the Company's ability to pay dividends.

Working Capital Reserves

The Company will maintain working capital reserves (and when not sufficient, access to borrowings) in amounts that the Board of Trustees determines to be adequate to meet normal contingencies in connection with the Company's business and investments.

Conflict of Interests Policies

The Company has not adopted any formal or informal policies intended to eliminate the influence of conflicts of interest. Under the Company's Declaration of Trust, a transaction effected by the Company or any entity controlled by the Company in which a Trustee or officer has a financial interest may only be consummated if the transaction is first approved by a majority of the Trustees who have no interest in the transaction.

Policies with Respect to Other Activities

The Company has authority to offer Common Shares, Preferred Shares, senior securities or options to purchase shares in exchange for property and, to the extent permitted by applicable law, to repurchase or otherwise acquire its Common Shares or other securities in the open market or otherwise and may engage in such activities in the future. The Board of Trustees periodically evaluates authorizing the Company to repurchase Common Shares and, as of the date of this Prospectus, has authorized the Company to repurchase up to 2.0 million Common Shares (net of approximately 87,000 shares previously purchased). The Company expects (but is not obligated) to issue Common Shares to holders of Units in the Operating Partnership upon exercise of their redemption rights. The Company may issue Preferred Shares from time to time, in one or more series, as authorized by the Board of Trustees without the need for shareholder approval. The Company has not engaged in trading, underwriting or agency distribution or sale of securities of issuers, nor has the Company invested in the securities of issuers (other than the Operating Partnership and its subsidiaries and the Real Estate Ventures) for the purposes of exercising control, and does not intend to do so. The Company intends to operate in a manner that will not subject it to regulation as an investment company under the Investment Company Act. At all times, the Company intends to make investments in such a manner as to qualify as a REIT, unless because of circumstances or changes in the Code (or the Treasury Regulations), the Board of Trustees determines that it is no longer in the best interest of the Company to qualify as a REIT. The Company may make loans to third parties, including, without limitation, to joint ventures in which it participates. The Company's policies with respect to such activities may be reviewed and modified or amended from time to time by the Company's Board of Trustees without a vote of the shareholders.

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FEDERAL INCOME TAX CONSIDERATIONS

The following discussion of material Federal income tax considerations is for general information only and is not tax advice. The following discussion summarizes all material federal income tax considerations to a holder of Common Shares. The applicable prospectus supplement will contain information about additional federal income tax considerations, if any, relating to Securities other than Common Shares. In the opinion of Arthur Andersen LLP, tax advisor to the Company (the Tax Advisor) the discussion below, insofar as it relates to Federal income tax matters, is correct in all material respects, and fairly summarizes the federal income tax considerations that are material to a shareholder. This discussion does not purport to deal with all aspects of taxation that may be relevant to particular shareholders in light of their personal investment or tax circumstances, or to certain types of shareholders (including insurance companies, tax-exempt organizations, financial institutions or broker dealers, foreign corporations and persons who are not citizens or residents of the United States, except to the extent discussed under Taxation of Foreign Shareholders below) subject to special treatment under the Federal income tax laws. The information in this section is based on the Code, current, temporary and proposed Treasury Regulations thereunder, the legislative history of the Code, current administrative interpretations and practices of the IRS (including its practices and policies as endorsed in private letter rulings, which are not binding on the IRS except with respect to a taxpayer that receives such a ruling), and court decisions, all as of the date hereof. The Taxpayer Relief Act of 1997 (the 1997 Act) was enacted on August 5, 1997. The 1997 Act contains many provisions which generally make it easier to operate and to continue to qualify as a REIT for taxable years beginning after the date of enactment (which, for the Company, would be applicable commencing with its taxable year beginning January 1, 1998).

EACH PROSPECTIVE PURCHASER IS ADVISED TO CONSULT HIS OWN TAX ADVISOR REGARDING THE SPECIFIC TAX CONSEQUENCES TO HIM OF THE PURCHASE, OWNERSHIP AND SALE OF SECURITIES AND OF THE COMPANY□S ELECTION TO BE TAXED AS A REAL ESTATE INVESTMENT TRUST, INCLUDING THE FEDERAL, STATE, LOCAL, FOREIGN AND OTHER TAX CONSEQUENCES OF SUCH PURCHASE, OWNERSHIP, SALE AND ELECTION AND OF POTENTIAL CHANGES IN APPLICABLE TAX LAWS.

General

The Company first elected to be taxed as a REIT for its taxable year ended December 31, 1986, and has operated and expects to continue to operate in such a manner so as to remain qualified as a REIT for Federal income tax purposes. In the opinion of the Tax Advisor, and based on certain factual representations made by the Company relating to the organization and operation of the Company, the Operating Partnership and AAPT, the Company will continue to qualify as a REIT under the Code. However, the opinion of the Tax Advisor is not binding upon the IRS and no absolute assurance can be given that the Company will continue to operate in a manner so as to remain qualified as a REIT.

The following is a general summary of the Code sections that govern the Federal income tax treatment of a REIT and its shareholders. These sections of the Code are highly technical and complex. This summary is qualified in its entirety by the applicable Code provisions, rules and regulations promulgated thereunder (□Treasury Regulations□), and administrative and judicial interpretations thereof as currently in effect. There is no assurance that there will not be future changes in the Code or administrative or judicial interpretation thereof which could adversely affect the Company□s ability to continue to qualify as a REIT or adversely affect the taxation of holders of Common Shares or which could further limit the amount of income the Company may derive from the management, construction, development, leasing or sale of properties owned by the Operating

Partnership or by third parties or in partnerships with third parties.

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Taxation of the Company as a REIT

An entity that qualifies for taxation as a REIT and distributes to its shareholders at least 95% of its REIT taxable income is generally not subject to Federal corporate income taxes on net income that it currently distributes to shareholders. This treatment substantially eliminates the double taxation (at the corporate and shareholder levels) that generally results from investment in a corporation. However, the Company will be subject to Federal income tax as follows:

The Company will be taxed at regular corporate rates on any undistributed REIT taxable income, including undistributed net capital gains.

(i) Under certain circumstances, the Company may be subject to the alternative minimum tax on its items of tax preference, if any.

(ii) If the Company has net income from prohibited transactions (which are, in general, certain sales or other dispositions of property other than foreclosure property held primarily for sale to customers in the ordinary course of business) such income will be subject to a 100% tax. See Sale of Partnership Property.

(iii) If the Company should fail to satisfy the 75% gross income test or the 95% gross income test (as discussed below), and has nonetheless maintained its qualification as a REIT because certain other requirements have been met, it will be subject to a 100% tax on the net income attributable to the greater of the amount by which the Company fails the 75% or 95% test, multiplied by a fraction intended to reflect the Companys profitability.

(iv) If the Company should fail to distribute during each calendar year at least the sum of (1) 85% of its REIT ordinary income for such year, (2) 95% of its REIT capital gain net income for such year, and (3) any undistributed taxable income from prior years, it would be subject to a 4% excise tax on the excess of such required distribution over the amounts actually distributed.

(v) If the Company has (1) net income from the sale or other disposition of foreclosure property (which is, in general, property acquired by the Company by foreclosure or otherwise or default on a loan secured by the property) which is held primarily for sale to customers in the ordinary course of business or (2) other nonqualifying income from foreclosure property, it will be subject to tax on such income at the highest corporate rate.

(vi) If the Company acquires any asset from a C corporation (i.e., generally a corporation subject to tax at the corporate level) in a transaction in which the basis of the asset in the Company's hands is determined by reference to the basis of the asset (or any other property) in the hands of the C corporation, and the Company recognizes gain on the disposition of such asset during the 10-year period (the Restriction Period) beginning on the date on which such asset was acquired by the Company then, pursuant to guidelines issued by the IRS, the excess of the fair market value of such property at the beginning of the applicable Restriction Period over the Company's adjusted basis in such asset as of the beginning of such Restriction Period will be subject to a tax at the highest regular corporate rate. The results described above with respect to the recognition of built-in gain assume that the Company will make an election pursuant to IRS Notice 88-19 or applicable future administrative rules or Treasury Regulations to avail itself of the benefits of the Restriction Period.

Qualification of the Company as a REIT

The Code defines a REIT as a corporation, trust or association:

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

(2) the beneficial ownership of which is evidenced by transferable shares or by transferable certificates of beneficial interest;

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(3) which would be taxable as a domestic corporation but for Sections 856 through 859 of the Code;

(4) which is neither a financial institution nor an insurance company subject to certain provisions of the Code;

(5) which has the calendar year as its taxable year;

(6) the beneficial ownership of which is held by 100 or more persons;

(7) during the last half of each taxable year not more than 50% in value of the outstanding stock of which is owned, directly or indirectly, by five or fewer individuals (as defined in the Code to include certain exempt organizations); and

(8) which meets certain income, asset and distribution tests, described below.

Conditions (1) through (5), inclusive, must be satisfied during the entire taxable year, and condition (6) must be satisfied during at least 335 days of a taxable year of 12 months, or during a proportionate part of a taxable year of less than 12 months. The Company has previously issued Common Shares in sufficient proportions to allow it to satisfy requirements (6) and (7) (the 100 Shareholder and five-or-fewer requirements), respectively. In addition, the Companys Declaration of Trust provides restrictions regarding the transfer of its Shares that are intended to assist the Company in continuing to satisfy the share ownership requirements described in (6) and (7) above. See Description of Shares of Beneficial Interest Restrictions on Transfer. However, these restrictions may not ensure that the Company will, in all cases, be able to satisfy the share ownership requirements described in (6) and (7) above. If the Company fails to satisfy such share ownership requirements, the Companys status as a REIT will terminate. Pursuant to the 1997 Act, for the Companys taxable years commencing on and after January 1, 1998, if the Company complies with regulatory rules pursuant to which it is required to send annual letters to certain of its shareholders requesting information regarding the actual ownership of its shares, but does not know, or exercising reasonable diligence would not have known, whether it failed to meet the requirement that it not be closely held, the Company will be treated as having met the five or fewer requirement. If the Company were to fail to comply with these regulatory rules for any year, it would be subject to a $25,000 penalty. If the Companys failure to comply was due to intentional disregard of the requirements, the penalty would be increased to $50,000. However, if the Companys failure to comply was due to reasonable cause and not willful neglect, no penalty would be imposed. See Failure to Qualify.

A REIT is permitted to have a wholly-owned subsidiary (also referred to as a qualified REIT subsidiary). A qualified REIT subsidiary is not treated as a separate entity for Federal income tax purposes. Rather, all of the assets and items of income, deductions and credit of a qualified REIT subsidiary are treated as if they were those of the REIT. The Company has formed several qualified REIT subsidiaries and may in the future form one or more qualified REIT subsidiaries. For the Companys 1997 taxable year, all of the stock of such subsidiaries must be owned by the Company from the commencement of each such subsidiarys existence. For taxable years of the Company beginning on and after January 1, 1998, the Company must own all of the stock of each such subsidiary, although it will not be required to own such stock of such subsidiary from the commencement of such subsidiarys existence.

A REIT is deemed to own its proportionate share of the assets of a partnership in which it is a partner and is deemed to receive its proportionate share of the income of the partnership. Thus, the Companys proportionate share of the assets and items of income of the Operating Partnership and each of the Title Holding Partnerships will be treated as assets and items of income of the Company for purposes of applying the requirements described herein, provided that the Operating Partnership and its subsidiary partnerships are treated as partnerships for Federal income tax purposes. In addition, the character of the assets and gross income of such partnerships shall retain the same character in the hands of the REIT for purposes of the requirements applicable to REITs under the Code including satisfying the income tests and the asset tests. See Income Taxation of the Operating Partnership, the Title Holding Partnerships and Their Partners.

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Income Tests

To maintain qualification as a REIT, there are three gross income requirements that must be satisfied annually. First, at least 75% of the Company's gross income (excluding gross income from prohibited transactions) for each taxable year must be derived directly or indirectly from investments relating to real property or mortgages on real property (including "rents from real property" and interest on obligations secured by a mortgage on real property) or from "qualified temporary investment income" (described below). Second, at least 95% of the Company's gross income (excluding gross income from prohibited transactions) for each taxable year must be derived from investments qualifying under the 75% test above, and from dividends, interest, and gain from the sale or disposition of stock or securities or from any combination of the foregoing. Third, for taxable years beginning on or before August 5, 1997, short-term gain from the sale or other disposition of stock or securities, gain from prohibited transactions, and gain on the sale or other disposition of real property held for less than four years (apart from involuntary conversions and sales of foreclosure property) must represent less than 30% of the Company's gross income (including gross income from prohibited transactions) for each taxable year. In applying these tests, the Company will be treated as realizing its share of any income and bearing its share of any loss of the Operating Partnership and the character of such income or loss, as well as other partnership items, will be determined at the partnership level.

Rents received by the Company will qualify as "rents from real property" for purposes of satisfying the 75% and 95% gross income tests only if several conditions are met. First the amount of rent must not be based in whole or in part on the income or profits of any person. However, an amount received or accrued generally will not be excluded from the term "rents from real property" solely by reason of being based on a fixed percentage or percentages of receipts or sales. Second, the Code provides that rents received from a tenant will not qualify as rents from real property if the REIT, or an owner of 10% or more of the REIT, directly or constructively owns 10% or more of such tenant (a Related Party Tenant). For the Companys taxable year which begins on January 1, 1998 and for all taxable years thereafter, only partners who own 25% or more of the capital or profits interest in a partnership are included in the determination of whether a tenant is a Related Party Tenant. Third, if rent attributable to personal property, leased in connection with a lease of real property, is greater than 15% of the total rent received under the lease, then the portion of rent attributable to such personal property will not qualify as rents from real property. Finally, for rents received to qualify as rents from real property, the REIT generally must not operate or manage the property or furnish or render services to the tenants of such property, other than through an independent contractor who is adequately compensated and from whom the REIT does not derive any income; provided, however, that the Company may directly perform certain customary services (e.g., furnishing water, heat, light and air conditioning, and cleaning windows, public entrances and lobbies) other than services which are considered rendered to the occupant of the property (e.g., renting parking spaces on a reserved basis to tenants).

For taxable years of the Company beginning after August 5, 1997, if the Company provides services to a tenant that are other than those usually or customarily provided in connection with the rental of space for occupancy only, amounts received or accrued by the Company for any such services will not be treated as rents from real property for purposes of the REIT gross income tests but will not cause other amounts received with respect to the property to fail to be treated as rents from real property if the amounts received in respect of such services, together with amounts received for certain management services, do not exceed 1% of all amounts received or accrued by the Company during the taxable year with respect to such property. If the 1% threshold is exceeded, then all amounts received or accrued by the Company with respect to the property will not qualify as rents from real property, even if the impermissible services are provided to some, but not all, of the tenants of the property.

The Company has represented that the Companys real estate investments, which include its allocable share of income from the Operating Partnership, will give rise to income that qualifies as rents from real property for purposes of the 75 percent and 95 percent gross income tests, other than rents received from a Related Party Tenant. In addition, the Company has represented that the rents received from Related Party Tenants, in addition to all other income which is not qualifying income for the 75 percent and 95 percent gross income tests, does not exceed five percent of the Companys gross income, and therefore, the Companys status as a REIT should not be jeopardized.

The Company has represented that it does not and will not (i) charge rent for any property that is based in whole or in part on the income or profits of any person (other than being based on a percentage of receipts or sales); (ii) receive rents in excess of a de minimis amount from Related Party Tenants; (iii) derive rents attributable to personal property which constitute greater than 15% of the total rents received under the lease; or (iv) perform services considered to be rendered to the occupant of property, other than through an independent contractor from whom the Company derives no income.

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The Operating Partnership owns 5% of the voting common stock, and all of the preferred stock of the Management Company, a corporation that is taxable as a regular corporation. The Management Company performs management, development and leasing services for the Operating Partnership and other real properties owned in whole or in part by third parties. The income earned by and taxed to the Management Company would be nonqualifying income if earned directly by the Company. As a result of the corporate structure, the income will be earned by and taxed to the Management Company and will be received by the Company only indirectly as dividends. Although interest and dividends are generally qualifying income under the 95% test, the IRS has announced a no-ruling policy on this issue when the dividends and interest are earned in this manner.

If the Company fails to satisfy one or both of the 75% of 95% gross income tests for any taxable year, it may nevertheless qualify as a REIT for such year if it is entitled to relief under certain provisions of the Code. These relief provisions will be generally available if (i) the Companys failure to meet such tests was due to reasonable cause and not due to willful neglect, (ii) the Company attaches a schedule of the sources of its income to its return, and (iii) any incorrect information on the schedule was not due to fraud with intent to evade tax. It is not possible, however, to state whether in all circumstances the Company would be entitled to the benefit of these relief provisions. As discussed above in Taxation of the Company as a REIT, even if these relief provisions apply, a tax would be imposed with respect to the excess net income. No similar mitigation provision applies to provide relief if the 30% income test is failed, and if such test is not met for the taxable years of the Company beginning before January 1, 1998, the Company would cease to qualify as a REIT. See Failure to Qualify.

Asset Tests

In order for the Company to maintain its qualification as a REIT, at the close of each quarter of its taxable year it must also satisfy three tests relating to the nature of its assets. First, at least 75% of the value of the Company's total assets must be represented by real estate assets (which for this purpose include (i) its allocable share of real estate assets held by partnerships in which the Company or a qualified REIT subsidiary of the Company owns an interest and (ii) stock or debt instruments purchased with the proceeds of a stock offering or a long-term (at least five years) debt offering of the Company and held for not more than one year from the date the Company receives such proceeds), cash, cash items, and government securities. Second, not more than 25% of the Company's total assets may be represented by securities other than those described above in the 75% asset class. Third, of the investments included in the 25% asset class, the value of any one issuer's securities owned by the Company may not exceed 5% of the value of the Company's total assets, and the Company may not own more than 10% of any one issuer's outstanding voting securities (excluding securities of a qualified REIT subsidiary, of which the REIT is required to own all of such stock, or another REIT).

The Company anticipates that it will be able to comply with these asset tests. The Company is deemed to hold directly its proportionate share of all real estate and other assets of the Operating Partnership and should be considered to hold its proportionate share of all assets deemed owned by the Operating Partnership through its ownership of partnership interests in other partnerships. As a result, the Company plans to hold more than 75% of its assets as real estate assets. In addition, the Company does not plan to hold any securities representing more than 10% of any one issuer's voting securities, other than any qualified REIT subsidiary of the Company or another REIT, nor securities of any one issuer exceeding 5% of the value of the Company's gross assets (determined in accordance with generally accepted accounting principles). As previously discussed, the Company is deemed to own its proportionate share of the assets of a partnership in which it is a partner so that the partnership interest, itself, is not a security for purposes of this asset test.

After initially meeting the asset tests at the close of any quarter, the Company will not lose its status as a REIT for failure to satisfy the asset tests at the end of a later quarter solely by reason of changes in asset values. If the failure to satisfy the asset tests results from an acquisition of securities or other property during a quarter, the failure can be cured by disposition of sufficient nonqualifying assets within 30 days after the close of that quarter. The Company intends to maintain adequate records of the value of its assets to ensure compliance with the asset tests, and to take such other action within 30 days after the close of any quarter as may be required to cure any noncompliance. However, there can be no assurance that such other action will always be successful. If the Company fails to cure any noncompliance with the asset test within such time period, its status as a REIT would be lost.

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As noted above, one of the requirements for qualification as a REIT is that a REIT not own more than 10 percent of the voting stock of a corporation other than the stock of a qualified REIT subsidiary (of which the REIT is required to own all of such stock) and stock in another REIT. The Operating Partnership will own only approximately 5 percent of the voting stock and all of the non-voting preferred stock of the Management Company and therefore will comply with this rule. However, the IRS could contend that the Company's ownership, through its interest in the Operating Partnership, of all of the non-voting preferred stock in the Management Company should be viewed as voting stock because of its substantial economic position in the Management Company. If the IRS were to be successful in such a contention, the Company's status as a REIT would be lost and the Company would become subject to federal corporate income tax on its net income, which would have a material adverse affect on the Company's cash available for distribution. The Company does not have the ability to designate a seat on the Board of Directors of the Management Company. The Company does not believe that it will be viewed as owning in excess of 10 percent of the voting stock of the Management Company.

Administration's Proposed Changes to REIT Asset Tests

On February 2, 1998, the Clinton Administration released a summary of its proposed budget plan, which contained provisions that, if enacted, would affect REITs, including the Company (the "REIT Proposals"). One such provision would prohibit REITs from owning more than ten percent of the vote or value of all classes of stock of any corporation (other than a "qualified REIT subsidiary" or another REIT). This provision would be effective with respect to stock acquired on or after the date of the first committee action. However, under the proposal, existing ownership arrangements such as the Company's ownership of shares of the Management Company would be grandfathered, provided that the subsidiary does not enter into a new trade or business or acquire substantial new assets after the effective date of the change in the law. Because the Company owns more than 10% of the value of the Management Company, the REIT Proposals could adversely affect the manner in which the Company structures its ownership of the Management Company and the magnitude of the property management activities conducted by the Company in the future. It is important to note that the REIT Proposals are only precursors to the first stage in the lengthy legislative process that may or may not culminate in the passage of legislation affecting REITs. Therefore, the Company is unable to determine whether the REIT Proposals will be enacted into legislation and, if enacted, the impact any final legislation may have on the Company.

Annual Distribution Requirements

The Company, in order to maintain its qualification as a REIT, is required to distribute dividends (other than capital gain dividends) to its shareholders in an amount at least equal to (A) the sum of (i) 95% of the Company's "REIT taxable income" (computed without regard to the dividends paid deduction and the REIT's net capital gain) and (ii) 95% of the net income (after tax), if any, from foreclosure property, minus (B) the excess of the sum of certain items of non-cash income (income attributable to leveled stepped rents, original issue discount on purchase money debt, or a like-kind exchange that is later determined to be taxable (plus, for the Company's 1998 taxable year and thereafter, income from cancellation of indebtedness, original issue discount, and coupon interest) over 5% of the amount determined under clause (i) above). Such distributions must be paid in the taxable year to which they relate, or in the following taxable year if declared before the Company timely files its tax return for such year and if paid on or before the first regular dividend payment after such declaration. To the extent that the Company does not distribute all of its net capital gain or distributes at least 95%, but less than 100%, of its "REIT taxable income," as adjusted, it will be subject to tax on the undistributed amount at regular capital gains and ordinary corporate tax rates. Furthermore, if the Company should fail to distribute during each calendar year at least the sum of (i) 85% of its REIT ordinary income for such year, (ii) 95%

of its REIT net capital gain income for such year, and (iii) any undistributed taxable income from prior periods, the Company would be subject to a 4% excise tax on the excess of such required distribution over the amounts actually distributed.

For the Company's taxable year beginning on January 1, 1998 and for all taxable years thereafter, undistributed capital gains may be so designated by the Company and are includable in the income of the holders of Common Shares. Such holders are treated as having paid the capital gains tax imposed on the Company on the designated amounts included in their income as long-term capital gains. Such shareholders would receive an increase in their basis for income recognized and a decrease in their basis for taxes paid by the Company. See "— Taxation of Taxable Domestic Shareholders."

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The Company intends to make timely distributions sufficient to satisfy the annual distribution requirements. In this regard, the limited partnership agreement of the Operating Partnership authorizes the Company, as general partner, to take such steps as may be necessary to cause the Operating Partnership to distribute to its partners an amount sufficient to permit the Company to meet these distribution requirements. It is possible that the Company, from time to time, may not have sufficient cash or other liquid assets to meet the 95% distribution requirement due primarily to the expenditure of cash for nondeductible items such as principal amortization or capital expenditures. In order to meet the 95% distribution requirement, the Company may borrow or may cause the Operating Partnership to arrange for short-term or other borrowing to permit the payment of required distributions or attempt to declare a consent dividend, which is a hypothetical distribution to holders of Common Shares out of the earnings and profits of the Company. The effect of such a consent dividend (which, in conjunction with distributions actually paid, must not be preferential to those holders who agree to such treatment) would be that such holders would be treated for federal income tax purposes as if they had received such amount in cash, and they then had immediately contributed such amount back to the Company as additional paid-in capital. This would result in taxable income to those holders without the receipt of any actual cash distribution but would also increase their tax basis in their Common Shares by the amount of the taxable income recognized.

Under certain circumstances, the Company may be able to rectify a failure to meet the distribution requirement for a certain year by paying deficiency dividends to shareholders in a later year that may be included in the Companys deduction for distributions paid for the earlier year. Thus, the Company may be able to avoid being taxed on amounts distributed as deficiency dividends; however, the Company will be required to pay to the IRS interest based upon the amount of any deduction taken for deficiency dividends.

Failure to Qualify

If the Company fails to qualify for taxation as a REIT in any taxable year and the relief provisions do not apply, the Company will be subject to tax (including any applicable corporate alternative minimum tax) on its taxable income at regular corporate rates. Distributions to shareholders in any year in which the Company fails to qualify will not be deductible by the Company, nor will they be required to be made. In such event, to the extent of current and accumulated earnings and profits, all distributions to shareholders will be taxable to them as ordinary income, and, subject to certain limitations of the Code, corporate distributees may be eligible for the dividends received deduction. Unless entitled to relief under specific statutory provisions, the Company also will be disqualified from taxation as a REIT for the four taxable years following the year during which qualification was lost. It is not possible to state whether in all circumstances the Company would be entitled to such statutory relief.

Income Taxation of the Operating Partnership, the Title Holding Partnerships and Their Partners

The following discussion summarizes certain Federal income tax considerations applicable to the Company's investment in the Operating Partnership and its subsidiary partnerships (referred to herein as the "Title Holding Partnerships") .

Classification of the Operating Partnership and Title Holding Partnerships as Partnerships

As of the date of this Prospectus, the Company owns all of the Properties or the economic interests therein through the Operating Partnership. The Company will be entitled to include in its income its distributive share of the income and to deduct its distributive share of the losses of the Operating Partnership (including the Operating Partnership's share of the income or losses of the Title Holding Partnerships) only if the Operating Partnership and the Title Holding Partnerships (collectively, the "Partnerships") are classified for

Federal income tax purposes as partnerships rather than as associations taxable as corporations. For taxable periods prior to January 1, 1997, an organization formed as a partnership was treated as a partnership for Federal income tax purposes rather than as a corporation only if it had no more than two of the four corporate characteristics that the Treasury Regulations used to distinguish a partnership from a corporation for tax purposes. These four characteristics were continuity of life, centralization of management, limited liability, and free transferability of interests.

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Neither the Operating Partnership nor any of the Title Holding Partnerships requested a ruling from the IRS that they would be treated as partnerships for Federal income tax purposes. The Company received an opinion of the Tax Advisor, which is not binding on the IRS, that the Operating Partnership and the Title Holding Partnerships will each be treated as partnerships for Federal income tax purposes and not as an association or publicly traded partnership taxable as a corporation. The opinion of the Tax Advisor is based on the provisions of the limited partnership agreement of the Operating Partnership and the limited partnership agreements of the Title Holding Partnerships, respectively, and certain factual assumptions and representations described in the opinion.

Effective January 1, 1997, newly promulgated Treasury Regulations eliminated the four-factor test described above and, instead, permit partnerships and other non-corporate entities to be taxed as partnerships for federal income tax purposes without regard to the number of corporate characteristics possessed by such entity. Under those Regulations, both the Operating Partnership and each of the Title Holding Partnerships will be classified as partnerships for federal income tax purposes unless an affirmative election is made by the entity to be taxed as a corporation. The Company has represented that no such election has been made, or is anticipated to be made, on behalf of the Operating Partnership or any of the Title Holding Partnerships. Under a special transitional rule in the Treasury Regulations, the IRS will not challenge the classification of an existing entity such as the Operating Partnership or a Title Holding Partnership for periods prior to January 1, 1997 if: (i) the entity has a reasonable basis for its classification; (ii) the entity and each of its members recognized the federal income tax consequences of any change in classification of the entity made within the 60 months prior to January 1, 1997; and (iii) neither the entity nor any of its members had been notified in writing on or before May 8, 1996 that its classification was under examination by the IRS. Neither the Operating Partnership nor any of the Title Holding

Partnerships changed their classification within the 60 month period preceding May 8, 1996, nor was any one of them notified that their classification as a partnership for federal income tax purposes was under examination by the IRS.

If for any reason the Operating Partnership or a Title Holding Partnership was classified as an association taxable as a corporation rather than as a partnership for Federal income tax purposes, the Company would not be able to satisfy the income and asset requirements for REIT status. See “— Income Tests” and “— Asset Tests.” In addition, any change in any such Partnership’s status for tax purposes might be treated as a taxable event, in which case the Company might incur a tax liability without any related cash distribution. See “— Annual Distribution Requirements.” Further, items of income and deduction of any such Partnership would not pass through to its partner (e.g., the Company), and its partners would be treated as shareholders for tax purposes. Any such Partnership would be required to pay income tax at corporate tax rates on its net income and distributions to its partners would constitute dividends that would not be deductible in computing such Partnership’s taxable income.

Partnership Allocations

Although a partnership agreement will generally determine the allocation of income and losses among partners, such allocations will be disregarded for tax purposes if they do not comply with the provisions of Section 704(b) and the Treasury Regulations promulgated thereunder, which require that partnership allocations respect the economic arrangement of the partners.

If an allocation is not recognized for Federal income tax purposes, the item subject to the allocation will be reallocated in accordance with the partners’ interests in the partnership, which will be determined by taking into account all of the facts and circumstances relating to the economic arrangement of the partners with respect to such item. The Operating Partnership’s allocations of taxable income and loss are intended to comply with the requirements of Section 704(b) of the Code and the Treasury Regulations promulgated thereunder.

Tax Allocations With Respect to Contributed Properties

The Company has represented that the fair market values of 98 of the Properties contributed directly or indirectly to the Operating Partnership in various transactions were different than the tax basis of such Properties. Pursuant to Section 704(c) of the Code, items of income, gain, loss, and deduction attributable to appreciated or depreciated property that is contributed to a partnership in exchange for an interest in the partnership must be allocated for Federal income tax purposes in a manner such that the contributor is charged with or benefits from the unrealized gain or unrealized loss associated with the property at the time of the contribution. The amount of such unrealized gain or unrealized loss is generally equal to the difference between the fair market value of the contributed property at the time of contribution and the adjusted tax basis of such property at the time of contribution (the Pre-Contribution Gain or Loss). The partnership agreement of the Operating Partnership requires allocations of income, gain, loss and deduction attributable to such contributed property to be made in a manner that is consistent with Section 704(c) of the Code. Thus, if the Operating Partnership sells contributed property at a gain or loss, such gain or loss will be allocated to the contributing partners, and away from the Company, generally to the extent of the Pre-Contribution Gain or Loss.

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The Treasury Department has issued final regulations under Section 704(c) of the Code (the "Regulations") which give partnerships great flexibility in ensuring that a partner contributing property to a partnership receives the tax benefits and burdens of any Pre-Contribution Gain or Loss attributable to the contributed property. The Regulations permit partnerships to use any "reasonable method" of accounting for Pre-Contribution Gain or Loss. The Regulations specifically describe three reasonable methods, including (i) the "traditional method" under current law, (ii) the traditional method with the use of "curative allocations" which would permit distortions caused by Pre-Contribution Gain or Loss to be rectified on an annual basis, and (iii) the "remedial allocation method" which is similar to the traditional method with "curative allocations." The Partnership Agreement permits the Company, as a general partner, to select one of these methods to account for Pre-Contribution Gain or Loss.

Depreciation

The Operating Partnership's assets other than cash consist largely of appreciated property contributed by its partners. Assets contributed to a partnership in a tax-free transaction generally retain the same depreciation method and recovery period as they had in the hands of the partner who contributed them to the partnership. Accordingly, the Operating Partnership's depreciation deductions for its real property are based largely on the historic tax depreciation schedules for the Properties prior to their contribution to the Operating Partnership. The Properties are being depreciated over a range of 15 to 40 years using various methods of depreciation which were determined at the time that each item of depreciable property was placed in service. Any real property purchased by the Partnerships will be depreciated over 40 years. In certain instances where a partnership interest rather than real property is contributed to the Partnership, the real property may not carry over its recovery period but rather may, similarly, be subject to the lengthier recovery period.

Section 704(c) of the Code requires that depreciation as well as gain and loss be allocated in a manner so as to take into account the variation between the fair market value and tax basis of the property contributed. Thus, because most of the property contributed to the Operating Partnerships is appreciated, the Company will generally receive allocations of tax depreciation in excess of its percentage interest in the Operating Partnership. Depreciation with respect to any property purchased by the Operating Partnership subsequent to the admission of its partners, however, will be allocated among the partners in accordance with their respective percentage interests in the Partnerships.

As described above (see Tax Allocations with Respect to Contributed Properties), the Treasury Deparment s Regulations give partnerships flexibility in ensuring that a partner contributing property to a partnership receives the tax benefits and burdens of any Pre-Contribution Gain or Loss attributable to the contributed property.

As described previously, the Company, as a general partner, may select any permissible method to account for Pre-Contribution Gain or Loss. The use of certain of these methods may result in the Company being allocated lower depreciation deductions than if a different method were used. The resulting higher taxable income and earnings and profits of the Company, as determined for federal income tax purposes, should decrease the portion of distributions by the Company which may be treated as a return of capital. See Annual Distribution Requirements.

Basis in Operating Partnership Interest

The Companys adjusted tax basis in each of the partnerships in which it has an interest generally (i) will be equal to the amount of cash and the basis of any other property contributed to such partnership by the Company, (ii) will be increased by (a) its allocable share of such partnerships income and (b) its allocable share of any indebtedness of such partnership, and (iii) will be reduced, but not below zero, by the Companys allocable share of (a) such partnership□s loss and (b) the amount of cash and the tax basis of any property distributed to the Company and by constructive distributions resulting from a reduction in the Company□s share of indebtedness of such partnership.

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If the Company's allocable share of the loss (or portion thereof) of any partnership in which it has an interest would reduce the adjusted tax basis of the Company's partnership interest in such partnership below zero, the recognition of such loss will be deferred until such time as the recognition of such loss (or portion thereof) would not reduce the Company's adjusted tax basis below zero. To the extent that distributions from a partnership to the Company, or any decrease in the Company's share of the nonrecourse indebtedness of a partnership (each such decrease being considered a constructive cash distribution to the partners), would reduce the Company's adjusted tax basis below zero, such distributions (including such constructive distributions) would constitute taxable income to the Company. Such distributions and constructive distributions normally would be characterized as long-term capital gain if the Company's interest in such partnership has been held for longer than the long-term capital gain holding period (currently 12 months).

Sale of Partnership Property

Generally, any gain realized by a partnership on the sale of property held by the partnership for more than 12 months will be long-term capital gain, except for any portion of such gain that is treated as depreciation or cost recovery recapture. However, under the requirements applicable to REITS under the Code, the Company's share as a partner of any gain realized by the Operating Partnership on the sale of any property held as inventory or other property held primarily for sale to customers in the ordinary course of a trade or business will be treated as income from a prohibited transaction that is subject to a 100% penalty tax. See " Taxation of the Company as a REIT." Such prohibited transaction income will also have an adverse effect upon the Company's ability to satisfy the income tests for REIT status. See " Income Tests." Under existing law, whether property is held as inventory or primarily for sale to customers in the ordinary course of a trade or business is a question of fact that depends on all the facts and circumstances with respect to the particular transaction. A safe harbor to avoid classification as a prohibited transaction exists as to real estate assets held for the production of rental income by a REIT for at least four years where in any taxable year the REIT has made no more than seven sales of property or, in the alternative, the aggregate of the adjusted bases of all properties sold does not exceed 10% of the adjusted bases of all of the REIT□s properties during the year and the expenditures includable in a property□s net sales price. The Company, as general partner of the Operating Partnership, has represented that the Operating Partnership and the Title Holding Partnerships intend to hold the Properties for investment with a view to long-term appreciation, to engage in the business of acquiring, developing, owning, and operating and leasing properties and to make such occasional sales of the properties as are consistent with the Company□s and the Operating Partnership□s investment objectives. No assurance can be given, however, that every property sale by the Partnerships will constitute a sale of property held for investment.

Taxation of Taxable Domestic Shareholders

As long as the Company qualifies as a REIT, distributions made to the Company□s taxable U.S. shareholders out of current or accumulated earnings and profits (and not designated as capital gain dividends) will be dividends taxable to such U.S. shareholders as ordinary income and will not be eligible for the dividends received deduction for corporations. Distributions that are designated as long-term capital gain dividends will be taxed as long-term capital gains (to the extent they do not exceed the Company□s actual net capital gain for the taxable year) without regard to the period for which the shareholder has held its shares of beneficial interest. However, corporate shareholders may be required to treat up to 20% of certain capital gain dividends as ordinary income. Distributions in excess of current and accumulated earnings and profits will not be taxable to a shareholder to the extent that they do not exceed the adjusted basis of the shareholder□s shares, but rather will reduce the adjusted basis of such shares. To the extent that distributions in excess of current and accumulated earnings and profits exceed the adjusted basis of a shareholder's shares, such distributions will be included in income as long-term capital gain (or short-term capital gain if the shares have been held for 12 months or less) assuming the shares are a capital asset in the hands of the shareholder. In addition, any distribution declared by the Company in October, November or December of any year payable to a shareholder of record on a specified date in any such month shall be treated as both paid by the Company and received by the shareholder on December 31 of such year, provided that the distribution is actually paid by the Company during January of the following calendar year. Shareholders may not include in their individual income tax returns any losses of the Company.

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For taxable years of the Company beginning after August 5, 1997, U.S. shareholders holding Shares at the close of the Company's taxable year will be required to include, in computing their long-term capital gains for the taxable year in which the last day of the Company's taxable year falls, such amount as the Company may designate in a written notice mailed to its shareholders. The Company may not designate amounts in excess of the Company's undistributed net capital gain for the taxable year. Each U.S. shareholder required to include such a designated amount in determining such shareholder's long-term capital gains will be deemed to have paid, in the taxable year of the inclusion, the tax paid by the Company in respect of such undistributed net capital gains. U.S. shareholders subject to these rules will be allowed a credit or a refund, as the case may be, for the tax deemed to have been paid by such shareholders. U.S. shareholders will increase their basis in their Shares by the difference between the amount of such includable gains and the tax deemed paid by the shareholder in respect of such gains.

In general, any loss upon a sale or exchange of shares by a shareholder who has held such shares for six months or less (after applying certain holding period rules) will be treated as a long-term capital loss to the extent such shareholder has received distributions from the Company required to be treated as long-term capital gain.

Distributions from the Company and gain from the disposition of Common Shares will not be treated as passive activity income and, therefore, shareholders may not be able to apply any "passive losses" against such income. Dividends from the Company (to the extent they do not constitute a return of capital or capital gain dividends) and, on an elective basis, capital gain dividends and gain from the disposition of Common Shares will generally be treated as investment income for purposes of the investment income limitation.

Backup Withholding

The Company will report to its U.S. shareholders and the IRS the amount of distributions paid during each calendar year, and the amount of tax withheld, if any. Under the backup withholding rules, a shareholder may be subject to backup withholding at the rate of 31% with respect to distributions paid unless such holder (a) is a corporation or comes within certain other exempt categories and, when required, demonstrates this fact, or (b) provides a taxpayer identification number, certifies as to no loss of exemption from backup withholding and otherwise complies with applicable requirements of the backup withholding rules. A shareholder that does not provide the Company with his correct taxpayer identification number may also be subject to penalties imposed by the IRS. Any amount paid as backup withholding will be creditable against the shareholder's income tax liability. In addition, the Company may be required to withhold a portion of capital gain distributions to any shareholders who fail to certify their non-foreign status to the Company. See " Taxation of Foreign Shareholders."

Taxation of Tax-Exempt Shareholders

Distributions by the Company to a shareholder that is a tax-exempt entity should not constitute "unrelated business taxable income" ("UBTI"), as defined in Section 512(a) of the Code provided that the tax-exempt entity has not financed the acquisition of its shares with "acquisition indebtedness" within the meaning of the Code and the shares are not otherwise used in an unrelated trade or business of the tax-exempt entity.

In the case of a "qualified trust" (generally, a pension or profit-sharing trust) holding shares in a REIT, the beneficiaries of such a trust are treated as holding shares in the REIT in proportion to their actuarial interests in the qualified trust, instead of treating the qualified trust as a single individual (the "look-through exception"). A qualified trust that holds more than 10 percent of the shares of a REIT is required to treat a percentage of REIT dividends as UBTI if the REIT incurs debt to acquire or improve real property. This rule applies, however, only if (i) the qualification of the REIT depends upon the application of the look through exception (described above) to the restriction on REIT shareholdings by five or fewer individuals, including qualified trusts (see Description of Shares of Beneficial Interest Restrictions on Transfer) and (ii) the REIT is predominantly held by qualified trusts, i.e., if either (x) a single qualified trust holds more than 25 percent by value of the interests in the REIT or (y) one or more qualified trusts, each owning more than 10 percent by value, holds in the aggregate more than 50 percent of the interests in the REIT. The percentage of any dividend paid (or treated as paid) to such a qualified trust that is treated as UBTI is equal to the amount of modified gross income (gross income less directly connected expenses) from the unrelated trade or business of the REIT (treating the REIT as if it were a qualified trust), divided by the total modified gross income of the REIT. A de minimis exception applies where the percentage is less than 5 percent.

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Taxation of Foreign Shareholders

The rules governing United States Federal income taxation of nonresident alien individuals, foreign corporations, foreign partnerships and other foreign shareholders (collectively, Non-U.S. Shareholders) are complex and no attempt will be made herein to provide more than a summary of such rules. Prospective Non-U.S. Shareholders should consult with their own tax advisors to determine the impact of Federal, state and local income tax laws with regard to an investment in Common Shares, including any reporting requirements.

Distributions that are not attributable to gain from sales or exchanges by the Company of United States real property interests and not designated by the Company as capital gains dividends will be treated as dividends of ordinary income to the extent that they are made out of current or accumulated earnings and profits of the Company. Such distributions will ordinarily be subject to a withholding tax equal to 30% of the gross amount of the distribution unless an applicable tax treaty reduces or eliminates that tax. However, if income from the investment in the Common Shares is treated as effectively connected with the Non-U.S. Shareholders conduct of a United States trade or business, the Non-U.S. Shareholder generally will be subject to a tax at graduated rates, in the same manner as U.S. shareholders are taxed with respect to such distributions (and may also be subject to the 30% branch profits tax in the case of a shareholder that is a foreign corporation). The Company expects to withhold United States income tax at the rate of 30% on the gross amount of any such distributions made to a Non-U.S. Shareholder unless (i) a lower treaty rate applies or (ii) the Non-U.S. Shareholder files an IRS Form 4224 with the Company claiming that the distribution is effectively connected income. Distributions in excess of current and accumulated earnings and profits of the Company will not be taxable to a shareholder to the extent that such distributions do not exceed the adjusted basis of the shareholders shares, but rather will reduce the adjusted basis of such shares. To the extent that distributions in excess of current and accumulated earnings and profits exceed the adjusted basis of a Non-Shareholder□s shares, such distributions will give rise to tax liability if the Non-U.S. Shareholder would otherwise be subject to tax on any gain from the sale or disposition of his shares in the Company, as described below. If it cannot be determined at the time a distribution is made whether or not such distribution will be in excess of current and accumulated earnings and profits, the distributions will be subject to withholding at the same rate as dividends. However, amounts thus withheld are refundable if it is subsequently determined that such distribution was, in fact, in excess of current and accumulated earnings and profits of the Company.

For any year in which the Company qualifies as a REIT, distributions that are attributable to gain from sales or exchanges by the Company of United States real property interests will be taxed to a Non-U.S. Shareholder under the provisions of the Foreign Investment in Real Property Tax Act of 1980 (□FIRPTA□). Under FIRPTA, distributions attributable to gain from sales of United States real property interests are taxed to a Non-U.S. Shareholder as if such gain were effectively connected with a United States business. Non-U.S. Shareholders would thus be taxed at the normal capital gain rates applicable to U.S. shareholders (subject to applicable alternative minimum tax and a special alternative minimum tax in the case of nonresident alien individuals). Also, distributions subject to FIRPTA may be subject to a 30% branch profits tax in the hands of a foreign corporate shareholder not entitled to treaty exemption. The Company is required by applicable Treasury Regulations to withhold 35% of any distribution that could be designated by the Company as a capital gains dividend. The amount is creditable against the Non-U.S. Shareholder FIRPTA tax liability.

Gain recognized by a Non-U.S. Shareholder upon a sale of Shares generally will not be taxed under FIRPTA if the Company is a □domestically controlled REIT,□ defined generally as a REIT in which at all times during a specified testing period less than 50% in value of the shares of beneficial interest was held directly or indirectly by foreign persons. It is currently anticipated that the Company will be a “domestically controlled REIT,” and therefore the sale of Shares will not be subject to taxation under FIRPTA. However, because the Common Shares will be publicly traded, no assurance can be given that the Company will continue to be a “domestically controlled REIT.” Gain not subject to FIRPTA will be taxable to a Non-U.S. Shareholder if (i) investment in the shares is effectively connected with the Non-U.S. Shareholder’s United States trade or business, in which case the Non-U.S. Shareholder will be subject to the same treatment as U.S. shareholders with respect to such gain or (ii) the Non-U.S. Shareholder is a nonresident alien individual who was present in the United States for 183 days or more during the taxable year, in which case the nonresident alien individual will be subject to a 30% tax on the individual’s capital gains. If the gain on the sale of Shares were to be subject to taxation under FIRPTA, the Non-U.S. Shareholder would be subject to the same treatment as U.S. shareholders with respect to such gain (subject to applicable alternative minimum tax and a special alternative minimum tax in the case of nonresident alien individuals).

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Statement of Share Ownership

The Company is required to demand annual written statements from the record holders of designated percentages of its Shares disclosing the actual owners of the Shares. The Company must also maintain, within the Internal Revenue District in which it is required to file its federal income tax return, permanent records showing the information it has received as to the actual ownership of such Shares and a list of those persons failing or refusing to comply with such demand.

Other Tax Consequences

The Company, the Operating Partnership, the Title Holding Partnerships and the Company's shareholders may be subject to state or local taxation in various state or local jurisdictions, including those in which it or they transact business or reside. The state and local tax treatment of the Company, the Operating Partnership, the Title Holding Partnerships and the Company's shareholders may not conform to the Federal income tax consequences discussed above. Consequently, prospective shareholders should consult their own tax advisors regarding the effect of state and local tax laws on an investment in the Company.

Possible Federal Tax Developments

The rules dealing with Federal income taxation are constantly under review by the IRS, the Treasury Department and Congress. New Federal tax legislation or other provisions may be enacted into law or new interpretations, rulings, Treasury Regulations or court decisions could be adopted, all of which could adversely affect the taxation of the Company or of its shareholders. No prediction can be made as to the likelihood of passage of any new tax legislation or other provisions or court decisions either directly or indirectly affecting the Company or its shareholders. Consequently, the tax treatment described herein may be modified prospectively or retroactively by legislative, judicial or administrative action.

PLAN OF DISTRIBUTION

The Company may sell the Securities to one or more underwriters for public offering and sale by them or may sell the Securities directly to one or more investors or through agents or through a combination of any of such methods. Any such underwriter or agent involved in the offer and sale of the Securities will be named in the applicable prospectus supplement.

The Company or underwriters may offer and sell the Securities at a fixed price or prices, which may be changed, at prices related to the prevailing market prices at the time of sale or at negotiated prices for cash or assets. The Company also may, from time to time, authorize underwriters acting as their agents to offer and sell the Securities upon the terms and conditions as are set forth in the applicable prospectus supplement. In connection with the sale of the Securities, underwriters may be deemed to have received compensation from the Company in the form of underwriting discounts or commissions and may also receive commissions from purchasers of the Securities for whom they may act as agent. Underwriters may sell Securities to or through dealers, and such dealers may receive compensation in the form of discounts, concessions or commissions from the underwriters and/or commissions from the purchasers for whom they may act as agent.

Any underwriting compensation paid by the Company to underwriters or agents in connection with the offering of the Securities, and any discounts, concessions or commissions allowed by underwriters to participating dealers, will be set forth or described in the applicable prospectus supplement. Underwriters, dealers and agents participating in the distribution of the Securities may be deemed to be underwriters, and any discounts and commissions received by them and any profit realized by them on resale of the Securities may be deemed to be underwriting discounts and commissions under the Securities Act.

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Underwriters, dealers and agents may be entitled, under agreements entered into with the Company, to indemnification against and contribution toward certain civil liabilities, including liabilities under the Securities Act. In the opinion of the Commission, such indemnification is against public policy as expressed in the Securities Act and is, therefore, unenforceable.

Unless otherwise specified in the related prospectus supplement, each series of Securities will be a new issue with no established trading market, other than the Common Shares which are listed on the NYSE. Any Common Shares sold pursuant to a prospectus supplement will be listed on the NYSE, subject to official notice of issuance. The Company may elect to list any series of Preferred Shares or American Depository Receipts representing Depository Shares on an exchange, but is not obligated to do so. It is possible that one or more underwriters may make a market in a series of Securities, but will not be obligated to do so and may discontinue any market making at any time without notice. Therefore, no assurance can be given as to the liquidity of, or the trading market for, the Securities.

If so indicated in the applicable prospectus supplement, the Company will authorize underwriters or other persons acting as the Companys agents to solicit offers by certain institutions to purchase Securities from the Company at the public offering price set forth in such prospectus supplement pursuant to Delayed Delivery Contracts (Contracts) providing for payment and delivery on the date or dates stated in such prospectus supplement. Institutions with whom Contracts, when authorized, may be made include commercial and savings banks, insurance companies, pension funds, investment companies, educational and charitable institutions, and other institutions but will in all cases be subject to the approval of the Company. Contracts will not be subject to any conditions except: (i) the purchase by an institution of the Securities covered by its Contracts shall not at the time of delivery be prohibited under the laws of any jurisdiction in the United States to which such institution is subject, and (ii) if the Securities are being sold to underwriters, the Company shall have sold to such underwriters the total principal amount of the Securities less the principal amount thereof covered by Contracts.

Underwriters, dealers and agents and their affiliates may engage in transactions with, or perform services for, or be tenants of, the Company and its subsidiaries in the ordinary course of business.

EXPERTS

The audited financial statements and schedules (other than financial statements identified in the next sentence) incorporated by reference in this Prospectus and elsewhere in the Registration Statement to the extent and for the periods indicated in their reports have been audited by Arthur Andersen LLP, independent public accountants, and are included herein in reliance upon the authority of said firm as experts in giving said reports.

The financial statements with respect to 1000/2000 West Lincoln Drive, 3000 West Lincoln Drive and 4000/5000 West Lincoln Drive incorporated by reference in this Prospectus from the Current Report on Form 8-K of the Company, dated June 27, 1997, have been audited by Zelenkofske, Axelrod & Co., Ltd., independent public accountants, as indicated in their report and are included herein in reliance upon the authority of said firm as experts in giving said report.

Future financial statements of the Company and the reports thereon of the Company's independent public accountants also will be incorporated by reference in this Prospectus in reliance upon the authority of that firm as experts in giving those reports to the extent said firm has audited those financial statements and consented to the use of their reports thereon.

LEGAL MATTERS

Unless otherwise set forth in a prospectus supplement, the validity of the Securities offered will be passed upon for the Company by Pepper Hamilton LLP, Philadelphia, Pennsylvania. Unless otherwise set forth in a prospectus supplement, Pepper Hamilton LLP will rely on Ballard Spahr Andrews & Ingersoll, LLP, Baltimore, Maryland, as to certain matters of Maryland law.

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TAX MATTERS

The opinion regarding the statements in this Prospectus under the caption Federal Income Tax Considerations has been rendered by Arthur Andersen LLP, independent public accountants, and has been referred to in reliance upon the authority of such firm as experts.

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2,000,000 Shares

BRANDYWINE REALTY TRUST

Preferred Shares

P R O S P E C T U S   S U P P L E M E N T

February __, 2004

Wachovia Securities

Bear, Stearns & Co. Inc.	**Raymond James & Associates**