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DUKE ENERGY CORP  
Form S-3/A  
August 22, 2002

AS FILED WITH THE SECURITIES AND EXCHANGE COMMISSION ON AUGUST 22, 2002

REGISTRATION NO. 333-85486

333-85486-03

333-85486-02

333-85486-01

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SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549  
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AMENDMENT NO. 1

TO

FORM S-3

REGISTRATION STATEMENT  
UNDER  
THE SECURITIES ACT OF 1933  
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DUKE ENERGY CORPORATION  
(Exact name of registrant as specified in its charter)

DUKE ENERGY CORPORATION	NORTH CAROLINA	56-0205520
DUKE ENERGY CAPITAL TRUST III	DELAWARE	52-2171524
DUKE ENERGY CAPITAL TRUST IV	DELAWARE	52-2171526
DUKE ENERGY CAPITAL TRUST V	DELAWARE	56-6575443
(Exact name of each registrant as specified in its charter)	(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Ident Nos.)

526 SOUTH CHURCH STREET  
CHARLOTTE, NORTH CAROLINA 28202  
(704) 594-6200  
(Address, including zip code, and telephone number,  
including area code, of registrant's principal executive offices)

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ROBERT P. BRACE  
 EXECUTIVE VICE PRESIDENT AND  
 CHIEF FINANCIAL OFFICER  
 DUKE ENERGY CORPORATION  
 526 SOUTH CHURCH STREET  
 CHARLOTTE, NORTH CAROLINA 28202  
 (704) 382-3400

VINCENT PAGANO, JR., ESQ.  
 SIMPSON THACHER & BARTLETT  
 425 LEXINGTON AVENUE  
 NEW YORK, NEW YORK 10017  
 (212) 455-2000

(Name, address, including zip code, and telephone number,  
 including area code, of agent for service)

Approximate date of commencement of proposed sale to the public: From time to time after the effective date of this registration statement as determined by market conditions and other factors.

If the only securities being registered on this form are being offered pursuant to dividend or interest reinvestment plans, please check the following box.

If any of the securities being registered on this form are being offered on a delayed or continuous basis pursuant to Rule 415 under the Securities Act of 1933, other than securities offered only in connection with dividend or interest reinvestment plans, please check the following box.

If this form is filed to register additional securities for an offering pursuant to Rule 462(b) under the Securities Act, check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering.

If this form is a post-effective amendment filed pursuant to Rule 462(c) under the Securities Act, check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering.

If delivery of the prospectus is expected to be made pursuant to Rule 434, please check the following box.

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 CALCULATION OF REGISTRATION FEE

TITLE OF EACH CLASS OF SECURITIES TO BE REGISTERED	AMOUNT TO BE REGISTERED (1)	PROPOSED MAXIMUM OFFERING PRICE PER UNIT			PR MAXIMU OFFER
		(1)	(2)	(3)	(1) (
Duke Energy Corporation Senior Notes.....		\$			
Duke Energy Corporation Junior Subordinated Notes.....		\$			
Duke Energy Corporation First and Refunding Mortgage Bonds.....		\$			
Duke Energy Corporation Common Stock, without par value(5).....		\$			

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Duke Energy Corporation Stock Purchase			
Contracts.....		\$	
Duke Energy Corporation Stock Purchase Units.....		\$	
Duke Energy Capital Trust III Trust Preferred			
Securities.....		\$	
Duke Energy Capital Trust IV Trust Preferred			
Securities.....		\$	
Duke Energy Capital Trust V Trust Preferred			
Securities.....		\$	
Duke Energy Corporation Guarantees with respect			
to Trust Preferred Securities of Duke Energy			
Capital Trust III, Duke Energy Capital Trust IV			
and Duke Energy Capital Trust V(6) (7).....		\$	
<hr style="border-top: 1px dashed black;"/>			
Total.....	\$2,000,000,000	100%	\$2,000,000,000
<hr style="border-top: 1px dashed black;"/>			

- (1) There are being registered hereunder such presently indeterminate number or principal amount of Senior Notes, Junior Subordinated Notes, First and Refunding Mortgage Bonds, shares of Common Stock, Stock Purchase Contracts and Stock Purchase Units of Duke Energy Corporation and such presently indeterminate number of Trust Preferred Securities of Duke Energy Capital Trust III, Duke Energy Capital Trust IV and Duke Energy Capital Trust V with an aggregate initial offering price, not to exceed \$2,000,000,000. Duke Energy Corporation Junior Subordinated Notes also may be issued to Duke Energy Capital Trust III, Duke Energy Capital Trust IV or Duke Energy Capital Trust V and later distributed upon dissolution and distribution of the assets thereof, which would include such Junior Subordinated Notes for which no separate consideration will be received. An indeterminate number of shares of Common Stock may also be issued by Duke Energy Corporation upon settlement of the Stock Purchase Contracts or Stock Purchase Units of Duke Energy Corporation. Pursuant to Rule 457(o) under the Securities Act of 1933, which permits the registration fee to be calculated on the basis of the maximum offering price of all the securities listed, the table does not specify by each class information as to the amount to be registered, proposed maximum offering price per unit or proposed maximum aggregate offering price.
  
- (2) Estimated solely for the purpose of determining the registration fee.
  
- (3) Exclusive of accrued interest and distributions, if any.
  
- (4) The registration fee of \$160,602 associated with the securities registered hereby has previously been paid. Accordingly, the registration fee consists of \$23,398 paid herewith and the \$160,602 previously paid.
  
- (5) Includes Duke Energy Corporation Preference Stock Purchase Rights. Prior to the occurrence of certain events, purchase rights for Duke Energy Corporation Series A Participating Preference Stock will not be evidenced separately from the Duke Energy Corporation Common Stock.
  
- (6) No separate consideration will be received for the Duke Energy Corporation Guarantees. Pursuant to Rule 457(n) under the Securities Act of 1933, no separate fee is payable in respect of the Duke Energy Corporation Guarantees.

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(7) Includes the obligations of Duke Energy Corporation under the respective Trust Agreements, the Subordinated Indenture, the related series of Junior Subordinated Notes, the respective Guarantees and the respective Agreements as to Expenses and Liabilities, which include the Corporation's covenant to pay any indebtedness, expenses or liabilities of the Trusts (other than obligations pursuant to the terms of the Trust Preferred Securities or other similar interests), all as described in this registration statement.

THE REGISTRANT HEREBY AMENDS THIS REGISTRATION STATEMENT ON SUCH DATE OR DATES AS MAY BE NECESSARY TO DELAY ITS EFFECTIVE DATE UNTIL THE REGISTRANT SHALL FILE A FURTHER AMENDMENT WHICH SPECIFICALLY STATES THAT THIS REGISTRATION STATEMENT SHALL THEREAFTER BECOME EFFECTIVE IN ACCORDANCE WITH SECTION 8(a) OF THE SECURITIES ACT OF 1933 OR UNTIL THE REGISTRATION STATEMENT SHALL BECOME EFFECTIVE ON SUCH DATE AS THE SECURITIES AND EXCHANGE COMMISSION, ACTING PURSUANT TO SAID SECTION 8(a), MAY DETERMINE.

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The information in this prospectus is not completed and may be changed. We may not sell these securities until the registration statement filed with the Securities and Exchange Commission is effective. This prospectus is not an offer to sell these securities and it is not soliciting an offer to buy these securities in any state where the offer or sale of these securities is not permitted.

SUBJECT TO COMPLETION, DATED AUGUST 22, 2002

PROSPECTUS

\$2,000,000,000

DUKE ENERGY CORPORATION

Senior Notes  
Junior Subordinated Notes  
First and Refunding Mortgage Bonds  
Common Stock  
Stock Purchase Contracts  
Stock Purchase Units

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DUKE ENERGY CAPITAL TRUST III

DUKE ENERGY CAPITAL TRUST IV

DUKE ENERGY CAPITAL TRUST V

Trust Preferred Securities  
Guaranteed, to the extent described herein, by

DUKE ENERGY CORPORATION  
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This prospectus contains summaries of the general terms of these securities. You will find the specific terms of these securities, and the manner

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in which they are being offered, in supplements to this prospectus. You should read this prospectus and the applicable prospectus supplement carefully before you invest.

The Common Stock of Duke Energy is listed on the New York Stock Exchange under the symbol "DUK."

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

This prospectus is dated \_\_\_\_\_, 2002.

### ABOUT THIS PROSPECTUS

This prospectus is part of a registration statement that Duke Energy, Duke Energy Capital Trust III, Duke Energy Capital Trust IV and Duke Energy Capital Trust V filed with the SEC utilizing a "shelf" registration process. Under the shelf registration process, Duke Energy may issue Senior Notes, Junior Subordinated Notes, First and Refunding Mortgage Bonds, Common Stock, Stock Purchase Contracts and Stock Purchase Units and the Trusts may issue Preferred Securities in one or more offerings up to a total dollar amount of \$2,000,000,000.

This prospectus provides general descriptions of the securities Duke Energy and the Trusts may offer. Each time securities are sold, a prospectus supplement will provide specific information about the terms of that offering. The prospectus supplement may also add, update or change information contained in this prospectus. The registration statement filed with the SEC includes exhibits that provide more details about the matters discussed in this prospectus. You should read this prospectus, the related exhibits filed with the SEC and any prospectus supplement, together with the additional information described under the caption "Where You Can Find More Information."

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### DUKE ENERGY CORPORATION

Duke Energy, together with its subsidiaries, an integrated provider of energy and energy services, offers physical delivery and management of both electricity and natural gas throughout the United States and abroad. Duke Energy, together with its subsidiaries, provides these and other services through seven business segments:

- o Franchised Electric
- o Natural Gas Transmission
- o Field Services
- o North American Wholesale Energy
- o International Energy
- o Other Energy Services
- o Duke Ventures

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Franchised Electric generates, transmits, distributes and sells electricity in central and western North Carolina and western South Carolina. It conducts operations primarily through Duke Power and Nantahala Power and Light. These electric operations are subject to the rules and regulations of the Federal Energy Regulatory Commission ("FERC"), the North Carolina Utilities Commission and the Public Service Commission of South Carolina.

Natural Gas Transmission provides transportation, storage and distribution of natural gas for customers throughout the east coast and southern portion of the United States and Canada. Natural Gas Transmission provides gas gathering, processing and transportation services to customers located in British Columbia, Canada and in the Pacific northwest region of the United States. Natural Gas Transmission does business primarily through Duke Energy Gas Transmission Corporation. Duke Energy acquired Westcoast Energy, Inc. on March 14, 2002. Interstate natural gas transmission and storage operations in the United States are subject to the FERC's rules and regulations while natural gas gathering, processing, transmission, distribution and storage operations in Canada are subject to the rules and regulations of the National Energy Board, the Ontario Energy Board and the British Columbia Utilities Commission.

Field Services gathers, processes, transports, markets and stores natural gas and produces, transports, markets and stores natural gas liquids. It conducts operations primarily through Duke Energy Field Services, LLC, which is approximately 30% owned by Phillips Petroleum. Field Services operates gathering systems in western Canada and 11 contiguous states in the United States. Those systems serve major natural gas-producing regions in the Rocky Mountains, Permian Basin, Mid-Continent, East Texas-Austin Chalk-North Louisiana, and onshore and offshore Gulf Coast areas.

Duke Energy North America develops, operates and manages merchant generation facilities and engages in commodity sales and services related to natural gas and electric power. Duke Energy North America conducts business throughout the United States and Canada through Duke Energy North America, LLC and Duke Energy Trading and Marketing, LLC. Duke Energy Trading and Marketing is approximately 40% owned by Exxon Mobil Corporation. Prior to April 1, 2002, the Duke Energy North America business segment was combined with Duke Energy Merchants Holdings, LLC to form a segment called North American Wholesale Energy. As of June 30, 2002, management combined Duke Energy Merchants Holdings with the Other Energy Services segment. Management separated Duke Energy North America for increased reporting transparency. Previous periods have been reclassified to conform to the current presentation. As of August 1, 2002, Duke Energy's North American trading and marketing functions currently in Duke Energy North America and Duke Energy Merchants Holdings, including Duke Energy Trading and Marketing and the Canadian trading operations, were consolidated into one group.

International Energy develops, operates and manages natural gas transportation and power generation facilities and engages in energy trading and marketing of natural gas and electric power. It conducts operations

primarily through Duke Energy International, LLC and its activities target the Latin American, Asia-Pacific and European regions.

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Other Energy Services is composed of diverse energy businesses, operating primarily through Duke Energy Merchants Holdings, Duke/Fluor Daniel and Energy Delivery Services. Duke Energy Merchants Holdings engages in commodity buying and selling, and risk management and financial services in the energy commodity markets other than natural gas and power (such as refined products, liquefied petroleum gas, residual fuels, crude oil and coal).

Duke/Fluor Daniel provides comprehensive engineering, procurement, construction, commissioning and operating plant services for fossil-fueled electric power generating facilities worldwide. It is a 50/50 partnership between Duke Energy and Fluor Enterprises, Inc., a wholly owned subsidiary of Fluor Corporation. Energy Delivery Services is an engineering, construction, maintenance and technical services firm specializing in electric transmission and distribution lines and substation projects. It was formed in the second quarter of 2002 from the power delivery services component of Duke Engineering & Services, Inc. This segment was excluded from the sale of Duke Engineering & Services on April 30, 2002. Other Energy Services also retained the portion of DukeSolutions, Inc. that was not sold on May 1, 2002. Duke Engineering & Services and DukeSolutions were included in Other Energy Services through the date of their sale.

Duke Ventures is composed of other diverse businesses, operating primarily through Crescent Resources, LLC, DukeNet Communications, LLC and Duke Capital Partners, LLC. Crescent Resources develops high-quality commercial, residential and multi-family real estate projects and manages land holdings primarily in the southeastern and southwestern United States. DukeNet Communications develops and manages fiber optic communications systems for wireless, local and long distance communications companies and selected educational, governmental, financial and health care entities. Duke Capital Partners, a wholly owned merchant banking company, provides debt and equity capital and financial advisory services primarily to the energy industry.

The foregoing information about Duke Energy and its business segments is only a general summary and is not intended to be comprehensive. For additional information about Duke Energy and its business segments, you should refer to the information described under the caption "Where You Can Find More Information."

Duke Energy is a North Carolina corporation. Its principal executive offices are located at 526 South Church Street, Charlotte, North Carolina 28202 (telephone (704) 594-6200).

### Ratio of Earnings to Fixed Charges (unaudited)

	YEAR ENDED DECEMBER 31,					SIX MONTHS ENDED JUNE 30,
	1997(1)	1998	1999	2000	2001	2002
Ratio of Earnings to Fixed Charges....	4.0	4.5	2.7	3.6	3.8	2.7

For purposes of this ratio (a) earnings consist of income from continuing

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operations before income taxes and fixed charges, and (b) fixed charges consist of all interest deductions, the interest component of rentals and preference security dividends of consolidated subsidiaries.

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- (1) Data reflects accounting for the stock-for-stock merger of Duke Energy and PanEnergy Corp on June 18, 1997 as a pooling of interests. As a result, the data gives effect to the merger as if it had occurred as of January 1, 1997.

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### USE OF PROCEEDS

Unless Duke Energy states otherwise in the accompanying prospectus supplement, Duke Energy intends to use the net proceeds from the sale of any offered securities:

- o to redeem or purchase from time to time presently outstanding securities when it anticipates those transactions will result in an overall cost savings;
- o to repay maturing securities;
- o to finance its ongoing construction program; or
- o for general corporate purposes.

The proceeds from the sale of Preferred Securities by a Trust will be invested in Junior Subordinated Notes issued by Duke Energy. Except as Duke Energy may otherwise describe in the related prospectus supplement, Duke Energy expects to use the net proceeds from the sale of such Junior Subordinated Notes to the applicable Trust for the above purposes.

### RECENT DEVELOPMENTS

Duke Energy adopted SFAS No. 142, "Goodwill and Other Intangible Assets," as of January 1, 2002. SFAS No. 142 requires that goodwill no longer be amortized over an estimated useful life, as previously required. Instead, goodwill amounts are subject to a fair-value-based annual impairment assessment. Duke Energy did not recognize any material impairment due to the implementation of SFAS No. 142. The standard also requires certain identifiable intangible assets to be recognized separately and amortized as appropriate upon reassessment. No adjustments to intangibles were identified by Duke Energy at transition.

The following table shows what net income and earnings per share would have been if amortization (including any related tax effects) related to goodwill that is no longer being amortized had been excluded from prior periods.

FOR THE YEAR ENDED

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	2001	2000	1999
	(IN MILLIONS, EXCEPT PER SHARE AMOUNTS)		
Income Before Extraordinary Item and Cumulative Effect of Change in Accounting Principle.....	\$1,994	\$1,776	\$ 847
Extraordinary Gain, net of tax.....	--	--	660
Cumulative Effect of Change in Accounting Principle, net of tax.....	(96)	--	--
Reported net income.....	1,898	1,776	1,507
Add back: Goodwill amortization, net of tax.....	75	56	39
Adjusted net income.....	\$1,973	\$1,832	\$1,546
BASIC EARNINGS PER SHARE (BEFORE EXTRAORDINARY ITEM AND CUMULATIVE EFFECT OF CHANGE IN ACCOUNTING PRINCIPLE)			
Reported earnings per share.....	\$ 2.58	\$ 2.39	\$ 1.13
Goodwill amortization.....	0.10	0.07	0.05
Adjusted earnings per share.....	\$ 2.68	\$ 2.46	\$ 1.18
DILUTED EARNINGS PER SHARE (BEFORE EXTRAORDINARY ITEM AND CUMULATIVE EFFECT OF CHANGE IN ACCOUNTING PRINCIPLE)			
Reported earnings per share.....	\$ 2.56	\$ 2.38	\$ 1.13
Goodwill amortization.....	0.10	0.07	0.05
Adjusted earnings per share.....	\$ 2.66	\$ 2.45	\$ 1.18

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	FOR THE YEAR ENDED		
	2001	2000	1999
	(IN MILLIONS, EXCEPT PER SHARE AMOUNTS)		
BASIC EARNINGS PER SHARE			
Reported earnings per share.....	\$ 2.45	\$ 2.39	\$ 2.04
Goodwill amortization.....	0.10	0.07	0.05
Adjusted earnings per share.....	\$ 2.55	\$ 2.46	\$ 2.09
DILUTED EARNINGS PER SHARE			
Reported earnings per share.....	\$ 2.44	\$ 2.38	\$ 2.03
Goodwill amortization.....	0.10	0.07	0.05
Adjusted earnings per share.....	\$ 2.54	\$ 2.45	\$ 2.08

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### THE TRUSTS

Duke Energy formed each Trust as a statutory business trust under Delaware law. Each Trust's business is defined in a trust agreement executed by Duke Energy, as depositor, and Chase Manhattan Bank USA, National Association (formerly known as Chase Manhattan Bank Delaware). Each trust agreement will be amended when Preferred Securities are issued under it and will be in substantially the form filed as an exhibit to the registration statement, of which this prospectus is a part. An amended trust agreement is called a "Trust Agreement" in this prospectus.

The Preferred Securities and the Common Securities of each Trust represent undivided beneficial interests in the assets of that Trust. The Preferred Securities and the Common Securities together are sometimes called the "Trust Securities" in this prospectus.

The trustees of each Trust will conduct that Trust's business and affairs. Duke Energy, as the holder of the Common Securities of each Trust, will appoint the trustees of that Trust. The trustees of each Trust will consist of:

- o two officers of Duke Energy as Administrative Trustees;
- o The JPMorgan Chase Bank as Property Trustee; and
- o Chase Manhattan Bank USA, National Association as Delaware Trustee.

The prospectus supplement relating to the Preferred Securities of a Trust will provide further information concerning that Trust.

No separate financial statements of any Trust are included in this prospectus. Duke Energy considers that such statements would not be material to holders of the Preferred Securities because no Trust has any independent operations and the sole purpose of each Trust is investing the proceeds of the sale of its Trust Securities in Junior Subordinated Notes. Duke Energy does not expect that any of the Trusts will be filing annual, quarterly or special reports with the SEC.

The principal place of business of each Trust will be c/o Duke Energy Corporation, 526 South Church Street, Charlotte, North Carolina 28202, telephone (704) 594-6200.

#### Accounting Treatment

Each Trust will be treated as a subsidiary of Duke Energy for financial reporting purposes. Accordingly, Duke Energy's consolidated financial statements will include the accounts of each Trust. The Preferred Securities, along with other trust preferred securities that Duke Energy guarantees on an equivalent basis, will be presented as a separate line item in Duke Energy's consolidated balance sheets, entitled "Guaranteed

Preferred Beneficial Interests in Subordinated Notes of Duke Energy Corporation or Subsidiaries." Duke Energy will record distributions that each Trust pays on the Preferred Securities as an expense in its consolidated statement of income.

#### DESCRIPTION OF THE SENIOR NOTES

Duke Energy will issue the Senior Notes in one or more series under its Senior Indenture dated as of September 1, 1998 between Duke Energy and JPMorgan Chase Bank (formerly known as The Chase Manhattan Bank), as Trustee, as

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supplemented from time to time. The Senior Indenture is an exhibit to the registration statement, of which this prospectus is a part.

The Senior Notes are unsecured and unsubordinated obligations and will rank equally with all of Duke Energy's other unsecured and unsubordinated indebtedness. The First and Refunding Mortgage Bonds are effectively senior to the Senior Notes to the extent of the value of the properties securing them. As of June 30, 2002, there were approximately \$790,000,000 in aggregate principal amount of First and Refunding Mortgage Bonds outstanding.

Duke Energy conducts its non-electric operations, and certain of its electric operations outside its service area in the Carolinas, through subsidiaries. Accordingly, its ability to meet its obligations under the Senior Notes is partly dependent on the earnings and cash flows of those subsidiaries and the ability of those subsidiaries to pay dividends or to advance or repay funds to Duke Energy. In addition, the rights that Duke Energy and its creditors would have to participate in the assets of any such subsidiary upon the subsidiary's liquidation or recapitalization will be subject to the prior claims of the subsidiary's creditors. Certain of Duke Energy's subsidiaries have incurred substantial amounts of debt in the expansion of their businesses, and Duke Energy anticipates that certain of its subsidiaries will do so in the future.

The following description of the Senior Notes is only a summary and is not intended to be comprehensive. For additional information you should refer to the Senior Indenture.

### General

The Senior Indenture does not limit the amount of Senior Notes that Duke Energy may issue under it. Duke Energy may issue Senior Notes from time to time under the Senior Indenture in one or more series by entering into supplemental indentures or by its Board of Directors or a duly authorized committee authorizing the issuance. The form of supplemental indenture to the Senior Indenture is an exhibit to the registration statement, of which this prospectus is a part.

The Senior Notes of a series need not be issued at the same time, bear interest at the same rate or mature on the same date.

The Senior Indenture does not protect the holders of Senior Notes if Duke Energy engages in a highly leveraged transaction.

### Provisions Applicable to Particular Series

The prospectus supplement for a particular series of Senior Notes being offered will disclose the specific terms related to the offering, including the price or prices at which the Senior Notes to be offered will be issued. Those terms may include some or all of the following:

- o the title of the series;
- o the total principal amount of the Senior Notes of the series;
- o the date or dates on which principal is payable or the method for determining the date or dates, and any right that Duke Energy has to change the date on which principal is payable;
- o the interest rate or rates, if any, or the method for determining the rate or rates, and the date or dates from which interest will accrue;

- o any interest payment dates and the regular record date for the interest payable on each interest payment date, if any;
- o whether Duke Energy may extend the interest payment periods and, if so, the terms of the extension;
- o the place or places where payments will be made;
- o whether Duke Energy has the option to redeem the Senior Notes and, if so, the terms of its redemption option;
- o any obligation that Duke Energy has to redeem the Senior Notes through a sinking fund or to purchase the Senior Notes through a purchase fund or at the option of the holder;
- o whether the provisions described under "Defeasance and Covenant Defeasance" will not apply to the Senior Notes;
- o the currency in which payments will be made if other than U.S. dollars, and the manner of determining the equivalent of those amounts in U.S. dollars;
- o if payments may be made, at Duke Energy's election or at the holder's election, in a currency other than that in which the Senior Notes are stated to be payable, then the currency in which those payments may be made, the terms and conditions of the election and the manner of determining those amounts;
- o the portion of the principal payable upon acceleration of maturity, if other than the entire principal;
- o whether the Senior Notes will be issuable as global securities and, if so, the securities depositary;
- o any changes in the events of default or covenants with respect to the Senior Notes;
- o any index or formula used for determining principal, premium or interest;
- o if the principal payable on the maturity date will not be determinable on one or more dates prior to the maturity date, the amount which will be deemed to be such principal amount or the manner of determining it; and
- o any other terms.

Unless Duke Energy states otherwise in the applicable prospectus supplement, Duke Energy will issue the Senior Notes only in fully registered form without coupons, and there will be no service charge for any registration of transfer or exchange of the Senior Notes. Duke Energy may, however, require payment to cover any tax or other governmental charge payable in connection with any transfer or exchange. Subject to the terms of the Senior Indenture and the limitations applicable to global securities, transfers and exchanges of the Senior Notes may be made at JPMorgan Chase Bank, 450 West 33rd Street, New York, New York 10001 or at any other office or agency maintained by Duke Energy for such purpose.

The Senior Notes will be issuable in denominations of \$1,000 and any integral multiples of \$1,000, unless Duke Energy states otherwise in the

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applicable prospectus supplement.

Duke Energy may offer and sell the Senior Notes, including original issue discount Senior Notes, at a substantial discount below their principal amount. The applicable prospectus supplement will describe special United States federal income tax and any other considerations applicable to those securities. In addition, the applicable prospectus supplement may describe certain special United States federal income tax or other considerations, if any, applicable to any Senior Notes that are denominated in a currency other than U.S. dollars.

### Global Securities

Duke Energy may issue some or all of the Senior Notes as book-entry securities. Any such book-entry securities will be represented by one or more fully registered global securities. Duke Energy will register each

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global security with or on behalf of a securities depository identified in the applicable prospectus supplement. Each global security will be deposited with the securities depository or its nominee or a custodian for the securities depository.

As long as the securities depository or its nominee is the registered holder of a global security representing Senior Notes, that person will be considered the sole owner and holder of the global security and the Senior Notes it represents for all purposes. Except in limited circumstances, owners of beneficial interests in a global security:

- o may not have the global security or any Senior Notes it represents registered in their names;
- o may not receive or be entitled to receive physical delivery of certificated Senior Notes in exchange for the global security; and
- o will not be considered the owners or holders of the global security or any Senior Notes it represents for any purposes under the Senior Notes or the Senior Indenture.

Duke Energy will make all payments of principal and any premium and interest on a global security to the securities depository or its nominee as the holder of the global security. The laws of some jurisdictions require that certain purchasers of securities take physical delivery of securities in definitive form. These laws may impair the ability to transfer beneficial interests in a global security.

Ownership of beneficial interests in a global security will be limited to institutions having accounts with the securities depository or its nominee, which are called "participants" in this discussion, and to persons that hold beneficial interests through participants. When a global security representing Senior Notes is issued, the securities depository will credit on its book entry, registration and transfer system the principal amounts of Senior Notes the global security represents to the accounts of its participants. Ownership of beneficial interests in a global security will be shown only on, and the transfer of those ownership interests will be effected only through, records maintained by:

- o the securities depository, with respect to participants' interests; and
- o any participant, with respect to interests the participant holds on behalf of other persons.

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Payments participants make to owners of beneficial interests held through those participants will be the responsibility of those participants. The securities depository may from time to time adopt various policies and procedures governing payments, transfers, exchanges and other matters relating to beneficial interests in a global security. None of the following will have any responsibility or liability for any aspect of the securities depository's or any participant's records relating to beneficial interests in a global security representing Senior Notes, for payments made on account of those beneficial interests or for maintaining, supervising or reviewing any records relating to those beneficial interests:

- o Duke Energy;
- o the Senior Indenture Trustee; or
- o an agent of either of them.

### Redemption

Provisions relating to the redemption of Senior Notes will be set forth in the applicable prospectus supplement. Unless Duke Energy states otherwise in the applicable prospectus supplement, Duke Energy may redeem Senior Notes only upon notice mailed at least 30 but not more than 60 days before the date fixed for redemption. Unless Duke Energy states otherwise in the applicable prospectus supplement, that notice may state that the redemption will be conditional upon the Senior Indenture Trustee, or the applicable paying agent, receiving sufficient funds to pay the principal, premium and interest on those Senior Notes on the date fixed for redemption and that if the Senior Indenture Trustee or the applicable paying agent does not receive those funds, the redemption notice will not apply, and Duke Energy will not be required to redeem those Senior Notes.

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Duke Energy will not be required to:

- o issue, register the transfer of, or exchange any Senior Notes of a series during the period beginning 15 days before the date the notice is mailed identifying the Senior Notes of that series that have been selected for redemption; or
- o register the transfer of or exchange any Senior Note of that series selected for redemption except the unredeemed portion of a Senior Note being partially redeemed.

### Consolidation, Merger, Conveyance or Transfer

The Senior Indenture provides that Duke Energy may consolidate or merge with or into, or convey or transfer all or substantially all of its properties and assets to, another corporation or other entity. Any successor must, however, assume Duke Energy's obligations under the Senior Indenture and the Senior Notes issued under it, and Duke Energy must deliver to the Senior Indenture Trustee a statement by certain of its officers and an opinion of counsel that affirm compliance with all conditions in the Senior Indenture relating to the transaction. When those conditions are satisfied, the successor will succeed to and be substituted for Duke Energy under the Senior Indenture, and Duke Energy will be relieved of its obligations under the Senior Indenture and the Senior Notes.

### Modification; Waiver

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Duke Energy may modify the Senior Indenture with the consent of the holders of a majority in principal amount of the outstanding Senior Notes of all series of Senior Notes that are affected by the modification, voting as one class. The consent of the holder of each outstanding Senior Note affected is, however, required to:

- o change the maturity date of the principal or any installment of principal or interest on that Senior Note;
- o reduce the principal amount, the interest rate or any premium payable upon redemption on that Senior Note;
- o reduce the amount of principal due and payable upon acceleration of maturity;
- o change the currency of payment of principal, premium or interest on that Senior Note;
- o impair the right to institute suit to enforce any such payment on or after the maturity date or redemption date;
- o reduce the percentage in principal amount of Senior Notes of any series required to modify the Senior Indenture, waive compliance with certain restrictive provisions of the Senior Indenture or waive certain defaults; or
- o with certain exceptions, modify the provisions of the Senior Indenture governing modifications of the Senior Indenture or governing waiver of covenants or past defaults.

In addition, Duke Energy may modify the Senior Indenture for certain other purposes, without the consent of any holders of Senior Notes.

The holders of a majority in principal amount of the outstanding Senior Notes of any series may waive, for that series, Duke Energy's compliance with certain restrictive provisions of the Senior Indenture, including the covenant described under "Negative Pledge." The holders of a majority in principal amount of the outstanding Senior Notes of all series under the Senior Indenture with respect to which a default has occurred and is continuing, voting as one class, may waive that default for all those series, except a default in the payment of principal or any premium or interest on any Senior Note or a default with respect to a covenant or provision which cannot be modified without the consent of the holder of each outstanding Senior Note of the series affected.

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### Events of Default

The following are events of default under the Senior Indenture with respect to any series of Senior Notes, unless Duke Energy states otherwise in the applicable prospectus supplement:

- o failure to pay principal of or any premium on any Senior Note of that series when due;
- o failure to pay when due any interest on any Senior Note of that series that continues for 60 days; for this purpose, the date on which interest is due is the date on which Duke Energy is required to make payment following any deferral of interest payments by it under the terms of Senior Notes that permit such deferrals;

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- o failure to make any sinking fund payment when required for any Senior Note of that series that continues for 60 days;
- o failure to perform any covenant in the Senior Indenture (other than a covenant expressly included solely for the benefit of other series) that continues for 90 days after the Senior Indenture Trustee or the holders of at least 33% of the outstanding Senior Notes of that series give Duke Energy written notice of the default; and
- o certain bankruptcy, insolvency or reorganization events with respect to Duke Energy.

In the case of the fourth event of default listed above, the Senior Indenture Trustee may extend the grace period. In addition, if holders of a particular series have given a notice of default, then holders of at least the same percentage of Senior Notes of that series, together with the Senior Indenture Trustee, may also extend the grace period. The grace period will be automatically extended if Duke Energy has initiated and is diligently pursuing corrective action.

Duke Energy may establish additional events of default for a particular series and, if established, any such events of default will be described in the applicable prospectus supplement.

If an event of default with respect to Senior Notes of a series occurs and is continuing, then the Senior Indenture Trustee or the holders of at least 33% in principal amount of the outstanding Senior Notes of that series may declare the principal amount of all Senior Notes of that series to be immediately due and payable. However, that event of default will be considered waived at any time after the declaration but before a judgment for payment of the money due has been obtained if:

- o Duke Energy has paid or deposited with the Senior Indenture Trustee all overdue interest, the principal and any premium due otherwise than by the declaration and any interest on such amounts, and any interest on overdue interest, to the extent legally permitted, in each case with respect to that series, and all amounts due to the Senior Indenture Trustee; and
- o all events of default with respect to that series, other than the nonpayment of the principal that became due solely by virtue of the declaration, have been cured or waived.

The Senior Indenture Trustee is under no obligation to exercise any of its rights or powers at the request or direction of any holders of Senior Notes unless those holders have offered the Senior Indenture Trustee security or indemnity against the costs, expenses and liabilities which it might incur as a result. The holders of a majority in principal amount of the outstanding Senior Notes of any series have, with certain exceptions, the right to direct the time, method and place of conducting any proceedings for any remedy available to the Senior Indenture Trustee or the exercise of any power of the Senior Indenture Trustee with respect to those Senior Notes. The Senior Indenture Trustee may withhold notice of any default, except a default in the payment of principal or interest, from the holders of any series if the Senior Indenture Trustee in good faith considers it in the interest of the holders to do so.

The holder of any Senior Note will have an absolute and unconditional right to receive payment of the principal, any premium and, within certain limitations, any interest on that Senior Note on its maturity date or redemption date and to enforce those payments.

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Duke Energy is required to furnish each year to the Senior Indenture Trustee a statement by certain of its officers to the effect that it is not in default under the Senior Indenture or, if there has been a default, specifying the default and its status.

### Payments; Paying Agent

The paying agent will pay the principal of any Senior Notes only if those Senior Notes are surrendered to it. The paying agent will pay interest on Senior Notes issued as global securities by wire transfer to the holder of those global securities. Unless Duke Energy states otherwise in the applicable prospectus supplement, the paying agent will pay interest on Senior Notes that are not in global form at its office or, at Duke Energy's option:

- o by wire transfer to an account at a banking institution in the United States that is designated in writing to the Senior Indenture Trustee at least 16 days prior to the date of payment by the person entitled to that interest; or
- o by check mailed to the address of the person entitled to that interest as that address appears in the security register for those Senior Notes.

Unless Duke Energy states otherwise in the applicable prospectus supplement, the Senior Indenture Trustee will act as paying agent for that series of Senior Notes, and the principal corporate trust office of the Senior Indenture Trustee will be the office through which the paying agent acts. Duke Energy may, however, change or add paying agents or approve a change in the office through which a paying agent acts.

Any money that Duke Energy has paid to a paying agent for principal or interest on any Senior Notes which remains unclaimed at the end of two years after that principal or interest has become due will be repaid to Duke Energy at its request. After repayment to Duke Energy, holders should look only to Duke Energy for those payments.

### Negative Pledge

While any of the Senior Notes remain outstanding, Duke Energy will not create, or permit to be created or to exist, any mortgage, lien, pledge, security interest or other encumbrance upon any of its property, whether owned on or acquired after the date of the Senior Indenture, to secure any indebtedness for borrowed money of Duke Energy, unless the Senior Notes then outstanding are equally and ratably secured for so long as any such indebtedness is so secured.

The foregoing restriction does not apply with respect to, among other things:

- o purchase money mortgages, or other purchase money liens, pledges, security interests or encumbrances upon property that Duke Energy acquired after the date of the Senior Indenture;
- o mortgages, liens, pledges, security interests or other encumbrances existing on any property at the time Duke Energy acquired it, including those which exist on any property of an entity with which Duke Energy is consolidated or merged or which transfers or leases all or substantially all of its properties to Duke Energy;
- o mortgages, liens, pledges, security interests or other encumbrances upon any property of Duke Energy that existed on the date of the initial

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issuance of the Senior Notes;

- o pledges or deposits to secure performance in connection with bids, tenders, contracts (other than contracts for the payment of money) or leases to which Duke Energy is a party;
- o liens created by or resulting from any litigation or proceeding which at the time is being contested in good faith by appropriate proceedings;
- o liens incurred in connection with the issuance of bankers' acceptances and lines of credit, bankers' liens or rights of offset and any security given in the ordinary course of business to banks or others to secure

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any indebtedness payable on demand or maturing within 12 months of the date that such indebtedness is originally incurred;

- o liens incurred in connection with repurchase, swap or other similar agreements (including commodity price, currency exchange and interest rate protection agreements);
- o liens securing industrial revenue or pollution control bonds;
- o liens, pledges, security interests or other encumbrances on any property arising in connection with any defeasance, covenant defeasance or in-substance defeasance of indebtedness of Duke Energy;
- o liens created in connection with, and created to secure, a non-recourse obligation;
- o Bonds issued or to be issued from time to time under Duke Energy's First and Refunding Mortgage, and the "permitted liens" specified in Duke Energy's First and Refunding Mortgage;
- o indebtedness which Duke Energy may issue in connection with its consolidation or merger with or into any other entity, which may be its affiliate, in exchange for or otherwise in substitution for secured indebtedness of that entity ("Third Party Debt") which by its terms (1) is secured by a mortgage on all or a portion of the property of that entity, (2) prohibits that entity from incurring secured indebtedness, unless the Third Party Debt is secured equally and ratably with such secured indebtedness or (3) prohibits that entity from incurring secured indebtedness;
- o indebtedness of any entity which Duke Energy is required to assume in connection with a consolidation or merger of that entity, with respect to which any property of Duke Energy is subjected to a mortgage, lien, pledge, security interest or other encumbrance;
- o mortgages, liens, pledges, security interests or other encumbrances upon any property that Duke Energy acquired, constructed, developed or improved after the date of the Senior Indenture which are created before, at the time of, or within 18 months after such acquisition -- or in the case of property constructed, developed or improved, after the completion of the construction, development or improvement and commencement of full commercial operation of that property, whichever is later -- to secure or provide for the payment of any part of its purchase price or cost; provided that, in the case of such construction, development or improvement, the mortgages, liens, pledges, security interests or other encumbrances shall not apply to any property that Duke Energy owns other

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than real property that is unimproved up to that time; and

- o the replacement, extension or renewal of any mortgage, lien, pledge, security interest or other encumbrance described above; or the replacement, extension or renewal (not exceeding the principal amount of indebtedness so secured together with any premium, interest, fee or expense payable in connection with any such replacement, extension or renewal) of the indebtedness so secured; provided that such replacement, extension or renewal is limited to all or a part of the same property that secured the mortgage, lien, pledge, security interest or other encumbrance replaced, extended or renewed, plus improvements on it or additions or accessions to it.

In addition, Duke Energy may create or assume any other mortgage, lien, pledge, security interest or other encumbrance not excepted in the Senior Indenture without Duke Energy equally and ratably securing the Senior Notes, if immediately after that creation or assumption, the principal amount of indebtedness for borrowed money of Duke Energy that all such other mortgages, liens, pledges, security interests and other encumbrances secure does not exceed an amount equal to 10% of Duke Energy's common stockholders' equity as shown on its consolidated balance sheet for the accounting period occurring immediately before the creation or assumption of that mortgage, lien, pledge, security interest or other encumbrance.

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### Defeasance and Covenant Defeasance

The Senior Indenture provides that Duke Energy may be:

- o discharged from its obligations, with certain limited exceptions, with respect to any series of Senior Notes, as described in the Senior Indenture, such a discharge being called a "defeasance" in this prospectus; and
- o released from its obligations under certain restrictive covenants especially established with respect to any series of Senior Notes, including the covenant described under "Negative Pledge," as described in the Senior Indenture, such a release being called a "covenant defeasance" in this prospectus.

Duke Energy must satisfy certain conditions to effect a defeasance or covenant defeasance. Those conditions include the irrevocable deposit with the Senior Indenture Trustee, in trust, of money or government obligations which through their scheduled payments of principal and interest would provide sufficient money to pay the principal and any premium and interest on those Senior Notes on the maturity dates of those payments or upon redemption.

Following a defeasance, payment of the Senior Notes defeased may not be accelerated because of an event of default under the Senior Indenture. Following a covenant defeasance, the payment of Senior Notes may not be accelerated by reference to the covenants from which Duke Energy has been released. A defeasance may occur after a covenant defeasance.

Under current United States federal income tax laws, a defeasance would be treated as an exchange of the relevant Senior Notes in which holders of those Senior Notes might recognize gain or loss. In addition, the amount, timing and character of amounts that holders would thereafter be required to include in income might be different from that which would be includible in the absence of that defeasance. Duke Energy urges investors to consult their own tax advisors as to the specific consequences of a defeasance, including the applicability and

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effect of tax laws other than United States federal income tax laws.

Under current United States federal income tax law, unless accompanied by other changes in the terms of the Senior Notes, a covenant defeasance should not be treated as a taxable exchange.

Concerning the Senior Indenture Trustee

JPMorgan Chase Bank (formerly known as The Chase Manhattan Bank) is the Senior Indenture Trustee and is also the trustee under Duke Energy's Subordinated Indenture and the trustee under Duke Energy's First and Refunding Mortgage. Duke Energy and certain of its affiliates maintain deposit accounts and banking relationships with JPMorgan Chase Bank. JPMorgan Chase Bank also serves as trustee or agent under other indentures and agreements pursuant to which securities of Duke Energy and of certain of its affiliates are outstanding.

The Senior Indenture Trustee will perform only those duties that are specifically set forth in the Senior Indenture unless an event of default under the Senior Indenture occurs and is continuing. In case an event of default occurs and is continuing, the Senior Indenture Trustee will exercise the same degree of care as a prudent individual would exercise in the conduct of his or her own affairs.

### DESCRIPTION OF THE JUNIOR SUBORDINATED NOTES

Duke Energy will issue the Junior Subordinated Notes in one or more series under its Subordinated Indenture dated as of December 1, 1997 between Duke Energy and JPMorgan Chase Bank (formerly known as The Chase Manhattan Bank), as Trustee, as supplemented from time to time. The Subordinated Indenture is an exhibit to the registration statement, of which this prospectus is a part.

The Junior Subordinated Notes are unsecured obligations of Duke Energy and are junior in right of payment to "Senior Indebtedness" of Duke Energy. You will find a description of the subordination provisions of the Junior Subordinated Notes, including a description of Senior Indebtedness of Duke Energy, under "Subordination."

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Duke Energy conducts its non-electric operations, and certain of its electric operations outside its service area in the Carolinas, through subsidiaries. Accordingly, its ability to meet its obligations under the Junior Subordinated Notes is partly dependent on the earnings and cash flows of those subsidiaries and the ability of those subsidiaries to pay dividends or to advance or repay funds to Duke Energy. In addition, the rights that Duke Energy and its creditors would have to participate in the assets of any such subsidiary upon the subsidiary's liquidation or recapitalization will be subject to the prior claims of the subsidiary's creditors. Certain of Duke Energy's subsidiaries have incurred substantial amounts of debt in the expansion of their businesses and Duke Energy anticipates that certain of its subsidiaries will do so in the future.

The following description of the Junior Subordinated Notes is only a summary and is not intended to be comprehensive. For additional information you should refer to the Subordinated Indenture.

General

The Subordinated Indenture does not limit the amount of Subordinated Notes, including Junior Subordinated Notes, that Duke Energy may issue under it. Duke Energy may issue Subordinated Notes, including Junior Subordinated Notes, from

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time to time under the Subordinated Indenture in one or more series by entering into supplemental indentures or by its Board of Directors or a duly authorized committee authorizing the issuance. Two forms of supplemental indenture to the Subordinated Indenture (one with respect to Junior Subordinated Notes initially issued to a Trust and the other with respect to Junior Subordinated Notes initially issued to the public) are exhibits to the registration statement, of which this prospectus is a part.

The Junior Subordinated Notes of a series need not be issued at the same time, bear interest at the same rate or mature on the same date.

The Subordinated Indenture does not protect the holders of Junior Subordinated Notes if Duke Energy engages in a highly leveraged transaction.

### Provisions Applicable to Particular Series

The prospectus supplement for a particular series of Junior Subordinated Notes being offered will disclose the specific terms related to the offering, including the price or prices at which the Junior Subordinated Notes to be offered will be issued. Those terms may include some or all of the following:

- o the title of the series;
  - o the total principal amount of the Junior Subordinated Notes of the series;
  - o the date or dates on which principal is payable or the method for determining the date or dates, and any right that Duke Energy has to change the date on which principal is payable;
  - o the interest rate or rates, if any, or the method for determining the rate or rates, and the date or dates from which interest will accrue;
  - o any interest payment dates and the regular record date for the interest payable on each interest payment date, if any;
  - o whether Duke Energy may extend the interest payment periods and, if so, the terms of the extension;
  - o the place or places where payments will be made;
  - o whether Duke Energy has the option to redeem the Junior Subordinated Notes and, if so, the terms of its redemption option;
  - o any obligation that Duke Energy has to redeem the Junior Subordinated Notes through a sinking fund or to purchase the Junior Subordinated Notes through a purchase fund or at the option of the holder;
  - o whether the provisions described under "Defeasance and Covenant Defeasance" will not apply to the Junior Subordinated Notes;
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- o the currency in which payments will be made if other than U.S. dollars, and the manner of determining the equivalent of those amounts in U.S. dollars;
  - o if payments may be made, at Duke Energy's election or at the holder's election, in a currency other than that in which the Junior Subordinated Notes are stated to be payable, then the currency in which those payments may be made, the terms and conditions of the election and the manner of

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- determining those amounts;
- o the portion of the principal payable upon acceleration of maturity, if other than the entire principal;
- o whether the Junior Subordinated Notes will be issuable as global securities and, if so, the securities depositary;
- o any changes in the events of default or covenants with respect to the Junior Subordinated Notes;
- o any index or formula used for determining principal, premium or interest;
- o if the principal payable on the maturity date will not be determinable on one or more dates prior to the maturity date, the amount which will be deemed to be such principal amount or the manner of determining it;
- o the subordination of the Junior Subordinated Notes to any other of Duke Energy's indebtedness, including other series of Subordinated Notes; and
- o any other terms.

The interest rate and interest and other payment dates of each series of Junior Subordinated Notes issued to a Trust will correspond to the rate at which distributions will be paid and the distribution and other payment dates of the Preferred Securities of that Trust.

Unless Duke Energy states otherwise in the applicable prospectus supplement, Duke Energy will issue the Junior Subordinated Notes only in fully registered form without coupons, and there will be no service charge for any registration of transfer or exchange of the Junior Subordinated Notes. Duke Energy may, however, require payment to cover any tax or other governmental charge payable in connection with any transfer or exchange. Subject to the terms of the Subordinated Indenture and the limitations applicable to global securities, transfers and exchanges of the Junior Subordinated Notes may be made at JPMorgan Chase Bank, 450 West 33rd Street, New York, New York 10001 or at any other office maintained by Duke Energy for such purpose.

The Junior Subordinated Notes will be issuable in denominations of \$1,000 and any integral multiples of \$1,000, unless Duke Energy states otherwise in the applicable prospectus supplement.

Duke Energy may offer and sell the Junior Subordinated Notes, including original issue discount Junior Subordinated Notes, at a substantial discount below their principal amount. The applicable prospectus supplement will describe special United States federal income tax and any other considerations applicable to those securities. In addition, the applicable prospectus supplement may describe certain special United States federal income tax or other considerations, if any, applicable to any Junior Subordinated Notes that are denominated in a currency other than U.S. dollars.

### Global Securities

Duke Energy may issue some or all of the Junior Subordinated Notes as book-entry securities. Any such book-entry securities will be represented by one or more fully registered global certificates. Duke Energy will register each global security with or on behalf of a securities depositary identified in the applicable prospectus supplement. Each global security will be deposited with the securities depositary or its nominee or a custodian for the securities depositary.

As long as the securities depositary or its nominee is the registered

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holder of a global security representing Junior Subordinated Notes, that person will be considered the sole owner and holder of the global security and

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the Junior Subordinated Notes it represents for all purposes. Except in limited circumstances, owners of beneficial interests in a global security:

- o may not have the global security or any Junior Subordinated Notes it represents registered in their names;
- o may not receive or be entitled to receive physical delivery of certificated Junior Subordinated Notes in exchange for the global security; and
- o will not be considered the owners or holders of the global security or any Junior Subordinated Notes it represents for any purposes under the Junior Subordinated Notes or the Subordinated Indenture.

Duke Energy will make all payments of principal and any premium and interest on a global security to the securities depository or its nominee as the holder of the global security. The laws of some jurisdictions require that certain purchasers of securities take physical delivery of securities in definitive form. These laws may impair the ability to transfer beneficial interests in a global security.

Ownership of beneficial interests in a global security will be limited to institutions having accounts with the securities depository or its nominee, which are called "participants" in this discussion, and to persons that hold beneficial interests through participants. When a global security representing Junior Subordinated Notes is issued, the securities depository will credit on its book-entry, registration and transfer system the principal amounts of Junior Subordinated Notes the global security represents to the accounts of its participants. Ownership of beneficial interests in a global security will be shown only on, and the transfer of those ownership interests will be effected only through, records maintained by:

- o the securities depository, with respect to participants' interests; and
- o any participant, with respect to interests the participant holds on behalf of other persons.

Payments participants make to owners of beneficial interests held through those participants will be the responsibility of those participants. The securities depository may from time to time adopt various policies and procedures governing payments, transfers, exchanges and other matters relating to beneficial interests in a global security. None of the following will have any responsibility or liability for any aspect of the securities depository's or any participant's records relating to beneficial interests in a global security representing Junior Subordinated Notes, for payments made on account of those beneficial interests or for maintaining, supervising or reviewing any records relating to those beneficial interests:

- o Duke Energy;
- o the Subordinated Indenture Trustee;
- o the Trust (if the Junior Subordinated Notes are issued to a Trust); or
- o any agent of any of them.

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### Redemption

Provisions relating to the redemption of Junior Subordinated Notes will be set forth in the applicable prospectus supplement. Unless Duke Energy states otherwise in the applicable prospectus supplement, Duke Energy may redeem Junior Subordinated Notes only upon notice mailed at least 30 but not more than 60 days before the date fixed for redemption.

Duke Energy will not be required to:

- o issue, register the transfer of, or exchange any Junior Subordinated Notes of a series during the period beginning 15 days before the date the notice is mailed identifying the Junior Subordinated Notes of that series that have been selected for redemption; or
- o register the transfer of or exchange any Junior Subordinated Note of that series selected for redemption except the unredeemed portion of a Junior Subordinated Note being partially redeemed.

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### Consolidation, Merger, Conveyance or Transfer

The Subordinated Indenture provides that Duke Energy may consolidate or merge with or into, or convey or transfer all or substantially all of its properties and assets to, another corporation or other entity. Any successor must, however, assume Duke Energy's obligations under the Subordinated Indenture and the Subordinated Notes, including the Junior Subordinated Notes, and Duke Energy must deliver to the Subordinated Indenture Trustee a statement by certain of its officers and an opinion of counsel that affirm compliance with all conditions in the Subordinated Indenture relating to the transaction. When those conditions are satisfied, the successor will succeed to and be substituted for Duke Energy under the Subordinated Indenture, and Duke Energy will be relieved of its obligations under the Subordinated Indenture and any Subordinated Notes, including the Junior Subordinated Notes.

### Modification; Waiver

Duke Energy may modify the Subordinated Indenture with the consent of the holders of a majority in principal amount of the outstanding Subordinated Notes of all series that are affected by the modification, voting as one class. The consent of the holder of each outstanding Subordinated Note affected is, however, required to:

- o change the maturity date of the principal or any installment of principal or interest on that Subordinated Note;
- o reduce the principal amount, the interest rate or any premium payable upon redemption on that Subordinated Note;
- o reduce the amount of principal due and payable upon acceleration of maturity;
- o change the currency of payment of principal, premium or interest on that Subordinated Note;
- o impair the right to institute suit to enforce any such payment on or after the maturity date or redemption date;
- o reduce the percentage in principal amount of Subordinated Notes of any series required to modify the Subordinated Indenture, waive compliance

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with certain restrictive provisions of the Subordinated Indenture or waive certain defaults; or

- o with certain exceptions, modify the provisions of the Subordinated Indenture governing modifications of the Subordinated Indenture or governing waiver of covenants or past defaults.

In addition, Duke Energy may modify the Subordinated Indenture for certain other purposes, without the consent of any holders of Subordinated Notes, including Junior Subordinated Notes.

The holders of a majority in principal amount of the outstanding Junior Subordinated Notes of any series may waive, for that series, Duke Energy's compliance with certain restrictive provisions of the Subordinated Indenture. The holders of a majority in principal amount of the outstanding Subordinated Notes of all series under the Subordinated Indenture with respect to which a default has occurred and is continuing, voting as one class, may waive that default for all those series, except a default in the payment of principal or any premium or interest on any Subordinated Note or a default with respect to a covenant or provision which cannot be modified without the consent of the holder of each outstanding Subordinated Note of the series affected.

Duke Energy may not amend the Subordinated Indenture to change the subordination of any outstanding Junior Subordinated Notes without the consent of each holder of Senior Indebtedness that the amendment would adversely affect.

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### Events of Default

The following are events of default under the Subordinated Indenture with respect to any series of Junior Subordinated Notes, unless Duke Energy states otherwise in the applicable prospectus supplement:

- o failure to pay principal of or any premium on any Junior Subordinated Note of that series when due;
- o failure to pay when due any interest on any Junior Subordinated Note of that series that continues for 60 days; for this purpose, the date on which interest is due is the date on which Duke Energy is required to make payment following any deferral of interest payments by it under the terms of Junior Subordinated Notes that permit such deferrals;
- o failure to make any sinking fund payment when required for any Junior Subordinated Note of that series that continues for 60 days;
- o failure to perform any covenant in the Subordinated Indenture (other than a covenant expressly included solely for the benefit of other series) that continues for 90 days after the Subordinated Indenture Trustee or the holders of at least 33% of the outstanding Junior Subordinated Notes of that series give Duke Energy written notice of the default; and
- o certain bankruptcy, insolvency or reorganization events with respect to Duke Energy.

In the case of the fourth event of default listed above, the Subordinated Indenture Trustee may extend the grace period. In addition, if holders of a particular series have given a notice of default, then holders of at least the same percentage of Junior Subordinated Notes of that series, together with the Subordinated Indenture Trustee, may also extend the grace period. The grace period will be automatically extended if Duke Energy has initiated and is

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diligently pursuing corrective action.

Duke Energy may establish additional events of default for a particular series and, if established, any such events of default will be described in the applicable prospectus supplement.

If an event of default with respect to Junior Subordinated Notes of a series occurs and is continuing, then the Subordinated Indenture Trustee or the holders of at least 33% in principal amount of the outstanding Junior Subordinated Notes of that series may declare the principal amount of all Junior Subordinated Notes of that series to be immediately due and payable. However, that event of default will be considered waived at any time after the declaration but before a judgment for payment of the money due has been obtained if:

- o Duke Energy has paid or deposited with the Subordinated Indenture Trustee all overdue interest, the principal and any premium due otherwise than by the declaration and any interest on such amounts, and any interest on overdue interest, to the extent legally permitted, in each case with respect to that series, and all amounts due to the Subordinated Indenture Trustee; and
- o all events of default with respect to that series, other than the nonpayment of the principal that became due solely by virtue of the declaration, have been cured or waived.

In the case of Junior Subordinated Notes issued to a Trust, a holder of Preferred Securities may institute a legal proceeding directly against Duke Energy, without first instituting a legal proceeding against the Property Trustee of the Trust by which those Preferred Securities were issued or any other person or entity, for enforcement of payment to that holder of principal or interest on an equivalent amount of Junior Subordinated Notes of the related series on or after the due dates specified in those Junior Subordinated Notes.

The Subordinated Indenture Trustee is under no obligation to exercise any of its rights or powers at the request or direction of any holders of Junior Subordinated Notes unless those holders have offered the Subordinated Indenture Trustee security or indemnity against the costs, expenses and liabilities that it might incur as a result. The holders of a majority in principal amount of the outstanding Junior Subordinated Notes of any series have, with certain exceptions, the right to direct the time, method and place of conducting any proceedings for any remedy available to the Subordinated Indenture Trustee or the exercise of any power of the Subordinated Indenture Trustee with respect to those Junior Subordinated Notes. The Subordinated Indenture Trustee may withhold notice of any default, except a default in the payment of principal or interest,

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from the holders of any series if the Subordinated Indenture Trustee in good faith considers it in the interest of the holders to do so.

The holder of any Junior Subordinated Note will have an absolute and unconditional right to receive payment of the principal, any premium and, within certain limitations, any interest on that Junior Subordinated Note on its maturity date or redemption date and to enforce those payments.

Duke Energy is required to furnish each year to the Subordinated Indenture Trustee a statement by certain of its officers to the effect that it is not in default under the Subordinated Indenture or, if there has been a default, specifying the default and its status.

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### Payments; Paying Agent

The paying agent will pay the principal of any Junior Subordinated Notes only if those Junior Subordinated Notes are surrendered to it. The paying agent will pay interest on Junior Subordinated Notes issued as global securities by wire transfer to the holder of those global securities. Unless Duke Energy states otherwise in the applicable prospectus supplement, the paying agent will pay interest on Junior Subordinated Notes that are not in global form at its office or, at Duke Energy's option:

- o by wire transfer to an account at a banking institution in the United States that is designated in writing to the Subordinated Indenture Trustee at least 16 days prior to the date of payment by the person entitled to that interest; or
- o by check mailed to the address of the person entitled to that interest as that address appears in the security register for those Junior Subordinated Notes.

Unless Duke Energy states otherwise in the applicable prospectus supplement, the Subordinated Indenture Trustee will act as paying agent for that series of Junior Subordinated Notes, and the principal corporate trust office of the Subordinated Indenture Trustee will be the office through which the paying agent acts. Duke Energy may, however, change or add paying agents or approve a change in the office through which a paying agent acts.

Any money that Duke Energy has paid to a paying agent for principal or interest on any Junior Subordinated Notes that remains unclaimed at the end of two years after that principal or interest has become due will be repaid to Duke Energy at its request. After repayment to Duke Energy, holders should look only to Duke Energy for those payments.

### Defeasance and Covenant Defeasance

The Subordinated Indenture provides that Duke Energy may be:

- o discharged from its obligations, with certain limited exceptions, with respect to any series of Junior Subordinated Notes, as described in the Subordinated Indenture, such a discharge being called a "defeasance" in this prospectus; and
- o released from its obligations under certain restrictive covenants especially established with respect to a series of Junior Subordinated Notes, as described in the Subordinated Indenture, such a release being called a "covenant defeasance" in this prospectus.

Duke Energy must satisfy certain conditions to effect a defeasance or covenant defeasance. Those conditions include the irrevocable deposit with the Subordinated Indenture Trustee, in trust, of money or government obligations which through their scheduled payments of principal and interest would provide sufficient money to pay the principal and any premium and interest on those Junior Subordinated Notes on the maturity dates of those payments or upon redemption. Following a defeasance, payment of the Junior Subordinated Notes defeased may not be accelerated because of an event of default under the Subordinated Indenture.

Under current United States federal income tax laws, a defeasance would be treated as an exchange of the relevant Junior Subordinated Notes in which holders of those Junior Subordinated Notes might recognize

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gain or loss. In addition, the amount, timing and character of amounts that holders would thereafter be required to include in income might be different from that which would be includible in the absence of that defeasance. Duke Energy urges investors to consult their own tax advisors as to the specific consequences of a defeasance, including the applicability and effect of tax laws other than United States federal income tax laws.

Junior Subordinated Notes issued to a Trust will not be subject to covenant defeasance.

### Subordination

Each series of Junior Subordinated Notes will be subordinate and junior in right of payment, to the extent set forth in the Subordinated Indenture, to all Senior Indebtedness as defined below. If:

- o Duke Energy makes a payment or distribution of any of its assets to creditors upon its dissolution, winding-up, liquidation or reorganization, whether in bankruptcy, insolvency or otherwise;
- o a default beyond any grace period has occurred and is continuing with respect to the payment of principal, interest or any other monetary amounts due and payable on any Senior Indebtedness; or
- o the maturity of any Senior Indebtedness has been accelerated because of a default on that Senior Indebtedness,

then the holders of Senior Indebtedness generally will have the right to receive payment, in the case of the first instance, of all amounts due or to become due upon that Senior Indebtedness, and, in the case of the second and third instances, of all amounts due on the Senior Indebtedness, or Duke Energy will make provision for those payments, before the holders of any Junior Subordinated Notes have the right to receive any payments of principal or interest on their Junior Subordinated Notes.

"Senior Indebtedness" means, with respect to any series of Junior Subordinated Notes, the principal, premium, interest and any other payment in respect of any of the following:

- o all of Duke Energy's indebtedness that is evidenced by notes, debentures, bonds or other securities Duke Energy sells for money or other obligations for money borrowed;
- o all indebtedness of others of the kinds described in the preceding category which Duke Energy has assumed or guaranteed or which Duke Energy has in effect guaranteed through an agreement to purchase, contingent or otherwise; and
- o all renewals, extensions or refundings of indebtedness of the kinds described in either of the preceding two categories.

Any such indebtedness, renewal, extension or refunding, however, will not be Senior Indebtedness if the instrument creating or evidencing it or the assumption or guarantee of it provides that it is not superior in right of payment to or is equal in right of payment with those Junior Subordinated Notes. Senior Indebtedness will be entitled to the benefits of the subordination provisions in the Subordinated Indenture irrespective of the amendment, modification or waiver of any term of the Senior Indebtedness.

Future series of Subordinated Notes that are not Junior Subordinated Notes may rank senior to outstanding series of Junior Subordinated Notes and would constitute Senior Indebtedness with respect to those series.

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The Subordinated Indenture does not limit the amount of Senior Indebtedness that Duke Energy may issue. As of June 30, 2002, Duke Energy's Senior Indebtedness totaled approximately \$4,600,000,000.

Concerning the Subordinated Indenture Trustee

JPMorgan Chase Bank (formerly known as The Chase Manhattan Bank) is the Subordinated Indenture Trustee and is also the Senior Indenture Trustee and the trustee under Duke Energy's First and Refunding Mortgage. Duke Energy and certain of its affiliates maintain deposit accounts and banking relationships with JPMorgan Chase Bank. JPMorgan Chase Bank also serves as trustee or agent under other indentures and agreements pursuant to which securities of Duke Energy and of certain of its affiliates are outstanding.

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The Subordinated Indenture Trustee will perform only those duties that are specifically set forth in the Subordinated Indenture unless an event of default under the Subordinated Indenture occurs and is continuing. In case an event of default occurs and is continuing, the Subordinated Indenture Trustee will exercise the same degree of care as a prudent individual would exercise in the conduct of his or her own affairs.

### DESCRIPTION OF THE FIRST AND REFUNDING MORTGAGE BONDS

Duke Energy will issue the First and Refunding Mortgage Bonds in one or more series under its First and Refunding Mortgage, dated as of December 1, 1927, to JPMorgan Chase Bank (formerly known as The Chase Manhattan Bank), as Trustee, as supplemented and amended. The First and Refunding Mortgage is sometimes called the "Mortgage" and the First and Refunding Mortgage Bonds are sometimes called the "Bonds" in this prospectus. The trustee under the Mortgage is sometimes called the "Bond Trustee" in this prospectus. The Mortgage is an exhibit to the registration statement, of which this prospectus is a part.

The following description of the Bonds is only a summary and is not intended to be comprehensive. For additional information you should refer to the Mortgage.

#### General

The amount of Bonds that Duke Energy may issue under the Mortgage is unlimited. Duke Energy's Board of Directors will determine the terms of each series of Bonds, including denominations, maturity, interest rate and payment terms and whether the series will have redemption or sinking fund provisions.

Unless Duke Energy states otherwise in the applicable prospectus supplement, Duke Energy will issue the Bonds only in fully registered form without coupons and there will be no service charge for any transfers and exchanges of the Bonds. Duke Energy may, however, require payment to cover any stamp tax or other governmental charge payable in connection with any transfer or exchange. Transfers and exchanges of the Bonds may be made at JPMorgan Chase Bank, 450 West 33rd Street, New York, New York 10001 or at any other office maintained by Duke Energy for such purpose.

The Bonds will be issuable in denominations of \$1,000 and multiples of \$1,000, unless Duke Energy states otherwise in the applicable prospectus supplement. The Bonds will be exchangeable for an equivalent principal amount of Bonds of other authorized denominations of the same series.

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The prospectus supplement for a particular series of Bonds will describe the maturity, interest rate and payment terms of those Bonds and any relevant redemption or sinking fund provisions.

### Security

The Mortgage creates a continuing lien to secure the payment of principal and interest on the Bonds. All the Bonds are equally and ratably secured without preference, priority or distinction. The lien of the Mortgage covers substantially all of Duke Energy's properties, real, personal and mixed, and Duke Energy's franchises, including properties acquired after the date of the Mortgage, with certain exceptions. Those exceptions include cash, accounts receivable, inventories of materials and supplies, merchandise held for sale, securities that Duke Energy holds, certain after-acquired property not useful in Duke Energy's electric business, certain after-acquired franchises and certain after-acquired non-electric properties.

The lien of the Mortgage is subject to certain permitted liens and to liens that exist upon properties that Duke Energy acquired after it entered into the Mortgage to the extent of the amounts of prior lien bonds secured by those properties (not, however, exceeding 75% of the cost or value of those properties) and additions to those properties. "Prior lien bonds" are bonds or other indebtedness that are secured at the time of acquisition by a lien upon property that Duke Energy acquires after the date of the Mortgage that becomes subject to the lien of the Mortgage.

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### Issuance of Additional Bonds

If Duke Energy satisfies the conditions in the Mortgage, the Bond Trustee may authenticate and deliver additional Bonds in an aggregate principal amount not exceeding:

- o the amount of cash that Duke Energy has deposited with the Bond Trustee for that purpose;
- o the amount of previously authenticated and delivered Bonds or refundable prior lien bonds that have been or are to be retired which, with certain exceptions, Duke Energy has deposited with the Bond Trustee for that purpose; or
- o 66 2/3% of the aggregate of the net amounts of additional property (electric) certified to the Bond Trustee after February 18, 1949.

The Bond Trustee may not authenticate and deliver any additional Bonds under the Mortgage, other than certain types of refunding Bonds, unless Duke Energy's available net earnings for twelve consecutive calendar months within the immediately preceding fifteen calendar months have been at least twice the amount of the annual interest charges on all Bonds outstanding under the Mortgage, including the Bonds proposed to be issued, and on all outstanding prior lien bonds that the Bond Trustee does not hold under the Mortgage.

Duke Energy may not apply to the Bond Trustee to authenticate and deliver any Bonds (1) in an aggregate principal amount exceeding \$26,000,000 on the basis of additional property (electric) that Duke Energy acquired or constructed prior to January 1, 1949 or (2) on the basis of Bonds or prior lien bonds paid, purchased or redeemed prior to February 1, 1949. Duke Energy may not certify any additional property (electric) which is subject to the lien of any prior lien bonds for the purpose of establishing those prior lien bonds as refundable if the aggregate principal amount of those prior lien bonds exceeds 66 2/3% of the

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net amount of the additional property that is subject to the lien of such prior lien bonds.

### Release Provisions

The Mortgage permits Duke Energy to dispose of certain property and to take other actions without the Bond Trustee releasing that property. The Mortgage also permits the release of mortgaged property if Duke Energy deposits cash or other consideration equal to the value of the mortgaged property to be released. In certain events and within certain limitations, the Bond Trustee is required to pay out cash that the Bond Trustee receives -- other than for the Replacement Fund or as the basis for issuing Bonds -- upon Duke Energy's application.

Duke Energy may withdraw cash that it deposited with the Bond Trustee as the basis for issuing Bonds in an amount equal to the principal amount of any Bonds that it is entitled to have authenticated and delivered on the basis of additional property (electric), on the basis of Bonds previously authenticated and delivered or on the basis of refundable prior lien bonds.

### Replacement Fund

The Mortgage requires Duke Energy to deposit with the Bond Trustee annually, for the Replacement Fund established under the Mortgage, the sum of the "replacement requirements" for all years beginning with 1949 and ending with the last calendar year preceding the deposit date, less certain deductions. Those deductions are (1) the aggregate original cost of all fixed property (electric) retired during that time period, not exceeding the aggregate of the gross amounts of additional property (electric) that Duke Energy acquired or constructed during the same period, and (2) the aggregate amount of cash that Duke Energy deposited with the Bond Trustee up to that time, or that Duke Energy would have been required to deposit except for permitted reductions, under the Replacement Fund.

The "replacement requirement" for any year is 2 1/2% of the average "amount of depreciable fixed property" (electric) owned by Duke Energy at the beginning and end of that year, not exceeding, however, the amount Duke Energy is permitted to charge as an operating expense for depreciation or retirement by any governmental authority, or the amount deductible as depreciation or similar expense for federal income tax purposes. The "amount of depreciable fixed property" (electric) is the amount by which the sum of

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\$192,913,385 plus the aggregate gross amount of all depreciable additional property (electric) that Duke Energy acquired or constructed from January 1, 1949 to the date as of which such amount is determined exceeds the original cost of all of Duke Energy's depreciable fixed property (electric) retired during that period or released from the lien of the Mortgage.

Duke Energy may reduce the amount of cash at any time required to be deposited in the Replacement Fund and may withdraw any cash that it previously deposited that is held in the Replacement Fund:

- o in an amount equal to 150% of the principal amount of Bonds previously authenticated and delivered under the Mortgage, or refundable prior lien bonds, deposited with the Bond Trustee and on the basis of which Duke Energy would otherwise have been entitled to have additional Bonds authenticated and delivered; and
- o in an amount equal to 150% of the principal amount of Bonds which Duke Energy would otherwise be entitled to have authenticated and delivered on the basis of additional property (electric).

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Upon Duke Energy's application, the Bond Trustee will apply cash that Duke Energy deposited in the Replacement Fund and has not previously withdrawn to the payment, purchase or redemption of Bonds issued under the Mortgage or to the purchase of refundable prior lien bonds.

Duke Energy has never deposited any cash with the Bond Trustee for the Replacement Fund. If Duke Energy deposits any cash in the future, it has agreed not to apply that cash to the redemption of the Bonds as long as any Bonds then outstanding remain outstanding.

### Amendments of the Mortgage

Duke Energy may amend the Mortgage with the consent of the holders of 66 2/3% in principal amount of the Bonds, except that no such amendment may:

- o affect the terms of payment of principal at maturity or of interest or premium on any Bond;
- o affect the rights of Bondholders to sue to enforce any such payment at maturity; or
- o reduce the percentage of Bonds required to consent to an amendment.

No amendment may affect the rights under the Mortgage of the holders of less than all of the series of Bonds outstanding unless the holders of 66 2/3% in principal amount of the Bonds of each series affected consent to the amendment.

The covenants included in the supplemental indenture for any series of Bonds to be issued will be solely for the benefit of the holders of those Bonds. Duke Energy may modify any such covenant only with the consent of the holders of 66 2/3% in principal amount of those Bonds outstanding, without the consent of Bondholders of any other series.

### Events of Default

The Bond Trustee may, and at the written request of the holders of a majority in principal amount of the outstanding Bonds will, declare the principal of all outstanding Bonds due when any event of default under the Mortgage occurs. The holders of a majority in principal amount of the outstanding Bonds may, however, waive the default and rescind the declaration if Duke Energy cures the default.

Events of default under the Mortgage include:

- o default in the payment of principal;
- o default for 60 days in the payment of interest;
- o default in the performance of any other covenant in the Mortgage continuing for 60 days after the Bond Trustee or the holders of not less than 10% in principal amount of the Bonds then outstanding give notice of the default; and

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- o certain bankruptcy or insolvency events with respect to Duke Energy.

Duke Energy provides a statement by certain of its officers each year to the Bond Trustee stating whether it has complied with the covenants of the

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Mortgage.

Concerning the Bond Trustee

JPMorgan Chase Bank (formerly known as The Chase Manhattan Bank) is the Bond Trustee and is also the Senior Indenture Trustee and the Subordinated Indenture Trustee. Duke Energy and certain of its affiliates maintain deposit accounts and banking relationships with JPMorgan Chase Bank. JPMorgan Chase Bank also serves as trustee or agent under other indentures and agreements pursuant to which securities of Duke Energy and of certain of its affiliates are outstanding.

The Bond Trustee is under no obligation to exercise any of its powers at the request of any of the holders of the Bonds unless those Bondholders have offered to the Bond Trustee security or indemnity satisfactory to it against the cost, expenses and liabilities it might incur as a result. The holders of a majority in principal amount of the Bonds outstanding may direct the time, method and place of conducting any proceeding for any remedy available to the Bond Trustee, or the exercise of any trust or power of the Bond Trustee. The Bond Trustee will not be liable for any action that it takes or omits to take in good faith in accordance with any such direction.

### DESCRIPTION OF THE COMMON STOCK

The following description of Duke Energy's Common Stock is only a summary and is not intended to be comprehensive. For additional information you should refer to the applicable provisions of the North Carolina Business Corporation Act and Duke Energy's Restated Articles of Incorporation (Articles) and By-Laws. The Articles and By-Laws are exhibits to the registration statement, of which this prospectus is a part.

General

Duke Energy is authorized to issue up to 2,000,000,000 shares of Common Stock. At June 30, 2002, approximately 832,000,000 shares of Common Stock were outstanding. Duke Energy is also authorized to issue up to 12,500,000 shares of Preferred Stock, 10,000,000 shares of Preferred Stock A, 20,000,000 shares of Serial Preferred Stock and 1,500,000 shares of Preference Stock. At June 30, 2002, 2,154,984 shares of Preferred Stock, 1,257,185 shares of Preferred Stock A and no shares of Serial Preferred Stock or Preference Stock were outstanding. The Preferred Stock, Preferred Stock A, Serial Preferred Stock and Preference Stock together are sometimes called the "Preferred Stocks."

Dividends

Holders of Common Stock are entitled to such dividends as may be declared from time to time by the Board of Directors from legally available funds but only if full dividends on all outstanding series of the Preferred Stocks for the then current and all prior dividend periods and any required sinking fund payments with respect to any outstanding series of such securities have been paid or provided for.

Voting Rights

Subject to the rights, if any, of the holders of the Preferred Stocks that may be outstanding or as otherwise provided by law, the holders of Common Stock have exclusive voting rights, each share being entitled to one vote. Holders of Common Stock have noncumulative voting rights, which means that the holders of more than 50% of the shares voting for the election of directors can elect 100% of the directors and the holders of the remaining shares voting for the election

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of directors will not be able to elect any directors.

Whenever dividends on any part of any outstanding Preferred Stock or Preferred Stock A are in arrears in an amount equivalent to the total dividends required to be paid on that Preferred Stock or Preferred Stock A in any period of 12 calendar months, the holders of the Preferred Stock as a class have the exclusive right to elect a majority of the authorized number of directors and the holders of the Preferred Stock A as a class have the exclusive right to elect two directors. Those rights cease whenever Duke Energy pays all accrued and

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unpaid dividends in full. Whenever six quarterly dividends on any outstanding series of the Preference Stock are in arrears or any required sinking fund payments are in default, the holders of the Preference Stock as a class have the exclusive right to elect two directors. This right ceases whenever all dividends and required sinking fund obligations in default have been paid in full or provided for. In addition, the consent of the holders of specified percentages of any outstanding Preferred Stock, Preferred Stock A or Preference Stock, or some or all of the holders of such classes, is required in connection with certain increases in authorized amounts of or changes in stock senior to the Common Stock or in connection with any sale of substantially all of Duke Energy's assets or certain mergers.

The holders of the Serial Preferred Stock will have such voting rights as a series or otherwise with respect to the election of directors or otherwise as may be fixed by the Board of Directors at the time of the creation of the series, in addition to any voting rights provided by law.

### Rights Upon Liquidation

The holders of Common Stock are entitled in liquidation to share ratably in the assets of Duke Energy after payment of all debts and liabilities and after required preferential payments to the holders of outstanding Preferred Stocks.

### Miscellaneous

The outstanding shares of Common Stock are, and the shares of Common Stock sold hereunder will be, upon payment for them, fully paid and nonassessable. Holders of Common Stock have no preemptive rights and no conversion rights. The Common Stock is not subject to redemption and is not entitled to the benefit of any sinking fund provisions.

If so provided by the Board of Directors at the time of creation of any series of Serial Preferred Stock, the shares of such series may be convertible or exchangeable into shares of Common Stock or other securities of Duke Energy or of any other corporation or other entity, upon terms fixed at the time of creation of the series.

### Transfer Agent and Registrar

Duke Energy acts as transfer agent and registrar for the Common Stock.

### Preference Stock Purchase Rights

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Each share of Common Stock has attached to it a Preference Stock Purchase Right. The Rights initially are represented only by the certificates for the shares of Common Stock and will not trade separately from those shares unless and until:

- o ten days after it is publicly announced that a person or group (with certain exceptions) has acquired, or has obtained the right to acquire, the beneficial ownership of 15% or more of the outstanding Common Stock (an "acquiring person"); or
- o ten business days (or a later date determined by Duke Energy's Board of Directors) after the date a person or group commences, or public announcement is made that the person or group intends to commence, a tender or exchange offer that would result in the person or group becoming an acquiring person.

If and when the Rights separate, each Right will entitle the holder to purchase 1/10,000 of a share of Duke Energy's Series A Participating Preference Stock for an exercise price that is presently \$190.

In the event that a person or group becomes an acquiring person, each Right (except for Rights beneficially owned by the acquiring person or its transferees, which Rights become void) will entitle its holder to purchase, for the exercise price, a number of shares of Common Stock having a market value of twice the exercise price. Also, if, after ten days following the date of the announcement that a person or group has become an acquiring person:

- o Duke Energy is involved in a merger or similar form of business combination in which Duke Energy is not the surviving corporation or in which Duke Energy is the surviving corporation but the Common Stock is changed or exchanged; or

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- o more than 50% of Duke Energy's assets or earning power is sold or transferred;

then each Right (except for voided Rights) will entitle its holder to purchase, for the exercise price, a number of shares of common stock of the acquiring company having a value of twice the exercise price. If any person or group acquires from 15% to but excluding 50% of the outstanding Common Stock, Duke Energy's Board of Directors may, at its option, exchange each outstanding Right (except for those held by an acquiring person or its transferees) for one share of Common Stock or 1/10,000 of a share of Series A Participating Preference Stock.

Duke Energy's Board of Directors may redeem the Rights for \$0.01 per Right prior to ten business days after the date of the public announcement that a person or group has become an acquiring person.

The Rights will not prevent a takeover of Duke Energy. However, the existence of the Rights may cause substantial dilution to a person or group that acquires 15% or more of the Common Stock unless the Board of Directors first redeems those Rights.

### Certain Anti-Takeover Matters

Duke Energy's Articles and By-Laws include a number of provisions that may have the effect of encouraging persons considering unsolicited tender offers or other unilateral takeover proposals to negotiate with the Board of Directors

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rather than pursue non-negotiated takeover attempts. Those provisions include:

### Classified Board of Directors; Removal of Directors; Vacancies

Duke Energy's Articles provide for a Board of Directors divided into three classes, with one class being elected each year to serve for a three-year term. As a result, at least two annual meetings of shareholders may be required for shareholders to change a majority of the Board of Directors. Duke Energy's shareholders may remove directors only for cause. Vacancies and newly created directorships on the Board of Directors may be filled only by the affirmative vote of a majority of the directors remaining in office, and no decrease in the number of directors may shorten the term of an incumbent director. The classification of directors and the inability of shareholders to remove directors without cause and to fill vacancies and newly created directorships on the Board of Directors will make it more difficult to change the composition of the Board of Directors, but will promote continuity of existing management.

### Advance Notice Requirements

Duke Energy's By-Laws establish advance notice procedures with regard to shareholder proposals relating to the nomination of persons for election as directors or new business to be brought before annual meetings of shareholders. These procedures provide that shareholders must give timely notice of such proposals in writing to the Secretary of Duke Energy. Generally, to be timely with respect to an annual meeting of shareholders, notice must be received at Duke Energy's principal executive offices not less than 90 days nor more than 120 days prior to the first anniversary date of the annual meeting for the preceding year. The notice must contain certain information specified in the By-Laws.

### Special Meetings of Shareholders

Neither the Articles nor the By-Laws of Duke Energy give shareholders the right to call a special meeting of shareholders. The By-Laws provide that special meetings of shareholders may be called only by the Board of Directors or the Chairman of the Board.

### Amendment of Charter and By-Laws

Duke Energy's Articles require the approval of not less than 80% of the voting power of all outstanding shares of Common Stock to amend provisions relating to the minimum and maximum size of the Board of Directors, the classification of the Board of Directors, the removal of directors, the filling of vacancies and newly created directorships on the Board of Directors and the requirement that a decrease in the number of directors constituting the Board of Directors may not shorten the term of any incumbent director. Duke Energy's Articles also require the affirmative vote of the holders of at least a majority of the combined voting power of the then outstanding shares of stock of all classes entitled to vote generally in the election of directors, voting together as a single class, for the shareholders to adopt, amend or repeal any provisions in the By-Laws. This voting requirement also applies to any amendment or repeal of this provision or the adoption of

any provision inconsistent with it. These amendment provisions will make it more

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difficult to dilute the anti-takeover effects of Duke Energy's Articles and By-Laws.

### Serial Preferred Stock

Serial Preferred Stock can be, and has been, used by corporations specifically for anti-takeover purposes. For example, shares of Serial Preferred Stock can be privately placed with purchasers who support a board of directors in opposing a tender offer or other hostile takeover bid, or can be issued to dilute the stock ownership and voting power of a third party seeking a merger or other extraordinary corporate transaction. Under these and similar circumstances, the Serial Preferred Stock can serve to perpetuate incumbent management and can adversely affect shareholders who may want to participate in the tender offer or other transaction.

Duke Energy's Board of Directors has adopted resolutions that state that the Serial Preferred Stock:

- a) not be used for the principal purpose of acting as an anti-takeover device without shareholder approval; and
- b) not be given supermajority voting rights except possibly with respect to proposed amendments to the Articles of Incorporation altering materially existing provisions of the Serial Preferred Stock or creating, or increasing the authorized amount of, any class of stock ranking, as to dividend or assets, prior to the Serial Preferred Stock.

### DESCRIPTION OF THE STOCK PURCHASE CONTRACTS AND THE STOCK PURCHASE UNITS

Duke Energy may issue stock purchase contracts representing contracts obligating holders to purchase from Duke Energy, and Duke Energy to sell to the holders, a specified number of shares of Common Stock (or a range of numbers of shares pursuant to a predetermined formula) at a future date or dates. The price per share of Common Stock may be fixed at the time the stock purchase contracts are issued or may be determined by reference to a specific formula set forth in the stock purchase contracts.

The stock purchase contracts may be issued separately or as a part of units, often known as stock purchase units, consisting of a stock purchase contract and either:

- o Senior Notes, Junior Subordinated Notes or other debt securities of Duke Energy or one of its subsidiaries;
- o debt obligations of third parties, including U.S. Treasury securities; or
- o Preferred Securities or trust preferred securities issued by trusts, all of whose common securities are owned by Duke Energy or by subsidiaries of Duke Energy,

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securing the holder's obligations to purchase the Common Stock under the stock purchase contracts.

The stock purchase contracts may require Duke Energy to make periodic payments to the holders of the stock purchase units or vice versa, and such payments may be unsecured or prefunded on some basis. The stock purchase contracts may require holders to secure their obligations in a specified manner and in certain circumstances Duke Energy may deliver newly issued prepaid stock purchase contracts, often known as prepaid securities, upon release to a holder of any collateral securing such holder's obligations under the original stock purchase contract.

The applicable prospectus supplement will describe the terms of any stock purchase contracts or stock purchase units and, if applicable, prepaid securities. The description in the applicable prospectus supplement will not contain all of the information that you may find useful. For more information, you should review the stock purchase contracts, the collateral arrangements and depositary arrangements, if applicable, relating to such stock purchase contracts or stock purchase units and, if applicable, the prepaid securities and the document pursuant to which the prepaid securities will be issued. These documents will be filed with the SEC promptly after the offering of such stock purchase contracts or stock purchase units and, if applicable, prepaid securities.

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### DESCRIPTION OF THE PREFERRED SECURITIES

Each Trust may issue only one series of Preferred Securities. The Trust Agreement of each Trust will authorize the Administrative Trustees to issue the Preferred Securities of that Trust on behalf of that Trust. For additional information you should refer to the applicable Trust Agreement. The form of Trust Agreement is an exhibit to the registration statement, of which this prospectus is a part.

The prospectus supplement for a particular series of Preferred Securities being offered will disclose the specific terms related to the offering, including the price or prices at which the Preferred Securities to be offered will be issued. Those terms will include some or all of the following:

- o the title of the series;
- o the number of Preferred Securities of the series;
- o the yearly distribution rate, or the method of determining that rate, and the date or dates on which distributions will be payable;
- o the date or dates, or method of determining the date or dates, from which distributions will be cumulative;
- o the amount that will be paid out of the assets of the Trust to the holders of the Preferred Securities upon the voluntary or involuntary dissolution, winding-up or termination of the Trust;
- o any obligation that the Trust has to purchase or redeem the Preferred Securities, and the price at which, the period within which, and the terms and conditions upon which the Trust will purchase or redeem them;
- o any voting rights of the Preferred Securities that are in addition to those legally required, including any right that the holders of the Preferred Securities have to approve certain actions under or amendments

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to the Trust Agreement;

- o any right that the Trust has to defer distributions on the Preferred Securities in the event that Duke Energy extends the interest payment period on the related Junior Subordinated Notes; and
- o any other rights, preferences, privileges, limitations or restrictions upon the Preferred Securities of the series.

Duke Energy will guarantee each series of Preferred Securities to the extent described below under the caption "Description of the Guarantees."

The applicable prospectus supplement will describe any material United States federal income tax considerations that apply to the Preferred Securities.

### DESCRIPTION OF THE GUARANTEES

Duke Energy will execute the Guarantees from time to time for the benefit of the holders of the Preferred Securities of the respective Trusts. JPMorgan Chase Bank will act as Guarantee Trustee under each Guarantee. The Guarantee Trustee will hold each Guarantee for the benefit of the holders of the Preferred Securities to which it relates.

The following description of the Guarantees is only a summary and is not intended to be comprehensive. The form of Guarantee is an exhibit to the registration statement, of which this prospectus is a part.

#### General

Duke Energy will irrevocably and unconditionally agree under each Guarantee to pay the Guarantee Payments that are defined below, to the extent specified in that Guarantee, to the holders of the Preferred Securities to which the Guarantee relates, to the extent that the Guarantee Payments are not paid by or on behalf of the related Trust. Duke Energy is required to pay the Guarantee Payments to the extent specified in the relevant Guarantee regardless of any defense, right of set-off or counterclaim that Duke Energy may have or may assert against any person.

The following payments and distributions on the Preferred Securities of a Trust are Guarantee Payments:

- o any accrued and unpaid distributions required to be paid on the Preferred Securities of the Trust, but only to the extent that the Trust has funds legally and immediately available for those distributions;

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- o the redemption price for any Preferred Securities that the Trust calls for redemption, including all accrued and unpaid distributions to the redemption date, but only to the extent that the Trust has funds legally and immediately available for the payment; and
- o upon a dissolution, winding-up or termination of the Trust, other than in connection with the distribution of Junior Subordinated Notes to the holders of Trust Securities of the Trust or the redemption of all the Preferred Securities of the Trust, the lesser of:
  - o the sum of the liquidation amount and all accrued and unpaid distributions on the Preferred Securities of the Trust to the payment date, to the extent that the Trust has funds legally and immediately available for the payment; and

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- o the amount of assets of the Trust remaining available for distribution to holders of the Preferred Securities of the Trust in liquidation of the Trust.

Duke Energy may satisfy its obligation to make a Guarantee Payment by making that payment directly to the holders of the related Preferred Securities or by causing the Trust to make the payment to those holders.

Each Guarantee will be a full and unconditional guarantee, subject to certain subordination provisions, of the Guarantee Payments with respect to the related Preferred Securities from the time of issuance of those Preferred Securities, except that the Guarantee will apply to the payment of distributions and other payments on the Preferred Securities only when the Trust has sufficient funds legally and immediately available to make those distributions or other payments.

IF DUKE ENERGY DOES NOT MAKE THE REQUIRED PAYMENTS ON THE JUNIOR SUBORDINATED NOTES THAT THE PROPERTY TRUSTEE HOLDS UNDER A TRUST, THAT TRUST WILL NOT MAKE THE RELATED PAYMENTS ON ITS PREFERRED SECURITIES.

### Subordination

Duke Energy's obligations under each Guarantee will be unsecured obligations of Duke Energy. Those obligations will rank:

- o subordinate and junior in right of payment to all of Duke Energy's other liabilities, other than obligations or liabilities that rank equal in priority or subordinate by their terms;
- o equal in priority with Duke Energy's Preferred Stock and Preferred Stock A and similar guarantees; and
- o senior to Duke Energy's Common Stock.

Duke Energy has Preferred Stock and Preferred Stock A outstanding that will rank equal in priority with the Guarantees and has Common Stock outstanding that will rank junior to the Guarantees.

Each Guarantee will be a guarantee of payment and not of collection. This means that the guaranteed party may institute a legal proceeding directly against Duke Energy, as guarantor, to enforce its rights under the Guarantee without first instituting a legal proceeding against any other person or entity.

The terms of the Preferred Securities will provide that each holder of the Preferred Securities, by accepting those Preferred Securities, agrees to the subordination provisions and other terms of the related Guarantee.

### Amendments and Assignment

Duke Energy may amend each Guarantee without the consent of any holder of the Preferred Securities to which that Guarantee relates if the amendment does not materially and adversely affect the rights of those holders. Duke Energy may otherwise amend each Guarantee with the approval of the holders of at least 66 2/3% of the outstanding Preferred Securities to which that Guarantee relates.

### Termination

Each Guarantee will terminate and be of no further effect when:

- o the redemption price of the Preferred Securities to which the Guarantee relates is fully paid;

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- o Duke Energy distributes the related Junior Subordinated Notes to the holders of those Preferred Securities; or

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- o the amounts payable upon liquidation of the related Trust are fully paid.

Each Guarantee will remain in effect or will be reinstated if at any time any holder of the related Preferred Securities must restore payment of any sums paid to that holder with respect to those Preferred Securities or under that Guarantee.

### Events of Default

An event of default will occur under any Guarantee if Duke Energy fails to perform any of its payment obligations under that Guarantee. The holders of a majority of the Preferred Securities of any series may waive any such event of default and its consequences on behalf of all of the holders of the Preferred Securities of that series. The Guarantee Trustee is obligated to enforce the Guarantee for the benefit of the holders of the Preferred Securities of a series if an event of default occurs under the related Guarantee.

The holders of a majority of the Preferred Securities to which a Guarantee relates have the right to direct the time, method and place of conducting any proceeding for any remedy available to the Guarantee Trustee with respect to that Guarantee or to direct the exercise of any trust or power that the Guarantee Trustee holds under that Guarantee. Any holder of the related Preferred Securities may institute a legal proceeding directly against Duke Energy to enforce that holder's rights under the Guarantee without first instituting a legal proceeding against the Guarantee Trustee or any other person or entity.

### Concerning the Guarantee Trustee

JPMorgan Chase Bank will be the Guarantee Trustee. It is also the Property Trustee, the Subordinated Indenture Trustee, the Senior Indenture Trustee and the Bond Trustee. Duke Energy and certain of its affiliates maintain deposit accounts and banking relationships with JPMorgan Chase Bank. JPMorgan Chase Bank also serves as trustee or agent under other indentures and agreements pursuant to which securities of Duke Energy and certain of its affiliates are outstanding.

The Guarantee TrusteeDeferred rent

2,308 465

### **Net cash provided by operating activities**

7,067 9,820

### **Cash flows from investing activities**

Purchase of property and equipment

(9,021 ) (596 )

Capitalized software development costs

(4,276 ) (4,518 )

Capitalized curriculum development costs

(6,961 ) (6,372 )

Purchase of AEC, net of cash acquired of \$3,841

(24,542 )

Cash advanced for AEC performance escrow		
(6,825 )		
Cash paid for investment in Web		
(10,000 )		
Cash paid for other investment		
(2,040 )		
<b>Net cash used in investing activities</b>		
(63,665 )	(11,486 )	
<b>Cash flows from financing activities</b>		
Repayments on capital lease obligations		
(7,303 )	(6,245 )	
Repayments on notes payable		
(930 )	(692 )	
Borrowings from line of credit		
15,000		
Proceeds from exercise of stock options		
2,911	4,928	
Proceeds from exercise of stock warrants		
50		
Excess tax benefit from stock-based compensation		
1,308	2,194	
Repurchase of restricted stock for income tax withholding		
(1,020 )		
<b>Net cash provided by financing activities</b>		
9,966	235	
<b>Effect of foreign exchange rate changes on cash and cash equivalents</b>		
38		
<b>Net change in cash and cash equivalents</b>		
(46,594 )	(1,431 )	
<b>Cash and cash equivalents, beginning of period</b>		
81,751	49,461	
<b>Cash and cash equivalents, end of period</b>		
\$ 35,157	\$ 48,030	

See notes to unaudited condensed consolidated financial statements.

**K12 Inc.**

**Notes to Unaudited Condensed Consolidated Financial Statements**

**1. Description of the Business**

K12 Inc. and its subsidiaries (K12 or the Company) are technology-based education companies. The Company offers proprietary curriculum and educational services created for individualized learning for students in kindergarten through 12th grade, or K-12. The K12 proprietary curriculum is research-based and combines content with innovative technology to allow students with a wide spectrum of learning styles to receive an effective and engaging education regardless of geographic location or socio-economic background. This learning system combines a cognitive research-based curriculum with an individualized learning approach well-suited for virtual public schools, online school district-wide programs, public charter schools, hybrid programs and private schools that combine varying degrees of online and traditional classroom instruction, and other educational applications.

The Company delivers its learning system to students primarily through virtual public schools and is building an institutional business with sales directly to school districts. The Company offers its proprietary curriculum, learning kits, use of a personal computer, online learning platform and varying levels of academic and management services, which can range from targeted programs to complete turnkey solutions.

As of December 31, 2010, the Company served virtual public schools or hybrid schools in 27 states and the District of Columbia. The Company expanded into two new states in fiscal year 2011, Massachusetts and Michigan. In addition, the Company operates an online private school, the K12 International Academy, and also sells access to its on-line curriculum and learning kits directly to individual consumers.

In April 2010, the Company formed a joint venture with Middlebury College known as Middlebury Interactive Languages LLC (MIL) to develop online foreign language courses. This new venture will create online language programs for pre-college students and will leverage Middlebury's recognized experience in foreign language instruction and K12's expertise in online education. In July 2010, the Company acquired all of the stock of KC Distance Learning, Inc. (KCDL), a provider of online curriculum and public and private virtual education. On December 1, 2010, the Company acquired American Education Corporation (AEC), a leading provider of research-based core curriculum instructional software for kindergarten through adult learners. These acquisitions and the formation of MIL increase K12's portfolio of innovative, high quality instructional and curriculum offerings.

**2. Basis of Presentation**

The accompanying condensed consolidated balance sheet as of December 31, 2010, the condensed consolidated statements of operations for the three and six months ended December 31, 2010 and 2009, the condensed consolidated statements of cash flows for the six months ended December 31, 2010 and 2009, and the condensed consolidated statements of equity for the six months ended December 31, 2010 are unaudited. The unaudited interim financial statements have been prepared on the same basis as the annual financial statements and in the opinion of management, reflect all adjustments, which include only normal recurring adjustments, necessary to present fairly the Company's financial position as of December 31, 2010, the results of operations for the three and six months ended December 31, 2010 and 2009, cash flows for the six months ended December 31, 2010 and 2009 and the condensed consolidated statements of equity for the six months ended December 31, 2010. The results of the three and six month period ended December 31, 2010 are not necessarily indicative of the results to be expected for the year ending June 30, 2011 or for any other interim period or for any other future fiscal year. The consolidated balance sheet as of June 30, 2010 has been derived from the audited consolidated financial statements at that date.

The accompanying unaudited condensed consolidated financial statements of the Company have been prepared in accordance with accounting principles generally accepted in the United States of America ( GAAP ) for interim financial information and with the instructions to Form 10-Q and Rule 10-01 of Regulation S-X of the Securities Exchange Act of 1934, as amended ( Exchange Act ). Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements. In the opinion of management, these statements include all adjustments (consisting of normal recurring adjustments) considered necessary to present a fair statement of our consolidated results of operations, financial position and cash flows. Preparation of the Company s financial

**K12 Inc.**

**Notes to Unaudited Condensed Consolidated Financial Statements (Continued)**

statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts in the financial statements and footnotes. Actual results could differ from those estimates. This quarterly report on Form 10-Q should be read in conjunction with the financial statements and the notes thereto included in the Company's latest annual report on Form 10-K filed on September 13, 2010, which contains the Company's audited financial statements for the fiscal year ended June 30, 2010.

**3. Summary of Significant Accounting Policies**

***Revenue Recognition***

Revenues are principally earned from long-term contractual agreements to provide on-line curriculum, books, materials, computers and management services to public charter schools and school districts. In addition to providing the curriculum, books and materials, under most contracts, the Company is responsible to the virtual public schools for all aspects of school management, including monitoring academic achievement, teacher hiring and training, compensation of school personnel, financial management, enrollment processing and procurement of curriculum, equipment and required services. The schools generally receive funding on a per student basis from the state in which the public school or school district is located.

Where the Company has determined that it is the primary obligor for substantially all expenses under these contracts, it records the associated per student revenue received by the school from its state funding up to the expenses incurred in accordance with ASC 605 (formerly Emerging Issues Task Force (EITF) 99-19, *Reporting Revenue Gross as a Principal Versus Net as an Agent*). For contracts in which the Company is not the primary obligor, the Company records revenue based on its net fees earned per the contractual agreement.

The Company generates revenues under contracts with virtual public schools which include multiple elements. These elements include: providing each of a school's students with access to the Company's on-line school and the on-line component of lessons; learning kits which include books and materials designed to complement and supplement the on-line lessons; use of a personal computer and associated reclamation services; internet access and technology support services; instruction from a state-certified teacher and; all management and technology services required to operate a virtual public school.

The Company has determined that the elements of our contracts are valuable to schools in combination, but do not have standalone value. While we have sold some of these elements in various combinations or bundles to schools and school districts, the value of each element across these combinations is indeterminable and we have concluded that we do not have sufficient objective and reliable evidence of fair value for each element. As a result, the elements within our multiple-element contracts do not qualify for treatment as separate units of accounting. Accordingly, the Company accounts for revenues received under multiple element arrangements as a single unit of accounting and recognizes the entire arrangement based upon the approximate rate at which we incur the costs associated with each element. In certain schools where the Company has a direct relationship with the state funding school district, the Company recognizes the associated per student revenue on a pro-rata basis over the school year.

Under the contracts with the schools where the Company provides turnkey management services, the Company has generally agreed to absorb any operating losses of the schools in a given school year. These school operating losses represent the excess of costs over revenues incurred by the virtual public schools as reflected on their financial statements. The costs include Company charges to the schools. These school operating losses may reduce the

Company's ability to collect invoices in full. Accordingly, the Company's amount of recognized revenue reflects this reduction.

Other revenues are generated from individual customers who prepay and have access for 12 or 24 months to curriculum via the Company's online learning system. The Company recognizes these revenues pro rata over the maximum term of the customer contract, which is either 12 or 24 months. Revenues from associated learning kits are recognized upon shipment.

**K12 Inc.**

**Notes to Unaudited Condensed Consolidated Financial Statements (Continued)**

***Consolidation***

The condensed consolidated financial statements include the accounts of the Company, its wholly-owned and affiliated companies, either owned directly or indirectly, and all controlled subsidiaries. All significant intercompany transactions and balances have been eliminated in consolidation.

***Reclassifications***

Certain prior year amounts related to capitalized software development costs and other long term liabilities have been reclassified to conform to the current year presentation.

***Series A Special Stock***

Equity that is redeemable upon occurrence of an event outside the Company's control should be classified outside of permanent equity per ASC 480, *Distinguishing Liabilities from Equity*. The Series A Special Stock as described further in Note 11, is considered redeemable outside of the Company's control and classified separately outside of permanent equity. At a Special Meeting of Shareholders held on January 27, 2011, the right to convert the Series A Special Stock to Common Stock was approved by shareholders. As a consequence, the right of redemption is no longer effective and the shares will be classified within stockholders' equity in the consolidated balance sheet in subsequent financial statements.

***Goodwill and Intangibles***

We record as goodwill the excess of purchase price over the fair value of the identifiable net assets acquired. Finite-lived intangible assets acquired in business combinations subject to amortization are recorded at their fair value in accordance with ASU Topic 350. Finite-lived intangible assets include trade names, customer relationships and non-compete agreements. Such intangible assets are amortized on a straight-line basis over their estimated useful lives.

In accordance with ASC 360 *Accounting for the Impairment or Disposal of Long-Lived Assets*, the Company reviews its recorded finite-lived intangible assets for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be fully recoverable. If the total of the expected undiscounted future cash flows is less than the carrying amount of the asset, a loss is recognized for the difference between fair value and the carrying value of the asset.

ASC 350 *Goodwill and Other Intangible Assets*, prescribes a two-step process for impairment testing of goodwill and intangibles with indefinite lives, which is performed annually, as well as when an event triggering impairment may have occurred. The first step tests for impairment, while the second step, if necessary, measures the impairment. Goodwill and intangible assets deemed to have an indefinite life are tested for impairment on an annual basis, or earlier when events or changes in circumstances suggest the carrying amount may not be fully recoverable. The Company has elected to perform its annual assessment on May 31st.

***Fair Value Measurements***

The carrying values reflected in our consolidated balance sheets for cash and cash equivalents, receivables, and short and long term debt approximate their fair values.

The following table summarizes certain fair value information at June 30, 2010 for assets and liabilities measured at fair value on a recurring basis. The redeemable noncontrolling interest is a result of the Company's venture with Middlebury College to form a new entity, Middlebury Interactive Languages. Under the agreement, Middlebury College has an irrevocable election to sell all (but not less than all) of its Membership Interest to the

**K12 Inc.****Notes to Unaudited Condensed Consolidated Financial Statements (Continued)**

Company ( put right ) after May 1, 2015. The fair value of the redeemable noncontrolling interest reflects management's best estimate of the redemption value of the put right.

Description	Fair Value	Fair Value Measurements Using:		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Input (Level 2)	Significant Unobservable Inputs (Level 3)
Redeemable Noncontrolling Interest	\$ 17,374	\$	\$	\$ 17,374
Total	\$ 17,374	\$	\$	\$ 17,374

The following table summarizes certain fair value information at December 31, 2010 for assets and liabilities measured at fair value on a recurring basis.

Description	Fair Value	Fair Value Measurements Using:		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Input (Level 2)	Significant Unobservable Inputs (Level 3)
Redeemable Noncontrolling Interest	\$ 20,800	\$	\$	\$ 20,800
Total	\$ 20,800	\$	\$	\$ 20,800

The following table presents activity related to our fair value measurements categorized as Level 3 of the valuation hierarchy, valued on a recurring basis, for the six months ended December 31, 2010. There have been no transfers in or out of Level 3 of the hierarchy for the period presented.

**Six Months Ended December 31, 2010**  
**Purchases,**

	<b>Fair Value June 30, 2010</b>	<b>Issuances, and Settlements (In thousands)</b>	<b>Unrealized Gains/(Losses)</b>	<b>Fair Value December 31, 2010</b>
Redeemable Noncontrolling Interest	\$ 17,374	\$	\$ 3,246	\$ 20,800
Total	\$ 17,374	\$	\$ 3,246	\$ 20,800

The fair value of the redeemable noncontrolling interest as of December 31, 2010 was estimated to be \$20.8 million. The fair value was measured in accordance with ASC 480, *Distinguishing Liabilities from Equity*, and initial valuations were determined by a third party valuation firm and updated by management for the current period. In determining the fair value of the redeemable noncontrolling interest, the Company incorporated a number of assumptions and estimates including utilizing various valuation methodologies including an income-based approach.

***Net Income Per Common Share***

Basic earnings per share is computed by dividing net income available to common stockholders by the weighted average number of shares of common stock outstanding during the period. The weighted average number of shares of common stock outstanding includes vested restricted stock awards. Diluted earnings per share reflects the potential dilution that could occur assuming conversion or exercise of all dilutive unexercised stock options, unvested restricted stock awards and warrants. The dilutive effect of stock options, restricted stock awards, and warrants was determined using the treasury stock method. Under the treasury stock method, the proceeds received

**K12 Inc.**

**Notes to Unaudited Condensed Consolidated Financial Statements (Continued)**

from the exercise of stock options and restricted stock awards, the amount of compensation cost for future service not yet recognized by the Company, and the amount of tax benefits that would be recorded in additional paid-in capital when the stock options and restricted stock awards become deductible for income tax purposes are all assumed to be used to repurchase shares of the Company's common stock. Stock options and restricted stock awards are not included in the computation of diluted earnings per share when they are antidilutive. Common stock outstanding reflected in our condensed consolidated balance sheet includes restricted stock awards outstanding.

Securities that may participate in undistributed earnings with common stock are considered participating securities. Since the Series A Shares participate in all dividends and distributions declared or paid on or with respect to common stock of the Company (as if a holder of common stock), the Series A Shares meet the definition of participating security under ASC 260, *Participating Securities and the Two-Class Method under FASB Statement No. 128*. All securities that meet the definition of a participating security, regardless of whether the securities are convertible, non-convertible, or potential common stock securities, are included in the computation of both basic and diluted EPS (as a reduction of the numerator) using the two-class method. Under the two-class method all undistributed earnings in a period are to be allocated to common stock and participating securities to the extent that each security may share in earnings as if all of the earnings for the period had been distributed.

**K12 Inc.****Notes to Unaudited Condensed Consolidated Financial Statements (Continued)**

The following schedule presents the calculation of basic and diluted net income per share:

	<b>Three Months Ended December 31,</b>		<b>Six Months Ended December 31,</b>	
	<b>2010</b>	<b>2009</b>	<b>2010</b>	<b>2009</b>
	<b>(In thousands, except share and per share data)</b>		<b>(In thousands, except share and per share data)</b>	
<b>Basic earnings per share computation:</b>				
Net income	\$ 7,839	\$ 9,638	\$ 10,037	\$ 16,721
Amount allocated to participating Series A stockholders	647		784	
Income available to common stockholders basic	\$ 7,192	\$ 9,638	\$ 9,253	\$ 16,721
Weighted average common shares basic historical	30,565,683	29,648,674	30,454,724	29,512,635
Basic net income per share	\$ 0.24	\$ 0.33	\$ 0.30	\$ 0.57
<b>Diluted earnings per share computation:</b>				
Net income	\$ 7,839	\$ 9,638	\$ 10,037	\$ 16,721
Amount allocated to participating Series A stockholders	647		784	
Income available to common stockholders diluted	\$ 7,192	\$ 9,638	\$ 9,253	\$ 16,721
<b>Shares computation:</b>				
Weighted average common shares basic historical	30,565,683	29,648,674	30,454,724	29,512,635
Effect of dilutive stock options and restricted stock awards	562,603	325,968	640,116	363,331
Weighted average common shares diluted	31,128,286	29,974,642	31,094,840	29,875,966
Diluted net income per share	\$ 0.23	\$ 0.32	\$ 0.30	\$ 0.56

***Recent Accounting Pronouncements***

In June 2009, the FASB issued an amendment to ASC 810, *Consolidation*, which modifies how a company determines when an entity that is insufficiently capitalized or is not controlled through voting (or similar rights) should be consolidated. ASC 810 clarifies that the determination of whether a company is required to consolidate an entity is based on, among other things, an entity's purpose and design and a company's ability to direct the activities of the entity that most significantly impact the entity's economic performance. ASC 810 requires an ongoing reassessment of whether a company is the primary beneficiary of a variable interest entity. ASC 810 also requires additional disclosures about a company's involvement in variable interest entities and any significant changes in risk exposure due to that involvement. ASC 810 is effective for fiscal years beginning after November 15, 2009 and is effective for the Company on July 1, 2010. The adoption of the policy did not have a material impact on our condensed consolidated financial statements.

In October 2009, the FASB issued ASU 2009-13, *Multiple-Deliverable Revenue Arrangements, a consensus of the FASB Emerging Issues Task Force*. Under the new guidance, when vendor specific objective evidence or third party evidence for deliverables in an arrangement cannot be determined, a best estimate of the selling price is required to separate deliverables and allocate arrangement consideration and the use of the relative selling price

**K12 Inc.**

**Notes to Unaudited Condensed Consolidated Financial Statements (Continued)**

method is required. The new guidance eliminated the residual method of allocating arrangement consideration to deliverables and includes new disclosure requirements on how the application of the relative selling price method affects the timing and amount of revenue recognition. ASU 2009-13 is effective for revenue arrangements entered into or materially modified in fiscal years beginning after June 15, 2010. ASU 2009-13 is effective for the Company on July 1, 2010. The adoption did not have a material impact on our condensed consolidated financial statements.

In January 2010, the FASB issued ASU 2010-06, *Fair Value Measurements and Disclosures*, which requires new disclosures for transfers in and out of Level 1 and Level 2 and activity in Level 3 of the fair value hierarchy. ASU 2010-06 requires separate disclosure of the amounts of significant transfers in and out of Level 1 and Level 2 fair value measurements and a description of the reasons for the transfers. In the reconciliation for fair value measurements using Level 3 inputs, a reporting entity should present separately information about purchases, sales, issuances and settlements. ASU 2010-06 is effective for new disclosures and clarification of existing disclosures for interim and annual periods beginning after December 15, 2009 except for disclosures about purchases, sales, issuances and settlements in the Level 3 activity rollforward. The provisions of ASU 2010-06 related to new disclosures and clarification of existing disclosures was adopted by the Company beginning January 1, 2010. As ASU 2010-06 relates only to disclosure, the adoption of these provisions did not have a material impact on its financial condition, results of operations, and disclosures. The provisions of ASU 2010-06 related to Level 3 rollforward activity are effective for fiscal years beginning after December 31, 2010 and will be effective for the Company on July 1, 2011. The Company is currently evaluating the impact that the adoption of ASU 2010-06 will have on our financial condition, results of operations, and disclosures.

**4. Income taxes**

The provision for income taxes is based on earnings reported in the condensed consolidated financial statements. A deferred income tax asset or liability is determined by applying currently enacted tax laws and rates to the expected reversal of the cumulative temporary differences between the carrying value of assets and liabilities for financial statement and income tax purposes. Deferred income tax expense is measured by the change in the deferred income tax asset or liability during the year.

**5. Long-term Obligations**

***Capital Leases***

As of December 31 and June 30, 2010, computer equipment and software under capital leases are recorded at a cost of \$44.3 million and \$38.8 million, respectively and accumulated depreciation of \$21.6 million and \$22.9 million, respectively. The Company's equipment lease line of credit with Hewlett-Packard Financial Services Company ( HPFSC ) expired on August 31, 2010. Prior borrowings under the HPFSC equipment lease line had interest rates ranging from 4.96% to 7.7% and included a 36-month payment term with a \$1 purchase option at the end of the term. The Company had pledged the assets financed with the HPFSC equipment lease line to secure the amounts outstanding. The Company entered into a guaranty agreement with HPFSC to guarantee the obligations under this equipment lease and financing agreement.

The Company has an equipment lease line of credit with PNC Equipment Finance, LLC effective August 2010 for new purchases. Availability for additional purchases terminates on March 31, 2011. We expect to renew this line of credit, obtain additional financing from other providers or use cash on hand for future purchases. The interest rate on

new advances under the PNC equipment lease line is set at the time the funds are advanced based upon interest rates in the Federal Reserve Statistical Release H.15. Borrowings under the equipment lease line had interest rates of 3.0% and include a 36-month payment term with a \$1 purchase option at the end of the term.

**K12 Inc.****Notes to Unaudited Condensed Consolidated Financial Statements (Continued)****Notes Payable**

The Company has purchased computer software licenses and maintenance services through notes payable arrangements with various vendors at interest rates ranging up to 6.1% and payment terms of three years. The balance of notes payable at December 31, and June 30, 2010 was \$1.0 million and \$1.9 million, respectively.

The following is a summary as of December 31, 2010 of the present value of the net minimum payments on capital leases and notes payable under the Company's commitments:

<b>As of December 31, 2010</b>	<b>Capital Leases</b>	<b>Notes Payable</b>	<b>Total</b>
2011	\$ 14,512	\$ 1,004	\$ 15,516
2012	8,564		8,564
2013	3,486		3,486
Thereafter			
Total minimum payments	26,562	1,004	27,566
Less amount representing interest (imputed average capital lease interest rate of 5.0%)	(1,081)	(30)	(1,111)
Net minimum payments	25,481	974	26,455
Less current portion	(13,736)	(974)	(14,710)
Present value of minimum payments, less current portion	\$ 11,745	\$	\$ 11,745

**6. Line of Credit**

The Company has a \$35 million line of credit with PNC Bank that expires in December 2012. As of December 31, 2010 and June 30, 2010, there was \$15 million and zero outstanding on the line of credit, respectively. As of December 31, 2010, borrowings on the line of credit had an interest rate of 1.8%.

**7. Stock Option Plan****Stock Options**

Stock option activity during the six months ended December 31, 2010 was as follows:

<b>Weighted- Average Exercise</b>	<b>Weighted- Average Remaining Contractual</b>	<b>Aggregate Intrinsic</b>
---	--	--------------------------------

	<b>Shares</b>	<b>Price</b>	<b>Life (Years)</b>	<b>Value</b>
Outstanding, June 30, 2010	3,913,847	\$ 16.81		
Granted	44,000	26.23		
Exercised	(308,286)	9.47		
Forfeited or canceled	(93,794)	21.69		
Outstanding, December 31, 2010	3,555,767	\$ 17.44	4.73	\$ 40,482
Stock options exercisable at December 31, 2010	1,976,236	\$ 14.13	4.22	\$ 28,713

The total intrinsic value of options exercised during the six months ended December 31, 2010 was \$5.1 million or \$16.65 per share.

**K12 Inc.****Notes to Unaudited Condensed Consolidated Financial Statements (Continued)**

The following table summarizes the option grant activity for the six months ended December 31, 2010. There were no new grants during the second quarter.

<b>Grant Date</b>	<b>Options Granted</b>	<b>Weighted-Average Exercise Price</b>	<b>Weighted Average Grant-Date Fair Value</b>	<b>Intrinsic Value</b>
September 2010	44,000	\$ 26.23	\$ 11.16	\$
	44,000			

As of December 31, 2010, there was \$6.4 million of total unrecognized compensation expense related to unvested stock options granted. The cost is expected to be recognized over a weighted average period of 2.65 years. During the six months ended December 31, 2010 and December 31, 2009, the Company recognized \$2.6 million and \$3.1 million, respectively of stock based compensation expense related to stock options.

***Restricted Stock Awards***

Restricted stock award activity during the six months ended December 31, 2010 was as follows:

	<b>Shares</b>	<b>Weighted- Average Fair Value</b>
Nonvested, June 30, 2010	187,850	\$ 18.46
Granted	426,863	24.86
Vested	(98,252)	22.64
Forfeited or canceled	(18,416)	22.05
Nonvested, December 31, 2010	498,045	\$ 22.99

As of December 31, 2010, there was \$8.6 million of total unrecognized compensation expense related to unvested restricted stock awards granted. The cost is expected to be recognized over a weighted average period of 2.79 years. The total fair value of shares vested during the six months ended December 31, 2010 was \$2.2 million. During the six months ended December 31, 2010 and December 31, 2009, the Company recognized \$2.8 million and \$0.4 million, respectively of stock based compensation expense related to restricted stock awards.

**8. Related Party**

In the second quarter, the Company purchased services and assets in the amount \$0.4 million from Knowledge Universe Technologies (KUT). KUT is an affiliate of the Learning Group, LLC a related party. Additionally, KC Distance Learning has capital leases with an outstanding balance due to KCDL Holdings Inc. in the amount of \$0.9 million as of December 31, 2010.

## **9. Commitments and Contingencies**

### ***Litigation***

In the ordinary conduct of business, the Company is subject to lawsuits, arbitrations and administrative proceedings from time to time. The Company expenses legal costs as incurred.

### ***Aventa Learning***

In June 2010, the shareholders of Aventa Learning, Inc. (Aventa) filed a lawsuit against KC Distance Learning, Inc. which is currently pending in the U.S. District Court for the Western District of Washington, *Axtman et al. v. KC Distance Learning, Inc.* (Case No. 2:10-cv-01022-JLR). The lawsuit alleges, among other things, that KCDL did not honor the terms of an earn-out provision contained in an asset purchase agreement after certain assets of Aventa

**K12 Inc.**

**Notes to Unaudited Condensed Consolidated Financial Statements (Continued)**

were acquired by KCDL in 2007. In addition, the plaintiffs allege breach of contract and misrepresentation claims, and seek the remedy of rescission for alleged violation of the Securities Act of Washington. On July 23, 2010, the Company acquired all of the shares of KCDL, which is now a wholly-owned subsidiary. On August 31, 2010, the plaintiffs amended their complaint to add K12 Inc. as a co-defendant in this matter, reflecting the change in ownership. On October 4, 2010, defendants filed a motion to dismiss plaintiff's amended complaint. Pursuant to the Agreement and Plan of Merger between K12 Inc. and KCDL Holdings LLC (Seller), Seller agreed to assume responsibility to defend this lawsuit and to fully indemnify K12 Inc. for any liability, including rescission. In addition, K12 Inc. obtained a guarantee from Seller's parent company, Learning Group LLC, from any losses related to this litigation. In our view, the outcome of this litigation will not have a material adverse effect on the financial condition or results of operations of K12 Inc. or any of our subsidiaries.

**10. Goodwill**

During the six months ended December 31, 2010, the Company's goodwill increased by approximately \$51.7 million due primarily to the acquisitions of KC Distance Learning, Inc. and American Education Corporation (see Note 11). The Company did not experience a significant adverse change in its business climate and therefore does not believe a triggering event occurred that would require a detailed test of goodwill for impairment as of an interim date. Consequently, the first step of the goodwill impairment test will not be performed during the second quarter of 2011. The Company will complete its annual goodwill impairment test as of May 31, 2011.

**11. Business combination**

***KC Distance Learning, Inc.***

On July 23, 2010, the Company acquired all of the stock of KCDL, a provider of online curriculum and public and private virtual education, by issuing to its parent company, KCDL Holdings LLC, 2,750,000 shares of a new class of stock designated as Series A Special Stock, which had a value at closing of \$63.1 million. KCDL Holdings, Inc. is an affiliate of the Learning Group, LLC, a related party. The holders of the Series A Special Stock initially had no voting rights and no rights of conversion with respect to those shares; however, the holders had and continue to have participating rights in all dividends and distributions declared or paid on or with respects to common stock of the Company.

On December 23, 2010, the Company filed a definitive proxy statement with the Securities and Exchange Commission (SEC) for the stockholder vote. On January 27, 2011, the Company held a Special Meeting at which the stockholders approved conversion and voting rights for the holders of the Series A Special Stock. The holders of the Series A Special Stock now have the right to convert those shares into common stock on a one-for-one basis and for the right to vote on all matters presented to K12 shareholders, other than for the election and removal of directors, for which holders of the Series A Special Stock shall have no voting rights. The redemption right of the holders of the Series A Special Stock terminated upon shareholder approval of their conversion and voting rights.

The KCDL businesses include: Aventa Learning (online curriculum and instruction), the iQ Academies (statewide virtual public charter schools for middle and high school); and The Keystone School (international online private school). K12 believes the acquisition of KCDL to be an important strategic step in the Company's efforts to expand its presence in a number of end markets. The operating results of KCDL have been included in the Company's condensed consolidated financial statements commencing as of the acquisition date of July 23, 2010. The acquisition of KCDL

has been accounted for under the acquisition method of accounting which requires the total purchase price to be allocated to the assets acquired and liabilities assumed based on their estimated fair values. The fair values assigned to the assets acquired and liabilities assumed are based on valuations using management's best estimates and assumptions. The allocation of the estimated consideration to the identifiable tangible and

**K12 Inc.****Notes to Unaudited Condensed Consolidated Financial Statements (Continued)**

intangible assets and liabilities assumed under the purchase method of accounting, is preliminary and based on their estimated fair values as of the acquisition date and summarized in the following table (in thousands):

	<b>Amount</b>
<b>As of July 23, 2010:</b>	
Current assets	\$ 8,538
Property and equipment, net	8,654
Capitalized curriculum development costs, net	3,873
Intangible assets, net	21,900
Goodwill	35,106
Other noncurrent assets	138
Current liabilities	(5,461)
Deferred tax liability	(6,275)
Deferred revenue	(2,111)
Other noncurrent liabilities	(1,250)
Fair value of total consideration transferred	\$ 63,112

The intangible assets of KCDL have been increased \$21.1 million to a total value of \$21.9 million to reflect the preliminary estimate of the fair value of intangible assets, including trade name/trademarks and customer relationships.

The capitalized curriculum development costs have decreased \$0.6 million to a value of \$3.9 million.

KCDL defers and expenses material costs over the period which revenue is recognized. K12 expenses material cost when materials are shipped. KCDL's deferred material costs as of July 23, 2010 were reduced \$0.3 million to a value of \$0.

Deferred revenue represents advance payments from customers for education services. The fair value was estimated based on a cost build-up approach. The cost build-up approach determines fair value by estimating the costs related to supporting the obligation plus an assumed profit which approximates, in theory, the amount that would be required to pay a third party to assume the obligation. As a result, the deferred revenues of KCDL have been decreased from \$4.2 million to \$2.1 million, which represents the estimated fair value of the contractual obligations assumed.

The following unaudited pro forma combined results of operations give effect to the acquisition of KCDL as if it had occurred at the beginning of the periods presented. The unaudited pro forma combined results of operations are provided for informational purposes only and do not purport to represent K12's actual consolidated results of operations had the acquisition occurred on the dates assumed, nor are these financial statements necessarily indicative of K12's future consolidated results of operations. K12 expects to incur costs and realize benefits associated with integrating the operations of K12 and KCDL. The unaudited pro forma combined results of operations do not reflect the costs of any integration activities or any benefits that may result from operating efficiencies or revenue synergies.

<b>Pro Forma Results of Operations</b>	<b>Three Months Ended December 31,</b>		<b>Six Months Ended December 31,</b>	
	<b>2010</b>	<b>2009</b>	<b>2010</b>	<b>2009</b>
Revenues	\$ 129,002	\$ 105,692	\$ 265,195	\$ 220,212
Net Income (Loss)	\$ 7,838	\$ 11,965	\$ 8,407	\$ 17,224

**K12 Inc.**

**Notes to Unaudited Condensed Consolidated Financial Statements (Continued)**

*American Education Corporation*

On December 1, 2010, the Company acquired American Education Corporation (AEC), a leading provider of research-based core curriculum instructional software for kindergarten through adult learners, headquartered in Oklahoma City, OK, for a total cash purchase price of \$35.2 million, including certain amounts held in escrow. The escrow amounts include \$6.8 million for the achievement of specified financial targets for quarter-ended December 31, 2010. As of the current date, the Company does not expect any of this contingent consideration to be distributed to the selling AEC shareholders. Consequently, this escrow amount is recorded in other current assets. In connection with the acquisition, the Company recorded net Working Capital accounts of \$2.9 million, net long term assets of \$8.3 million, goodwill of approximately \$15.8 million, intangible assets of approximately \$4.5 million, and other long term liabilities and taxes payable of \$3.1 million. The acquisition of AEC has been included in the Company's results since the acquisition date of December 1, 2010. The allocation of the estimated consideration to the identifiable tangible and intangible assets and liabilities assumed under the purchase method of accounting is preliminary and based on their estimated fair values as of the acquisition date.

An additional amount of approximately \$6.8 million is held in escrow and, if specified claims against AEC arise for which the Company is indemnified, such amounts may be used to satisfy those claims but not to exceed it. K12 is not entitled to any claims against the indemnification escrow amount unless and until the aggregate claim amount exceeds \$250,000, at which time K12 is only entitled to reimbursement for any claims exceeding the \$250,000 up to a maximum of \$6.8 million. Any amounts remaining in escrow after the satisfaction of any such claims are to be paid to the selling AEC shareholders in two fifty percent installments of the remaining balance of the \$6.8 million in the indemnification escrow, at 6 and 12 months after closing. At closing, the Company recognized a liability of \$1 million relating to potential claims offset by a receivable from the escrow account of \$750,000.

**K12 Inc.****Notes to Unaudited Condensed Consolidated Financial Statements (Continued)****12. Supplemental Disclosure of Cash Flow Information**

	<b>Six Months Ended December 31,</b>	
	<b>2010</b>	<b>2009</b>
Cash paid for interest	\$ 517	\$ 665
Cash paid for taxes, net of refunds	\$ 3,631	\$ 589
Supplemental disclosure of non-cash investing and financing activities:		
New capital lease obligations	\$ 12,897	\$ 10,244
Business Combinations:		
Current assets	\$ 17,317	\$
Property and equipment	\$ 4,981	\$
Capitalized curriculum development costs	\$ 8,073	\$
Capitalized software development costs	\$ 7,898	\$
Intangible assets	\$ 27,310	\$
Goodwill	\$ 51,678	\$
Other non-current assets	\$ 138	\$
Deferred tax liabilities	\$ (8,768)	\$
Assumed liabilities	\$ (9,829)	\$
Deferred revenue	\$ (3,671)	\$
Other noncurrent liabilities	\$ (1,931)	\$
Contingent consideration	\$ 1,700	\$
Issuance of Series A Special Stock	\$ 63,112	\$
Purchase of perpetual license agreement/accrued liabilities	\$ 1,250	\$

**13. Subsequent events**

On January 3, 2011, K12 invested \$10 million in Web International Education Group, Ltd. (Web). This strategic investment gives the Company a 20% minority interest in Web, with the option to acquire the remainder of Web within a period of five years. Web is a leader in English language training for learners of all ages throughout China, including university students, government workers, and employees of international companies. Web has a network of 72 learning centers in 47 cities. It currently serves more than 35,000 students. The proceeds of the investment will primarily be used to expand Web's learning center network into more Chinese cities. As of December 31, 2010, the \$10 million cash investment was in transit and recorded in long-term other assets.

On January 13, 2011, K12 announced a partnership with the George Washington University to launch an online private high school, the George Washington University Online High School (GWUOHS). The private school will serve students in the U.S. and in countries around the world. The program offers K12's college preparatory curriculum and is designed for high school students who are seeking a challenging academic experience and aspire to attend top colleges and universities.

On January 27, 2011, shareholders approved the right of the holders of the Series A Special Stock to convert those shares into common stock on a one-for-one basis and for the right to vote on all matters presented to K12 shareholders, other than for the election and removal of directors, for which holders of the Series A Special Stock shall have no voting rights unless converted to common. In addition, the right of redemption is no longer effective.

**Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations.**

Certain statements in Management's Discussion and Analysis (MD&A), other than purely historical information, including estimates, projections, statements relating to our business plans, objectives, and expected operating results, and the assumptions upon which those statements are based, are forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995, Section 27A of the Securities Act of 1933, as amended (the Securities Act), and Section 21E of the Securities Exchange Act of 1934, as amended (the Exchange Act). These forward-looking statements generally are identified by the words believe, project, expect, anticipate, estimate, intend, strategy, plan, may, should, will, would, will be, will continue, will likely result, and similar expressions. Historical results may not indicate future performance. Our forward-looking statements reflect our current views about future events, are based on assumptions and are subject to known and unknown risks and uncertainties that could cause actual results to differ materially from those contemplated by these statements. Factors that may cause differences between actual results and those contemplated by forward-looking statements include, but are not limited to, those discussed in Risk Factors in Part I, Item 1A, of our Annual Report on Form 10-K (Annual Report), including any updates found in Part II, Item 1A, Risk Factors, of this quarterly report. We undertake no obligation to publicly update or revise any forward-looking statements, including any changes that might result from any facts, events, or circumstances after the date hereof that may bear upon forward-looking statements. Furthermore, we cannot guarantee future results, events, levels of activity, performance, or achievements.

This MD&A is intended to assist in understanding and assessing the trends and significant changes in our results of operations and financial condition. As used in this MD&A, the words, we, our and us refer to K12 Inc. and its consolidated subsidiaries. This MD&A should be read in conjunction with our condensed consolidated financial statements and related notes included in this report, as well as the consolidated financial statements and MD&A of our Annual Report. The following overview provides a summary of the sections included in our MD&A:

*Executive Summary* a general description of our business and key highlights of the current period.

*Critical Accounting Policies and Estimates* a discussion of critical accounting policies requiring critical judgments and estimates.

*Results of Operations* an analysis of our results of operations in our consolidated financial statements.

*Liquidity and Capital Resources* an analysis of cash flows, sources and uses of cash, commitments and contingencies, seasonality in the results of our operations, the impact of inflation, and quantitative and qualitative disclosures about market risk.

**Executive Summary**

We are a technology-based education company. We offer proprietary curriculum and educational services designed to facilitate individualized learning for students in kindergarten through 12th grade, or K-12. Our mission is to maximize a child's potential by providing access to an engaging and effective education, regardless of geographic location or socio-economic background. Since our inception, we have invested more than \$200 million to develop curriculum and an online learning platform that promotes mastery of core concepts and skills for students of all abilities. This learning system combines a cognitive research-based curriculum with an individualized learning approach well-suited for virtual public schools, online school district-wide programs, public charter schools, hybrid programs and private schools that combine varying degrees of online and traditional classroom instruction, and other educational applications.

We deliver our learning system to students primarily through virtual public schools and are building an institutional business with sales directly to school districts. Many states have embraced virtual public schools as a means to provide families with a publicly funded alternative to a traditional classroom-based education. We offer virtual schools our proprietary curriculum, online learning platform and varying levels of academic and management services, which can range from targeted programs to complete turnkey solutions. Additionally, without the requirement of a physical classroom, virtual schools can be scaled quickly to accommodate a large dispersed student population, and allow more capital resources to be allocated towards teaching, curriculum and technology rather than towards a physical infrastructure.

For the 2010-11 school year, we manage virtual public schools or hybrid schools in 27 states and the District of Columbia, including new schools in two new states, Massachusetts and Michigan. For the most part, these schools are able to enroll students on a statewide basis. Most of these enrollments are in virtual public schools. We are serving a growing number of hybrid schools the first of which opened in Chicago in 2006. A hybrid school is a virtual public school that combines the benefits of one or two days a week of face-to-face time for students and teachers in a traditional classroom setting along with the flexibility and individualized learning advantages of online instruction. In July 2010, we extended our involvement with traditional classroom settings to the full operational management of a brick and mortar school. Specifically, the Delaware Department of Education contracted with us to assume responsibility for all aspects of the operation of the Moyer Charter School, and authorized us to serve up to 460 students in grades 6-12. This contract furthers the use of our learning systems and instructional methods in a traditional classroom setting.

For the three months ended December 31, 2010, we served 98,296 total average enrollments, including the recently acquired Aventa, iQ, and Keystone programs, as compared to 68,519 for the same period in the prior year, a growth rate of 43.5%. For the three months ended December 31, 2010, excluding the newly acquired programs, total average enrollments in K12 programs increased to 83,318, as compared to 68,519 for the same period in the prior year, a growth rate of 21.6%. These enrollments include public and private school enrollments as well as those in the K12 International Academy. Enrollments from the Aventa, iQ, and Keystone for the three months ended December 31, 2010 were 14,978 and contributed 21.9% to enrollment growth. Enrollments exclude students in our direct-to-consumer and pilot programs and enrollments acquired with AEC.

We executed on our acquisition strategy this fiscal year and acquired KC Distance Learning and American Education Corporation and invested in Web International. With these additions, along with the recent formation of Middlebury Interactive Languages, we believe we have improved our growth potential and the ability to scale our business even further.

For the three months ended December 31, 2010, we increased revenues to \$129.0 million from \$93.3 million in the same period in the prior year, a growth rate of 38.4%. Over the same period, operating income declined to \$14.2 million from operating income of \$14.3 million, a decrease of 0.7%, and net income to shareholders declined to \$7.8 million from net income to shareholders of \$9.6 million, a decrease of 18.7%. The decline in operating income and net income was primarily attributable to: several new growth initiatives; increased depreciation and amortization including the impact of new curriculum releases, systems enhancements and the effects of purchase accounting; merger integration, financial systems and process improvement costs; and M&A transaction expenses.

#### *Middlebury Interactive languages*

In April 2010, we formed a joint venture with Middlebury College known as Middlebury Interactive Languages LLC (MIL) to develop online foreign language courses. This new venture will create innovative, online language programs for pre-college students and will leverage Middlebury's recognized experience in foreign language instruction and K12's expertise in online education. Language faculty from Middlebury will work with K12 to develop and manage the academic content of the Web-based language courses, which K12 will offer through its online education programs. The new courses will use features such as animation, music, videos and other elements that immerse students in new languages. The joint venture will also expand the Middlebury-Monterey Language Academy (MMLA), a language immersion summer program for middle and high school students. Our results for the six months ending December 31, 2010 include the summer 2010 four week residential session that offered Arabic, Chinese, French, German and Spanish at four college campuses. MMLA intends to expand to eight campuses for summer 2011.

#### *Acquisition of KC Distance Learning*

On July 23, 2010, we acquired all of the stock of KCDL, a provider of online curriculum and public and private virtual education, by issuing to its parent company, KCDL Holdings LLC, 2,750,000 shares of a new class of stock designated as Series A Special Stock, which had a value at closing of \$63.1 million. KCDL Holdings, Inc. is an affiliate of the Learning Group, LLC, a related party. The holders of the Series A Special Stock initially had no

voting rights and no rights of conversion with respect to those shares; however, the holders had and still have participating rights in all dividends and distributions declared or paid on or with respects to our common stock.

On December 23, 2010, we filed a definitive proxy statement with the Securities and Exchange Commission (SEC) for the stockholder vote. On January 27, 2011, we held a Special Meeting at which the stockholders approved conversion and voting rights for the holders of the Series A Special Stock. The holders of the Series A Special Stock now have the right to convert those shares into common stock on a one-for-one basis and for the right to vote on all matters presented to K12 shareholders, other than for the election and removal of directors, for which the holders shall have no voting rights unless converted to common.

The KCDL businesses include: Aventa Learning (online curriculum and instruction), the iQ Academies (statewide virtual public charter schools for middle and high school); and The Keystone School (international online private school). Aventa Learning offers to schools and school districts over 140 core, elective and AP courses in grades 6-12, from credit recovery courses to full-scale virtual school programs, as well as instructional services. Aventa Learning is accredited by the Northwest Association of Accredited Schools (NAAS). The Keystone School is an online private school for middle and high school students, which is also accredited by the NAAS. It was established in 1974 and has served over 250,000 students from 84 countries. The school enrolls both full-time and part-time students and its course offerings are supported by certified teachers. The iQ Academies are statewide online public schools that partner with school districts or public charter schools to serve middle and high school students. iQ Academies currently operate in California, Kansas, Minnesota, Nevada, Texas, Washington, and Wisconsin.

#### *Acquisition of American Education Corporation*

On December 1, 2010, we acquired the operating assets and liabilities of American Education Corporation (AEC), a leading provider of research-based core curriculum instructional software for kindergarten through adult learners, headquartered in Oklahoma City, OK, for a total cash purchase price of \$35.2 million, subject to certain adjustments. The acquisition increases our portfolio of innovative, high quality instructional and curriculum offerings to school districts all over the country. The purchase price includes \$6.8 million held in escrow that selling AEC shareholders may receive based upon achievement of specified financial targets for the three months ended December 31, 2010. As of the current date, we do not expect any of this contingent consideration will be distributed to the selling AEC shareholders.

#### *Web International*

On January 3, 2011, we invested \$10 million in cash in Web International Education Group Ltd. ( Web ). This strategic investment gives us a 20% minority interest in Web, with the option to acquire the remainder of the company within a period of five years. Web is a leader in English language training for learners of all ages throughout China, including university students, government workers, and employees of international companies. Web has a network of 72 learning centers in 47 cities. It currently serves more than 35,000 students. The proceeds of the investment will primarily be used to expand Web s learning center network into more Chinese cities.

#### *The George Washington University Online High School*

On January 13, 2011, K12 announced a partnership with the George Washington University to launch an online private high school, the George Washington University Online High School (GWUOHS). The private school will serve students in the U.S. and in countries around the world. The program offers K12 s college preparatory curriculum and is designed for high school students who are seeking a challenging academic experience and aspire to attend top colleges and universities.

*Developments in Education Funding*

Our annual revenue growth is impacted by changes in federal, state and district per enrollment funding levels. Due to the budgetary problems arising from the economic recession, many states reduced per enrollment funding for public education affecting many of the virtual public schools we serve. While the American Recovery and

Reinvestment Act of 2009 (ARRA) has provided additional funds to states, it has not fully offset the state funding reductions. Thus, the net impact to funding was negative and had a negative effect on both revenue and income for our fiscal years 2009 and 2010. Our financial results reflect these reductions, ARRA funds, and expense reductions that we undertook in order to mitigate the impact of the funding reductions. In August 2010, the Education Jobs and Medicaid Assistance Act was enacted into law, providing \$10 billion in federal aid for schools. This assistance will reach some of the schools we serve, although we cannot be certain of the aggregate impact. At this time, many states still have budget issues. The specific level of federal, state and district funding for the coming years is not yet known, and taken as a whole, it is possible the public schools we serve could experience lower per enrollment funding in the future.

### **Strategic Marketing and Student Recruiting Initiatives**

We continue to pursue opportunities to open virtual public schools, hybrid schools, and classroom-based programs in additional states and are marketing our post-secondary curriculum offering under Capital Education. Our follow-on marketing and student recruiting spending plans to support the success of these business development efforts are based upon historical trends. If we are more successful than anticipated, we will invest incrementally in marketing and student recruiting to support future revenue growth. The nature and timing of these events may result in higher fourth fiscal quarter marketing expenses with the corresponding increase in revenue occurring in future periods.

### **Critical Accounting Policies and Estimates**

The preparation of financial statements in conformity with GAAP requires us to make estimates and assumptions about future events that affect the amounts reported in our consolidated financial statements and accompanying notes. Future events and their effects cannot be determined with certainty. Therefore, the determination of estimates requires the exercise of judgment. Actual results could differ from those estimates, and any such differences may be material to our consolidated financial statements. Critical accounting policies are disclosed in our fiscal year 2010 audited consolidated financial statements, which are included in our Annual Report. Other than those described in the condensed consolidated financial statements, there have been no significant updates to our critical accounting policies disclosed in our Annual Report.

### **Results of Operations**

#### *Enrollment*

Due to growth in our private school and institutional sales business, including the increasing number of students who enroll part-time or take a single course in these programs, we are including additional enrollment information for fiscal year 2011. We believe this information, combined with the existing virtual public school enrollment data, provides a more complete picture of the drivers of revenue.

Total average enrollments in public schools for the three months ended December 31, 2010, the metric previously reported, increased to 81,083, or 20.4%, as compared to 67,354 for the same period in the prior year. High school students comprised 25.9% of public school enrollment as compared to 21.6% in the same period in the prior year. New schools in Delaware, Massachusetts and Michigan contributed 1.2% to total average enrollment in public schools. With the acquisition of KCDL, we added 14,978 enrollments to the total.

Enrollment growth in K12 managed virtual public schools was 20.0%. Enrollment growth in online curriculum sales to public schools, school districts and other schools (institutional sales) was 22.5%. These enrollments exclude students in our direct-to-consumer and pilot programs.

Enrollments in K12 private schools for the three months ended December 31, 2010 increased 91.9% to 2,235 from 1,165 for the same period in the prior year. Private schools include the K12 International Academy as well as private brick and mortar schools. These private schools offer educational services on a full and part-time basis. For better comparability, enrollments reported are converted to full-time equivalents (FTEs).

For the three months ended December 31, 2010, enrollments in the Aventa, iQ, and Keystone School brands obtained through our acquisition of KC Distance Learning were 5,830, 3,128, and 6,020, respectively. These

programs serve students in grades 6-12 on a full and part-time basis. For better comparability, enrollments reported are converted to full-time equivalents (FTEs).

The following tables set forth average enrollment data for each of the periods indicated:

**Total Average Enrollment (FTEs)**

	Three Months Ending December 31,				Six Months Ending December 31,			
	2010	2009	Change	Change %	2010	2009	Change	Change %
<b>Total Average Enrollment</b>								
K12 public schools	81,083	67,354	13,729	20.4%	81,480	67,901	13,579	20.0%
K12 private schools	2,235	1,165	1,070	91.9%	2,246	1,012	1,234	122.0%
<b>K12 total</b>	83,318	68,519	14,799	21.6%	83,726	68,913	14,813	21.5%
iQ	3,128	n.a.			3,165	n.a.		
Aventa	5,830	n.a.			5,680	n.a.		
Keystone	6,020	n.a.			6,054	n.a.		
<b>Total acquired enrollment</b>	14,978		14,978	NM	14,899		14,898	NM
<b>Total Average Enrollment</b>	98,296	68,519	29,777	43.5%	98,625	68,913	29,712	43.1%

*Enrollment mix by sales channel for K12 programs*

	Three Months Ending December 31,				Six Months Ending December 31,			
	2010	2009	Change	Change %	2010	2009	Change	Change %
<b>K12 Public schools</b>								
K12 managed schools	68,722	57,264	11,458	20.0%	69,157	57,834	11,323	19.6%
K12 institutional sales	12,361	10,090	2,271	22.5%	12,323	10,068	2,255	22.4%
Total K12 public	81,083	67,354	13,729	20.4%	81,480	67,902	13,578	20.0%
<b>K12 Private schools</b>								
K12 managed	1,622	1,165	457	39.2%	1,571	1,012	559	55.2%
	613		613	NM	676		676	NM

K12 institutional  
sales

Total K12 private	2,235	1,165	1,070	91.8%	2,247	1,012	1,235	122.0%
<b>K12 total</b>	83,318	68,519	14,799	21.6%	83,726	68,913	14,813	21.5%

The above enrollments exclude those in our direct-to-consumer and pilot programs, and enrollments acquired with AEC.

The following table sets forth statements of operations data for each of the periods indicated:

	<b>Three Months Ended December 31,</b>		<b>Six Months Ended December 31,</b>	
	<b>2010</b>	<b>2009</b>	<b>2010</b>	<b>2009</b>
	<b>(In thousands)</b>		<b>(In thousands)</b>	
<b>Revenues</b>	\$ 129,002	\$ 93,197	\$ 263,873	\$ 199,522
<b>Cost and expenses</b>				
Instructional costs and services	76,195	51,589	151,277	109,682
Selling, administrative, and other operating expenses	35,177	24,899	85,675	58,226
Product development expenses	3,435	2,415	7,346	4,653
<b>Total costs and expenses</b>	<b>114,807</b>	<b>78,903</b>	<b>244,298</b>	<b>172,561</b>
<b>Income from operations</b>	<b>14,195</b>	<b>14,294</b>	<b>19,575</b>	<b>26,961</b>
<b>Interest expense, net</b>	<b>(366)</b>	<b>(324)</b>	<b>(663)</b>	<b>(681)</b>
<b>Income before income taxes and noncontrolling interest</b>	<b>13,829</b>	<b>13,970</b>	<b>18,912</b>	<b>26,280</b>
<b>Income tax expense</b>	<b>(6,119)</b>	<b>(4,381)</b>	<b>(9,050)</b>	<b>(9,749)</b>
<b>Net income</b>	<b>\$ 7,710</b>	<b>\$ 9,589</b>	<b>\$ 9,862</b>	<b>\$ 16,531</b>
<b>Add net loss attributable to noncontrolling interest</b>	<b>\$ 129</b>	<b>\$ 49</b>	<b>\$ 175</b>	<b>\$ 190</b>
<b>Net Income K12 Inc.</b>	<b>\$ 7,839</b>	<b>\$ 9,638</b>	<b>\$ 10,037</b>	<b>\$ 16,721</b>

The following table sets forth statements of operations data as a percentage of revenues for each of the periods indicated:

	<b>Three Months Ended December 31,</b>		<b>Six Months Ended December 31,</b>	
	<b>2010</b>	<b>2009</b>	<b>2010</b>	<b>2009</b>
<b>Revenues</b>	100.0%	100.0%	100.0%	100.0%
<b>Cost and expenses</b>				
Instructional costs and services	59.1	55.4	57.3	55.0
Selling, administrative, and other operating expenses	27.3	26.7	32.5	29.2
Product development expenses	2.6	2.6	2.8	2.3

<b>Total costs and expenses</b>	89.0	84.7	92.6	86.5
<b>Income from operations</b>	11.0	15.3	7.4	13.5
<b>Interest expense, net</b>	(0.3)	(0.3)	(0.2)	(0.3)
<b>Income before income taxes and noncontrolling interest</b>	10.7	15.0	7.2	13.2
<b>Income tax expense</b>	(4.7)	(4.7)	(3.4)	(4.9)
<b>Net income</b>	6.0	10.3	3.8	8.3
<b>Add net loss attributable to noncontrolling interest</b>	0.1	0.0	0.1	0.1
<b>Net income K12 Inc.</b>	6.1%	10.3%	3.9%	8.4%

We have included below a discussion of our operating results and significant items which explain the material changes in our operating results during the three and six months ended December 31, 2010 as compared to the same period in the prior year.

### **Comparison of the Three Months Ended December 31, 2010 and Three Months Ended December 31, 2009**

*Revenues.* Our revenues for the three months ended December 31, 2010 were \$129.0 million, representing an increase of \$35.8 million, or 38.4%, as compared to revenues of \$93.2 million for the same period in the prior year. This increase was primarily attributable to 21.6% increase in enrollments in K12 programs. In addition, Aventa, iQ and Keystone programs obtained through our acquisition of KCDL contributed 10.5% to revenue growth.

*Instructional costs and services expenses.* Instructional costs and services expenses for the three months ended December 31, 2010 were \$76.2 million, representing an increase of \$24.6 million, or 47.7%, as compared to instructional costs and services expenses of \$51.6 million for the same period in the prior year. This increase was primarily attributable to a \$16.9 million increase in expenses to operate and manage schools including the programs acquired with KCDL. In addition, costs to supply curriculum, books, educational materials and computers to students increased \$5.2 million, including \$3.3 million due to a timing difference benefiting the prior period. Amortization of curriculum and learning systems increased \$2.5 million. Included in the \$24.6 million increase in instructional costs and services expenses are start-up and launch expenses of \$2.9 million for several new businesses and initiatives. As a percentage of revenues, instructional costs and services expenses increased to 59.1% for the three months ended December 31, 2010, as compared to 55.4% for the same period in the prior year. This increase as a percentage of revenues was primarily attributable to the benefit of materials returns in the prior year, increased amortization of curriculum and learning systems, and an increase in the percentage of high school enrollments relative to total enrollments, as high school enrollments have higher costs as a percentage of revenues due to increased teacher and related services costs. These increases were partially offset by increased productivity at the schools we serve and leverage of fixed school infrastructure costs.

*Selling, administrative, and other operating expenses.* Selling, administrative, and other operating expenses for the three months ended December 31, 2010 were \$35.2 million, representing an increase of \$10.3 million, or 41.3%, as compared to selling, administrative and other operating expenses of \$24.9 million for the same period in the prior year. This increase is primarily attributable to increases in: personnel costs including those acquired with KCDL and AEC; merger integration, financial systems and process improvement costs; the effects of purchase accounting; and M&A transaction expenses. Included in the \$10.3 million increase in selling, administrative, and other operating expenses are start-up and launch expenses of \$2.3 million for several new businesses and initiatives. As a percentage of revenues, selling, administrative, and other operating expenses increased to 27.3% for the three months ended December 31, 2010 as compared to 26.7% for the same period in the prior year primarily due to the items identified above.

*Product development expenses.* Product development expenses for the three months ended December 31, 2010 were \$3.4 million, representing an increase of \$1.0 million, or 42.2%, as compared to product development expenses of \$2.4 million for the same period in the prior year. The increase is primarily due to initiatives to support the Aventa curriculum acquired with KCDL. As a percentage of revenues, product development expenses increased to 2.6% for the three months ended December 31, 2010 as compared to 2.6% for the same period in the prior year primarily due to the items identified above.

*Interest expense, net.* Net interest expense for the three months ended December 31, 2010 was \$0.4 million as compared to net interest expense of \$0.3 million for the same period in the prior year. The increase in net interest expense is primarily due to borrowings on our line of credit. In addition, balances outstanding on capital leases increased but were offset by a decrease in average interest rates.

*Income taxes.* Income tax expense for the three months ended December 31, 2010 was \$6.1 million, or 44.2% of income before income taxes, as compared to an income tax expense of \$4.4 million, or 31.4% of income before taxes, for the same period in the prior year. The increase in the tax rate is primarily due to non-deductible transaction expenses in the current period as well as the benefit of tax credits recognized in the same period in the prior year.

*Noncontrolling interest.* Noncontrolling interest for the three months ended December 31, 2010 was \$0.1 million and de minimus in the same period in the prior year. Noncontrolling interest reflects the after-tax losses attributable to shareholders in our joint venture in the Middle East and Middlebury Interactive Languages.

### **Comparison of the Six Months Ended December 31, 2010 and Six Months Ended December 31, 2009**

*Revenues.* Our revenues for the six months ended December 31, 2010 were \$263.9 million, representing an increase of \$64.4 million, or 32.3%, as compared to revenues of \$199.5 million for the same period in the prior year. This increase was primarily attributable to 21.5% increase in enrollments in K12 programs. In addition, Aventa, iQ and Keystone programs obtained through our acquisition of KCDL contributed 7.7% to revenue growth.

*Instructional costs and services expenses.* Instructional costs and services expenses for the six months ended December 31, 2010 were \$151.3 million, representing an increase of \$41.6 million, or 37.9%, as compared to instructional costs and services expenses of \$109.7 million for the same period in the prior year. This increase was primarily attributable to a \$28.3 million increase in expenses to operate and manage schools including the MIL summer programs and the programs acquired with KCDL. In addition, costs to supply curriculum, books, educational materials and computers to students increased \$8.4 million, including a \$0.8 million increase in the provision for inventory obsolescence. Included in the \$41.6 million increase in instructional costs and services expenses were start-up and launch expenses of \$5.3 million for several new businesses and initiatives. Amortization of curriculum and learning systems increased \$5.0 million. As a percentage of revenues, instructional costs and services expenses increased to 57.3% for the six months ended December 31, 2010, as compared to 55.0% for the same period in the prior year. This increase as a percentage of revenues was primarily attributable to increased amortization of curriculum and learning systems, the benefit from return of instructional materials in the prior period and an increase in the percentage of high school enrollments relative to total enrollments, as high school enrollments have higher costs as a percentage of revenues due to increased teacher and related services costs. To a lesser extent, the increase in expense as a percentage of revenue was also impacted by the additional startup expenses that did not have the corresponding growth in revenues in the current period. These increases were partially offset by lower fulfillment costs for materials and computers, increased productivity at the schools we serve, and leverage of fixed school infrastructure costs.

*Selling, administrative, and other operating expenses.* Selling, administrative, and other operating expenses for the six months ended December 31, 2010 were \$85.7 million, representing an increase of \$27.4 million, or 47.1%, as compared to selling, administrative and other operating expenses of \$58.2 million for the same period in the prior year. This increase is primarily attributable to increases in: strategic marketing including brand awareness and student recruitment; personnel costs including those acquired with KCDL and AEC; merger integration, financial systems and process improvement costs; the effects of purchase accounting; M&A transaction expenses; one-time stock compensation expenses associated with the execution of a new long-term employment agreement with our CEO; and other professional services. Included in the \$27.4 million increase in selling, administrative, and other operating expenses are start-up and launch expenses of \$3.3 million for several new businesses and initiatives. As a percentage of revenues, selling, administrative, and other operating expenses increased to 32.5% for the six months ended December 31, 2010 as compared to 29.2% for the same period in the prior year primarily due to the items identified above.

*Product development expenses.* Product development expenses for the six months ended December 31, 2010 were \$7.3 million, representing an increase of \$2.7 million, or 57.9%, as compared to product development expenses of \$4.7 million for the same period in the prior year. The increase is primarily due to initiatives to support the Aventa curriculum acquired during the period as well as the timing of new development projects. As a percentage of revenues, product development expenses increased to 2.8% for the six months ended December 31, 2010 as compared to 2.3% for the same period in the prior year primarily due to the items identified above.

*Interest expense, net.* Net interest expense for the six months ended December 31, 2010 and 2009 was \$0.7 million. Balances outstanding on capital leases increased for the six months ended December 31, 2010, but were offset by a decrease in average interest rates.

*Income taxes.* Income tax expense for the six months ended December 31, 2010 was \$9.1 million, or 47.9% of income before income taxes, as compared to an income tax expense of \$9.7 million, or 37.1% of income before

taxes, for the same period in the prior year. The increase in the tax rate is primarily due to non-deductible transaction expenses in the current period as well as the benefit of tax credits recognized in the same period in the prior year.

*Noncontrolling interest.* Noncontrolling interest for the six months ended December 31, 2010 and 2009 was \$0.2 million. Noncontrolling interest reflects the after-tax losses attributable to shareholders in our joint venture in the Middle East and Middlebury Interactive Languages.

### **Liquidity and Capital Resources**

As of December 31, 2010 and June 30, 2010, we had cash and cash equivalents of \$35.2 million and \$81.8 million, respectively and excluding restricted cash. We financed our capital expenditures during the six months ended December 31, 2010 primarily with cash and capital lease financing. As of December 31, 2010, our cash balance included \$11.0 million associated with our joint ventures.

Our cash requirements consist primarily of day-to-day operating expenses, capital expenditures and contractual obligations with respect to facility leases, capital equipment leases and other operating leases. We expect capital expenditures for fiscal year 2011 of \$38 million to \$40 million including expenditures for additional courses, new releases of existing courses, foreign language courses developed in our MIL joint venture, and internal systems enhancements and software purchases to support our growth, the integration of KCDL, and a second data center. We also expect expenditures for computers provided for use by students of approximately \$14 million to support growth in virtual school enrollments. We expect to be able to fund these capital expenditures with cash on hand, cash generated from operations, capital lease financing or advances under our line of credit. As of March 31, 2011, advances for additional purchases are no longer available under our existing capital lease line of credit. We expect to renew this line of credit, obtain additional financing from other providers or pay for future purchases with cash on hand. We lease all of our office facilities. We expect to make future payments on existing leases from cash generated from operations.

On December 1, 2010, we closed the acquisition of AEC. We funded the purchase price of \$28.4 million plus a contingent consideration escrow of \$6.8 million, for a total of \$35.2 million with cash on hand and a \$15 million advance under our line of credit. We believe that the contingent consideration of \$6.8 million will not be paid and that the escrowed funds will be released back to the Company.

We believe that the combination of funds currently available and funds to be generated from operations will be adequate to finance our ongoing operations for the foreseeable future. In addition, we continue to explore acquisitions, strategic investments, and joint ventures related to our business that we may acquire using cash, stock, debt, contribution of assets or a combination thereof.

### ***Redemption Right of Middlebury College***

In the formation of our joint venture with Middlebury College (Middlebury), at any time after May 1, 2015, Middlebury may give written notice of its irrevocable election to sell all (but not less than all) of its Membership Interest to us (put right). Given the put right is redeemable outside of our control it is recorded outside of permanent equity at its estimated redemption value. The purchase price for Middlebury's Membership Interest shall be its fair market value and we may, in our sole discretion, pay the purchase price in cash or shares of our common stock. As of December 31, 2010, the redeemable noncontrolling interest was estimated to be \$20.8 million.

### ***Redemption Right of Series A Special Stock***

In July 2010, we acquired all of the stock of KC Distance Learning, Inc. (KCDL), a provider of online curriculum and public and private virtual education, by issuing to its parent company KCDL Holdings LLC, 2.75 million shares of a new class of stock designated as Series A Special Stock, which had a value at closing of \$63.1 million. After the approval of shareholders on January 27, 2011, the holders of Series A Special Stock have the right to convert those shares into common stock on a one-for-one basis and for the right to vote on all matters presented to K12 shareholders, other than for the election and removal of directors, for which the holders shall have no voting rights unless converted to common. The redemption right of the holders of the Series A Special Stock terminated upon shareholder approval of their conversion and voting rights.

### ***Operating Activities***

Net cash provided by operating activities for the six months ended December 31, 2010 and 2009 was \$7.1 million and \$9.8 million, respectively.

The increase in accounts receivable was primarily attributable to our growth in revenues including the businesses acquired with KCDL during the period. Accounts receivable balances tend to be at the highest levels in the first quarter as we begin billing for students. Deferred revenues are primarily a result of invoicing upfront fees, not cash payments. Deferred revenues increased primarily due to growth in enrollments, and to a lesser extent from the businesses of KCDL acquired during the period. Deferred revenue balances tend to be highest in the first quarter, when the majority of students enroll, and are generally amortized over the course of the fiscal year.

The increase in accounts payable and accrued liabilities is primarily due to the timing of payments to vendors and service providers for transaction related costs, professional services, and equipment purchases. The decrease in inventories is primarily due to materials shipments to students, partially offset by purchases. The increase in cash used in accrued compensation and benefits is primarily due to a net increase in incentive compensation payments.

### ***Investing Activities***

Net cash used in investing activities for the six months ended December 31, 2010 and 2009 was \$63.7 million and \$11.5 million, respectively.

Net cash used in investing activities for the six months ended December 31, 2010 was primarily due to the purchase of AEC for \$24.5 million net of cash received of \$3.8 million and \$6.8 million for the achievement of specified financial targets for three months ended December 31, 2010. As of the current date, we do not expect any of this contingent consideration to be distributed to the selling AEC shareholders. Consequently, this escrow amount is recorded in other current assets as of December 31, 2010. We also transferred \$10 million for our investment in Web. This cash was in transit as of December 31, 2010 and is recorded in long-term other assets. In addition, investing activities included purchases of property and equipment of \$9.0 million including \$3.8 million to license an enterprise software application, investment in capitalized curriculum development of \$7.0 million, primarily related to the production of high school courses, middle school math courses, and language courses; and investment in capitalized software development of \$4.3 million.

Net cash used in investing activities for the six months ended December 31, 2009 was primarily due to investment in capitalized curriculum development of \$6.4 million, primarily related to the production of high school courses, elementary school math courses, and remedial reading; investment in capitalized software development of \$4.5 million; and purchases of property and equipment of \$0.6 million, including purchased software.

In addition to the investing activities above, for the six months ended December 31, 2010 and 2009, we financed through capital leases purchases of computers and software primarily for use by students in the amount of \$12.9 million and \$10.2 million, respectively.

### ***Financing Activities***

Net cash provided by financing activities for the six months ended December 31, 2010 and 2009 was \$10.0 million and \$0.2 million, respectively.

For the six months ended December 31, 2010, net cash provided by financing activities was primarily due to \$15 million from our line of credit, proceeds from the exercise of stock options of \$2.9 million, and the excess tax

benefit from stock-based compensation of \$1.3 million, partially offset by payments on capital leases and notes payable of \$8.2 million. As of December 31, 2010, there was \$15 million outstanding on our \$35 million line of credit.

For the six months ended December 31, 2009, net cash provided by financing activities was primarily due to the exercise of stock options of \$4.9 million and the excess tax benefit from stock-based compensation of \$2.2 million, partially offset by payments on capital leases and notes payable of \$6.9 million.

### **Off Balance Sheet Arrangements, Contractual Obligations and Commitments**

There were no substantial changes to our guarantee and indemnification obligations in the six months ended December 31, 2010 from those disclosed in our fiscal year 2010 audited consolidated financial statements.

Our contractual obligations consist primarily of leases for office space, capital leases for equipment and other operating leases. The total amount due under contractual obligations increased during the six months ended December 31, 2010 primarily due to approximately \$4.4 million for capital leases related to student computers, net of payments.

### **Item 3. *Quantitative and Qualitative Disclosures About Market Risk***

#### *Interest Rate Risk*

At December 31, 2010 and June 30, 2010, we had cash and cash equivalents totaling \$35.2 million and \$81.8 million, respectively. Our excess cash has been invested primarily in U.S. Treasury money market funds although we may also invest in money market accounts, government securities, corporate debt securities and similar investments. Future interest and investment income is subject to the impact of interest rate changes and we may be subject to changes in the fair value of our investment portfolio as a result of changes in interest rates. At December 31, 2010, a 1% gross increase in interest rates earned on cash and cash equivalents would result in a \$0.4 million annualized increase in interest income.

Our debt obligations under our revolving credit facility are subject to interest rate exposure. As of December 31, 2010, \$15 million was outstanding on this facility at an interest rate of 1.8%. At December 31, 2010, a 1% gross increase in interest rates would result in a \$0.2 million annualized increase in interest expense.

#### *Foreign Currency Exchange Risk*

We currently operate in foreign countries. In the past, we did not transact a material amount of business in a foreign currency and therefore fluctuations in exchange rates did not have a material impact on our financial statements. However, we continue to pursue opportunities in international markets. If we enter into any material transactions in a foreign currency or establish or acquire any subsidiaries that measure and record their financial condition and results of operation in a foreign currency, we will be exposed to currency transaction risk and/or currency translation risk. Exchange rates between U.S. dollars and many foreign currencies have fluctuated significantly over the last few years and may continue to do so in the future. Accordingly, we may decide in the future to undertake hedging strategies to minimize the effect of currency fluctuations on our financial condition and results of operations.

### **Item 4. *Controls and Procedures***

#### *Evaluation of Disclosure Controls and Procedures*

We maintain disclosure controls and procedures (as defined in Rule 13a-15(e) of the Exchange Act) that are designed to ensure that information required to be disclosed in our Exchange Act reports is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure. In designing and evaluating the disclosure controls and procedures, management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, and management necessarily was required to apply its judgment in evaluating the cost benefit relationship of possible

controls and procedures.

As described in Item 9A of our Annual Report on Form 10K for the fiscal year ended June 30, 2010, a material weakness was identified in our internal control over financial reporting ( ICFR ) relating to our accounting for complex transactions that are non-routine and non-recurring. Rule 12b-2 and Rule 1-02 of Regulation S-X define a material weakness as a deficiency, or a combination of deficiencies, in ICFR such that there is a reasonable possibility that a material misstatement of the registrant's annual or interim financial statements will not be

prevented or detected on a timely basis. As a result of the material weakness, our Chief Executive Officer and Chief Financial Officer concluded that, as of June 30, 2010, the end of the period covered by our Annual Report, our disclosure controls and procedures were not effective at a reasonable assurance level.

We carried out an evaluation, required by paragraph (b) of Rule 13a-15 or Rule 15d-15 under the Exchange Act, under the supervision and with the participation of management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of our disclosure controls and procedures (as defined in Rule 13a-15(e) or Rule 15d-15(e) of the Exchange Act) as of the end of the period covered by this Quarterly Report on Form 10Q. Based on this review, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were not effective as of December 31, 2010 as the material weakness identified as of June 30, 2010 still exists.

#### *Changes in Internal Control over Financial Reporting*

As described in Item 9A of our Annual Report on Form 10K for the fiscal year ended June 30, 2010, management has been undertaking improvements in our internal control over financial reporting and our accounting procedures and practices generally. Specifically, management has approved the addition of several new positions to our finance and accounting staff which we are in the process of filling from internal resources and outside recruitment efforts (including the possibility of using external staffing firms), we have targeted potential new hires for recruitment, we have engaged a Big Four accounting firm to provide consulting services to our finance and accounting staff regarding process improvement opportunities, best practices and relevant training, and we are in the process of implementing an enterprise-wide financial management solution from Oracle Corporation to improve our overall accounting function. In addition, we are arranging for additional internal training of our finance staff as to GAAP requirements and SEC guidance in connection with accounting for complex, non-routine and non-recurring transactions. Management believes the measures that have been implemented to remediate the material weakness in our ICFR concerning our accounting for complex, non-routine and non-recurring transactions have had a material impact on our internal control over financial reporting since June 30, 2010, and anticipates that these measures and other ongoing enhancements will continue to improve our internal control over financial reporting in future periods.

During the six months ended December 31, 2010, in connection with the evaluation required by paragraph (d) of Rule 13a-15 or Rule 15d-15 under the Exchange Act, the effort to remediate the material weakness in our internal control over financial reporting that occurred during our last fiscal quarter has had a positive effect on our internal control over financial reporting. Management anticipates that these measures and other ongoing enhancements will continue to have a positive impact on our internal control over financial reporting in future periods. Notwithstanding such efforts, the material weakness related to our accounting for complex transactions that are non-routine and non-recurring described above will not be remediated until the new controls operate for a sufficient period of time and are tested to enable management to conclude that the controls are effective. Management will consider the design and operating effectiveness of these controls and will make any additional changes management determines appropriate.

## **Part II. Other Information**

### **Item 1. Legal Proceedings.**

In the ordinary conduct of our business, we are subject to lawsuits, arbitrations and administrative proceedings from time to time.

In June 2010, the shareholders of Aventa Learning, Inc. (Aventa) filed a lawsuit against KCDL which is currently pending in the U.S. District Court for the Western District of Washington, *Axtman et al. v. KC Distance Learning, Inc.* (Case No. 2:10-cv-01022-JLR). The lawsuit alleges, among other things, that KCDL did not honor the terms of an earn-out provision contained in an asset purchase agreement after certain assets of Aventa were acquired by KCDL in

2007. In addition, the plaintiffs allege breach of contract and misrepresentation claims, and seek the remedy of rescission for alleged violation of the Securities Act of Washington. On July 23, 2010, we acquired all of the shares of KCDL, which is now our wholly-owned subsidiary. On August 31, 2010, the plaintiffs amended their complaint to add K12 Inc. as a co-

defendant in this matter, reflecting the change in ownership. On October 4, 2010, defendants filed a motion to dismiss plaintiff's amended complaint. Pursuant to the Agreement and Plan of Merger between K12 Inc. and KCDL Holdings LLC (Seller), Seller agreed to assume responsibility to defend this lawsuit and to fully indemnify us for any liability, including rescission. In addition, we obtained a guarantee from Seller's parent company, Learning Group LLC, from any losses related to this litigation. In our view, the outcome of this litigation will not have a material adverse effect on our financial condition or results of operations or of any of our subsidiaries.

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

There have been no material changes to the risk factors disclosed in *Risk Factors* in Part I, Item 1A, of our Annual Report.

**Item 2. *Unregistered Sales of Equity Securities and Use of Proceeds.***

None.

**Item 3. *Defaults Upon Senior Securities.***

None.

**Item 4. *Removed and Reserved.***

**Item 5. *Other Information.***

None.

**Item 6. *Exhibits.***

(a) Exhibits.

The exhibits listed on the accompanying Exhibit Index are filed as part of this report and such Exhibit Index is incorporated herein by reference.

**SIGNATURES**

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

K12 INC.

/s/ RONALD J. PACKARD

Ronald J. Packard  
Chief Executive Officer

Date: February 9, 2011

**EXHIBIT INDEX**

<b>Number</b>	<b>Description</b>
3.1	Third Amended and Restated Certificate of Incorporation of K12 Inc. (Incorporated by reference to Exhibit 3.1 to K12's Quarterly Report on Form 10-Q for the quarter ended December 31, 2007).
3.2	Amended and Restated Bylaws of K12 Inc. (Incorporated by reference to Exhibit 3.2 to K12's Quarterly Report on Form 10-Q for the quarter ended December 31, 2007).
3.3	Certificate of Designations, Preferences and Relative and Other Special Rights of Series A Special Stock (Incorporated by reference to Exhibit 3.1 to K12's Current Report on Form 8-K filed on July 26, 2010).
10.1*	Amendment to Amended and Restated Stock Option Agreement with Ronald J. Packard.
31.1*	Certification of Principal Executive Officer Required Under Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended.
31.2*	Certification of Principal Financial Officer Required Under Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended.
32.1*	Certification of Principal Executive Officer and Principal Financial Officer Required Under Rule 13a-14(b) of the Securities Exchange Act of 1934, as amended, and 18 U.S.C. Section 1350.

\* Filed herewith.