WACHOVIA CORP NEW
Form POS AM
April 23, 2003
**Table of Contents**

**As filed with the Securities and Exchange Commission on April 23, 2003**

**Registration No. 333-99847**

---

## SECURITIES AND EXCHANGE COMMISSION

**Washington, D.C. 20549**

---

**POST - EFFECTIVE**
**AMENDMENT NO. 4**

**TO**
# FORM S-3
**REGISTRATION STATEMENT**
***UNDER***
***THE SECURITIES ACT OF 1933***
**OF**

| | |
|---|---|
| **WACHOVIA CORPORATION**<br>**(Formerly named First Union Corporation)**<br>**(Exact name of registrant as specified in its charter)** | **WACHOVIA PREFERRED FUNDING CORP.**<br>**(Exact name of registrant as specified in its charter)** |
| **North Carolina**<br>**(State or other jurisdiction of incorporation or organization)** | **Delaware**<br>**(State or other jurisdiction of incorporation or organization)** |
| **56-0898180**<br>**(I.R.S. Employer Identification No.)** | **56-1986430**<br>**(I.R.S. Employer Identification No.)** |
| **One Wachovia Center**<br>**Charlotte, North Carolina 28288**<br>**(704) 374-6565**<br>**(Address, including zip code, and telephone number,**<br>**including area code, of registrant s principal executive offices)** | **1620 East Roseville Parkway**<br>**Roseville, California 95661**<br>**(877) 867-7378**<br>**(Address, including zip code, and telephone number, including area code, of registrant s principal executive offices)** |

---

**Ross E. Jeffries, Jr., Esq.**

**Senior Vice President and Assistant General Counsel**

**WACHOVIA CORPORATION**

**One Wachovia Center**

**Charlotte, North Carolina 28288-0630**

**(704) 374-6611**

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

---

*Copies to:*

**Mark J. Menting, Esq.**
**Robert W. Downes, Esq.**
**Sullivan & Cromwell**
**125 Broad Street**
**New York, New York 10004**
**(212) 558-4000**

**Kenneth L. Bachman, Esq.**
**Cleary, Gottlieb, Steen & Hamilton**
**2000 Pennsylvania Avenue**
**Washington, D.C. 20006**
**(202) 974-1500**

---

**Approximate date of commencement of proposed sale to the public: As soon as practicable after this Registration Statement becomes effective.**

If any of the securities being registered on this form are to be offered on a delayed or continuous basis pursuant to Rule 415 under the Securities Act of 1933, check the following box. x

If this Form is filed to register additional securities for an offering pursuant to Rule 462(b) under the Securities Act, please 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 this Form is a post-effective amendment filed pursuant to Rule 462(d) 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. ¨

---

The Registrants hereby amend the Registration Statement on such date or dates as may be necessary to delay its effective date until the Registrants shall file a further amendment which specifically states that the 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 or dates as the Securities and Exchange Commission, acting pursuant to said Section 8(a), may determine.

Table of Contents

**18,000,000 Series A Preferred Securities**

# Wachovia Preferred Funding Corp.

**7.25% Non-cumulative Exchangeable**

**Perpetual Series A Preferred Securities**

**(Liquidation Preference $25.00 Per Security)**

**Automatically Exchangeable in Specified Circumstances into**

**Depositary Shares representing Preferred Stock of Wachovia Corporation**

Terms of the Series A preferred securities include:

- Dividends are:
  - payable quarterly only if declared, and
  - non-cumulative, which means that you will not receive them later if they are not declared in the applicable period.
- Conditionally exchangeable, without your approval or any action on your part, for depositary shares with substantially equivalent terms as to dividends, liquidation preference and redemption of Wachovia Corporation, our indirect parent company, except that the depositary shares will:
  - not have any voting rights,
  - not have the right to elect independent directors,
  - not have the benefit of similar favorable covenants as the Series A preferred securities, and
  - not be listed on any securities exchange.
- This exchange will be made only at the direction of the Office of the Comptroller of the Currency under the following specified circumstances:
  - Wachovia Bank, National Association, our indirect parent company, becomes undercapitalized under the OCC s prompt corrective action regulations, or
  - the Bank is placed into conservatorship or receivership, or
  - the OCC, in its sole discretion, anticipates that the Bank may become undercapitalized in the near term, or takes supervisory action that limits the payment of dividends by us and in connection therewith directs an exchange.
- Redeemable at our option on or after December 31, 2022, with the prior consent of the OCC.
- Senior to our common stock and our Series C preferred securities but on a parity with our Series B and D preferred securities.
- Entitled to 1/10th of one vote per security on all matters submitted to holders of our common stock.

We are qualified as a real estate investment trust, or REIT, for Federal income tax purposes.

Prior to this offering, there has been no public market for the Series A preferred securities. We have applied for the listing of the Series A preferred securities on the New York Stock Exchange under the symbol WNA Pr . Trading in the Series A preferred securities is expected to commence not later than 30 days after the delivery of the Series A preferred securities. Consequently, there will be no trading market for the Series A preferred securities, at least in the short term.

**See Risk Factors beginning on page 14 for a description of risk factors you should consider before you invest in these securities.**

The Series A preferred securities solely represent an interest in us and are not the obligation of, or guaranteed by, any other entity. These securities are not deposits or accounts and are not insured or guaranteed by the Federal Deposit Insurance Corporation or any other governmental agency.

**Neither the Securities and Exchange Commission, the OCC, nor any other federal agency or state securities regulator has approved or disapproved these securities or determined if this prospectus is accurate or complete. Any representation to the contrary is a criminal offense.**

Any broker-dealer affiliate of Wachovia Preferred Funding Corp., including, without limitation, Wachovia Securities, Inc., may use this prospectus in market-making transactions involving the Series A preferred securities after their initial sale or depositary shares of Wachovia Corporation after the occurrence of a conditional exchange in the circumstances described above.

*Wachovia Securities*

*Sole Bookrunner*

| | | |
|---|---|---|
| *A. G. Edwards & Sons, Inc.* | *Banc of America Securities LLC* | *Merrill Lynch & Co.* |
| *Morgan Stanley* | *Prudential Securities* | *UBS Warburg* |

Prospectus dated December 11, 2002

**Table of Contents**

*The following table of contents has been designed to help you find important information contained in this prospectus. We encourage you to read the entire prospectus.*

*Wachovia Funding , we , our and us refer to Wachovia Preferred Funding Corp. Wachovia Preferred Holding refers to Wachovia Preferred Funding Holding Corp., the Bank refers to Wachovia Bank, National Association, and Wachovia refers to Wachovia Corporation.*

**TABLE OF CONTENTS**


| | Page |
|---|---|
| Forward-Looking Statements | ii |
| Prospectus Summary | 1 |
| Risk Factors | 14 |
| Information Concerning the Bank | 25 |
| Use of Proceeds | 29 |
| Capitalization | 30 |
| Ratios of Earnings to Fixed Charges | 31 |
| Business | 32 |
| Selected Consolidated Financial Data | 52 |
| Unaudited Pro Forma Condensed Consolidated Financial Information | 53 |
| Management s Discussion and Analysis of Financial Condition and Results of Operations | 59 |
| Management | 74 |
| Certain Relationships and Related Party Transactions | 76 |
| Beneficial Ownership of Our Capital Stock | 77 |
| Description of the Series A Preferred Securities | 77 |
| Description of Other Wachovia Funding Capital Stock | 86 |
| Description of Wachovia Series G, Class A Preferred Stock | 91 |
| Description of Wachovia Depositary Shares | 94 |
| Description of Other Wachovia Capital Stock | 97 |
| Global Securities | 98 |
| Federal Income Tax Considerations | 100 |
| ERISA Considerations | 110 |
| Plan of Distribution | 112 |
| Experts | 112 |
| Validity of Securities | 113 |
| Where You Can Find More Information about Wachovia Funding | 113 |
| Where You Can Find More Information about Wachovia | 114 |
| Glossary | 116 |
| Wachovia Preferred Funding Corp. and Subsidiary Index to Consolidated Financial Statements | F-1 |
| Wachovia Corporation and Subsidiaries Supplementary Consolidating Financial Information | F-22 |


**FORWARD-LOOKING STATEMENTS**

This prospectus contains or incorporates statements that are forward-looking statements. These statements can be identified by the use of forward-looking language such as will likely result , may , are expected to , is anticipated , estimate , projected , intends to , or other simila

Wachovia Funding s and Wachovia s actual results, performance or achievements could be significantly different from the results expressed in or implied by these forward-looking statements. These statements are subject to certain risks and uncertainties, including but not limited to certain risks described in this prospectus or the documents incorporated by reference. When considering these forward-looking statements, you should keep in mind these risks, uncertainties and other cautionary statements made in this prospectus. You should not place undue reliance on any forward-looking statement, which speaks only as of the date made. You should refer to Wachovia Funding s and Wachovia s periodic and current reports filed with the SEC for specific risks which could cause actual results to be significantly different from those expressed or implied by these forward-looking statements.

Table of Contents

## PROSPECTUS SUMMARY

*Before you decide to invest in the Series A preferred securities, conditionally exchangeable into the Wachovia depositary shares representing interests in Wachovia Series G, Class A preferred stock, you should carefully read the following summary, together with the more detailed information and financial statements and related notes contained elsewhere in this prospectus, especially the risks of investing in the Series A preferred securities discussed under Risk Factors .*

*You should refer to the Glossary on page 116 for the definitions of certain capitalized and industry and proprietary terms used in this prospectus.*

### General

**Wachovia Preferred Funding Corp.**

We are a Delaware corporation, formed in July 2002 and the survivor of a merger with First Union Real Estate Asset Company of Connecticut, which was formed in 1996. Our principal business objective is to hold and manage mortgage assets and other authorized investments that will generate net income for distribution to our shareholders. We are qualified as a real estate investment trust, or REIT, for Federal income tax purposes. As a REIT, we generally will not be required to pay Federal income tax on distributed income if we distribute at least 90% of our earnings to our shareholders and continue to meet a number of other requirements as discussed below.

Upon our merger, we were a direct subsidiary of the Bank and an indirect subsidiary of Wachovia. By the completion of this offering, we will be a direct subsidiary of Wachovia Preferred Holding as a result of the Bank transferring certain assets, including 99.85% of our common stock and 87.62% of our Series D preferred securities, to Wachovia Preferred Holding in exchange for additional shares of Wachovia Preferred Holding common stock.

Our principal executive offices are located at 1620 East Roseville Parkway, Roseville, California 95661, and our telephone number is (877) 867-7378.

*Assets*

All of the financial information in this section is presented on a pro forma basis to reflect the following:

- $866 million of participation interests in home equity loans received by us as collateral for an intercompany loan to the Bank in October 2002. The underlying home equity loans were originated by the Bank; and the issuance of three new series of preferred securities (Series A, B and C ) to Wachovia Preferred Holding in exchange for participations in commercial and commercial real estate loans prior to this offering. The commercial and commercial real estate loans were originated by the Bank and contributed to Wachovia Preferred Holding. We will issue the preferred securities to Wachovia Preferred Holding in exchange for participations in the loans prior to this offering.

At September 30, 2002, we had total assets of $12.5 billion, total liabilities of $607 million, and stockholders equity of $11.9 billion. As of such date,

$9.8 billion, or 78.7% of our assets, were comprised of participation interests in commercial real estate loans;

$866 million, or 6.9% of our assets, were comprised of an intercompany loan to the Bank secured by participation interests in home equity loans;

1

**Table of Contents**

- $661 million, or 5.3% of our assets, were comprised of participation interests in commercial loans;
- $605 million, or 4.8% of our assets, were comprised of interest rate swaps;
- $303 million, or 2.4% of our assets, were comprised of cash and cash equivalents;
- $205 million, or 1.6% of our assets, were comprised of participation interests in home equity loans;
- $89 million, or 0.7% of our assets, were comprised of residential mortgage loans; and
- $31 million, or 0.3% of our assets, were comprised of net other assets;

each before the allowance for loan losses.

In the past, we have purchased or accepted as capital contributions, loans and participation interests in loans both secured and not secured by real property along with other assets. We anticipate that we will acquire, or receive as capital contributions, interests in additional real estate secured loans from the Bank or its affiliates. Although we are permitted to do so, we have no present plans or intentions to purchase loans or loan participation interests from unaffiliated third parties.

*Dividends*

We currently expect to pay an aggregate amount of dividends with respect to the outstanding shares of our capital stock equal to substantially all of our REIT taxable income, which excludes capital gains. In order to remain qualified as a REIT, we must distribute annually at least 90% of our REIT taxable income to stockholders. Dividends will be authorized and declared at the discretion of our board of directors after considering our distributable funds, financial condition and capital needs, the impact of current and pending legislation and regulations, economic conditions, tax considerations, our continued qualification as a REIT, and other factors. Although there can be no assurances, we currently expect that both our cash available for distribution and our REIT taxable income will be in excess of amounts needed to pay dividends on the Series A preferred securities, at the dividend rate of 7.25% per annum of the $25.00 liquidation preference per security, in the foreseeable future because:

- substantially all of our mortgage assets and other authorized investments are interest-earning;
- we do not anticipate incurring any indebtedness, although we may incur indebtedness that in an aggregate amount does not exceed 20% of our shareholders equity;
- we expect that our interest-earning assets will continue to exceed the liquidation preference of all of our series of preferred stock;

the amount of loan servicing costs and management fees paid to the Bank are expected to be less than 4% of our income per year; and

we anticipate that, in addition to cash flows from operations, additional cash will be available from principal payments on our loan portfolio.

*Management*

Our board of directors is currently composed of one member who is also an employee of Wachovia and therefore not considered independent. Prior to this offering, we will elect three additional directors, two of whom will satisfy the definition of being independent as set forth in the corporate governance standards of the New York Stock Exchange, as amended from time to time. We refer to directors satisfying this NYSE independence definition as Independent Directors . We currently have two executive officers and approximately 15 additional officers. Our executive officers are also executive officers of Wachovia. All of our day-to-day activities and the servicing of the loans in our portfolio are administered, pursuant to participation and servicing agreements, by the Bank, which is our indirect parent company.

Table of Contents

**Risk Factors**

A purchase of our Series A preferred securities is subject to a number of risks described in more detail under Risk Factors beginning on page 14. These risks include, but are not limited to:

- Dividends on the Series A preferred securities are not cumulative. Consequently, our board of directors may decide to declare less than a full dividend or no dividend on the Series A preferred securities for any quarterly period and you will not be entitled to receive that dividend whether or not funds are or subsequently become available.

- The Series A preferred securities solely represent an interest in us and are not the obligation of, or guaranteed by, Wachovia, the Bank or any other entity. A decline in the performance and capital levels of the Bank or the placement by the Office of the Comptroller of the Currency, or the OCC , of the Bank into conservatorship or receivership could result in the automatic exchange of each Series A preferred security for one depositary share representing a one-sixth interest in one share of Wachovia Series G, Class A, preferred stock. Upon such an exchange, you would have an investment in Wachovia and not in us at a time when the Bank s and, ultimately, Wachovia s financial condition is deteriorating.

- Based on our ownership immediately after the offering, the holders of our Series A preferred securities not affiliated with Wachovia will have the right to vote less than 2% of all votes on matters on which all our shareholders are entitled to vote and the right to vote 60% of all votes on any matter which requires the holders of Series A preferred securities to vote separately as a single class.

- Due to, among other things, certain changes in legislation, regulations or our capital structure, we could fail to qualify as a REIT. As a result of such loss of qualification, we would suffer adverse tax consequences.

- Our close relationship with Wachovia and the Bank may create potential conflicts of interest. Wachovia and the Bank are involved in virtually every aspect of our existence.

- We have no control over changes in interest rates and such changes could negatively impact our financial condition, results of operations, and ability to pay dividends.

- The loans in our portfolio are subject to economic conditions that could negatively affect the value of the collateral securing such loans and/or the results of our operations.

- We cannot assure you that we paid the Bank fair value for all of our assets because we have not obtained any third party valuation of all those assets. Nor can we assure you that we will acquire or dispose of assets in the future at their fair market value.

- The exchange of our Series A preferred securities for depositary shares representing an interest in Wachovia Series G, Class A, preferred stock would most likely be a taxable event to you under the Code, and you would incur a gain or loss.

- A decline in Wachovia s financial condition following an exchange may restrict its ability to pay dividends and could result in a loss on your investment.

The holders of the depositary shares representing Wachovia Series G, Class A, preferred stock will:

- not have voting rights;
- not have the right to elect Independent Directors even if dividends are not authorized and declared by Wachovia s board of directors;
- not have the benefit of similar favorable covenants as the Series A preferred securities; and
- not be listed on any securities exchange.

Table of Contents

*Conflicts of Interest*

Because our day-to-day business affairs are managed by the Bank, conflicts of interest will arise from time to time between us and the Bank. These conflicts of interest relate to, among other things:

- the amount, type, and price of loan participation interests and other assets we acquire from or sell to the Bank;
- the servicing of the underlying loans, particularly with respect to loans that are placed on non-accrual status;
- the management of the cash collateral related to our interest rate swaps;
- the amount of loan servicing costs and management fees paid to the Bank;
- the treatment of new business opportunities identified by the Bank; and
- the modification of the loan participation and servicing agreements.

We have adopted policies with a view to ensuring that all financial dealings between the Bank and us will be fair to both parties and consistent with market terms.

**Wachovia Preferred Funding Holding Corp.**

Wachovia Preferred Holding is a California corporation which by completion of this offering will own:

- 99,851,752 (or 99.85%) of our common stock;
- 12,000,000 (or 40%) of our outstanding Series A preferred securities;
- 40,000,000 (or 100%) of our outstanding Series B preferred securities;
- 4,233,754 (or 100%) of our outstanding Series C preferred securities; and
- 800 (or approximately 88%) of our outstanding Series D preferred securities.

By the completion of this offering, the Bank will own 99.95% of the outstanding shares of common stock of Wachovia Preferred Holding. Approximately two weeks prior to this offering, the Bank will contribute its ownership of us, consisting of 99.85% of our common stock and 87.62% of our Series D preferred securities, as well as commercial and commercial real estate loan participations to Wachovia Preferred Holding in exchange for Wachovia Preferred Holding common stock. Immediately thereafter, pursuant to an assignment of a participation agreement, Wachovia Preferred Holding will acquire from us 30,000,000 Series A, 40,000,000 Series B and 4,233,754 Series C preferred securities, with liquidation preferences of $25.00, $25.00 and $1,000 per security, respectively, in exchange for participation interests in certain commercial and commercial real estate loans. Subsequent to this exchange, Wachovia Preferred Holding will offer for sale 18,000,000 Series A preferred securities in this offering.

Although a statutory underwriter in connection with this offering, Wachovia Preferred Holding will not sell the Series A preferred securities directly to the public and will not have the rights and obligations of an underwriter under the underwriting agreement that we will enter into with the underwriters of this offering.

Wachovia Preferred Holding s principal executive offices are located at 1620 East Roseville Parkway, Roseville, California 95661, and its telephone number is (877) 867-7378.

**Wachovia Corporation**

Wachovia was incorporated under the laws of North Carolina in 1967. Wachovia is registered as a financial holding company and a bank holding company under the Bank Holding Company Act of 1956, as amended, and is supervised and regulated by the Board of Governors of the Federal Reserve System. Wachovia s banking and securities subsidiaries are supervised and regulated by various Federal and state

Table of Contents

banking and securities regulatory authorities. On September 1, 2001, the former Wachovia Corporation merged with and into First Union Corporation, and First Union Corporation changed its name to Wachovia Corporation .

Wachovia s full-service banking subsidiaries provide a wide range of commercial and retail banking and trust services. Wachovia also provides a variety of other financial services through other subsidiaries, including mortgage banking, home equity lending, leasing, investment banking, insurance and securities brokerage services.

Wachovia is a separate and distinct legal entity from its banking and other subsidiaries. Dividends received by it from its subsidiaries are Wachovia s principal source of funds to pay dividends on its common and preferred stock and to service its debt. Various Federal and state statutes and regulations limit the amount of dividends that Wachovia s subsidiaries may pay to Wachovia without regulatory approval.

In 1985, the Supreme Court upheld regional interstate banking legislation. Since then, Wachovia has concentrated its efforts on building a large regional banking organization in what it perceives to be some of the better banking markets in the eastern United States. Since November 1985, Wachovia has completed over 90 banking-related acquisitions.

Wachovia continually evaluates its business operations and organizational structures to ensure they are aligned closely with its goal of maximizing performance in its core business lines. Therefore, Wachovia routinely explores acquisition opportunities, particularly in areas that would complement its core business lines, and frequently conducts due diligence activities in connection with possible acquisitions. As a result, acquisition discussions and, in some cases, negotiations frequently take place, and future acquisitions involving cash, debt or equity securities can be expected. When consistent with Wachovia s overall business strategy, Wachovia also considers the potential disposition of certain of its assets, branches, subsidiaries or lines of business.

The principal executive offices of Wachovia are located at One Wachovia Center, Charlotte, North Carolina 28288, and its telephone number is (704) 374-6565.

**Wachovia Bank, National Association**

The Bank is a national banking association with its principal office in Charlotte, North Carolina, that offers a wide range of domestic and international retail and commercial banking and trust services. The Bank has offices in Connecticut, Florida, Georgia, Maryland, New Jersey, New York, North Carolina, Pennsylvania, South Carolina, Virginia and Washington, D.C., and in several foreign countries. On April 1, 2002, the former Wachovia Bank, National Association merged with and into First Union National Bank, and First Union National Bank changed its name to Wachovia Bank, National Association . The Bank s business is subject to examination and regulation by United States Federal banking authorities. Based on deposits of $195.4 billion as of September 30, 2002, the Bank was the fifth largest bank in the United States. The Bank has numerous wholly-owned subsidiaries, none of which contributes over 30% of its consolidated net income. For more information see Information Concerning the Bank .

The principal executive offices of the Bank are located at One Wachovia Center, Charlotte, North Carolina 28288, and its telephone number is (704) 374-6565.

5

Table of Contents

### Our Organizational Structure

Upon the completion of this offering, our legal and organizational structure will be as follows:

(1)The remaining 12.38% of our Series D preferred securities is held by employees of Wachovia or its affiliates.

### Conditional Exchange of Series A Preferred Securities

The Series A preferred securities will be exchanged automatically for depositary shares representing Series G, Class A preferred stock of Wachovia at the direction of the OCC if any of the following events occurs:

- the Bank becomes undercapitalized under the OCC s prompt corrective action regulations;
- the Bank is placed into conservatorship or receivership; or
- the OCC, in its sole discretion, anticipates that the Bank may become undercapitalized in the near term or takes supervisory action that limits the payment of dividends by us and in connection therewith directs an exchange.

In an exchange, you would receive one depositary share representing a one-sixth interest in one share of Wachovia Series G, Class A preferred stock with a liquidation preference of $25.00 per depositary share for each of our Series A preferred securities you own. The Wachovia Series G, Class A preferred stock will be non-cumulative, perpetual, non-voting preferred stock of Wachovia ranking equally upon issuance with the most senior preferred stock of Wachovia then outstanding. If a Conditional Exchange occurs you would own an investment in Wachovia and not in us at a time when the Bank s and, ultimately, Wachovia s financial condition is deteriorating or the Bank may have been placed into conservatorship or receivership. Please see Where You Can Find More Information about Wachovia .

### Reasons for the Offering

The Series A preferred securities are being offered for sale to increase the Bank s and Wachovia s regulatory capital. The proceeds from the sale of the Series A preferred securities will be included as Tier 1 capital of the Bank and Wachovia under relevant regulatory capital guidelines.

Additionally, the Series A preferred securities will be included in other liabilities on the consolidated balance sheet of Wachovia.

6

**Table of Contents**

**Selected Consolidated Financial Data**

The following selected consolidated financial data for the three years ended December 31, 2001, are derived from our audited consolidated financial statements. The following selected consolidated financial data for the nine months ended September 30, 2002 and 2001, are derived from unaudited consolidated financial statements and reflect all adjustments, consisting only of normal recurring adjustments, that, in the opinion of our management, are necessary for a fair and consistent presentation of such data. Operating results for the nine months ended September 30, 2002, are not necessarily indicative of results expected for the entire year. This data should be read in conjunction with the consolidated financial statements, related notes, and other financial information beginning on page F-1 of this prospectus and Wachovia s unaudited supplementary consolidating financial information as of and for the nine months ended September 30, 2002, and the years ended December 31, 2001 and 2000, which includes certain consolidated financial information for the Bank, beginning on Page F-22 of this prospectus.

| | Nine Months Ended September 30, | | Years Ended December 31, | | |
|---|---|---|---|---|---|
| **(In thousands, except per share data)** | **2002** | **2001** | **2001** | **2000** | **1999** |
| **Income Statement Data** | | | | | |
| Net interest income | $ 127,098 | 43,374 | 67,322 | 57,257 | 47,005 |
| Provision for loan losses | 7,033 | 6,290 | 5,262 | 3,602 | 1,034 |
| Other income (loss) | 68,356 | | (95,890) | 395 | 96 |
| Noninterest expense | 6,597 | 1,013 | 2,394 | 2,207 | 3,078 |
| Net income (loss) | $ 305,936 | 23,446 | (23,545) | 32,434 | 27,951 |
| **Balance Sheet Data** | | | | | |
| Cash and cash equivalents | $ 1,169,380 | 327,057 | 957,454 | 183,223 | 196,397 |
| Loans, net of unearned income | 4,297,280 | 440,040 | 4,378,961 | 558,756 | 512,858 |
| Allowance for loan losses | (37,335) | (5,655) | (37,158) | (3,833) | (1,285) |
| Interest rate swaps | 605,438 | | 573,620 | | |
| Total assets | 6,071,086 | 775,039 | 5,889,666 | 746,803 | 714,097 |
| Collateral held on interest rate swaps | 599,570 | | 570,340 | | |
| Total liabilities | 606,938 | 5,082 | 732,246 | 283 | |
| Total stockholders equity | $ 5,464,148 | 769,957 | 5,157,420 | 746,520 | 714,097 |
| **Selected Other Information** | | | | | |
| Nonperforming loans | $ 16,425 | 2,882 | 5,024 | 2,684 | 3,733 |
| Nonperforming loans as a % of total loans | 0.38% | 0.65 | 0.11 | 0.48 | 0.73 |
| Nonperforming loans as a % of total assets | 0.27 | 0.37 | 0.09 | 0.36 | 0.52 |
| Allowance for loan losses as a % of nonperforming loans | 227.31 | 196.22 | 739.61 | 142.81 | 34.42 |
| Allowance for loan losses as a % of total loans | 0.87% | 1.29 | 0.85 | 0.69 | 0.25 |

7

Table of Contents

## The Offering

| | |
|---|---|
| **Issuer** | Wachovia Preferred Funding Corp., a Delaware corporation that will be an indirect subsidiary of Wachovia and the Bank and operates as a REIT for Federal income tax purposes. |
| **Securities Offered** | 18,000,000 7.25% Non-cumulative Exchangeable Perpetual Series A Preferred Securities. |
| **Ranking** | With respect to the payment of dividends and liquidation preference, the Series A preferred securities will rank equal to our Series B and D preferred securities and senior to our common stock and Series C preferred securities. Additional preferred stock ranking senior to the Series A preferred securities, which we refer to as Senior Stock , may not be issued without the approval of holders of at least two-thirds of the Series A preferred securities. Additional preferred stock ranking on a parity with the Series A preferred securities, which we refer to as Parity Stock , may be issued without your approval, but that issuance requires the approval of a majority of our Independent Directors. |
| **Dividends** | Dividends on the Series A preferred securities are payable at the rate of 7.25% per annum of the liquidation preference of $25.00 per security, if, when, and as declared by our board of directors. If declared, dividends are payable quarterly in arrears on March 31, June 30, September 30 and December 31 of each year or, if any such day is not a business day, on the next business day, unless the next business day falls in a different calendar year, in which case the dividend will be paid on the preceding business day, commencing December 31, 2002. A business day is any day other than a Saturday, Sunday or bank holiday. |
| | Dividends accrue in each quarterly period from the first day of such period, whether or not dividends are paid with respect to the preceding period. Dividends on the Series A preferred securities are not cumulative and, accordingly, if we do not declare a dividend or declare less than a full dividend on the Series A preferred securities for a quarterly dividend period, holders of the Series A preferred securities will have no right to receive a dividend or the full dividend, as the case may be, for that period, and we will have no obligation to pay a |

8

Table of Contents

| | |
|---|---|
| | dividend for that period, whether or not dividends are declared and paid for any future period with respect to either the Series A preferred securities, other series of preferred securities or our common stock. If the full dividend is not paid on the Series A preferred securities for a quarterly dividend period, the payment of dividends on our common stock (100% of which will be owned collectively by Wachovia and Wachovia Preferred Holding) and other preferred securities ranking subordinate to the Series A preferred securities will be prohibited for that period and at least the following three quarterly dividend periods. |
| **Liquidation Preference** | The liquidation preference for each Series A preferred security is \$25.00, plus an amount equal to any authorized, declared, but unpaid dividends, if any. The Bank through Wachovia Preferred Holding may cause us to liquidate, dissolve or wind up at any time. |
| **Redemption** | The Series A preferred securities are not redeemable prior to December 31, 2022, except upon the occurrence of a Special Event which may be a Tax Event, an Investment Company Act Event or a Regulatory Capital Event. On and after December 31, 2022, the Series A preferred securities may be redeemed for cash at our option, with the prior approval of the OCC, in whole or in part, at any time and from time to time, at a redemption price of \$25.00 per security, plus authorized, declared, but unpaid dividends, if any. Upon the occurrence of a Special Event, we will have the right prior to December 31, 2022, with the prior approval of the OCC, to redeem the Series A preferred securities in whole, but not in part, at a redemption price of \$25.00 per security, plus authorized, declared, but unpaid dividends, if any. The Series A preferred securities are not subject to any sinking fund or mandatory redemption and are not convertible into any of our other securities. |
| **Conditional Exchange** | Each Series A preferred security will automatically be exchanged at the direction of the OCC upon the occurrence of a Supervisory Event for one depositary share representing a one-sixth interest in one share of Wachovia Series G, Class A preferred stock. Each depositary share will represent a one-sixth interest in the Wachovia Series G, Class A preferred stock and will: |

rank equal to the most senior preferred stock of Wachovia then outstanding;

Table of Contents

pay dividends at the rate of 7.25% per annum of the liquidation preference of $25.00 per depositary share, if, when, and as declared by Wachovia s board of directors;

have a liquidation preference of $25.00 per depositary share;

be non-cumulative and non-voting;

be redeemable on the same terms as the Series A preferred securities; and

be evidenced by a depositary receipt.

**Voting Rights**

Holders of the Series A preferred securities are entitled to 1/10th of one vote per security on all matters submitted to a vote of the holders of our common stock. Without the consent of holders of two-thirds of the Series A preferred securities, voting as a separate class, we will not:

amend, alter or repeal our certificate of incorporation in a manner that materially and adversely affects the terms of the Series A preferred securities;

effect a consolidation or merger with or into another entity other than an entity controlled by, or under common control with, the Bank unless certain conditions have been met; or

approve the issuance of any Senior Stock.

Holders of the Series A preferred securities, voting together as a class with the holders of any Parity Stock with the same voting rights, will also have the right to elect two directors in addition to the directors then in office if we fail to pay, or declare and set aside for payment, dividends on the Series A preferred securities for six quarters. The term of such additional directors will terminate when we pay for three consecutive quarters and pay or declare and set aside for payment for the fourth consecutive quarter dividends on the Series A preferred securities or, if earlier, upon the redemption of all Series A preferred securities or a Conditional Exchange.

Holders of depositary shares representing Wachovia Series G, Class A preferred stock will not have voting rights.

Table of Contents

**Covenants**

Our certificate of incorporation provides certain covenants in favor of the holders of the Series A preferred securities. Specifically we will not, except with the consent or affirmative vote of the holders of at least two thirds of the Series A preferred securities, voting as a separate class:

make or permit to be made any payment to the Bank or its affiliates relating to our indebtedness or beneficial interests in us when we are precluded, as described under Dividends above, from making payments in respect of our common stock and all other stock ranking subordinate to our Series A preferred securities, which we refer to as Junior Stock , or make such payment or permit such payment to be made in anticipation of any liquidation, dissolution or winding up;

at any time incur indebtedness in an aggregate amount exceeding 20% of our shareholders equity;

pay dividends on our common stock or other Junior Stock unless our funds from operations, or FFO, for the four prior fiscal quarters equals or exceeds 150% of the amount that would be required to pay full annual dividends on the Series A preferred securities as well as any other Parity Stock, except as may be necessary to maintain our status as a REIT;

make any payment of interest or principal with respect to our indebtedness to the Bank or its affiliates unless our FFO for the four prior fiscal quarters equals or exceeds 150% of the amount that would be required to pay full annual dividends on the Series A preferred securities as well as any other Parity Stock, except as may be necessary to maintain our status as a REIT;

amend or otherwise change our policy of reinvesting the proceeds of our assets in other interest-earning assets such that our FFO over any period of four fiscal quarters will be anticipated to equal or exceed 150% of the amount that would be required to pay full annual dividends on the Series A preferred securities as well as any other Parity Stock, except as may be necessary to maintain our status as a REIT;

issue any additional shares of common stock to anyone other than the Bank or its affiliates; or

remove Wachovia from our name unless the name of either the Bank or Wachovia changes and we need to make a change to our name to be consistent with the new group name.

Wachovia s articles of incorporation do not contain similar covenants regarding the Series G, Class A preferred stock.

**Transfer Restrictions**

Our certificate of incorporation prohibits any transfer of shares or securities that would result in more than 50% in value of our outstanding shares of capital stock being owned by five or fewer individuals, under the applicable attribution rules of the Code, or that would cause our shares of capital stock to be beneficially owned by fewer than 100 persons. This prohibition is necessary to maintain our status as a REIT. Any transfer of Series A preferred securities that would violate this prohibition will be null and void and the purported transferee will acquire no rights or economic interest in such Series A preferred securities.

**Listing**

We have applied for the listing of the Series A preferred securities on the New York Stock Exchange under the symbol WNA Pr . Trading in the Series A preferred securities is expected to commence not later than 30 days after the date of delivery of the Series A preferred securities. Consequently, there will be no trading market for the Series A preferred securities, at least in the short term. We do not anticipate that the depositary shares representing interests in Wachovia Series G, Class A preferred stock to be issued in the event of a Conditional Exchange will be listed on any securities exchange or quotation system.

**Use of Proceeds**

Prior to this offering, Wachovia Preferred Holding will acquire from us 30,000,000 Series A, 40,000,000 Series B and 4,233,754 Series C preferred securities in exchange for participation interests, with an aggregate fair market value of $6.0 billion, in certain commercial and commercial real estate loans. Wachovia Preferred Holding will subsequently sell the 18,000,000 Series A preferred securities offered hereby to the public for cash consideration of $25.00 per security. Wachovia Preferred Holding will receive all proceeds from this offering and will pay all expenses of and underwriting discounts and commissions associated with this offering.

Table of Contents

| | |
|---|---|
| | Wachovia Preferred Holding intends to use the net proceeds from this offering for general corporate purposes.<br><br>The pro forma condensed consolidated financial information included under Unaudited Pro Forma Condensed Consolidated Financial Information reflects, on a pro forma basis as of and for the nine months ended September 30, 2002, the assets we will acquire in connection with the issuance of the Series A, Series B and Series C preferred securities. |
| **Tax Consequences** | As long as we qualify as a REIT, corporate holders of the Series A preferred securities will not be entitled to a dividends-received deduction for any income recognized from the Series A preferred securities.<br><br>Additionally, if the Series A preferred securities are exchanged for Wachovia Series G, Class A preferred stock, the exchange would most likely be a taxable event to holders of the Series A preferred securities.<br><br>See Federal Income Tax Considerations . |
| **Settlement** | We expect that delivery of the Series A preferred securities will be made to investors through the facilities of The Depository Trust Company on or about December 16, 2002. |
| **ERISA Considerations** | If you are a fiduciary of a pension, profit-sharing or other employee benefit plan subject to Title I of the Employee Retirement Income Security Act of 1974, as amended ( ERISA ), or Section 4975 of the Code, you should consider the requirements of ERISA and the Code in the context of the plan s particular circumstances and ensure the availability of an applicable exemption before authorizing an investment in the Series A preferred securities (and the depositary shares representing the Wachovia Series G, Class A preferred stock into which the Series A preferred securities are exchangeable upon the occurrence of a Conditional Exchange). See ERISA Considerations . |

Table of Contents

## RISK FACTORS

*You should consider carefully the following risks before purchasing our Series A preferred securities, conditionally exchangeable into depositary shares representing interests in Wachovia s Series G, Class A preferred stock.*

*All of the financial information in this section is presented on a pro forma basis to reflect the following:*

- *$866 million of participation interests in home equity loans received by us as collateral for an intercompany loan to the Bank in October 2002. The underlying home equity loans were originated by the Bank; and*

- *the issuance of three new series of preferred securities (Series A, B and C) to Wachovia Preferred Holding in exchange for participations in commercial and commercial real estate loans prior to this offering. The commercial and commercial real estate loans were originated by the Bank and contributed to Wachovia Preferred Holding. We will issue the preferred securities to Wachovia Preferred Holding in exchange for participations in the loans prior to this offering.*

**Risks Relating to the Terms of the Series A Preferred Securities.**

*Dividends are not cumulative and you are not entitled to receive dividends unless authorized and declared by our board of directors.*

Dividends on the Series A preferred securities are not cumulative. Consequently, if our board of directors does not declare a dividend on the Series A preferred securities for any quarterly period, you will not be entitled to receive that dividend whether or not funds are or subsequently become available. Our board of directors may determine that it would be in our best interests to pay less than the full amount of the stated dividends on the Series A preferred securities or no dividends for any quarter even though funds are available. Factors that would generally be considered by our board of directors in making this determination are the amount of our distributable funds, our financial condition and capital needs, the impact of current and pending legislation and regulations, economic conditions, tax considerations, and our continued qualification as a REIT. If we fail to pay, or declare and set aside for payment, dividends on the Series A preferred securities for six quarters, the holders of the Series A preferred securities, voting together as a class with the holders of other stock ranking on parity with our Series A preferred securities, which we refer to as Parity Stock , with the same voting rights, will have the right to elect two directors in addition to those already on the board.

*The Series A preferred securities solely represent an interest in us and are not the obligation of, or guaranteed by, any other entity.*

The Series A preferred securities do not constitute obligations or equity securities of Wachovia, the Bank, or any other entity, nor are our obligations with respect to the Series A preferred securities guaranteed by any other entity. In particular, none of Wachovia, the Bank, or any other entity guarantees that we will declare or pay any dividends nor are they obligated to provide additional capital or other support to us to enable us to pay dividends in the event our assets and results of operations are insufficient for such purpose. The Series A preferred securities are not exchangeable for Wachovia preferred stock except in connection with a Supervisory Event. No holder of Series A preferred securities will have the right to require us to exchange such holder s Series A preferred securities for depositary shares of Wachovia.

*A decline in the Bank s capital levels may result in your Series A preferred securities being exchanged for depositary shares representing Wachovia preferred stock and such exchange is likely to occur at a time when the Bank s and Wachovia s financial condition has deteriorated.*

The returns from your investment in the Series A preferred securities will be dependent to a significant extent on the performance and capital of the Bank. A decline in the performance and capital levels of the Bank

**Table of Contents**

or the placement by the OCC of the Bank into conservatorship or receivership could result in the automatic exchange of each Series A preferred security for one depositary share representing a one-sixth interest in one share of Wachovia Series G, Class A preferred stock, which would represent an investment in Wachovia and not in us. Under these circumstances:

- you would become a preferred shareholder of Wachovia at a time when the Bank s and, ultimately, Wachovia s financial condition has deteriorated or when the Bank may have been placed into conservatorship or receivership and, accordingly, it is unlikely that Wachovia would be in a financial position to make any dividend payments on Wachovia preferred stock;

- in the event of a liquidation of Wachovia, the claims of depositors and creditors of Wachovia would be entitled to priority in payment over the claims of holders of equity interests such as the depositary shares representing Wachovia Series G, Class A preferred stock, and, therefore, you may receive substantially less than you would receive had the Series A preferred securities not been exchanged for the depositary shares;

- the exchange of the Series A preferred securities for depositary shares representing Wachovia Series G, Class A preferred stock would most likely be a taxable event to you under the Code, and in that event you would incur a gain or loss, as the case may be, measured by the difference between your basis in the Series A preferred securities and the fair market value of depositary shares representing Wachovia Series G, Class A preferred stock received in the exchange; and

- although the terms of the Wachovia Series G, Class A preferred stock are substantially similar to the terms of our Series A preferred securities, there are differences that you might deem to be important, such as the fact that holders of depositary shares representing Wachovia Series G, Class A preferred stock will not have any voting rights, any right to elect additional directors regardless of whether dividends are paid and will not benefit from any covenants. In addition, neither the Wachovia Series G, Class A preferred stock nor the depositary shares representing an interest in that stock will be listed on any securities exchange.

*We may liquidate, dissolve or wind up at any time without your approval or consent.*

Our certificate of incorporation provides that, subject to the terms of the capital stock we have outstanding at the time, we may liquidate, dissolve or wind up upon the affirmative vote of a majority of our Independent Directors. However, since the Series A preferred securities will not have voting rights as a separate class with respect to these matters, Wachovia Preferred Holding, which will be the holder of substantially all of our common stock, will have control over our liquidation, dissolution or winding up. Although Wachovia Preferred Holding has no present intention to cause such an event to occur, there can be no assurance that it will not cause us to liquidate, dissolve or wind up at any time or for any reason. If such an event were to occur, you may not be able to invest your liquidation proceeds in securities with a dividend yield comparable to that of the Series A preferred securities.

*The holders of Series A preferred securities have limited voting rights.*

Holders of Series A preferred securities are entitled to 1/10th of one vote per security on all matters to be voted on by all our shareholders. Immediately after the offering, Wachovia and its affiliates will have the right to vote approximately 98% of all votes and the holders of Series A preferred securities not affiliated with Wachovia will have the right to vote less than 2% of all votes on any matter to be voted on by all our shareholders. In addition, each of Wachovia Preferred Holding and the holders of Series A preferred securities not affiliated with Wachovia will have the right to vote 60% of all votes on any matter which requires the holders of Series A preferred securities to vote separately as a single class. The consent or vote of the holders of at least two-thirds of the outstanding Series A preferred securities is required for an adoption of any matter on which the holders of Series A preferred securities have a right to vote separately as a single class. See Description of the Series A Preferred Securities Voting Rights .

15

Table of Contents

*We may redeem the Series A preferred securities upon the occurrence of a Special Event.*

At any time following the occurrence of a Special Event, even if such Special Event occurs prior to December 31, 2022, we will have the right to redeem the Series A preferred securities in whole, subject to the prior written approval of the OCC. The occurrence of such a Special Event will not, however, give a shareholder any right to request that the Series A preferred securities be redeemed. There are three types of Special Events: Tax Events, Investment Company Events and Regulatory Capital Events.

A Tax Event occurs when we receive an opinion of counsel to the effect that, as a result of a judicial decision or administrative pronouncement, ruling, or other action or as a result of certain changes in the tax laws, regulations, or related interpretations, there is a significant risk that dividends with respect to our capital stock will not be fully deductible by us or we will be subject to additional taxes or governmental charges.

An Investment Company Event occurs when we receive an opinion of counsel to the effect that, as a result of certain changes in the applicable laws, regulations, or related interpretations, there is a significant risk that we will be considered an investment company under the Investment Company Act of 1940 (the Investment Company Act ).

A Regulatory Capital Event occurs when, as a result of certain changes in the applicable laws, regulations, or related interpretations, there is a significant risk that our Series A preferred securities will no longer constitute Tier 1 capital of the Bank or Wachovia.

If we redeem the Series A preferred securities, you may not be able to invest your redemption proceeds in securities with a dividend yield comparable to that of the Series A preferred securities.

*The Series A preferred securities will rank subordinate to claims of our creditors and on a parity with our Series B and D preferred securities and any other Parity Stock we may issue.*

The Series A preferred securities will rank subordinate to all claims of our creditors. The Series A, B and D preferred securities will rank on parity with each other with respect to dividend rights and upon our liquidation, dissolution or winding up. In addition, we may issue additional Parity Stock at any time in the future without your consent or approval but upon the approval of a majority of our Independent Directors. Accordingly, if

we do not have funds legally available to pay full dividends on the Series A, B and D preferred securities and any other Parity Stock we may issue; or

in the event of our liquidation, dissolution or winding up, we do not have funds legally available to pay the full liquidation value of the Series A, B and D preferred securities and any other Parity Stock,

any funds that are legally available to pay such amounts will be paid *pro rata* to the Series A, B and D preferred securities and any other Parity Stock outstanding. See Description of Other Wachovia Funding Capital Stock Preferred Stock Series B Preferred Securities and Series D

Preferred Securities .

*There has never been a market for the Series A preferred securities.*

Prior to this offering, there has been no public market for the Series A preferred securities. We have applied for the listing of the Series A preferred securities on the New York Stock Exchange under the symbol WNA Pr . Trading in the Series A preferred securities is expected to commence not later than 30 days after the date of delivery of the Series A preferred securities. Consequently, there will be no trading market for the Series A preferred securities, at least in the short term. We cannot assure you that an active and liquid trading market for the Series A preferred securities will develop or be sustained. If such a market were to develop, the prices at which the Series A preferred securities trade would depend on many factors, including prevailing

Table of Contents

interest rates, our operating results, and the market for similar securities. You may not be able to resell your Series A preferred securities at or above the initial price to the public or at all.

**Risks Relating to Our Status as a REIT.**

*We would suffer adverse tax consequences if we fail to qualify as a REIT.*

Although we currently conduct our operations so as to qualify as a REIT under the Code, we may not be able to continue to qualify as a REIT. Qualification as a REIT involves the application of highly technical and complex tax law provisions for which there are only limited judicial or administrative interpretations and involves the determination of various factual matters and circumstances not entirely within our control. No assurance can be given that new legislation or new regulations, administrative interpretations, or court decisions will not significantly change the tax laws in the future with respect to qualification as a REIT or the Federal income tax consequences of such qualification in a way that would materially and adversely affect our ability to operate. Any such new legislation, regulation, interpretation or decision could be the basis of a Tax Event that would permit us to redeem the Series A preferred securities. See Description of the Series A Preferred Securities Redemption .

If we were to fail to qualify as a REIT, the dividends on our preferred stock, including the Series A preferred securities, would not be deductible by us for Federal income tax purposes, and we would likely become part of the consolidated group of which the Bank is a member. Consequently, the consolidated group would face a greater tax liability which could result in a reduction in the Bank s net earnings after taxes. We would also become jointly and severally liable for the consolidated group s United States Federal income tax liabilities. A reduction in the Bank s net earnings after taxes could adversely affect the Bank s ability to raise additional capital, as well as its ability to generate additional capital internally, and consequently its ability to add interest-earning assets to its portfolio.

If in any taxable year we fail to qualify as a REIT, unless we are entitled to relief under certain statutory provisions, we would also be disqualified from treatment as a REIT for the four taxable years following the year our qualification was lost. As a result, the amount of funds available for distribution to our shareholders would be reduced for the year or years involved.

As a REIT, we generally will be required each year to distribute as dividends to our shareholders at least 90% of our REIT taxable income, excluding capital gains. Failure to comply with this requirement would result in our earnings being subject to tax at regular corporate rates. In addition, we would be subject to a 4% non-deductible excise tax on the amount by which certain distributions considered as paid by us with respect to any calendar year are less than the sum of:

85% of our ordinary income for the calendar year;

95% of our capital gains net income for the calendar year; and

100% of undistributed taxable income from prior periods.

We currently intend to operate in a manner designed to qualify as a REIT. However, future economic, market, legal, tax, or other considerations may cause us to determine that it is in our best interests and the best interests of holders of our common stock and preferred stock to revoke our

REIT election. As long as any Series A preferred securities are outstanding, any such determination by us may not be made without the approval of a majority of our Independent Directors.

*If ownership of our capital stock becomes concentrated in a small number of individuals, we may fail to qualify as a REIT.*

In order to maintain our qualification as a REIT under the Code, not more than 50% in value of our outstanding shares of capital stock may be owned, directly or constructively, by five or fewer individuals (as

Table of Contents

defined in the Code to include certain entities) at any time during the last half of a taxable year, and the shares of capital stock must be beneficially owned by 100 or more persons during at least 335 days of a taxable year of 12 months (or during a proportionate part of a shorter taxable year, other than the first 12 months as a REIT). Therefore, our certificate of incorporation contains provisions restricting the ownership and transfer of our preferred securities.

Our certificate of incorporation provides that a transfer of shares that would otherwise result in more than 50% in value of our outstanding shares of capital stock being owned by five or fewer individuals, under the applicable attribution rules of the Code, or which would cause our shares of capital stock to be beneficially owned by fewer than 100 persons, will be null and void and the purported transferee will acquire no rights or economic interest in such shares.

These transfer restrictions imposed by us could impair the liquidity of the Series A preferred securities and thereby affect the secondary market for the Series A preferred securities.

**Risks Associated with Our Business.**

*We are effectively controlled by Wachovia and our relationship with Wachovia and/or the Bank may create potential conflicts of interest.*

All of our officers and certain of our directors are also either officers or directors of Wachovia or the Bank or their affiliates. After this offering, Wachovia, the Bank and Wachovia Preferred Holding will continue to control a substantial majority of our outstanding voting shares. In effect, Wachovia, the Bank and Wachovia Preferred Holding will have the right to elect all of our directors, including Independent Directors, except under limited circumstances if we fail to pay dividends.

The Bank may have interests that are not identical to our interests. Wachovia, the owner of the Bank s common stock, may have investment goals and strategies that differ from those of the holders of the Series A preferred securities. Consequently, conflicts of interest between us, on one hand, and the Bank and/or Wachovia, on the other hand, may arise.

*We are dependent on the officers and employees of Wachovia and the Bank for the selection, structuring and monitoring of the loans in our portfolio and our relationship with Wachovia and/or the Bank may create potential conflicts of interest.*

Wachovia and the Bank are involved in virtually every aspect of our existence. The Bank administers our day-to-day activities under the terms of participation and servicing agreements between the Bank and us. We are dependent on the diligence and skill of the officers and employees of the Bank for the selection, structuring and monitoring of the loans in our portfolio and our other authorized investments.

This dependency and our close relationship with Wachovia and the Bank may create potential conflicts of interest. Specifically, such conflicts of interest may arise because the employees of Wachovia and the Bank (i) were directly involved in the decisions regarding the amount, type and price of loan participation interests and other assets acquired indirectly from the Bank prior to the offering, and (ii) will make decisions on the amount, type and price of future acquisitions of loan participation interests and other assets from the Bank as well as future dispositions of loan participation interests to the Bank or third parties.

*We are dependent on the officers and employees of the Bank for the servicing of the loans in our portfolio and our relationship with the Bank may create potential conflicts of interest.*

We are dependent on the Bank and others for the servicing of the loans in our portfolio. The Bank administers our day-to-day activities under the terms of participation and servicing agreements relating to our

Table of Contents

assets. These agreements contain terms which we believe are consistent with those resulting from arm s length negotiations and contain the following fees:

with respect to the commercial, commercial real estate and home equity loans, an annual service fee of 0.03% multiplied by the outstanding principal balance of each loan, and

with respect to residential mortgages, $48.00 per loan. Additionally, we are subject to Wachovia s management fee policy and thus reimburse Wachovia on a monthly basis for general overhead expenses.

Despite our belief that the terms of the loan participation and servicing agreements between the Bank and us reflect terms consistent with those negotiated on an arms-length basis, our dependency on the Bank s officers and employees and our close relationship with the Bank may create potential conflicts of interest. Specifically, such conflicts of interest may arise because the employees of the Bank have the power to set the amount of the service fees paid to the Bank, modify the loan participation and servicing agreements, and make business decisions with respect to servicing of the underlying loans, particularly the loans that are placed on non-accrual status or are otherwise non-performing.

*We are dependent on the officers and employees of the Bank for the management of the cash collateral related to the interest rate swaps and our relationship with the Bank may create potential conflicts of interest.*

Wachovia and the Bank are involved in virtually every aspect of our existence. The Bank manages our cash collateral related to the interest rate swaps. We are dependent on the diligence, skill and discretion of the officers and employees of the Bank for the selection and monitoring of the investments made with our cash collateral. This dependency and our close relationship with Wachovia and the Bank may create potential conflicts of interest.

*We are dependent on the officers and employees of the Bank for the identification and treatment of new business opportunities and our relationship with the Bank may create potential conflicts of interest.*

Wachovia and the Bank are involved in virtually every aspect of our existence. The employees of the Bank identify any new business opportunities for us and the Bank decides whether such opportunities are directed to us or other affiliates. As a result, we are dependent on the diligence, skill and discretion of the officers and employees of the Bank for the identification and treatment of new business opportunities and this dependency and our close relationship with Wachovia and the Bank may create potential conflicts of interest.

*Bank regulators may limit our ability to implement our business plan and may restrict our ability to pay dividends.*

Because we are an indirect subsidiary of the Bank, bank regulatory authorities will have the right to examine us and our activities and, under certain circumstances, to impose restrictions on the Bank or us that could impact our ability to conduct business pursuant to our business plan and that could adversely effect our financial condition and results of operations.

If the OCC, which is the Bank s primary regulator, determines that the Bank s relationship with us results in an unsafe and unsound banking practice, the Bank s regulators have the authority to:

- restrict our ability to transfer assets;
- restrict our ability to make distributions to our shareholders, including dividends to holders of the Series A preferred securities;
- restrict our ability to redeem our preferred stock; or
- require the Bank to sever its relationship with us or divest its ownership of us.

**Table of Contents**

If the OCC determines that the Bank is operating with an insufficient level of capital, or that the payment of dividends by either the Bank or its subsidiaries is under the then present circumstances an unsafe and unsound banking practice, the OCC could restrict our ability to pay dividends.

Certain of these actions by the OCC would likely result in our failure to qualify as a REIT.

*If we lose our exemption under the Investment Company Act it could have a material adverse effect on us and would likely result in a redemption of the Series A preferred securities.*

We believe that we are not, and intend to conduct our operations so as not to become, regulated as an investment company under the Investment Company Act. Under the Investment Company Act, a non-exempt entity that is an investment company is required to register with the SEC and is subject to extensive, restrictive and potentially adverse regulation relating to, among other things, operating methods, management, capital structure, dividends and transactions with affiliates. The Investment Company Act exempts entities that, directly or through majority-owned subsidiaries, are primarily engaged in the business of purchasing or otherwise acquiring mortgages and other liens on and interests in real estate (which we refer to as Qualifying Interests ). Under current interpretations of the staff of the SEC, in order to qualify for this exemption, we, among other things, must maintain at least 55% of our assets in Qualifying Interests and also may be required to maintain an additional 25% in Qualifying Interests or other real estate-related assets. The assets that we may acquire therefore may be limited by the provisions of the Investment Company Act. We have established a policy of limiting authorized investments which are not Qualifying Interests to no more than 20% of the value of our total assets. The Investment Company Act does not treat cash and cash equivalents as either Qualifying Interests or other real estate-related assets.

Based on the criteria outlined above, we believe that, as of the time of this offering, our Qualifying Interests will be comprised of approximately 87% of the estimated fair market value of our total assets. As a result, we believe that we are not required to register as an investment company under the Investment Company Act. We do not intend, however, to seek an exemptive order, no-action letter or other form of interpretive guidance from the SEC or its staff on this position. If the SEC or its staff were to take a different position with respect to whether our assets constitute Qualifying Interests, we could be required either (a) to change the manner in which we conduct our operations to avoid being required to register as an investment company or (b) to register as an investment company, either of which could have a material adverse effect on us, the price of our securities and our ability to make payments in respect of the Series A preferred securities. Further, in order to ensure that we at all times continue to qualify for the above exemption from the Investment Company Act, we may be required at times to adopt less efficient methods of financing certain of our assets than would otherwise be the case and may be precluded from acquiring certain types of assets whose yield is somewhat higher than the yield on assets that could be purchased in a manner consistent with the exemption. The net effect of these factors may be to lower at times our net interest income. Finally, if we were an unregistered investment company, there would be a risk that we would be subject to monetary penalties and injunctive relief in an action brought by the SEC, that we would be unable to enforce contracts with third parties and that third parties could seek to obtain rescission of transactions undertaken during the period we were determined to be an unregistered investment company. In the event we are ever considered an investment company under the Investment Company Act as a result of an Investment Company Act Event, we would likely redeem the Series A preferred securities. See above under We may redeem the Series A preferred securities upon the occurrence of a Special Event .

*We have no control over changes in interest rates and such changes could negatively impact our financial condition, results of operations, and ability to pay dividends.*

Our income consists primarily of interest payments on the loans in our portfolio. At September 30, 2002, 14% of the loans in our portfolio, as measured by the aggregate outstanding principal amount, bore

20

Table of Contents

interest at fixed rates and the remainder bore interest at adjustable rates. Adjustable-rate loans decrease the risks to a lender associated with changes in interest rates but involve other risks. As interest rates rise, the payment by the borrower rises to the extent permitted by the terms of the loan, and the increased payment increases the potential for default. At the same time, the marketability of the underlying property may be adversely affected by higher interest rates. In a declining interest rate environment, there may be an increase in prepayments on the loans in our portfolio as the borrowers refinance their mortgages at lower interest rates. Under these circumstances, we may find it more difficult to purchase additional participation interests with rates sufficient to support the payment of the dividends on the Series A preferred securities. A declining interest rate environment would adversely affect our ability to pay full, or even partial, dividends on the Series A preferred securities.

*The loans in our portfolio are subject to economic conditions that could negatively affect the value of the collateral securing such loans and/or the results of our operations.*

The value of the collateral underlying our loans and/or the results of our operations could be affected by various conditions in the economy, such as:

- local and other economic conditions affecting real estate and other collateral values;
- sudden or unexpected changes in economic conditions, including changes that might result from terrorist attacks and the United States response to such attacks;
- the continued financial stability of a borrower and the borrower s ability to make loan principal and interest payments, which may be adversely affected by job loss, recession, divorce, illness or personal bankruptcy;
- the ability of tenants to make lease payments;
- the ability of a property to attract and retain tenants, which may be affected by conditions such as an oversupply of space or a reduction in demand for rental space in the area, the attractiveness of properties to tenants, competition from other available space, and the ability of the owner to pay leasing commissions, provide adequate maintenance and insurance, pay tenant improvement costs, and make other tenant concessions;
- interest rate levels and the availability of credit to refinance loans at or prior to maturity; and
- increased operating costs, including energy costs, real estate taxes, and costs of compliance with environmental controls and regulations.

*The loans in our portfolio are concentrated in five states, and adverse conditions in those states, in particular, could negatively impact our operations.*

At September 30, 2002, 71% (as a percentage of loan principal balances) of the assets in our portfolio were located in Florida, North Carolina, Pennsylvania, New Jersey and Virginia. Because of the concentration of our interests in those states, in the event of adverse economic conditions in those states, we would likely experience higher rates of loss and delinquency on our loan portfolio than if the underlying loans were more geographically diversified. Additionally, the loans in our portfolio may be subject to a greater risk of default than other comparable loans in the event of adverse economic, political, or business developments or natural hazards that may affect Florida, North Carolina, Pennsylvania, New Jersey or Virginia, and the ability of property owners or commercial borrowers in those states to make payments of principal and interest on the underlying loans. In the event of any adverse development or natural disaster, our ability to pay dividends on the Series A preferred securities could be adversely affected.

*Our acquisitions of participation interests in commercial and commercial mortgage loans subjects us to risks that are not present in our portfolio of residential mortgage loans, including the fact that some commercial loans are unsecured.*

As of September 30, 2002, 84% of our assets, as measured by aggregate outstanding principal amount, consisted of participation interests in commercial and commercial real estate loans. Commercial and

**Table of Contents**

commercial real estate loans generally tend to have shorter maturities than residential mortgage loans and may not be fully amortizing, meaning that they may have a significant principal balance or balloon payment due on maturity. Commercial real estate properties tend to be unique and are more difficult to value than single-family residential real estate properties. They are also subject to relatively greater environmental risks and to the corresponding burdens and costs of compliance with environmental laws and regulations. In addition, some of our commercial loans are unsecured. Such unsecured loans are more likely than loans secured by real estate or personal property collateral to result in a loss upon a default.

*We cannot assure you that we paid the Bank fair value for all of our assets because we have not obtained any third party valuation of all those assets. Nor can we assure you that we will acquire or dispose of assets in the future at their fair market value.*

We have adopted policies with a view to ensuring that all financial dealings between the Bank and us will be fair to both parties and consistent with market terms. However, there has been no third party valuation of all our assets. In addition, it is not anticipated that third party valuations will be obtained in connection with future acquisitions or dispositions of assets even in circumstances where an affiliate of ours is selling the assets to us, or purchasing the assets from us. Accordingly, we cannot assure you that the purchase price we paid for all of our assets was equal to the fair value of those assets. Nor can we assure you that the consideration to be paid by us to, or received by us from, the Bank or any of our affiliates in connection with future acquisitions or dispositions of assets will be equal to the fair value of such assets.

*We could incur losses as a result of environmental liabilities of properties underlying our assets through foreclosure action.*

We may be forced to foreclose on an underlying commercial, commercial real estate or residential loan where the borrower has defaulted on its obligation to repay the loan. It is possible that we may be subject to environmental liabilities with respect to foreclosed property, particularly industrial and warehouse properties, which are generally subject to relatively greater environmental risks than non-commercial properties. The discovery of these liabilities and any associated costs for removal of hazardous substances, wastes, contaminants, or pollutants, could have a material adverse effect on the fair value of such loan and therefore we may not recover any or all of our investment in the underlying commercial, commercial real estate or residential loan.

*We do not have insurance to cover our exposure to borrower defaults and bankruptcies and special hazard losses that are not covered by standard insurance.*

Generally, neither we nor the Bank obtain credit enhancements such as borrower bankruptcy insurance or obtain special hazard insurance for the loans in our portfolio, other than standard hazard insurance typically required by the Bank, which relates only to individual loans. Without third party insurance, we are subject to risks of borrower defaults and bankruptcies and special hazard losses that are not covered by standard hazard insurance.

*Delays in liquidating defaulted loans could occur which could cause our business to suffer.*

Substantial delays could be encountered in connection with the liquidation of the collateral securing defaulted loans in our portfolio, with corresponding delays in our receipt of related proceeds. An action to foreclose on a mortgaged property or repossess and sell other collateral securing a loan is regulated by state statutes and rules. Any such action is subject to many of the delays and expenses of lawsuits, which may impede our ability to foreclose on or sell the collateral or to obtain proceeds sufficient to repay all amounts due on the related loan in our portfolio.

Table of Contents

*We may invest in assets which involve new risks and need not maintain the current asset coverage.*

Although our portfolio currently consists primarily of commercial, commercial real estate and residential loan interests, and we presently intend to reinvest proceeds of such interests in similar assets, we are not required to limit our investments to assets of the types currently in our portfolio. Assets such as mortgage-backed securities, equipment loans or real estate may involve different risks not described in this prospectus. Nevertheless, we will not invest in assets that are not REIT Qualified Assets if such investments would cause us to violate the requirements for taxation as a REIT. Moreover, while our policies will call for maintaining specified levels of funds from operations coverage as to expected dividend distributions, we are not required to maintain the levels of asset coverage that currently exist.

**Risk Factors Applicable Only to Wachovia Depositary Shares Representing the Wachovia Series G, Class A Preferred Stock Issued upon the Occurrence of a Conditional Exchange.**

*You may have adverse tax consequences as a result of a Conditional Exchange.*

The exchange of our Series A preferred securities for depositary shares representing an interest in Wachovia Series G, Class A preferred stock would most likely be a taxable event to you under the Code, and you would incur a gain or loss, as the case may be, measured by the difference between your basis in our Series A preferred securities and the fair market value of the depositary shares.

*A decline in Wachovia s financial condition may restrict its ability to pay dividends and could result in a loss on your investment.*

If Wachovia s financial condition were to deteriorate, the holders of the depositary shares representing the Wachovia Series G, Class A preferred stock could suffer direct and materially adverse consequences, including suspension of the payment of non-cumulative dividends on the Wachovia Series G, Class A preferred stock and, if a liquidation, dissolution or winding up of Wachovia were to occur, loss by holders of depositary shares of all or part of their investment. See Description of Wachovia Series G, Class A Preferred Stock .

*A Conditional Exchange may be based on the Bank s receivership, which could lead to Wachovia s receivership and would mean that others may have liquidation claims senior to yours.*

A Supervisory Event triggering a Conditional Exchange will occur if the Bank is placed into conservatorship or receivership. The Bank s conservatorship or receivership could lead to Wachovia being placed into conservatorship or receivership. In the event of Wachovia s receivership, the claims of Wachovia s secured, senior, general and subordinated creditors would be entitled to a priority of payment over the claims of holders of equity interests such as the Wachovia Series G, Class A preferred stock. As a result of such subordination, either if Wachovia were to be placed into receivership after a Conditional Exchange or if a Conditional Exchange were to occur after Wachovia s receivership, the holders of the depositary shares would likely receive, if anything, substantially less than they would have received had our Series A preferred securities not been exchanged.

*Upon the occurrence of a Conditional Exchange, the holders of the depositary shares will not have any voting rights, the right to elect Independent Directors nor have the benefit of the same favorable covenants as the Series A preferred securities.*

Upon the occurrence of a Conditional Exchange, the holders of the depositary shares representing Wachovia Series G, Class A preferred stock will not have voting rights, the right to elect Independent Directors if dividends are not authorized and declared by Wachovia s board of directors nor have the benefit of the same favorable covenants as the Series A preferred securities. Therefore, Wachovia may authorize and issue additional shares of preferred stock that may rank junior to, on parity with or senior to the Series G, Class A preferred stock as to dividend rights and rights upon liquidation, winding up, or dissolution without the consent of the holders of the Series G, Class A preferred stock.

Table of Contents

*Wachovia is not obligated to pay, and is subject to certain limitations on the payment of, dividends on the Wachovia Series G, Class A preferred stock and dividends on these securities are not cumulative.*

Dividends on the Wachovia Series G, Class A Preferred stock are not cumulative. Consequently, if Wachovia s board of directors does not declare dividends on the Wachovia Series G, Class A preferred stock for any quarterly period, the holders of the Wachovia Series G, Class A preferred stock and the depositary shares represented thereby would not be entitled to any such dividend whether or not funds are or subsequently become available. Under an indenture between Wachovia and Wilmington Trust Company, as trustee, Wachovia has agreed not to pay any dividends on, or make a liquidation payment relating to, any of Wachovia s common stock or preferred stock, including its Series G, Class A preferred stock, if, at that time, there is a default under the indenture or a related Wachovia guarantee or Wachovia has delayed interest payments on trust preferred securities issued under the indenture. Currently, there are $1.3 billion aggregate principal amount of trust preferred securities outstanding under such indenture.

The Wachovia board of directors may determine that it would be in Wachovia s best interests to pay less than the full amount of the stated dividends on the Wachovia Series G, Class A preferred stock or no dividends for any quarter even if funds are available. Factors that would be considered by the Wachovia board of directors in making this determination are Wachovia s financial condition and capital needs, the impact of current and pending legislation and regulations, economic conditions, tax considerations, and such other factors as the board of directors may deem relevant. In addition, as a bank holding company, Wachovia is subject to various general regulatory policies and requirements relating to the payment of dividends, including requirements to maintain adequate capital above regulatory minimums. The Federal Reserve Board is authorized to determine, under certain circumstances relating to the financial condition of a bank holding company, such as Wachovia, that the payment of dividends would be an unsound and unsafe practice and to prohibit payment thereof. See Description of Wachovia Series G, Class A Preferred Stock Dividends .

*There is no active trading market for the Wachovia Series G, Class A preferred stock or the depositary shares representing that stock and no such trading market may develop.*

The Wachovia Series G, Class A preferred stock and the depositary shares representing that stock will be new issues of securities. Prior to this offering, there has been no public market for the Wachovia Series G, Class A preferred stock or the depositary shares. Wachovia does not intend to cause the listing or quotation of the Wachovia Series G, Class A preferred stock or the depositary shares representing an interest in that stock on the New York Stock Exchange or on any other national securities exchange or quotation system on which the Series A preferred securities are then listed or quoted. Consequently, it is unlikely that an active and liquid trading public market for the depositary shares or the underlying Wachovia Series G, Class A preferred stock will develop or be maintained. The lack of liquidity and an active trading market could adversely affect your ability to dispose of the depositary shares representing an interest in the Wachovia Series G, Class A preferred stock.

Table of Contents

## INFORMATION CONCERNING THE BANK

### General

The Bank is a national banking association organized under the laws of the United States and with its principal office in Charlotte, North Carolina. The Bank offers a wide range of domestic and international , retail and commercial banking and trust services. At September 30, 2002, the Bank operated 2,769 branches in Connecticut, Florida, Georgia, Maryland, New Jersey, New York, North Carolina, Pennsylvania, South Carolina, Virginia and Washington, D.C., and in several foreign countries. At September 30, 2002, the Bank had total assets of $312 billion, total liabilities of $280 billion and total shareholders equity of $32 billion. On April 1, 2002, the former Wachovia Bank, National Association merged with and into First Union National Bank, and First Union National Bank changed its name to Wachovia Bank, National Association . Presentation of certain financial information in this prospectus for periods prior to April 1, 2002, will be for First Union National Bank only.

The Series A preferred securities will be exchangeable, without your approval or any action on your part, for depositary shares representing interests in the Wachovia Series G, Class A preferred stock if the OCC so directs under the following circumstances, each of which is referred to as a Supervisory Event:

- the Bank becomes undercapitalized under prompt corrective action regulations,
- the Bank is placed into conservatorship or receivership, or
- the OCC, in its sole discretion, anticipates that the Bank may become undercapitalized in the near term or takes supervisory action that limits the payment of dividends by us and in connection therewith directs an exchange.

The Series A preferred securities are exchangeable only for the depositary shares. Under no circumstances will you ever receive securities of the Bank upon the occurrence of a Supervisory Event or for any other reason.

### Capital Adequacy

The OCC has issued regulations addressing the capital adequacy of national banks. Under these regulations, capital adequacy is measured by three different ratios: a ratio of total capital to risk-weighted assets; a ratio of Tier 1 capital to risk-weighted assets; and a leverage ratio of Tier 1 capital to balance sheet assets. For purposes of determining risk-weighted assets for the risk-based capital ratios, the book value of each of the bank s on-balance sheet assets, and a portion of certain off-balance sheet items and exposures, are weighted from 0% to 100% based on broad categories. For instance, U.S. government debt obligations are generally risk weighted at 0%; residential real estate mortgage loans on one-to-four family dwellings are generally risk weighted at 50%; and commercial loans and most other assets are generally risk-weighted at 100%. Off-balance sheet items (including letters of credit, loan commitments, swaps and other derivatives) are converted into on-balance sheet equivalent amounts for risk-based capital purposes, then assigned a risk weight like other assets. Under amendments adopted in November 2001 and being phased in by year-end 2002, the capital risk weighting assigned to certain asset-backed securities may vary from 20% to 200% depending on credit rating. Subordinated residual interests retained in asset securitizations, credit enhancement and forms of recourse can result in higher capital charges. The sum of all risk-weighted assets are measured against total capital and Tier 1 capital to determine risk-based capital ratios. A bank s leverage ratio represents Tier 1 capital divided by average total on-balance sheet assets, without recognizing off-balance sheet exposures or applying risk weights. As noted below, to be considered adequately capitalized, a national bank generally must maintain a total risk-based capital ratio of at least 8%, a Tier 1 risk-based ratio of at least 4%, and a Tier 1 leverage ratio of at least 4% (or 3% in exceptional cases).

**Table of Contents**

For purposes of these regulations, total capital is defined as the sum of Tier 1 capital and Tier 2 capital. Tier 1 capital generally includes common shareholders equity; non-cumulative perpetual preferred stock and related surplus; and qualifying minority interests in the equity accounts of consolidated subsidiaries (which may include such instruments as qualifying REIT preferred stock and trust preferred stock). Tier 2 capital generally includes (subject to certain limits and sub-limits): cumulative perpetual preferred stock; limited-life preferred stock; Dutch auction and money market preferred stock; hybrid capital instruments (including certain mandatory convertible notes); term subordinated debt; the bank s allowance for loan and lease losses (up to a maximum of 1.25% of total risk-weighted assets); and up to 45% of the pretax net unrealized gains of available-for-sale equity securities investments. Tier 2 capital is permitted to count towards only one-half of total capital. In addition, limited-life instruments generally can represent not more than one-half of Tier 2 capital and are phased out of capital over the last five years before maturity. Deductions from Tier 1 capital include goodwill, certain other intangible assets, and deferred tax assets in excess of certain limits.

For national banks with large trading portfolios, a different method known as the Market Risk Measure is applied to determine the risk-based capital requirements for items booked in the trading account and for foreign exchange and commodity positions, wherever booked. Under the Market Risk Measure, capital requirements for these portfolios are based on value-at-risk calculations and certain other factors, and the result is combined into the bank s total risk-based capital ratio. For purposes of the Market Risk Measure only, a portion of a bank s total capital can consist of certain Tier 3 capital instruments subordinated two-year notes with lock-in clauses restricting payment of principal or interest (even at maturity) if the bank falls below required capital ratios.

Under the OCC s prompt corrective action regulations, issued pursuant to the Federal Deposit Insurance Corporation Improvement Act of 1991, national banks are placed into one of five capital categories, as follows:

1. Well capitalized banks:

   have a total risk-based capital ratio of 10% or greater;

   have a Tier 1 risk-based capital ratio of 6% or greater;

   have a leverage ratio of 5% or greater; and

   are not subject to any other OCC action directed at a specific level of capital.

2. Adequately capitalized banks:

   have a total risk-based capital ratio of 8% or greater;

   have a Tier 1 risk-based capital ratio of 4% or greater;

   have a leverage ratio of

(a) 4% or greater; or

(b) 3% or greater for certain exceptionally well managed and well run banks; and

do not meet the definition of well capitalized.

3. Undercapitalized banks:

have a total risk-based capital that is less than 8%;

have a Tier 1 risk-based capital ratio that is less than 4%; or

have a leverage ratio of less than 4% or, if the bank is exceptionally well managed and well run, less than 3%.

Table of Contents

4. Significantly undercapitalized banks:

- have a total risk-based capital ratio that is less than 6%;
- have a Tier 1 risk-based capital that is less than 3%; or
- have a leverage ratio that is less than 3%.

5. Critically undercapitalized banks:

- have a ratio of tangible equity capital (Tier 1 capital plus cumulative preferred stock less certain intangible capital) that is equal to or less than 2%.

Under prompt corrective action provisions, if a national bank becomes undercapitalized , significantly undercapitalized or critically undercapitalized , the OCC may undertake (and, in some cases, may be compelled by statute to undertake) a variety of actions of increasing severity. Among other things, an undercapitalized bank must submit an acceptable capital restoration plan and is generally restricted from paying dividends, redeeming stock or making other capital distributions. Failure to achieve the goals of a capital restoration plan could subject a bank to penalties and to being considered significantly undercapitalized . A significantly undercapitalized bank is subject to a broad range of restrictions, including restrictions on growth, limits on activities, divestiture requirements, limits on interest rates paid on deposits, restrictions on transactions with affiliates, limits on executive compensation, and mandated changes in directors or management. Critically undercapitalized banks face even stricter measures, including possible receivership.

In addition, the OCC from time to time may impose higher specific capital requirements on any national bank that is perceived to have risks, exposures, asset concentrations, rapid growth or other circumstances warranting special attention. Failure to satisfy such a capital directive could subject a bank to civil money penalties, judicial enforcement and administrative remedies available to the OCC, as well as a finding that the bank is undercapitalized .

A national bank s capital ratios are monitored through the quarterly reports of condition submitted by each national bank pursuant to 12 U.S.C. §181 (frequently referred to as call reports ). These call reports are filed with the Federal Deposit Insurance Corporation.

Whether the Bank would ever be determined by the OCC to be undercapitalized , or at risk of becoming undercapitalized in the near term thereby triggering the exchange of the Series A preferred securities into depositary shares representing Wachovia Series G, Class A preferred stock could be influenced not only by the OCC s capital adequacy regulations, but also by the regulator s interpretations and judgment on other matters. For example, the OCC s views on asset credit quality could potentially affect a bank s capital status. Among other things, the OCC typically evaluates asset quality, loan loss reserves and procedures during periodic regulatory examinations of each national bank. If, following such an examination or otherwise, the OCC in its discretion were to require the Bank to significantly increase its reserves against credit losses (*i.e.*, the allowance for loan and lease losses), this could potentially reduce the Bank s retained earnings and regulatory capital. As noted above, a bank s allowance for loan and lease losses is includible within Tier 2 capital only up to a limit, and is not includible at all in Tier 1 capital.

A bank s regulatory capital status, and the risk of being deemed undercapitalized also could be affected by other developments or by future changes in regulatory capital and other standards. The Banking Supervision Committee of the Bank for International Settlements (the Basel Committee ) has proposed for comment, and is continuing to study and revise, substantial changes to its 1988 Basel Accord on international bank capital adequacy. We and the Bank are unable to predict whether or when the Basel Committee s proposed new capital accord may be finalized, how the new accord might be interpreted and implemented by the OCC, or what impact any such new standards might have on the Bank and its capital status.

27

Table of Contents

The following table presents the capital ratios reported to the OCC by the Bank, as well as those of Wachovia, the Bank s parent company, compared to the standards for adequately capitalized and well capitalized status, as of the dates indicated.

| | | | Regulatory Standards | |
|---|---|---|---|---|
| | The Bank | Wachovia | Adequately Capitalized | Well Capitalized |
| **September 30, 2002** | | | | |
| Tier 1 capital | 7.63 | 8.11 | 4.00 | 6.00 |
| Total capital | 12.12 | 12.02 | 8.00 | 10.00 |
| Leverage | 6.61 | 6.82 | 4.00 | 5.00 |
| **December 31, 2001** | | | | |
| Tier 1 capital | 7.55 | 7.04 | 4.00 | 6.00 |
| Total capital | 11.68 | 11.08 | 8.00 | 10.00 |
| Leverage | 6.29 | 6.19 | 4.00 | 5.00 |
| **December 31, 2000** | | | | |
| Tier 1 capital | 6.92 | 7.02 | 4.00 | 6.00 |
| Total capital | 10.73 | 11.19 | 8.00 | 10.00 |
| Leverage | 6.04% | 5.92 | 4.00 | 5.00 |

The Bank currently intends to maintain its capital ratios in excess of the well capitalized levels under the prompt corrective action regulations. However, there is no guarantee that the Bank s capital ratios will be maintained in the future at their current or historical levels. Accordingly, there is no assurance that the Bank will not be deemed to be undercapitalized by the OCC in the future or that the Bank will not be placed in conservatorship or receivership in the future. Consequently, there can be no assurance that a Supervisory Event will not occur and that the Series A preferred securities will not be exchanged for depositary shares in the future. You should therefore carefully consider the description of the Wachovia Series G, Class A preferred stock set forth under the caption Description of Wachovia Series G, Class A Preferred Stock and the description of the depositary shares representing interests in that stock set forth under the caption Description of Wachovia Depositary Shares before investing in the Series A preferred securities.

Supplementary consolidating financial information for Wachovia, which includes certain financial information for the Bank as of and for the nine months ended September 30, 2002, and as of and for the years ended December 31, 2001 and 2000, is included in the prospectus beginning on page F-22. We will continue to provide annual unaudited financial information for the Bank on an ongoing basis in the reports we file under the Securities Exchange Act of 1934, as amended (the Exchange Act ). We will also continue to provide in those reports current unaudited capital and capital ratio information. Additional information regarding the Bank can be obtained on Wachovia s website, www.wachovia.com, but that information is not incorporated by reference in this prospectus.

**Benefits to the Bank and Wachovia**

The Bank has received confirmation from the OCC that proceeds from the public sale of Series A preferred securities will qualify as Tier 1 capital of the Bank under relevant regulatory capital guidelines. Those guidelines limit the inclusion of our Series A preferred securities, together with all other outstanding non-cumulative perpetual preferred securities, to 25% of the Bank s Tier 1 capital, with the balance treated as Tier 2 capital of the Bank. The Bank and Wachovia expect that as of December 31, 2002, all of the proceeds from the public sale of Series A preferred securities will qualify as Tier 1 capital of the Bank and Wachovia. The increase in the Bank s Tier 1 risk-based capital level that will result from the treatment of the Series A preferred securities as Tier 1 capital will enable the Bank to retain a higher base of interest-earning assets, resulting in incrementally higher related earnings.

Table of Contents

**USE OF PROCEEDS**

Prior to this offering, Wachovia Preferred Holding will acquire from us 30,000,000 Series A, 40,000,000 Series B and 4,233,754 Series C preferred securities with liquidation preferences of $25.00, $25.00, and $1,000 per security, respectively. Wachovia Preferred Holding will acquire these preferred securities in exchange for participation interests with an aggregate fair market value of $6.0 billion, calculated using a discounted cash-flow methodology, in certain commercial and commercial real estate loans originated by and acquired from the Bank. Wachovia Preferred Holding acquired these participation interests from the Bank in exchange for 2,400 newly issued shares of Wachovia Preferred Holding s common stock valued at $6.0 billion. We intend to hold these participation interests as long-term investments.

Wachovia Preferred Holding, a statutory underwriter, will subsequently sell the 18,000,000 Series A preferred securities offered hereby through an underwriting syndicate to the public for cash consideration of $25.00 per security. We will not receive any of the proceeds from the sale of our Series A preferred securities owned by Wachovia Preferred Holding. The proceeds, before expenses and commissions, to be received by Wachovia Preferred Holding from the sale of the 18,000,000 Series A preferred securities are expected to be $450 million in the aggregate. Wachovia Preferred Holding intends to use the net proceeds from this offering for general corporate purposes and will not use the proceeds to purchase additional assets for contribution to us.

The Series A preferred securities are being offered for sale to increase the Bank s and Wachovia s regulatory capital. The proceeds from the sale of the Series A preferred securities will be included as Tier 1 capital of the Bank and Wachovia under relevant regulatory capital guidelines.

Wachovia Preferred Holding will pay all expenses and underwriting discounts and commissions involved with the offering to the public.

The depositary shares each representing a one-sixth interest in a share of Series G, Class A preferred stock of Wachovia will be made available, if ever, in connection with a Conditional Exchange of our Series A preferred securities at the direction of the OCC following a Supervisory Event. Wachovia will not receive any proceeds, directly or indirectly, from the subsequent exchange of the Series A preferred securities for the depositary shares.

Table of Contents

**CAPITALIZATION**

The following table sets forth our unaudited capitalization as of September 30, 2002, and as adjusted to reflect the issuance of our Series A, B and C preferred securities to Wachovia Preferred Holding.

| | September 30, 2002 | |
|---|---|---|
| **(In thousands)** | **Actual** | **Pro Forma** |
| **Long-term debt** | $ | |
| **Stockholders equity** | | |
| Preferred stock | | |
| Series A preferred securities, $0.01 par value, $25.00 liquidation preference, non-cumulative and conditionally exchangeable, 30,000,000 shares authorized, issued and outstanding(1) | | 300 |
| Series B preferred securities, $0.01 par value, $25.00 liquidation preference, non-cumulative and conditionally exchangeable, 40,000,000 shares authorized, issued and outstanding | | 400 |
| Series C preferred securities, $0.01 par value, $1,000 liquidation preference, cumulative, 5,000,000 shares authorized, 4,233,754 shares issued and outstanding | | 42 |
| Series D preferred securities, $0.01 par value, $1,000 liquidation preference, non-cumulative, 913 shares authorized, issued and outstanding | | |
| Common stock, $0.01 par value, 100,000,000 shares authorized, 99,999,900 shares issued and outstanding | 1,000 | 1,000 |
| Paid-in capital | 5,086,474 | 11,519,803 |
| Retained earnings | 376,674 | 376,674 |
| Total stockholders equity | 5,464,148 | 11,898,219 |
| Total capitalization | $ 5,464,148 | 11,898,219 |

(1) Our Series A preferred securities are exchangeable, without the approval or any action on the part of the holder, for depositary shares representing one-sixth of a share of Series G, Class A preferred stock of Wachovia if such an exchange is directed by the OCC upon the occurrence of a Supervisory Event.

The following table sets forth the unaudited capitalization of Wachovia at September 30, 2002.

| **(In millions)** | **September 30, 2002** |
|---|---|
| **Long-term debt** | $ 39,758 |

| | | |
|---|---|---|
| **Stockholders equity** | | |
| Dividend Equalization Preferred shares, issued 97 million shares | | 2 |
| Common stock, authorized 3 billion shares, issued 1.373 billion shares | | 4,577 |
| Paid-in capital | | 18,233 |
| Retained earnings | | 7,221 |
| Accumulated other comprehensive income, net | | 2,072 |
| Total stockholders equity | | 32,105 |
| Total capitalization | $ | 71,863 |

30

Table of Contents

## RATIOS OF EARNINGS TO FIXED CHARGES

The following table provides our consolidated ratio of earnings to fixed charges for the nine months ended September 30, 2002 and the year ended December 31, 2001. Data for the four years ended December 31, 2000, is not meaningful due to the immaterial amount of fixed charges in each of the four years.

| | Nine Months Ended September 30, 2002 | Year Ended December 31, 2001 |
|---|---|---|
| Pretax income (loss) from continuing operations | $ 181,824 | (36,224) |
| Fixed charges, excluding capitalized interest | 8,287 | 857 |
| Earnings (loss) | $ 190,111 | (35,367) |
| Interest | $ 8,287 | 857 |
| One-third of rents | | |
| Capitalized interest | | |
| Fixed charges | $ 8,287 | 857 |
| Consolidated ratios of earnings to fixed charges | 22.94x | n/m |

n/m not meaningful.

For purposes of computing the ratio in the table above, earnings represent income from continuing operations and fixed charges represent interest.

The following table provides Wachovia s consolidated ratios of earnings to fixed charges and preferred stock dividends.

| | Nine Months Ended September 30, | Years Ended December 31, | | | | |
|---|---|---|---|---|---|---|
| | 2002 | 2001 | 2000 | 1999 | 1998 | 1997 |
| **Consolidated Ratios of Earnings to Fixed Charges and Preferred Stock Dividends** | | | | | | |
| Excluding interest on deposits | 2.87x | 1.61 | 1.13 | 2.29 | 2.13 | 2.50 |
| Including interest on deposits | 1.79x | 1.27 | 1.06 | 1.62 | 1.51 | 1.57 |

For purposes of computing the ratios in the table above:

- earnings represent income from continuing operations before extraordinary items and cumulative effect of a change in accounting principles, plus income taxes and fixed charges (excluding capitalized interest);
- fixed charges, excluding interest on deposits, represent interest (including capitalized interest), one-third of rents and all amortization of debt issuance costs; and
- fixed charges, including interest on deposits, represent all interest (including capitalized interest), one-third of rents and all amortization of debt issuance costs.

One-third of rents is used because it is the proportion deemed representative of the interest factor.

Table of Contents

## BUSINESS

### General

We are a Delaware corporation, formed in July 2002 and the survivor of a merger with First Union Real Estate Asset Company of Connecticut, which was formed in 1996. By the completion of this offering, we will be a direct subsidiary of Wachovia Preferred Holding and Wachovia and an indirect subsidiary of the Bank. Wachovia Preferred Holding will own 99.85% of our common stock and Wachovia will own the remaining .15%. The Bank will own 99.95% of the common stock of Wachovia Preferred Holding and Wachovia will own the remaining 0.05%. Wachovia Preferred Holding will own 87.62% of our Series D preferred securities, while the remaining 12.38% is owned by 113 employees of Wachovia or its affiliates.

After our merger with First Union Real Estate Asset Company of Connecticut, we issued and sold 913 shares of our Series D preferred securities to Wachovia Realty Management Corporation, an affiliate of Wachovia. In a series of related corporate reorganization transactions that occurred in July 2002, Wachovia Realty Management Corporation merged with and into its parent, Wachovia Realty Management Holding Company, Inc., a Delaware corporation, with the then holders of its preferred securities (113 employees of Wachovia or its affiliates ) receiving Series D preferred securities as merger consideration. Wachovia Realty Management Holding Company, Inc. in turn merged with and into its parent, Wachovia Management Company, Inc., a Delaware corporation. Wachovia Management Company, Inc. then liquidated and distributed all of its assets, including the Series D preferred securities, to the Bank. As a result of this series of related corporate reorganization transactions, 87.62% of our Series D preferred securities are now owned by the Bank and the remaining 12.38% by 113 employees of Wachovia or its affiliates. Upon our merger with First Union Real Estate Asset Company of Connecticut, we were a direct subsidiary of the Bank and an indirect subsidiary of Wachovia. By the completion of this offering, we will be a direct subsidiary of Wachovia Preferred Holding as a result of the Bank transferring certain interests in mortgage assets and other authorized investments through a loan participation agreement, 99.85% of our common stock and 87.62% of our Series D preferred securities to Wachovia Preferred Holding in exchange for additional shares of Wachovia Preferred Holding common stock.

One of our subsidiaries, Wachovia Real Estate Investment Corp., was formed as a Delaware corporation in 1996 and has operated as a REIT since its formation. Of the 645 shares of Wachovia Real Estate Investment Corp. common stock outstanding, we own 644 shares or 99.84% and the remaining 1 share is owned by Wachovia. Of the 667 shares of preferred stock outstanding, we own 529.3 shares, 131 shares are owned by employees of Wachovia or its affiliates and 6.7 shares are owned by Wachovia.

Our other subsidiary, Wachovia Preferred Realty, LLC ( WPR ), was formed as a Delaware limited liability company in October 2002. Under the REIT Modernization Act, which became effective on January 1, 2001, a REIT is permitted to own taxable REIT subsidiaries which are subject to taxation similar to corporations that do not qualify as REITs or for other special tax rules. Our ownership of WPR provides us with additional flexibility by allowing us to hold assets which earn non-qualifying REIT income while maintaining our REIT status. Following formation of WPR, we transferred our interest-rate swaps and related cash collateral, including those described below, to WPR. We are the sole member of WPR.

In December 2001, the Bank contributed received-fixed interest rate swaps, commercial loans and commercial real estate loans to us in exchange for shares of our common stock. The swaps had a notional amount of $4.25 billion and a fair value of $673 million. The commercial and commercial real estate loans had a book value of $4.0 billion. Prior to this transaction, our consolidated assets primarily consisted of home equity loans and residential mortgage loans.

All of the financial information and other data in this section is presented on a pro forma basis to reflect the following:

$866 million of participation interests in home equity loans received by us as collateral for an intercompany loan to the Bank in October 2002. The underlying home equity loans were originated by the Bank; and

32

**Table of Contents**

the issuance of three new series of preferred securities (Series A, B and C) to Wachovia Preferred Holding in exchange for participations in commercial and commercial real estate loans prior to this offering. The commercial and commercial real estate loans were originated by the Bank and contributed to Wachovia Preferred Holding. We will issue the preferred securities to Wachovia Preferred Holding in exchange for participations in the loans prior to this offering.

Our principal business objective is to acquire, hold, and manage mortgage assets and other authorized investments that will generate net income for distribution to our stockholders. At September 30, 2002, we had total assets of $12.5 billion, total liabilities of $607 million, and stockholders equity of $11.9 billion. As of such date,

$9.8 billion, or 78.7% of our assets, were comprised of participation interests in commercial real estate loans;

$866 million, or 6.9% of our assets, were comprised of an intercompany loan to the Bank secured by participation interests in home equity loans;

$661 million, or 5.3% of our assets, were comprised of participation interests in commercial loans;

$605 million, or 4.8% of our assets, were comprised of interest rate swaps;

$303 million, or 2.4% of our assets, were comprised of cash and cash equivalents;

$205 million, or 1.6% of our assets, were comprised of participation interests in home equity loans;

$89 million, or 0.7% of our assets, were comprised of residential mortgage loans; and

$31 million, or 0.3% of our assets, were comprised of net other assets;

each before the allowance for loan losses.

Additionally, unfunded commitments and letters of credit at September 30, 2002, were $1.5 billion and $216 million, respectively.

The weighted average yield earned on total interest-earning assets for the nine months ended September 30, 2002, was 3.31%.

Although we have the authority to acquire interests in an unlimited number of mortgage and other assets from unaffiliated third parties, the majority of our interests in mortgage and other assets acquired prior to this offering have been acquired from the Bank or an affiliate pursuant to loan participation agreements between the Bank or an affiliate and us. The remainder of our assets were acquired directly from the Bank. The Bank either originated the mortgage assets or acquired them as part of the acquisition of other financial institutions. We may also acquire from time to time mortgage-backed securities and a limited amount of additional non-mortgage related securities. We have no present plans or expectations with respect to purchases of mortgage assets or other assets from unaffiliated third parties.

The loans in our portfolio are serviced by the Bank pursuant to the terms of participation and servicing agreements between the Bank and us. The Bank has delegated servicing responsibility of the residential mortgage loans to third parties which are not affiliated with us or the Bank.

**General Description of Mortgage Assets and Other Authorized Investments; Investment Policy**

The Code requires us to invest at least 75% of the total value of our assets in real estate assets, which includes residential mortgage loans and commercial mortgage loans, including participation interests in residential or commercial mortgage loans, mortgage-backed securities eligible to be held by REITs, cash, cash equivalents, including receivables and government securities, and other real estate assets. We refer to these types of assets as REIT Qualified Assets . We may invest up to 25% of the value of a REIT s total assets in non-mortgage-related securities as defined in the Investment Company Act. Under the Investment Company Act, the term security is defined broadly to include, among other things, any note, stock, treasury stock, debenture, evidence of indebtedness, or certificate of interest or participation in any profit sharing agreement or a group or index of securities. The Code also requires that the value of any one issuer s securities, other

Table of Contents

than those securities included in the 75% test, may not exceed 5% by value of the total assets of the REIT. In addition, under the Code, the REIT may not own more than 10% of the voting securities or more than 10% of the value of the outstanding securities of any one issuer, other than those securities included in the 75% test and the securities of wholly-owned, qualified REIT subsidiaries. Generally, the Code designation for REIT Qualified Assets is less stringent than the Investment Company Act designation for Qualifying Interests, due to the ability under the Code to treat cash and cash equivalents as REIT Qualified Assets and a lower required ratio of REIT Qualified Assets to total assets.

All of the financial information and other data in the following discussion is presented on a pro forma basis to reflect the following:

- $866 million of participation interests in home equity loans received by us as collateral for an intercompany loan to the Bank in October 2002. The underlying home equity loans were originated by the Bank; and

- the issuance of three new series of preferred securities (Series A, B and C) to Wachovia Preferred Holding in exchange for participations in commercial and commercial real estate loans prior to this offering. The commercial and commercial real estate loans were originated by the Bank and contributed to Wachovia Preferred Holding. We will issue the preferred securities to Wachovia Preferred Holding in exchange for participations in the loans prior to this offering.

Under the Code, as of the time of this offering approximately 90% of our assets will be invested in REIT Qualified Assets and approximately 10% will be invested in commercial loans and other assets that are not REIT Qualified Assets. We do not hold any securities nor do we intend to hold securities in any one issuer that exceed 5% of our total assets or more than 10% of the voting securities of any one issuer. Our assets will consist of the following as of the time of this offering:

| | Pro Forma | |
|---|---|---|
| **(Dollars in thousands)** | **Amount** | **Percentage of Assets** |
| **REIT Qualified Assets** | | |
| Cash and cash equivalents | $ 303,327 | 2.4% |
| Participation interests | | |
| Commercial real estate loans | 9,846,391 | 78.7 |
| Home equity loans | 205,305 | 1.6 |
| Residential mortgage loans | 88,668 | 0.7 |
| Intercompany loan to Bank secured by participation interests in home equity loans | 866,053 | 6.9 |
| Allowance for loans losses | (101,230) | (0.8) |
| Total REIT Qualified Assets | 11,208,514 | 89.6 |
| **Other Non-Qualified Assets** | | |
| Commercial loans | 660,549 | 5.3 |
| Interest rate swaps | 605,438 | 4.8 |
| Accounts receivable-affiliates | 22,274 | 0.2 |
| Other assets and unearned income | 8,382 | 0.1 |
| Total other non-qualified assets | 1,296,643 | 10.4 |
| Total assets | $ 12,505,157 | 100.0% |

REITs generally are subject to tax at the maximum corporate rate on income from foreclosure property less deductible expenses directly connected with the production of that income. Income from foreclosure property includes gain from the sale of foreclosure property and income from operating foreclosure property, but income that would be qualifying income for purposes of the 75% gross income test is not treated as income from foreclosure property. Qualifying income for purposes of the 75% gross income test includes, generally, rental income and gain from the sale of property not held as inventory or for sale in the ordinary course of a trade or business. In accordance with the terms of the commercial, commercial mortgage and

**Table of Contents**

residential mortgage participation and servicing agreements, we maintain the authority to decide whether to foreclose on collateral that secures a loan. In the event we determine a foreclosure proceeding is appropriate, we may direct the Bank to prosecute the foreclosure on our behalf. Upon sale or other disposition of foreclosure property, the Bank will remit to us the proceeds less the cost of holding and selling the foreclosure property.

*Commercial and Commercial Real Estate Loans*

We own participation interests in commercial loans secured by non-real property such as industrial equipment, aircraft, livestock, furniture and fixtures, and inventory. Participation interests acquired in commercial real estate loans are secured by real property such as office buildings, multi-family properties of five units or more, industrial, warehouse and self-storage properties, office and industrial condominiums, retail space, strip shopping centers, mixed use commercial properties, mobile home parks, nursing homes, hotels and motels, churches, and farms. In addition, some of our commercial loans are unsecured. Such unsecured loans are more likely than loans secured by real estate or personal property collateral to result in a loss upon default. Commercial and commercial real estate loans also may not be fully amortizing. This means that the loans may have a significant principal balance or balloon payment due on maturity. Additionally, there is no requirement regarding the percentage of any commercial or commercial real estate property that must be leased at the time we acquire a participation interest in a commercial or commercial real estate loan secured by such property nor are commercial loans required to have third party guarantees.

Commercial properties, particularly industrial and warehouse properties, generally are subject to relatively greater environmental risks than non-commercial properties. This gives rise to increased costs of compliance with environmental laws and regulations. We may be affected by environmental liabilities related to the underlying real property which could exceed the value of the real property. Although the Bank has exercised and will continue to exercise due diligence to discover potential environmental liabilities prior to our acquisition of any participation in loans secured by such property, hazardous substances or wastes, contaminants, pollutants, or their sources may be discovered on properties during our ownership of the participation interests. There can be no assurance that we would not incur full recourse liability for the entire cost of any removal and clean-up on a property, that the cost of removal and clean-up would not exceed the value of the property, or that we could recoup any of the costs from any third party.

The credit quality of a commercial or commercial real estate loan may depend on, among other factors:

- the existence and structure of underlying leases;
- the physical condition of the property, including whether any maintenance has been deferred;
- the creditworthiness of tenants;
- the historical and anticipated level of vacancies;
- rents on the property and on other comparable properties located in the same region;
- potential or existing environmental risks;

- the availability of credit to refinance the loan at or prior to maturity; and

- the local and regional economic climate in general.

Foreclosures of defaulted commercial or commercial real estate loans generally are subject to a number of complicating factors, including environmental considerations, which are not generally present in foreclosures of residential mortgage loans.

Table of Contents

The following table sets forth certain information at September 30, 2002, with respect to the types of loans underlying the commercial and commercial real estate loan participations.

**Type of Commercial Loans**

| | Pro Forma | |
|---|---|---|
| **(Dollars in thousands)** | **Aggregate Principal Balance** | **Percentage by Aggregate Principal Balance** |
| **Type** | | |
| Commercial loans | $ 660,549 | 6.3% |
| Commercial mortgage loans | 9,846,391 | 93.7 |
| Total | $ 10,506,940 | 100.0% |

The following table shows data with respect to the collateral, if any, securing the loans underlying the commercial and commercial real estate loan participations and the weighted average maturity by primary collateral, if any, of the loans underlying the commercial and commercial real estate loan participations at September 30, 2002.

**Commercial and Commercial Real Estate Loans by Primary Collateral and Maturity**

| | Pro Forma | | |
|---|---|---|---|
| **(Dollars in thousands)** | **Aggregate Principal Balance** | **Percentage by Aggregate Principal Balance** | **Weighted Average Months to Maturity** |
| **Collateral, if any** | | | |
| Real estate | $ 9,846,391 | 93.7% | 80 |
| Receivables | 49,329 | 0.5 | 13 |
| Equipment/inventory | 52,359 | 0.5 | 41 |
| Assignments | 42,682 | 0.4 | 34 |
| Securities | 12,054 | 0.1 | 22 |
| Miscellaneous | 6,040 | 0.1 | 59 |
| Unsecured | 498,085 | 4.7 | 19 |
| Total | $ 10,506,940 | 100.0% | 76 |

The following table shows data with respect to the geographic distribution of the loans underlying the commercial and commercial real estate loan participations at September 30, 2002.

**Geographic Distribution of Commercial and Commercial Real Estate Loans**

| | Pro Forma | | |
|---|---|---|---|
| **(Dollars in thousands)** | **Number of Loans** | **Aggregate Principal Balance** | **Percentage by Aggregate Principal Balance** |
| **State** | | | |
| Connecticut | 101 | $ 242,058 | 2.3% |
| Florida | 722 | 1,997,197 | 19.0 |
| Georgia | 217 | 602,043 | 5.7 |
| Maryland | 78 | 272,271 | 2.6 |
| New Jersey | 371 | 1,240,761 | 11.8 |
| New York | 79 | 229,901 | 2.2 |
| North Carolina | 666 | 1,968,901 | 18.7 |
| Ohio | 19 | 124,758 | 1.2 |
| Pennsylvania | 456 | 1,364,944 | 13.0 |
| South Carolina | 169 | 497,072 | 4.7 |
| Virginia | 316 | 960,386 | 9.1 |
| Other states, each less than 1% of aggregate principal balance | 336 | 1,006,648 | 9.7 |
| Total | 3,530 | $ 10,506,940 | 100.0% |

Table of Contents

The following table shows data with respect to the principal balance of the loans underlying the commercial and commercial real estate loan participations at September 30, 2002.

**Principal Balances of Commercial and Commercial Real Estate Loans**

| | Pro Forma | | |
|---|---|---|---|
| **(Dollars in thousands)** | **Number of Loans** | **Aggregate Principal Balance** | **Percentage by Aggregate Principal Balance** |
| **Principal Balance** | | | |
| Less than $50,000 | 14 | $ 283 | % |
| $50,000 to $99,999 | 7 | 510 | |
| $100,000 to $249,999 | 18 | 3,321 | |
| $250,000 to $499,999 | 40 | 17,956 | 0.2 |
| $500,000 to $999,999 | 1,039 | 759,713 | 7.2 |
| $1,000,000 to $1,999,999 | 1,054 | 1,504,099 | 14.3 |
| $2,000,000 to $2,999,999 | 395 | 962,966 | 9.2 |
| $3,000,000 to $3,999,999 | 275 | 961,742 | 9.2 |
| $4,000,000 to $4,999,999 | 179 | 804,438 | 7.7 |
| $5,000,000 to $9,999,999 | 322 | 2,216,496 | 21.1 |
| Greater than $10,000,000 | 187 | 3,275,416 | 31.1 |
| Total | 3,530 | $ 10,506,940 | 100.0% |

Some of the loans underlying our commercial and commercial real estate loan participations bear interest at fixed rates and some bear interest at variable rates based on indices such as LIBOR and the prime rate. The following tables show data with respect to interest rates of the loans underlying our commercial and commercial real estate loan participations at September 30, 2002.

**Fixed and Variable Rate Commercial and Commercial Real Estate Loans**

| | Pro Forma | | | |
|---|---|---|---|---|
| **(Dollars in thousands)** | **Number of Loans** | **Aggregate Principal Balance** | **Percentage by Aggregate Principal Balance** | **Weighted Average Interest Rate** |
| **Type** | | | | |
| Fixed rate | 124 | $ 459,749 | 4.4% | 4.95% |
| Variable rate | 3,406 | 10,047,191 | 95.6 | 3.44 |
| Total | 3,530 | $ 10,506,940 | 100.0% | 3.51% |

Table of Contents

**Interest Rate Distribution Commercial and Commercial Real Estate Loans**

| | Pro Forma | | | | | |
|---|---|---|---|---|---|---|
| | Fixed Rate | | | Variable Rate | | |
| (Dollars in thousands) | Number of Loans | Aggregate Principal Balance | Percentage by Aggregate Principal Balance | Number of Loans | Aggregate Principal Balance | Percentage by Aggregate Principal Balance |
| **Interest Rate** | | | | | | |
| Less than 2.00% | | $ | % | 8 | $ 40,595 | 0.4% |
| 2.00% to 2.99% | 6 | 51,695 | 0.5 | 374 | 1,810,849 | 17.2 |
| 3.00% to 3.99% | 32 | 179,731 | 1.7 | 2,152 | 6,667,226 | 63.5 |
| 4.00% to 4.99% | 12 | 47,810 | 0.4 | 738 | 1,358,998 | 12.9 |
| 5.00% to 5.99% | 8 | 19,149 | 0.2 | 93 | 123,035 | 1.2 |
| 6.00% to 6.99% | 25 | 48,375 | 0.5 | 16 | 21,220 | 0.2 |
| 7.00% to 7.99% | 29 | 79,807 | 0.8 | 15 | 18,044 | 0.2 |
| 8.00% to 8.99% | 9 | 25,510 | 0.2 | 6 | 4,673 | |
| 9.00% and greater | 3 | 7,672 | 0.1 | 4 | 2,551 | |
| Total | 124 | $ 459,749 | 4.4% | 3,406 | $ 10,047,191 | 95.6% |

The following table provides delinquency information for the underlying loans in the commercial and commercial real estate loan participations at September 30, 2002.

**Commercial and Commercial Real Estate Loan Delinquencies**

| | Pro Forma | | | | | |
|---|---|---|---|---|---|---|
| | Fixed Rate | | | Variable Rate | | |
| (Dollars in thousands) | Number of Loans | Aggregate Principal Balance | Percent of Total | Number of Loans | Aggregate Principal Balance | Percent of Total |
| **Delinquencies** | | | | | | |
| Current | 124 | $ 459,749 | 4.4% | 3,262 | $ 9,711,476 | 92.4% |
| 1 to 30 days delinquent | | | | 142 | 333,570 | 3.2 |
| 31 to 60 days delinquent | | | | 2 | 2,145 | |
| 61 to 90 days delinquent | | | | | | |
| Over 90 days delinquent | | | | | | |
| Total | 124 | $ 459,749 | 4.4% | 3,406 | $ 10,047,191 | 95.6% |

*Home Equity Loans*

We own participation interests in home equity loans secured by a first, second or third mortgage which primarily is on the borrowers residence. These loans typically are made for reasons such as home improvements, acquisition of furniture and fixtures, purchases of automobiles, and debt consolidation. Generally, second and third liens are repaid on an installment basis and income is accrued based on the outstanding balance of the loan. First liens are repaid on an amortizing basis. All of the loans currently underlying the home equity loan participations bear interest at fixed rates.

Table of Contents

The following table shows data with respect to the geographic distribution of the loans underlying the home equity loan participations at September 30, 2002, and includes $866 million of participation interests in home equity loans received as collateral for an intercompany loan to the Bank in October 2002.

**Geographic Distribution of Home Equity Loans**

| | Pro Forma | | |
|---|---|---|---|
| (Dollars in thousands) | Number of Loans | Aggregate Principal Balance | Percentage by Aggregate Principal Balance |
| **State** | | | |
| Connecticut | 837 | $ 39,704 | 3.7% |
| Delaware | 369 | 12,426 | 1.2 |
| Florida | 2,620 | 86,954 | 8.1 |
| Georgia | 1,006 | 33,649 | 3.1 |
| Illinois | 225 | 11,286 | 1.1 |
| Maryland | 938 | 32,842 | 3.1 |
| Missouri | 226 | 10,271 | 1.0 |
| New Jersey | 4,555 | 206,438 | 19.3 |
| New York | 1,288 | 55,160 | 5.1 |
| North Carolina | 2,707 | 107,352 | 10.0 |
| Ohio | 462 | 18,598 | 1.7 |
| Pennsylvania | 6,843 | 235,566 | 22.0 |
| South Carolina | 648 | 26,106 | 2.4 |
| Tennessee | 292 | 13,058 | 1.2 |
| Virginia | 2,480 | 86,339 | 8.1 |
| Other states, each less than 1% of aggregate principal balance | 2,717 | 95,609 | 8.9 |
| Total | 28,213 | $ 1,071,358 | 100.0% |

**Interest Rate Distribution Home Equity Loans**

| | Pro Forma | | |
|---|---|---|---|
| | Fixed Rate | | |
| (Dollars in thousands) | Number of Loans | Aggregate Principal Balance | Percentage by Aggregate Principal Balance |
| **Interest Rate** | | | |
| 5.00% to 5.99% | 6 | $ 273 | % |
| 6.00% to 6.99% | 639 | 37,018 | 3.5 |

| | | | |
|---|---|---|---|
| 7.00% to 7.99% | 9,726 | 421,082 | 39.3 |
| 8.00% to 8.99% | 10,254 | 354,554 | 33.1 |
| 9.00% to 9.99% | 2,899 | 99,904 | 9.3 |
| 10.00% to 10.99% | 3,602 | 110,958 | 10.4 |
| 11.00% to 11.99% | 455 | 26,721 | 2.5 |
| 12.00% to 12.99% | 450 | 15,629 | 1.5 |
| 13.00% to 13.99% | 112 | 3,515 | 0.3 |
| 14.00% to 14.99% | 70 | 1,704 | 0.1 |
| Total | 28,213 | $ 1,071,358 | 100.0% |

Table of Contents

The home equity loans have a weighted average of 151 months to maturity and a weighted average interest rate of 8.60%.

The following table provides delinquency information for the underlying loans in the home equity loan participations at September 30, 2002, and includes $866 million of participation interests in home equity loans received as collateral for an intercompany loan to the Bank in October 2002.

**Home Equity Loan Delinquencies**

| | Pro Forma | | |
|---|---|---|---|
| | Fixed Rate | | |
| **(Dollars in thousands)** | **Number of Loans** | **Aggregate Principal Balance** | **Percent of Total** |
| **Delinquencies** | | | |
| Current | 27,791 | $ 1,047,344 | 97.8% |
| 1 to 30 days delinquent | 184 | 9,423 | 0.9 |
| 31 to 60 days delinquent | 78 | 4,620 | 0.4 |
| 61 to 90 days delinquent | 37 | 2,367 | 0.2 |
| Over 90 days delinquent | 123 | 7,604 | 0.7 |
| Total | 28,213 | $ 1,071,358 | 100.0% |

*Residential Mortgage Loans*

We have acquired both conforming and non-conforming residential mortgage loans from the Bank. Conforming residential mortgage loans comply with the requirements for inclusion in a loan guarantee or purchase program sponsored by either the FHLMC or FNMA. Under current regulations, the maximum principal balance allowed on conforming residential mortgage loans ranges from $300,700 for one-unit residential loans to $578,150 for four-unit residential loans. Nonconforming residential mortgage loans are residential mortgage loans that do not qualify in one or more respects for purchase by FHLMC or FNMA under their standard programs. A majority of the non-conforming residential mortgage loans acquired by us to date are non-conforming because they have original principal balances which exceeded the requirements for FHLMC or FNMA programs, the original terms are shorter than the minimum requirements for FHLMC or FNMA programs at the time of origination, the original balances are less than the minimum requirements for FHLMC or FNMA programs, or generally because they vary in certain other respects from the requirements of such programs other than the requirements relating to creditworthiness of the mortgagors. A substantial portion of our non-conforming residential mortgage loans are expected to meet the requirements for sale to national private mortgage conduit programs or other investors in the secondary mortgage market. However, we have no intent to sell any of our residential mortgage loans.

Each residential mortgage loan is evidenced by a promissory note secured by a mortgage or deed of trust or other similar security instrument creating a first lien on one-to-four family residential property. Residential real estate properties underlying residential mortgage loans consist of single-family detached units, individual condominium units, two-to-four-family dwelling units, and townhouses.

Our portfolio of residential mortgage loans currently consists of both adjustable and fixed rate mortgage loans and we may purchase additional interests in both types of residential mortgage loans in the future, although the mix of variable and fixed rate mortgage loans may change. Fixed rate mortgage loans currently consist of the following fixed rate product types:

*Fixed Rate Mortgage Loans:* A mortgage loan that bears interest at a fixed rate for the term of the loan. Such loans generally mature in 15, 20, 25 or 30 years.

**Table of Contents**

*Government Fixed Rate Loans:* A fixed rate mortgage loan originated under a specific governmental agency program, for example, the Federal Housing Authority or the Veterans Administration. Such loans generally mature in 15 or 30 years and may be guaranteed by a government agency.

*Balloon Mortgage Loans*: A fixed rate mortgage loan having original or modified terms to maturity for a specified period, which is typically 5, 7, 10 or 15 years, at which time the full outstanding principal balance on the loan will be due and payable. Such loans provide for level monthly payments of principal and interest based on a longer amortization schedule, generally 30 years. Some of these loans may have a conditional refinancing option at the balloon maturity, which provides that, in lieu of repayment in full, the loan may be modified to a then-current market interest rate for the remaining unamortized term. None of the residential balloon mortgage loans in the portfolio have yet reached the balloon maturity.

Adjustable rate mortgage loans, or ARMs, currently consist of the following adjustable rate product types:

*Conventional:*

*One-year Adjustable Rate Loans:* A loan with interest adjustments in 12-month intervals. Payment frequencies may include biweekly, semimonthly, or monthly. Such loans may have yearly and lifetime caps on the amount the interest rate may change at an interval. The interest rate change calculation is typically tied to a Treasury index rate. Typically, the interest rate is based on the weekly average yield on United States Treasury securities adjusted to a constant maturity of one year plus the margin stated in the note, subject to rounding and any caps.

*3/1 Adjustable Rate Loans:* A one-year ARM that is fixed for the first three years of the loan. After the initial three-year period, the interest adjusts in 12-month intervals with caps on the initial change and each subsequent annual change and may be subject to a maximum cap on lifetime changes. Typically, the interest is based on the same Treasury security as the one-year ARM and is calculated using the margin and caps stated in the note.

*5/1 Adjustable Rate Loans:* A one-year ARM that is fixed for the first five years of the loan. After the initial five-year period, the interest adjusts in 12-month intervals with caps on the initial change and each subsequent annual change and may be subject to a maximum cap on lifetime changes. Typically, the interest is based on the same Treasury security as the one-year ARM and is calculated using the margin and caps stated in the note.

*7/1 Adjustable Rate Loans:* A one-year ARM that is fixed for the first seven years of the loan. After the initial seven-year period, the interest adjusts in 12-month intervals with caps on the initial change and each subsequent annual change and may be subject to a maximum cap on lifetime changes. Typically, the interest is based on the same Treasury security as the one-year ARM and is calculated using the margin and caps stated in the note.

*10/1 Adjustable Rate Loans:* A one-year ARM that is fixed for the first ten years of the loan. After the initial 10-year period, the interest adjusts in 12-month intervals with caps on the initial change and each subsequent annual change and may be subject to a maximum cap on lifetime changes. Typically, the interest is based on the same Treasury security as the one-year ARM and is calculated using the margin and caps stated in the note.

*Government:* An adjustable rate loan originated under a specific government agency program. Generally, the interest rate adjusts in 12-month intervals, and is based on specific requirements for date of index and calculations.

Table of Contents

**Type of Residential Mortgage Loans**

| | Pro Forma | | | | |
|---|---|---|---|---|---|
| (Dollars in thousands) | Number of Loans | Aggregate Principal Balance | Percentage by Aggregate Principal Balance | Weighted Average Months to Maturity | Weighted Average Interest Rate |
| **Type** | | | | | |
| Conventional | | | | | |
| **Fixed rate** | | | | | |
| First lien | 330 | $ 49,487 | 55.8% | 199 | 7.14% |
| **Adjustable rate** | | | | | |
| First lien | 274 | 39,181 | 44.2 | 207 | 6.15 |
| Total | 604 | $ 88,668 | 100.0% | 202 | 6.70% |

The following table sets forth data with respect to the geographic distribution of the residential mortgage loans in our portfolio at September 30, 2002.

**Geographic Distribution of Residential Mortgage Loans**

| | Pro Forma | | |
|---|---|---|---|
| (Dollars in thousands) | Number of Loans | Aggregate Principal Balance | Percentage by Aggregate Principal Balance |
| **State** | | | |
| Arizona | 2 | $ 445 | 0.5% |
| California | 2 | 512 | 0.6 |
| Colorado | 1 | 256 | 0.3 |
| Connecticut | 546 | 72,294 | 81.5 |
| Florida | 9 | 5,431 | 6.1 |
| Georgia | 3 | 501 | 0.6 |
| Illinois | 2 | 439 | 0.5 |
| Maryland | 2 | 615 | 0.7 |
| Massachusetts | 4 | 556 | 0.6 |
| New Jersey | 2 | 607 | 0.7 |
| New Mexico | 1 | 445 | 0.5 |
| New York | 8 | 902 | 1.0 |
| North Carolina | 5 | 1,104 | 1.2 |
| Oklahoma | 1 | 523 | 0.6 |
| Pennsylvania | 2 | 426 | 0.5 |

| | | | |
|---|---|---|---|
| South Carolina | 2 | 486 | 0.5 |
| Texas | 7 | 1,838 | 2.1 |
| Vermont | 1 | 163 | 0.2 |
| Virginia | 2 | 509 | 0.6 |
| Washington | 2 | 616 | 0.7 |
| Total | 604 | $ 88,668 | 100.0% |

Table of Contents

The following table shows data with respect to the principal balance of the loans in our residential mortgage loan portfolio at September 30, 2002.

**Principal Balances of Residential Mortgage Loans**

| (Dollars in thousands) | Pro Forma Number of Loans | Aggregate Principal Balance | Percentage by Aggregate Principal Balance |
|---|---|---|---|
| **Principal Balance** | | | |
| Less than $25,000 | 88 | $ 1,125 | 1.3% |
| $25,000 to $49,999 | 101 | 3,721 | 4.2 |
| $50,000 to $74,999 | 84 | 5,266 | 5.9 |
| $75,000 to $99,999 | 69 | 5,923 | 6.7 |
| $100,000 to $249,999 | 156 | 27,105 | 30.6 |
| $250,000 to $499,999 | 87 | 28,753 | 32.4 |
| $500,000 to $749,999 | 13 | 7,845 | 8.8 |
| $750,000 to $999,999 | 3 | 2,679 | 3.0 |
| $1,000,000 to $1,499,999 | 1 | 1,497 | 1.7 |
| $1,500,000 to $1,999,999 | 1 | 1,761 | 2.0 |
| Greater than $2,000,000 | 1 | 2,993 | 3.4 |
| Total | 604 | $ 88,668 | 100.0% |

Of the residential mortgage loans in our portfolio, approximately 55.8% by principal balance bear interest at fixed rates and 44.2% at variable rates. The following table contains additional data with respect to the interest rates of such fixed and variable rate residential mortgage loans at September 30, 2002.

**Interest Rate Distribution Residential Mortgage Loans**

| | Pro Forma | | | | | |
|---|---|---|---|---|---|---|
| | Fixed Rate | | | Variable Rate | | |
| (Dollars in thousands) | Number of Loans | Aggregate Principal Balance | Percentage by Aggregate Principal Balance | Number of Loans | Aggregate Principal Balance | Percentage by Aggregate Principal Balance |
| **Interest Rate** | | | | | | |
| Under 6.00% | 33 | $ 3,074 | 3.5% | 86 | $ 15,773 | 17.8% |

| | | | | | | |
|---|---|---|---|---|---|---|
| 6.00% to 6.99% | 110 | 20,488 | 23.1 | 145 | 15,800 | 17.8 |
| 7.00% to 7.99% | 84 | 18,769 | 21.2 | 33 | 6,390 | 7.2 |
| 8.00% to 8.99% | 64 | 5,415 | 6.1 | 10 | 1,218 | 1.4 |
| 9.00% to 9.99% | 28 | 1,438 | 1.6 | | | |
| 10.00% to 10.99% | 8 | 247 | 0.3 | | | |
| 11.00% to 11.99% | 2 | 47 | | | | |
| 12.00% to 12.99% | | | | | | |
| 13.00% to 13.99% | 1 | 9 | | | | |
| Total | 330 | $ 49,487 | 55.8% | 274 | $ 39,181 | 44.2% |

Gross Margin with respect to a residential mortgage loan that is an adjustable rate residential mortgage loan means the applicable fixed rate that, when added to the applicable index, results in the current interest rate paid by the borrower of such residential mortgage loan without taking into account any interest

Table of Contents

rate caps or minimum interest rates. The following table sets forth certain additional data with respect to the gross margin on residential mortgage loans at September 30, 2002.

**Gross Margin of Adjustable Rate Residential Mortgage Loans**

| | Pro Forma | | |
|---|---|---|---|
| **(Dollars in thousands)** | **Number of Loans** | **Aggregate Principal Balance** | **Percentage by Aggregate Principal Balance** |
| **Gross Margin** | | | |
| Greater than 3.00% | 274 | $ 39,181 | 44.2% |

The following table provides certain delinquency and other information for the loans in our residential mortgage portfolio at September 30, 2002.

**Residential Mortgage Loan Delinquencies**

| | Pro Forma | | |
|---|---|---|---|
| **(Dollars in thousands)** | **Number of Loans** | **Aggregate Principal Balance** | **Percent of Total** |
| **Delinquencies** | | | |
| Current | 561 | $ 84,320 | 95.1% |
| 1 to 30 days delinquent | 31 | 3,030 | 3.4 |
| 31 to 60 days delinquent | 7 | 863 | 1.0 |
| 61 to 90 days delinquent | 1 | 132 | 0.1 |
| Over 90 days delinquent | 4 | 323 | 0.4 |
| Total | 604 | $ 88,668 | 100.0% |

**Interest Rate Swaps**

In December 2001, the Bank contributed receive-fixed interest rate swaps with a notional amount of $4.25 billion and a fair value of $673 million to us in exchange for 89 shares of our common stock. After the contribution, we entered into pay-fixed interest rate swaps with a notional amount of $4.25 billion that serve as an off-setting economic hedge of the contributed swaps. All interest rate swaps are entered into with the same unaffiliated third party. The receive-fixed swaps are financial derivatives contracts under which we have agreed to receive specified fixed rates on the notional amounts of the contracts in exchange for payment of floating rates on the notional amounts of the contracts to the counterparties. The pay-fixed swaps are financial derivatives contracts under which we have agreed to pay specified fixed rates on the notional amounts of the contracts in exchange for the receipt of floating rates on the notional amounts of the contracts from the counterparties. Although the pay-fixed interest rate swaps are considered an economic hedge, we expect volatility of unrealized gains and losses as a result of certain interest rate fluctuations due to a difference in fixed rates between the receive-fixed and pay-fixed interest rate swaps. Realized and unrealized gains and losses are recorded immediately in earnings as a net gain or loss on interest rate swaps. At any point in time, the fair value of the interest rate swaps is based on then-prevailing interest rates on that day compared to the fixed interest rates associated with the interest rate swaps. As a result of the difference in the fixed rates of the receive-fixed and pay-fixed interest rate swaps of 7.41% and 5.69%, respectively, our net position will always be reflected as an asset on our consolidated balance sheet.

Because the $4.25 billion of receive-fixed interest rate swaps reprice using the same index as the $4.25 billion of pay-fixed interest rate swaps, we have no index basis risk related to the swaps.

At September 30, 2002, our total credit risk, as represented by the fair value of all derivatives in a gain position, amounted to $1.2 billion. Credit risk is reduced significantly by entering into master netting

Table of Contents

agreements. The net fair value is the most relevant measure of credit risk when there is a master netting agreement. As our swap transactions are with one counterparty and there is a legally enforceable master netting agreement between the parties, the exposure to our counterparty represents the net of the gain and loss positions with that counterparty, which was $605 million as of September 30, 2002 all of which is substantially collateralized by cash.

None of the swaps are used for the purpose of hedging, but the swaps introduce no interest rate risk to us because the floating rate components of the swaps offset each other. The net effect of the swaps is to lock in a gain on which we will receive cash over the duration of the instruments.

We use collateral arrangements, credit approvals, limits and monitoring procedures to manage credit risk for derivatives. Collateral for dealer transactions is delivered by either party when the credit risk associated with a particular transaction, or group of transactions to the extent netting exists, exceeds defined thresholds of credit risk. Thresholds are determined based on the strength of the individual counterparty.

At September 30, 2002, our receive-fixed interest rate swaps with a notional amount of $4.25 billion had a weighted average maturity of 9.50 years, weighted average receive rate of 7.41% and weighted average pay rate of 1.82%. Our pay-fixed interest rate swaps with a notional amount of $4.25 billion had a weighted average maturity of 9.50 years, weighted average receive rate of 1.82% and weighted average pay rate of 5.69% at September 30, 2002. All of the interest rate swaps have variable pay or receive rates based on three- or six-month LIBOR, and they are the pay or receive rates in effect at September 30, 2002.

**Dividend Policy**

We expect to distribute annually an aggregate amount of dividends with respect to our outstanding capital stock equal to approximately 100% of our REIT taxable income, which excludes capital gains. In order to remain qualified as a REIT, we are required to distribute annually at least 90% of our REIT taxable income to our shareholders.

Dividends will be authorized and declared at the discretion of our board of directors. Factors that would generally be considered by our board of directors in making this determination are our distributable funds, financial condition and capital needs, the impact of current and pending legislation and regulations, economic conditions, tax considerations, and our continued qualification as a REIT. We currently expect that both our cash available for distribution and our REIT taxable income will be in excess of the amounts needed to pay dividends on all outstanding Series A, Series B and Series D preferred securities, even in the event of a significant drop in interest rate levels because:

- substantially all of our mortgage assets and other authorized investments are interest-bearing;
- we do not anticipate incurring any indebtedness, although we may incur indebtedness that in an aggregate amount does not exceed 20% of our shareholders equity;
- we expect that our interest-earning assets will continue to exceed the liquidation preference of our preferred stock;
- the amount of loan servicing costs and management fees paid to the Bank are expected to be less than 4% of our income per year; and

we anticipate that, in addition to cash flows from operations, additional cash will be available from principal payments on our loan portfolio.

Accordingly, we expect that we will, after paying the dividends on all classes of preferred securities, pay dividends to holders of shares of our common stock in an amount sufficient to comply with applicable requirements regarding qualification as a REIT. There are, however, certain limitations that restrict our ability to pay dividends on our common stock which are more fully described in this prospectus under the heading Description of Other Wachovia Funding Capital Stock Preferred Stock .

Table of Contents

Under certain circumstances, including any determination that the Bank s relationship to us results in an unsafe and unsound banking practice, the OCC will have the authority to issue an order that restricts our ability to make dividend payments to our shareholders, including holders of the Series A preferred securities. Banking capital adequacy rules limit the total dividend payments made by a consolidated banking entity to be the sum of earnings for the current year and prior two years less dividends paid during the same periods. Any dividends paid in excess of this amount can only be made with the approval of the Bank s regulator. This could have a material adverse effect on the financial condition of the Bank due to our size and the Bank s reliance on our payment of dividends on our common stock.

**Conflicts of Interest and Related Management Policies and Programs**

*General*

In administering our loan portfolio and other authorized investments pursuant to the participation and servicing agreements, the Bank has a high degree of autonomy. The Bank has, however, adopted certain policies to guide our administration with respect to the acquisition and disposition of assets, use of capital and leverage, credit risk management, and certain other activities. These policies, which are discussed below, may be amended or revised from time to time at the discretion of our board of directors and, in certain circumstances subject to the approval of a majority of our Independent Directors, but without a vote of our shareholders, including holders of the Series A preferred securities.

*Underwriting Standards*. Described below are underwriting standards used by the Bank or its affiliates, as applicable, to originate loans that have been or may be transferred to us from the Bank or its affiliates. We do not have lending operations. The Bank or its applicable affiliates perform all of these lending and underwriting operations.

*Commercial and Commercial Real Estate Loans*

Real estate loans are loans secured by real estate and for which the primary source of repayment is based on the quality and sufficiency of a stream of rental income from the property. The income stream from a real estate loan either amortizes the loan or permits the property s sale or refinance. The Bank makes the following types of real estate loans:

office (including multi-tenant, single tenant and condominiums);

retail;

apartments;

commercial development;

warehouse/industrial (including self-storage facilities);

continuing care retirement communities;

senior living facilities;

lodging;

loans to residential builders for the purpose of developing residential home sites or construction; and

commercial and industrial real estate loans (where the primary source of repayment is based on the financial strength of the business operations or the borrower instead of the income stream from the real estate).

The Bank analyzes the borrower s creditworthiness, repayment capacity, and adequacy of the real property provided as collateral. For each product type listed above, the Bank utilizes underwriting guidelines

46

for loan-to-value, debt service coverage and amortization. These guidelines are adjusted based upon the overall market conditions or local market-specific requirements. The Bank also takes into account the following factors when underwriting real estate loans:

- preference to lend to existing customers;
- the risk and return to the Bank on the use of its capital;
- preference to lend within its existing market in its franchise;
- secondary sources of repayment, including guarantees;
- the amount of borrower equity;
- preference for loan terms of three years or less;
- exposure limits per customer and project;
- knowledge of the repayment sources, including permanent loan conditions, interest rate sensitivity and property values;
- need for property type diversification in its portfolio; and
- preference against financing projects with speculative market risk.

*Home Equity Loans*

The Bank and Wachovia Bank of Delaware, National Association (a subsidiary of Wachovia and our affiliate, which we refer to as Wachovia Delaware ), originates and underwrites, or purchases and re-underwrites, home equity loans secured by a first, second or third mortgage primarily on the borrower s residence. The underwriting process is intended to assess both the prospective borrower s ability to repay and the adequacy of the real property security as collateral for the loan. Factors analyzed in determining the borrower s ability to repay the loan include:

- income;
- credit history (including credit scores and credit bureau information); and
- debt-to-income ratio.

Factors analyzed in determining the adequacy of the real property security include:

- Loan-to-Value Ratio;
- appraisals; and
- homeowners insurance.

*Residential Mortgage Loans*

Wachovia Mortgage Corporation, a subsidiary of Wachovia and an affiliate of the Bank and us, which we refer to as Wachovia Mortgage , originates and underwrites, or purchases and re-underwrites, consumer first mortgage loans. These loans typically are used to acquire or re-finance customers primary residences. Wachovia Mortgage s underwriting criteria are focused primarily on secondary market guidelines. The underwriting process is intended to assess both the prospective borrower s ability to repay and the adequacy of the real property security as collateral for the loan. Factors analyzed in determining the borrower s ability to repay the loan include:

- stability of income;
- credit history (including credit scores and credit bureau information); and
- debt-to-income ratio.

**Table of Contents**

Factors analyzed in determining the adequacy of the real property security include:

- Loan-to-Value Ratio;
- appraisals; and
- homeowners and title insurance.

*Asset Acquisition and Disposition Policies.* It is our policy to purchase, or accept as capital contributions, loans or participation interests in loans from the Bank or its affiliates that generally are:

- performing, meaning they have no more than two payments past due, if any;
- in accrual status; and
- secured by real property such that they are REIT Qualified Assets.

Our policy also allows for investment in loans or assets which are not REIT Qualified Assets up to but not exceeding the statutory limitations imposed on organizations that qualify as a REIT under the Code. In the past, we have purchased or accepted as capital contributions loans and participation interests in loans both secured and not secured by real property along with other assets. We anticipate that we will acquire, or receive as capital contributions, interests in additional real estate secured loans from the Bank or its affiliates. We may use any proceeds received in connection with the repayment or disposition of loan participation interests in our portfolio to acquire additional loans. Although we are not precluded from purchasing additional types of loans, loan participation interests or other assets, we anticipate that participation interests in additional loans acquired by us will be of the types described above under the heading General Description of Mortgage Assets and Other Authorized Investments; Investment Policy . Although we are permitted to do so, we have no present plans or intentions to purchase loans or loan participation interests from unaffiliated third parties. In addition, we will not invest in assets that are not REIT Qualified Assets if such investments would cause us to violate the requirements for taxation as a REIT under the Code.

We may from time to time acquire a limited amount of other authorized investments. Although we currently do not intend to acquire any mortgage-backed securities representing interests in or obligations backed by pools of mortgage loans that are secured by single-family residential, multi-family or commercial real estate properties located throughout the United States, we are not restricted from doing so. We do not intend to acquire any interest-only or principal-only mortgage-backed securities. At September 30, 2002, we did not hold any mortgage-backed securities.

We currently anticipate that the Bank or its affiliates will continue to act as servicer of any additional loans that we acquire through purchase or participation interests. We anticipate that any servicing arrangement that we enter into in the future with the Bank or its affiliates will contain fees and other terms that most likely will be substantially equivalent to but may be more favorable to us than those that would be contained in servicing arrangements entered into with unaffiliated third parties.

In accordance with the terms of the commercial, commercial real estate and residential loan participation and servicing agreements, we maintain the authority to decide whether to foreclose on collateral that secures a loan. In the event we determine a foreclosure proceeding is appropriate, we may direct the Bank to prosecute the foreclosure on our behalf. Upon sale or other disposition of foreclosure property, the Bank will remit to us the proceeds less the cost of holding and selling the foreclosure property.

*Credit Risk Management Policies.* For a description of our credit risk management policies, see below under Management s Discussion and Analysis of Financial Condition and Results of Operations Risk Governance and Administration .

Table of Contents

*Conflict of Interest Policies.* Because of the nature of our relationship with the Bank or its affiliates, it is likely that conflicts of interest will arise with respect to certain transactions, including, without limitation, our acquisition of participation interests in loans from, or disposition of participation interests in loans to, the Bank, foreclosure on defaulted loans, management of the cash collateral related to the interest rate swaps and the modification of either the participation or servicing agreements. It is our policy that the terms of any financial dealings with the Bank will be consistent with those available from third parties in the lending industry.

Conflicts of interest among us and the Bank or its affiliates may also arise in connection with making decisions that bear upon the credit arrangements that the Bank or its affiliates may have with a borrower under a loan. Conflicts also could arise in connection with actions taken by us or the Bank or its affiliates. It is our intention that any agreements and transactions between us on the one hand, and the Bank or its affiliates on the other hand, including, without limitation, any loan participation agreements, be fair to all parties and consistent with market terms for such types of transactions. The requirement in our certificate of incorporation that certain of our actions be approved by a majority of our Independent Directors also is intended to ensure fair dealings among us and the Bank or its affiliates. There can be no assurance, however, that any such agreement or transaction will be on terms as favorable to us as could have been obtained from unaffiliated third parties.

There are no provisions in our certificate of incorporation limiting any of our officers, directors, shareholders, or affiliates from having any direct or indirect pecuniary interest in any asset to be acquired or disposed of by us or in any transaction in which we have an interest or from engaging in acquiring, holding, and managing our assets. As described in this prospectus, it is expected that the Bank will have direct interests in transactions with us including, without limitation, the sale of assets to us; however, none of our officers or directors will have any interests in such mortgage assets.

*Other Policies.* We intend to operate in a manner that will not subject us to regulation under the Investment Company Act. Therefore, we do not intend to:

- invest in the securities of other issuers for the purpose of exercising control over such issuers;
- underwrite securities of other issuers;
- actively trade in loans or other investments;
- offer securities in exchange for property; or
- make loans to third parties, including our officers, directors or other affiliates.

The Investment Company Act exempts entities that, directly or through majority-owned subsidiaries, are primarily engaged in the business of purchasing or otherwise acquiring mortgages and other liens on and interests in real estate . We refer to these interests as Qualifying Interests . Under current interpretations by the staff of the SEC, in order to qualify for this exemption, we, among other things, must maintain at least 55% of our assets in Qualifying Interests and also may be required to maintain an additional 25% in Qualifying Interests or other real estate-related assets. The assets that we may acquire therefore may be limited by the provisions of the Investment Company Act. We have established a policy of limiting authorized investments which are not Qualifying Interests to no more than 20% of the value of our total assets.

We may, under certain circumstances, purchase the Series A preferred securities and other shares of capital stock in the open market or otherwise. We have no present intention of repurchasing any of our shares of capital stock, and any such action would be taken only in conformity with applicable Federal and state laws and regulations and the requirements for qualifying as a REIT.

We intend to distribute to our shareholders, in accordance with the Exchange Act, annual reports containing consolidated financial statements prepared in accordance with accounting principles generally accepted in the United States of America and certified by our independent auditors. Our certificate of incorporation provides that we will maintain our status as a reporting company under the Exchange Act for so long as any of the Series A preferred securities are outstanding and held by unaffiliated shareholders.

We currently make investments and operate our business in such a manner consistent with the requirements of the Code to qualify as a REIT. However, future economic, market, legal, tax, or other considerations may cause our board of directors, subject to approval by a majority of our Independent Directors, to determine that it is in our best interest and the best interest of our shareholders to revoke our REIT status. The Code prohibits us from electing REIT status for the four taxable years following the year of such revocation.

**Servicing**

The loans in our portfolio are serviced by the Bank or its affiliates pursuant to the terms of participation and servicing agreements between the Bank and its affiliates and us. The Bank has delegated servicing responsibility of the residential mortgage loans to third parties that are not affiliated with us or the Bank or its affiliates.

We pay the Bank a monthly loan servicing fee for its services under the terms of the loan participation and servicing agreements. The amount and terms of the fee are determined by mutual agreement of the Bank and us from time to time during the terms of the participation and servicing agreements.

We paid the Bank total servicing fees of $0.4 million, $1.2 million and $1.8 million for the years ended December 31, 2001, 2000, and 1999, respectively. Total servicing fees paid to the Bank for the nine months ended September 30, 2002, were $0.7 million. For 2002, the annual servicing fee with respect to the commercial real estate, commercial, and home equity loans is equal to the outstanding principal balance of each loan multiplied by a fee of 0.03% and the annual servicing fee with respect to residential mortgages is equal to $48 per loan.

The participation and servicing agreements require the Bank to service the loans in our portfolio in a manner substantially the same as for similar work performed by the Bank for transactions on its own behalf. The Bank or its affiliates collect and remit principal and interest payments, maintain perfected collateral positions, and submit and pursue insurance claims. The Bank and its affiliates also provide accounting and reporting services required by us for our participation interests and loans. We also may direct the Bank to dispose of any loans that become classified as non-performing, placed in a non-performing status, or are renegotiated due to the financial deterioration of the borrower. The Bank is required to pay all expenses related to the performance of its duties under the participation and servicing agreements, including any payment to its affiliates or third parties for servicing the loans.

In accordance with the terms of the commercial, commercial real estate and residential loan participation and servicing agreements, we maintain the authority to decide whether to foreclose on collateral that secures a loan. In the event we determine a foreclosure proceeding is appropriate, we may direct the Bank to prosecute the foreclosure on our behalf. Upon sale or other disposition of foreclosure property, the Bank will remit to us the proceeds less the cost of holding and selling the foreclosure property.

**Competition**

In order to qualify as a REIT under the Code, we can only be a passive investor in real estate loans and certain other assets. Thus, we will not originate loans. We anticipate that we will continue to possess interests in mortgage and other loans in addition to those in the current portfolio and that substantially all of these

Table of Contents

loans will be owned by the Bank, although we may purchase loans from unaffiliated third parties. Accordingly, while the Bank competes with mortgage conduit programs, investment banking firms, savings and loan associations, banks, thrift and loan associations, finance companies, mortgage bankers, or insurance companies in acquiring and originating loans, we do not. Because we will not originate loans and do not anticipate purchasing loans from unaffiliated third parties, we do not expect to compete with other REITs holding similar assets.

**Regulatory Considerations**

As a financial holding company and a bank holding company under the Bank Holding Company Act, Wachovia is regulated, supervised and examined by the Federal Reserve Board. For a discussion of the material elements of the regulatory framework applicable to financial holding companies, bank holding companies and their subsidiaries and specific information relevant to Wachovia, please refer to Wachovia s annual report on Form 10-K for the fiscal year ended December 31, 2001, and any subsequent reports Wachovia files with the SEC, which are incorporated by reference in this prospectus. This regulatory framework is intended primarily for the protection of depositors and the Federal deposit insurance funds and not for the protection of security holders. As a result of this regulatory framework, Wachovia s earnings are affected by actions of the Federal Reserve Board, the OCC, which regulates its banking subsidiaries such as the Bank, the Federal Deposit Insurance Corporation, which insures the deposits of Wachovia s banking subsidiaries within certain limits, and the SEC, which regulates the activities of certain subsidiaries engaged in the securities business.

Wachovia s earnings are also affected by general economic conditions, its management policies and legislative action.

In addition, there are numerous governmental requirements and regulations that affect Wachovia s business activities. A change in applicable statutes, regulations or regulatory policy may have a material effect on Wachovia s business.

Depository institutions, like Wachovia s bank subsidiaries, are also affected by various Federal laws, including those relating to consumer protection and similar matters. Wachovia also has other financial services subsidiaries regulated, supervised and examined by the Federal Reserve Board, as well as other relevant state and Federal regulatory agencies and self-regulatory organizations. Wachovia s non-bank subsidiaries may be subject to other laws and regulations of the Federal government or the various states in which they are authorized to do business.

**Legal Proceedings**

We are not the subject of any litigation. We, Wachovia and the Bank are not currently involved in nor, to our knowledge, currently threatened with any material litigation with respect to the assets included in our portfolio, other than routine litigation arising in the ordinary course of business.

**Employees**

We have 2 executive officers, each of whom is described further below under Management, and approximately 15 additional non-executive officers. Our executive officers are also executive officers of Wachovia. We do not anticipate that we will require any additional employees because employees of the Bank and its affiliates are servicing the loans under the participation and servicing agreements. All of our officers are also officers or employees of Wachovia and/or the Bank. We maintain corporate records and audited financial statements that are separate from those of the Bank. Except as borrowers under home equity or residential mortgage loans, none of our officers, employees or directors will have any direct or indirect pecuniary interest in any mortgage asset to be acquired or disposed of by us or in any transaction in which we have an interest or will engage in acquiring, holding, and managing mortgage assets. However, 113 employees of Wachovia or its affiliates, including certain of the executive officers and non-executive officers discussed above, own one Series D preferred security each.

Table of Contents

**SELECTED CONSOLIDATED FINANCIAL DATA**

The following selected consolidated financial data for the three years ended December 31, 2001, are derived from our audited consolidated financial statements. The following selected consolidated financial data for the two years ended December 31, 1998 and for the nine months ended September 30, 2002 and 2001, are derived from unaudited consolidated financial statements and reflect all adjustments, consisting only of normal recurring adjustments, that, in the opinion of our management, are necessary for a fair and consistent presentation of such data. Operating results for the nine months ended September 30, 2002, are not necessarily indicative of results expected for the entire year. This data should be read in conjunction with the consolidated financial statements, related notes, and other financial information beginning on page F-1 of this prospectus and Wachovia s unaudited supplementary consolidating financial information as of and for the nine months ended September 30, 2002, and the years ended December 31, 2001 and 2000, which includes certain consolidated financial information for the Bank, beginning on Page F-22 of this prospectus.

| | Nine Months Ended September 30, | | Years Ended December 31, | | | | |
|---|---|---|---|---|---|---|---|
| (In thousands, except per share data) | 2002 | 2001 | 2001 | 2000 | 1999 | 1998 | 1997 |
| **Income Statement Data** | | | | | | | |
| Net interest income | $ 127,098 | 43,374 | 67,322 | 57,257 | 47,005 | 47,520 | 47,370 |
| Provision for loan losses | 7,033 | 6,290 | 5,262 | 3,602 | 1,034 | 1,099 | (228) |
| Other income (loss) | 68,356 | | (95,890) | 395 | 96 | (172) | 669 |
| Noninterest expense | 6,597 | 1,013 | 2,394 | 2,207 | 3,078 | 3,083 | 2,953 |
| Net income (loss) | $ 305,936 | 23,446 | (23,545) | 32,434 | 27,951 | 28,057 | 29,458 |
| **Balance Sheet Data** | | | | | | | |
| Cash and cash equivalents | $ 1,169,380 | 327,057 | 957,454 | 183,223 | 196,397 | 97,978 | 187,992 |
| Loans, net of unearned income | 4,297,280 | 440,040 | 4,378,961 | 558,756 | 512,858 | 586,616 | 483,904 |
| Allowance for loan losses | (37,335) | (5,655) | (37,158) | (3,833) | (1,285) | (849) | (541) |
| Interest rate swaps | 605,438 | | 573,620 | | | | |
| Total assets | 6,071,086 | 775,039 | 5,889,666 | 746,803 | 714,097 | 686,269 | 690,241 |
| Collateral held on interest rate swaps | 599,570 | | 570,340 | | | | |
| Total liabilities | 606,938 | 5,082 | 732,246 | 283 | | 115 | 32,144 |
| Total stockholders equity | $ 5,464,148 | 769,957 | 5,157,420 | 746,520 | 714,097 | 686,154 | 658,097 |
| **Selected Other Information** | | | | | | | |
| Nonperforming loans | $ 16,425 | 2,882 | 5,024 | 2,684 | 3,733 | 2,910 | 6,603 |
| Nonperforming loans as a % of total loans | 0.38% | 0.65 | 0.11 | 0.48 | 0.73 | 0.50 | 1.36 |
| Nonperforming loans as a % of total assets | 0.27 | 0.37 | 0.09 | 0.36 | 0.52 | 0.42 | 0.96 |
| Allowance for loan losses as a % of nonperforming loans | 227.31 | 196.22 | 739.61 | 142.81 | 34.42 | 29.18 | 8.19 |
| Allowance for loan losses as a % of total loans | 0.87% | 1.29 | 0.85 | 0.69 | 0.25 | 0.14 | 0.11 |

52

Table of Contents

**UNAUDITED PRO FORMA CONDENSED CONSOLIDATED FINANCIAL INFORMATION**

The unaudited pro forma condensed consolidated financial information includes our historical consolidated balance sheet as of September 30, 2002, and our historical consolidated statements of income for the nine months ended September 30, 2002, and the year ended December 31, 2001, each giving effect to the issuance of our Series A, Series B and Series C preferred securities in exchange for loan participations, as if such transactions had occurred at the beginning of the period presented.

These unaudited pro forma results include management s best estimate of the impact of the issuance of the Series A, Series B and Series C preferred securities in exchange for loan participations and the issuance of our Series D preferred securities. The unaudited pro forma condensed consolidated financial information may not be indicative of the financial position or results of operations that actually would have occurred had the transactions been consummated during the period or as of the date indicated, or which will be attained in the future. The unaudited pro forma condensed consolidated financial information should be read in conjunction with our historical consolidated financial statements, which appear elsewhere in this prospectus.

Table of Contents

**WACHOVIA PREFERRED FUNDING CORP.**

**AND SUBSIDIARY**

**PRO FORMA COMBINED BALANCE SHEET**

**(Unaudited)**

The following unaudited pro forma combined balance sheet combines our historical consolidated balance sheet as of September 30, 2002, with the transactions described in the accompanying note to the pro forma condensed consolidated financial information, including the issuance of our Series A, B and C preferred securities to Wachovia Preferred Holding.

| | September 30, 2002 | | |
|---|---|---|---|
| (In thousands) | Wachovia Funding | Pro Forma Adjustments | Wachovia Funding Combined |
| **ASSETS** | | | |
| Cash and cash equivalents | $ 1,169,380 | (866,053) | 303,327 |
| Loans | 4,302,947 | 6,497,966 | 10,800,913 |
| Intercompany loan to Bank secured by participation interests in home equity loans | | 866,053 | 866,053 |
| Total loans | 4,302,947 | 7,364,019 | 11,666,966 |
| Unearned income | (5,667) | | (5,667) |
| Loans, net of unearned income | 4,297,280 | 7,364,019 | 11,661,299 |
| Allowance for loan losses | (37,335) | (63,895) | (101,230) |
| Loans, net | 4,259,945 | 7,300,124 | 11,560,069 |
| Interest rate swaps | 605,438 | | 605,438 |
| Accounts receivable affiliates | 22,274 | | 22,274 |
| Other assets | 14,049 | | 14,049 |
| Total assets | $ 6,071,086 | 6,434,071 | 12,505,157 |
| **LIABILITIES AND STOCKHOLDERS EQUITY** | | | |
| Liabilities | | | |
| Collateral held on interest rate swaps | 599,570 | | 599,570 |
| Other liabilities | 7,368 | | 7,368 |
| Total liabilities | 606,938 | | 606,938 |
| Stockholders equity | | | |
| Preferred stock | | | |
| Series A preferred securities, $0.01 par value, $25.00 liquidation preference, non-cumulative and conditionally exchangeable, 30,000,000 shares authorized, issued and outstanding | | 300 | 300 |

| | | | |
|---|---|---|---|
| Series B preferred securities, $0.01 par value, $25.00 liquidation preference, non-cumulative and conditionally exchangeable, 40,000,000 shares authorized, issued and outstanding | | 400 | 400 |
| Series C preferred securities, $0.01 par value, $1,000 liquidation preference, cumulative, 5,000,000 shares authorized, 4,233,754 shares issued and outstanding | | 42 | 42 |
| Series D preferred securities, $0.01 par value, $1,000 liquidation preference, non-cumulative, 913 shares authorized, issued and outstanding | | | |
| Common stock, $.01 par value, 100,000,000 shares authorized, 99,999,900 shares issued and outstanding | 1,000 | | 1,000 |
| Paid-in capital | 5,086,474 | 6,433,329 | 11,519,803 |
| Retained earnings | 376,674 | | 376,674 |
| Total stockholders equity | 5,464,148 | 6,434,071 | 11,898,219 |
| Total liabilities and stockholders equity | $ 6,071,086 | 6,434,071 | 12,505,157 |

See accompanying note to pro forma condensed consolidated financial information.

Table of Contents

**WACHOVIA PREFERRED FUNDING CORP.**

**AND SUBSIDIARY**

**PRO FORMA COMBINED STATEMENT OF INCOME**

**(Unaudited)**

The following unaudited pro forma combined statement of income combines our historical consolidated statement of income for the nine months ended September 30, 2002, with the transactions described in the accompanying note to the pro forma condensed consolidated financial information.

| (In thousands, except per share data and average shares) | Nine Months Ended September 30, 2002 Wachovia Funding | Pro Forma Adjustments | Wachovia Funding Combined |
|---|---|---|---|
| **INTEREST INCOME** | $ 135,385 | 220,326 | 355,711 |
| **INTEREST EXPENSE** | 8,287 | | 8,287 |
| Net interest income | 127,098 | 220,326 | 347,424 |
| Provision for loan losses | 7,033 | | 7,033 |
| Net interest income after provision for loan losses | 120,065 | 220,326 | 340,391 |
| **OTHER INCOME** | | | |
| Gain on interest rate swaps | 68,352 | | 68,352 |
| Other income | 4 | | 4 |
| Total other income | 68,356 | | 68,356 |
| **NONINTEREST EXPENSE** | | | |
| Loan servicing costs | 1,082 | 1,357 | 2,439 |
| Management fees | 4,371 | 5,482 | 9,853 |
| Other | 1,144 | | 1,144 |
| Total noninterest expense | 6,597 | 6,839 | 13,436 |
| Income before income tax expense (benefit) | 181,824 | 213,487 | 395,311 |
| Income tax expense (benefit) | (124,112) | 148,035 | 23,923 |
| Net income | 305,936 | 65,452 | 371,388 |
| Dividends on preferred securities | | 152,397 | 152,397 |
| Net income available to common stockholders | $ 305,936 | (86,945) | 218,991 |

| | | | |
|---|---|---|---|
| **PER COMMON SHARE DATA** | | | |
| Basic earnings | $ 3.06 | | 2.19 |
| Diluted earnings | $ 3.06 | | 2.19 |
| **AVERAGE SHARES** | | | |
| Basic | 99,999,900 | | 99,999,900 |
| Diluted | 99,999,900 | | 99,999,900 |

See accompanying note to pro forma condensed consolidated financial information.

Table of Contents

**WACHOVIA PREFERRED FUNDING CORP.**

**AND SUBSIDIARY**

**PRO FORMA COMBINED STATEMENT OF INCOME (LOSS)**

**(Unaudited)**

The following unaudited pro forma combined statement of income (loss) combines our historical consolidated statement of income (loss) for the year ended December 31, 2001, with the transactions described in the accompanying note to the pro forma condensed consolidated financial information.

| | Year Ended December 31, 2001 | | |
|---|---|---|---|
| **(In thousands, except per share data and average shares)** | **Wachovia Funding** | **Pro Forma Adjustments** | **Wachovia Funding Combined** |
| **INTEREST INCOME** | $ 68,179 | 216,053 | 284,232 |
| **INTEREST EXPENSE** | 857 | | 857 |
| Net interest income | 67,322 | 216,053 | 283,375 |
| Provision for loan losses | 5,262 | | 5,262 |
| Net interest income after provision for loan losses | 62,060 | 216,053 | 278,113 |
| **OTHER INCOME** | | | |
| Loss on interest rate swaps | (95,890) | | (95,890) |
| Total other income | (95,890) | | (95,890) |
| **NONINTEREST EXPENSE** | | | |
| Loan servicing costs | 602 | 1,293 | 1,895 |
| Other | 1,792 | | 1,792 |
| Total noninterest expense | 2,394 | 1,293 | 3,687 |
| Income (loss) before income tax benefit | (36,224) | 214,760 | 178,536 |
| Income tax benefit | (12,679) | (20,883) | (33,562) |
| Net income (loss) | (23,545) | 235,643 | 212,098 |
| Dividends on preferred securities | | 203,196 | 203,196 |
| Net income (loss) available to common stockholders | $ (23,545) | 32,447 | 8,902 |
| **PER COMMON SHARE DATA** | | | |
| Basic earnings | $ (1.07) | | 0.41 |

| | | | |
|---|---|---|---|
| Diluted earnings | $ (1.07) | | 0.41 |
| **AVERAGE SHARES** | | | |
| Basic | 21,925,904 | | 21,925,904 |
| Diluted | 21,925,904 | | 21,925,904 |

See accompanying note to pro forma condensed consolidated financial information.

Table of Contents

**WACHOVIA PREFERRED FUNDING CORP.**

**AND SUBSIDIARY**

**NOTE TO PRO FORMA CONDENSED CONSOLIDATED FINANCIAL INFORMATION**

**(Unaudited)**

**September 30, 2002 and December 31, 2001**

**NOTE 1: DESCRIPTION OF PRO FORMA ADJUSTMENTS**

The pro forma adjustments assume the issuance of Series A and Series B preferred securities with a $25.00 liquidation preference and Series C preferred securities with a $1,000 liquidation preference, to Wachovia Preferred Holding.

It has been assumed that Wachovia Preferred Holding will pay $25.00 per Series A and Series B preferred security and $1,000 per Series C preferred security. Wachovia Preferred Holding's payment for the three Series of preferred securities will be in the form of additional participation interests in commercial and commercial real estate loans. We intend to hold these participation interests as long-term investments.

This pro forma condensed consolidated financial information assumes that Wachovia Preferred Holding receives all 30,000,000 Series A preferred securities, all 40,000,000 Series B preferred securities and 4,233,754 Series C preferred securities in exchange for commercial and commercial real estate loan participation interests, which have a book value of approximately $6.5 billion and a fair market value of approximately $6.0 billion.

Wachovia Preferred Holding, a statutory underwriter, will sell 18,000,000 Series A preferred securities through underwriters to the public for cash consideration of $25.00 per preferred security. We will not receive any proceeds from the sale of our Series A preferred securities owned by Wachovia Preferred Holding. The proceeds, before expenses and commissions to be received by Wachovia Preferred Holding from the sale of 18,000,000 Series A preferred securities, are expected to be $450 million. Wachovia Preferred Holding will pay all expenses and underwriting discounts and commissions related to the public offering of the preferred securities.

Pro forma combined balance sheet adjustments include: (i) cash of $866 million loaned to the Bank and secured by participation interests in home equity loans; and (ii) participation interests in commercial and commercial real estate loans with a book value of $6.5 billion, received by us in exchange for the issuance to Wachovia Preferred Holding of $750 million, $1.0 billion and $4.2 billion in Series A, Series B and Series C preferred securities, respectively, and a related increase in paid-in capital of $430 million reflecting the excess of the book value of the loan participations over the fair market value of the loan participations or the liquidation preference of the Series A, Series B and Series C preferred securities. The adjustments also include an additional allowance for loan losses of $64 million related to the participation interests in home equity loans and commercial and commercial real estate loans referred to in (i) and (ii).

Pro forma combined statement of income adjustments include interest income of $220 million and $216 million for the nine months ended September 30, 2002, and the year ended December 31, 2001, respectively, representing the interest assumed to be earned on the $866 million loan to the Bank secured by participation interests in home equity loans net of loan servicing costs and management fees and the $6.5 billion participation interests in commercial and commercial real estate loans contributed, and $6.8 million and $1.3 million of loan servicing costs and management fees for the nine months ended September 30, 2002, and the year ended December 31, 2001, respectively, representing additional estimated expenses that would have been incurred on the $6.5 billion in commercial and commercial real estate loans contributed, and dividends on preferred securities of $152 million and $203 million for the nine months ended September 30, 2002, and the year ended December 31, 2001, respectively. Management fees represent reimbursement to Wachovia for general overhead expenses paid on our behalf that are charged by Wachovia to affiliates that have over $10

Table of Contents

million in assets and over $2 million in estimated noninterest expense. In 2001, we did not meet the second of these criteria and were not charged a management fee; accordingly, we did not include a pro forma adjustment for management fees for 2001. We expect to meet these criteria in 2002 and as a result, we included a pro forma adjustment for management fees for 2002. The income and expense adjustments were estimated on the received and contributed loan participations as if they had been outstanding during each period, unless the underlying loans were originated during the respective period. In cases where the underlying loans were originated during either period, we estimated income from the date of origination to the end of the respective period. Approximately $2.6 billion of the commercial and commercial real estate loan participations contributed were from a recent merger where no origination data was available for early 2001, therefore no income was estimated for those loan participations for 2001. Income on these loan participations was $73 million for the nine months ended September 30, 2002, and resulted in pro forma adjustments of $586,000 and $2.4 million of loan servicing costs and management fees, respectively. The weighted average yield for 2001 was 6% compared with 4% for the nine months ended September 30, 2002, which offsets income not included for 2001. The impact of these items results in similar interest income in both periods in the accompanying pro forma combined statements of income. For the nine months ended September 30, 2002, an income tax benefit of $124 million associated with our change in tax status from a taxable corporation to a REIT has been eliminated. In addition, for the nine months ended September 30, 2002, and the year ended December 31, 2001, an income tax expense (benefit) of $24 million and ($34) million, respectively, is provided to the extent of the income or loss of our taxable REIT subsidiary, Wachovia Preferred Realty, LLC ( WPR ). Because WPR s assets consist primarily of our interest rate swap assets, our income tax expense (benefit) is based on our income from these assets. No income tax expense is provided on the remainder of our income due to our status as a REIT.

The interest income estimates are equal to the actual interest income earned on the loan to the Bank secured by home equity loan participations net of loan servicing costs and management fees, and commercial and commercial real estate loan participations for the nine months ended September 30, 2002, and the year ended December 31, 2001 (except as noted above). Loan servicing costs and management fees represent estimates based on actual costs for the nine months ended September 30, 2002, and the year ended December 31, 2001.

Table of Contents

**MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND**

**RESULTS OF OPERATIONS**

The following discussion and analysis of our financial condition and results of operations should be read in conjunction with Selected Consolidated Financial Data and our audited and unaudited consolidated financial statements and related notes included elsewhere in this prospectus. In addition to historical information, the discussion in this prospectus contains certain forward-looking statements that involve risks and uncertainties. Our actual results could differ materially from those anticipated by these forward-looking statements due to factors including, but not limited to, those factors set forth under Risk Factors and elsewhere in this prospectus. See also Forward-Looking Statements .

The financial information presented in this section is derived from our historical consolidated financial statements and has not been adjusted for the effect of the issuance of our four series of preferred securities or the related contributions of loan participations.

For the tax year ending December 31, 2002, we will be taxed as a REIT, and we intend to comply with the relevant provisions of the Code to be taxed as a REIT. Accordingly, with the exception of the income of our taxable REIT subsidiary, WPR, we will not be subject to Federal income tax on net income currently distributed to shareholders to the extent we meet these provisions, including distributing the majority of our earnings to shareholders and satisfying certain asset, income and stock ownership tests. As a result of our change in tax status from a taxable corporation to a REIT, our net deferred tax liability as of December 31, 2001, was written off as a benefit to income tax expense in January 2002. Due to the establishment of WPR in October 2002, a deferred tax expense will be recorded to establish the initial deferred tax liability on the book versus tax basis differences of the assets contributed to WPR. In addition, we will incur Federal income tax to the extent of the earnings of WPR.

**Critical Accounting Policies**

Our consolidated financial statements are prepared in accordance with accounting principles generally accepted in the United States of America. We have identified the allowance for loan losses as a significant policy that involves a significant amount of judgment and requires use of estimates that are difficult to validate by reference to outside sources, which is discussed below. We also identified the accounting for nonperforming assets and derivatives as policies that impact our business.

*Allowance for Loan Losses*

The allowance for loan losses is maintained at a level that we believe is adequate to cover probable losses inherent in the loan portfolio as of the respective dates of the consolidated financial statements. We employ a variety of techniques as well as our judgment in assessing the adequacy of the allowance. Our methodology for assessing the adequacy of the allowance is comprised of both an allocated and an unallocated component. The allocated component of the allowance for commercial loans is based principally on current loan grades and historical loss rates. For residential loans, it is based on loan payment status and historical loss rates. The unallocated component of the allowance represents the results of analyses that estimate probable losses inherent in the portfolio that are not fully captured in the allocated allowance. These analyses include industry concentrations, model imprecision and the estimated impact of current economic conditions on historical loss rates. We continuously monitor trends in the loan portfolio including trends in the levels of past due, criticized and nonperforming loans. The trends in these factors are used to evaluate the reasonableness of the unallocated component.

We believe we have developed appropriate policies and processes in the determination of an allowance for loan losses reflective of our assessment of credit risk after careful consideration of known relevant facts and trends. In developing this assessment, we must rely on estimates and exercise judgment regarding matters where the ultimate outcome is unknown. Depending on changes in circumstances, future assessments of credit risk may yield materially different results that may result in increases or decreases in the allowance for loan losses.

Table of Contents

*Nonperforming Assets*

Nonperforming assets consist of underlying loans that no longer accrue interest. The accrual of interest is generally discontinued on loans, except residential loans, that become 90 days past due as to principal or interest unless collection of both principal and interest is assured by way of collateralization, guarantees or other security. Generally, loans past due 180 days or more are classified as nonaccrual regardless of security. Home equity loans that become 120 days past due are generally charged to the allowance for loan losses. When borrowers demonstrate over an extended period the ability to repay a loan in accordance with the contractual terms of a loan classified as nonaccrual, the loan is returned to accrual status. When loans or participation interests in loans are obtained from the Bank, the underlying loans are performing at the date of purchase.

The participation and servicing agreements require the Bank to service loan portfolios in a manner substantially the same as for similar work performed by the Bank for transactions on its own behalf. The Bank collects and remits principal and interest payments, maintains perfected collateral positions, and submits and pursues insurance claims. The Bank also provides to us accounting and reporting services required by our participations. We also may direct the Bank to dispose of any underlying loan that becomes classified as nonaccrual, is placed in a nonperforming status, or is renegotiated due to the financial deterioration of the borrower. The Bank is required to pay all expenses related to the performance of its duties under the participation and servicing agreements. In accordance with the terms of the commercial, commercial real estate and residential loan participation and servicing agreements, we maintain the authority to decide whether to foreclose on collateral that secures a loan. In the event we determine a foreclosure proceeding is appropriate, we may direct the Bank to prosecute the foreclosure on our behalf. Upon sale or other disposition of foreclosure property, the Bank will remit to us the proceeds less the cost of holding and selling the foreclosure property.

*Derivatives*

We account for derivative financial instruments in accordance with Statement of Financial Accounting Standards (referred to as SFAS ) No. 133, *Accounting for Derivative Instruments and Hedging Activities*, as subsequently amended by SFAS 137 and SFAS 138, which establishes accounting and reporting standards for derivatives and hedging activities. Under SFAS 133, all of our derivatives (currently consisting of interest rate swaps) are recorded at fair value in the balance sheet. When we have more than one transaction with a counterparty and there is a legally enforceable master netting agreement between the parties, the net of the gain and loss positions are recorded as an asset or liability on our consolidated balance sheet. Realized and unrealized gains and losses are recorded as a net gain or loss on interest rate swaps on our consolidated statement of operations.

In December 2001, the Bank contributed receive-fixed interest rate swaps with a notional amount of $4.25 billion and a fair value of $673 million to us in exchange for common stock. The unaffiliated counterparty to the receive-fixed interest rate swaps provided cash collateral to us. We pay interest to the counterparty on the collateral at a short-term market rate. We also invest the cash in overnight eurodollar investments and earn a short-term market rate. After the contribution of the receive-fixed interest rate swaps, we entered into pay-fixed interest rate swaps with a notional amount of $4.25 billion that serve as an economic hedge of the contributed swaps. All interest rate swaps are transacted with the same unaffiliated third party. Prior to the time that we entered into the pay-fixed interest rate swaps, we realized a decrease in fair value of $95.6 million in the receive-fixed interest rate swaps as a result of changes in then-prevailing interest rates.

At September 30, 2002, receive-fixed interest rate swaps with a notional amount of $4.25 billion had a weighted average maturity of 9.5 years, weighted average receive rate of 7.41% and weighted average pay rate of 1.82%. Pay-fixed interest rate swaps with a notional amount of $4.25 billion had a weighted average maturity of 9.5 years, weighted average receive rate of 1.82% and weighted average pay rate of 5.69% at

September 30, 2002. All of the interest rate swaps have variable pay or receive rates based on three- or six-month LIBOR, and they are the pay or receive rates in effect at September 30, 2002.

Table of Contents

Although the pay-fixed interest rate swaps are considered an economic hedge, we expect volatility of unrealized gains and losses as a result of certain interest rate fluctuations due to a difference in fixed rates between the receive-fixed and pay-fixed interest rate swaps. At any point in time, the fair value of the interest rate swaps is based on then-prevailing interest rates on that day compared to the fixed interest rates associated with the interest rate swaps. As a result of the difference in the fixed rates of the receive-fixed and pay-fixed interest rate swaps of 7.41% and 5.69%, respectively, our net position will always be reflected as an asset on our consolidated balance sheet. At September 30, 2002, our net position was an asset of $605 million.

**Results of Operations**

For purposes of this discussion, the term residential loans includes home equity loans and residential mortgages and the term commercial loans includes commercial and commercial real estate loans. See Table 1 in Accounting and Regulatory Matters for certain performance and dividend payout ratios for the nine months ended September 30, 2002 and 2001, and for the two years ended December 31, 2001.

*2002 to 2001 Nine Month Comparison*

*Interest Income*. Interest income increased $92.0 million from the first nine months of 2001, or 212%, to $135.4 million in the first nine months of 2002. Interest on commercial loans increased to $101.1 million in the first nine months of 2002 from zero in the first nine months of 2001 representing nine months of interest in 2002 on commercial loans contributed to us by the Bank in December 2001. Interest on residential loans decreased $11.9 million, or 34%, to $23.1 million in the first nine months of 2002 from $35.0 million in the first nine months of 2001 as a result of a decrease in residential loan balances and a declining interest rate environment. Interest income on cash invested in overnight eurodollar investments increased $2.8 million, or 33%, in the first nine months of 2002 to $11.2 million from the first nine months of 2001 due to cash investment balances increasing from loan collections and cash received in December 2001 as collateral for interest rate swaps.

The average balances, interest income and rates related to interest-earning assets for the nine months ended September 30, 2002 and 2001, are presented below.

| | **Nine Months Ended September 30, 2002** | | | Nine Months Ended September 30, 2001 | | |
|---|---|---|---|---|---|---|
| **(In thousands)** | **Average Balance** | **Interest Income** | **Rate** | Average Balance | Interest Income | Rate |
| Loan participations | | | | | | |
| Commercial and commercial real estate loans | $ 4,082,323 | 101,102 | 3.31% | $ | | % |
| Home equity loans | 244,783 | 18,058 | 9.86 | 371,575 | 27,460 | 9.90 |
| Total loan participations | 4,327,106 | 119,160 | 3.68 | 371,575 | 27,460 | 9.90 |
| Residential mortgages | 100,532 | 5,038 | 6.68 | 133,585 | 7,507 | 7.49 |

| | | | | | | |
|---|---|---|---|---|---|---|
| Interest-bearing deposits in banks | 1,047,483 | 11,187 | 1.43 | 253,011 | 8,407 | 4.44 |
| Total interest-earning assets | $ 5,475,121 | 135,385 | 3.31% | $ 758,171 | 43,374 | 7.65% |

*Interest Expense.* Interest expense increased to $8.3 million in the first nine months of 2002 from zero in the first nine months of 2001 representing interest paid on cash collateral received related to interest rate swaps that were contributed in December 2001. Interest is paid based on a short-term market rate.

*Gain on Interest Rate Swaps.* The gain on interest rate swaps was $68.4 million in the first nine months of 2002 compared with zero in the first nine months of 2001 representing the net increase in fair value of interest rate swaps. The receive-fixed interest rate swaps were contributed to us by the Bank in December 2001 and the pay-fixed interest rate swaps were entered into by us shortly thereafter as an economic hedge. See Critical Accounting Policies Derivatives above for more information.

Table of Contents

*Loan Servicing Costs.* Loan servicing costs increased $0.7 million, or 151%, to $1.1 million in the first nine months of 2002 from $0.4 million in the first nine months of 2001 due to higher average loans from the commercial loan contribution in December 2001 and an increase in fees paid for residential loan servicing. The loans are serviced by the Bank pursuant to our participation and servicing agreements. For commercial loans, the fee is equal to the average outstanding principal balance of each loan multiplied by 0.03%.

*Management Fees*. Management fees were $4.4 million in the first nine months of 2002 compared with zero in the first nine months of 2001. Management fees represent reimbursements to Wachovia for general overhead expenses paid on our behalf, plus a 10% markup to represent an arm s length fee. The management fee is charged by Wachovia to affiliates that have over $10 million in assets and over $2 million in estimated annual noninterest expense. In 2001, we did not meet the second of those criteria and were not charged a management fee. We anticipate that we will meet both of these criteria in the future, and accordingly, we will continue to incur management fee expense.

*Other Expense*. Other expense increased $0.6 million, or 97%, to $1.1 million in the first nine months of 2002. Foreclosure expense increased $0.7 million due to additional costs associated with foreclosures related to a declining residential portfolio. Additionally, 2001 included $0.3 million for net losses on loan sales, of which there were none in the first nine months of 2002.

*Income Tax Expense.* Income tax expense decreased $136.7 million to a benefit of $124.1 million in the first nine months of 2002 from the first nine months of 2001 as a result of a change in tax status from a taxable corporation to a REIT in 2002. The benefit of $124.1 million in the first nine months of 2002 relates to the reversal of the net deferred tax liability as of December 31, 2001 in January 2002 on our becoming a REIT.

*2001 to 2000 Twelve Month Comparison*

*Interest Income.* Interest income increased $10.9 million from 2000, or 19%, to $68.2 million in 2001. Interest income on commercial loans increased to $12.5 million in 2001 from zero in 2000 representing one month of interest in 2001 on commercial loans that were contributed by the Bank in December 2001. Interest income on residential loans increased $4.5 million, or 11.3%, from 2000 to $44.8 million in 2001 as a result of a full year of interest on $400 million in higher yielding home equity loans purchased from the Bank in August 2000. Interest income on cash invested in overnight eurodollar investments decreased $6.1 million, or 35.7%, from 2000 to $10.9 million in 2001 due to the lower interest rate environment.

The average balances, interest income and rates related to interest-earning assets for the two years ended December 31, 2001, are presented below.

| | **Year Ended December 31, 2001** | | | Year Ended December 31, 2000 | | |
|---|---|---|---|---|---|---|
| **(In thousands)** | **Average Balance** | **Interest Income** | **Rate** | Average Balance | Interest Income | Rate |

| | | | | | | |
|---|---|---|---|---|---|---|
| Loan participations | | | | | | |
| Commercial and commercial real estate loans | $ 338,233 | 12,456 | 3.68% | $ | | % |
| Home equity loans | 352,778 | 35,098 | 9.95 | 174,750 | 20,659 | 11.82 |
| Total loan participations | 691,011 | 47,554 | 6.88 | 174,750 | 20,659 | 11.82 |
| Residential mortgages | 131,756 | 9,714 | 7.37 | 276,777 | 19,621 | 7.09 |
| Interest-bearing deposits in banks | 269,689 | 10,911 | 4.05 | 273,008 | 16,977 | 6.22 |
| Total interest-earning assets | $ 1,092,456 | 68,179 | 6.24% | $ 724,535 | 57,257 | 7.90% |

62

The dollar amount of change in interest income related to our interest-earning assets for the two years ended December 31, 2001, is presented below.

| | 2001 Compared to 2000 | | | 2000 Compared to 1999 | | |
|---|---|---|---|---|---|---|
| | | Variance Attributable to (a) | | | Variance Attributable to (a) | |
| (In thousands) | Interest Income Variance | Rate | Volume | Interest Income Variance | Rate | Volume |
| **Earning Assets** | | | | | | |
| Commercial and commercial real estate loans | $ 12,456 | 6,228 | 6,228 | | | |
| Home equity loans | 14,439 | (4,940) | 19,379 | 15,822 | 3,576 | 12,246 |
| Residential mortgages | (9,907) | 579 | (10,486) | (13,662) | (202) | (13,460) |
| Interest-bearing deposits in banks | (6,066) | (5,896) | (170) | 8,037 | 2,918 | 5,119 |
| Total earning assets | $ 10,922 | (4,029) | 14,951 | 10,197 | 6,292 | 3,905 |

(a) Changes attributable to rate/volume are allocated to both rate and volume on an equal basis.

*Interest Expense.* Interest expense increased to $0.9 million in 2001 from zero in 2000 representing approximately one month of interest paid on cash collateral received related to interest rate swaps that were contributed in December 2001. Interest is paid based on a short-term market rate.

*Loss on Interest Rate Swaps.* The loss on interest rate swaps was $95.9 million in 2001 representing the decrease in fair value of the receive-fixed interest rate swaps contributed to us by the Bank in December 2001 between the time the contribution was made and the time we entered into pay-fixed interest rate swaps that serve as an economic hedge of the contributed receive-fixed interest rate swaps. See Critical Accounting Policies Derivatives above for more information.

*Loan Servicing Costs.* Loan servicing costs decreased $0.8 million, or 57%, to $0.6 million in 2001 from $1.4 million in 2000 due to the Bank entering into a lower cost sub-servicing agreement in February 2001. The loans are serviced by the Bank pursuant to our participation and servicing agreements. For commercial loans, the fee is equal to the average outstanding principal balance of each loan multiplied by 0.03%.

*Management Fees.* Management fees were zero in 2001 compared with $0.8 million in 2000. As described above, in 2001 we did not meet the second of Wachovia s criteria for assessment of a management fee.

*Other Income.* Other income decreased to zero in 2001 from $0.4 million in 2000 due to 2000 including $0.5 million net gains on loan sales of which there were none in 2001.

*Other Expense.* Other expense increased to $1.8 million in 2001 from zero in 2000 primarily due to $0.4 million in increased foreclosure expense, $0.4 million in losses on loan sales, and $1 million paid to the Bank in consideration for the Bank providing a guaranty of our obligations under the receive-fixed interest rate swaps before we entered into the pay-fixed interest rate swaps. The guaranty fee is equal to 0.03% multiplied by the absolute value of the net notional amount of the interest rate swaps.

*2000 to 1999 Twelve Month Comparison*

*Interest Income.* Interest income increased $10.2 million from 1999, or 22%, to $57.3 million in 2000. Interest income on residential loans increased $2.2 million, or 5.7%, from 1999 to $40.3 million in 2000 due to four months of interest on $400 million of a participation interest in higher yielding home equity loans purchased from the Bank in August 2000, slightly offset by lower residential mortgage loan balances and a declining interest rate environment. Interest income on cash invested in overnight eurodollar investments increased $8 million in 2000 to $17 million from 1999 due to higher cash investment balances.

Table of Contents

The average balances, interest income and rates related to interest-earning assets for the two years ended December 31, 2000, are presented below.

| (In thousands) | Year Ended December 31, 2000 Average Balance | Interest Income | Rate | Year Ended December 31, 1999 Average Balance | Interest Income | Rate |
|---|---|---|---|---|---|---|
| Loan participations | | | | | | |
| Commercial and commercial real estate loans | $ | | % | $ | | % |
| Home equity loans | 174,750 | 20,659 | 11.82 | 55,496 | 4,837 | 8.72 |
| Total loan participations | 174,750 | 20,659 | 11.82 | 55,496 | 4,837 | 8.72 |
| Residential mortgages | 276,777 | 19,621 | 7.09 | 465,924 | 33,283 | 7.14 |
| Interest-bearing deposits in banks | 273,008 | 16,977 | 6.22 | 181,202 | 8,940 | 4.93 |
| Total interest-earning assets | $ 724,535 | 57,257 | 7.90% | $ 702,622 | 47,060 | 6.70% |

*Loan Servicing Costs.* Loan servicing costs decreased $0.5 million, or 27%, to $1.4 million in 2000 from $1.9 million in 1999 due to lower average loan balances. The loans are serviced by the Bank pursuant to our servicing agreement. For residential mortgages and home equity loans, the fee was equal to the average outstanding principal balance of each loan multiplied by 0.38%.

*Management Fees.* Management fees decreased $0.2 million from 1999, or 22%, to $0.8 million in 2000 as a result of lower fees assessed by Wachovia.

*Other Income.* Other income increased $0.3 million in 2000 from 1999 representing gains on loan sales.

**Balance Sheet Analysis**

*September 30, 2002 to September 30, 2001*

At September 30, 2002, total assets were $6.1 billion compared with $775 million at September 30, 2001. As of September 30, 2002, $4.0 billion, or 66% of our assets, consisted of a 100% participation interest in commercial loans, and $205 million, or 3.4% of our assets, consisted of a 100% participation interest in home equity loans, before the allowance for loan losses.

*Loans.* Net loans increased $3.8 billion to $4.3 billion at September 30, 2002, compared with September 30, 2001, due to a $4.0 billion increase in commercial loans contributed to us by the Bank in December 2001 partially offset by decreased residential loans.

*Allowance for Loan Losses.* The allowance for loan losses increased $31.7 million from September 30, 2001, to $37.3 million at September 30, 2002, as a result of allowance transferred with the commercial loans contributed to us by the Bank in December 2001. The allowance was 1.0% of loans at September 30, 2002, and 1.3% at September 30, 2001. See Table 2 in Accounting and Regulatory Matters for additional information.

*Interest Rate Swaps.* Interest rate swaps increased to $605 million at September 30, 2002, from zero at September 30, 2001, which represents fair value of our net position in interest rate swaps.

*Accounts Receivable-Affiliates.* Accounts receivable from affiliates increased to $22.3 million at September 30, 2002, from September 30, 2001, as a result of intercompany transactions related to income tax allocations for the 2001 tax year which represent receivables for taxes paid prior to our becoming a REIT.

*Other Assets.* Other assets increased $2.4 million, or 21%, to $14 million at September 30, 2002, from $11.7 million at September 30, 2001, due to a $6.6 million increase in interest receivables and a $1.2 million increase in foreclosed property, offset by a $5.3 million decrease in loans held for sale.

Table of Contents

*Collateral Held on Interest Rate Swaps.* Collateral held on interest rate swaps increased to $599.6 million at September 30, 2002, from zero at September 30, 2001. As part of the receive-fixed interest rate swaps contributed to us by the Bank in December 2001, the unaffiliated counterparty to the swaps provided collateral that we hold. The cash collateral is recorded at fair value.

*Other Liabilities.* Other liabilities increased to $7.4 million at September 30, 2002, from $89 thousand at September 30, 2001, due to the increase in minority interests after the sale of a 1% interest in our subsidiary s common stock to Wachovia in exchange for cash in December 2001.

*December 31, 2001 to December 31, 2000*

At December 31, 2001, total assets were $5.9 billion compared with $746.8 million at December 31, 2000. As of December 31, 2001, $4 billion, or 68% of our assets, consisted of a 100% participation interest in commercial loans and $286 million, or 5% of our assets, consisted of a 100% participation interest in home equity loans, before the allowance for loan losses.

*Loans.* Net loans were $4.3 billion at December 31, 2001, up $3.8 billion from December 31, 2000, due to the December 2001 contribution to us of $4 billion of commercial loans by the Bank offset by a $156.8 million decrease in residential loans.

Commercial loan maturities on a historical and pro forma basis for the year ended December 31, 2001 are presented below.

| | December 31, 2001 | |
|---|---|---|
| | Commercial and Commercial Real Estate | |
| **(In thousands)** | **Actual** | **Pro Forma** |
| **Fixed Rate** | | |
| 1 year or less | $ | 40,280 |
| 1-5 years | 37,833 | 130,196 |
| After 5 years | 30,570 | 342,935 |
| Total fixed rate | 68,403 | 513,411 |
| **Adjustable Rate** | | |
| 1 year or less | 401,889 | 603,154 |
| 1-5 years | 2,575,536 | 4,063,069 |
| After 5 years | 944,528 | 3,970,651 |
| Total adjustable rate | 3,921,953 | 8,636,874 |

| | | |
|---|---|---|
| Total | $ 3,990,356 | 9,150,285 |

*Allowance for Loan Losses.* The allowance for loan losses increased $33.3 million December 31, 2000 to $37.2 million at December 31, 2001, as a result of the allowance transferred with the commercial loans contributed to us by the Bank in December 2001. The allowance was 0.9% of loans at December 31, 2001, and 0.7% at December 31, 2000. See Table 2 in Accounting and Regulatory Matters for additional information on allowance for loan losses.

*Interest Rate Swaps*. Interest rate swaps increased to $573.6 million at December 31, 2001, from zero at December 31, 2000, from the contribution of the receive-fixed interest rate swaps to us by the Bank in December 2001. Interest rate swaps are recorded at fair value. Subsequent to the contribution, we entered into pay-fixed interest rate swaps that serve as an economic hedge to the receive-fixed interest rate swaps.

*Other Assets.* Other assets increased $9.3 million to $16.8 million at December 31, 2001, from $7.5 million at December 31, 2000, due to a $9.6 million increase in interest receivable, related to the contribution of commercial loans in December 2001, offset by a $0.7 million decrease in consumer interest receivable due to lower consumer loan balances.

Table of Contents

*Collateral Held on Interest Rate Swaps.* Collateral held on interest rate swaps increased to $570.3 million at December 31, 2001, from zero at December 31, 2000. As part of the receive-fixed interest rate swaps contributed to us by the Bank in December 2001, the unaffiliated counterparty to the swaps provided collateral that we hold. The cash collateral is recorded at fair value.

*Other Liabilities.* Other liabilities increased $7.5 million at December 31, 2001, from $0.1 million at December 31, 2000, due to the increase in minority interests after the sale of a 1% interest in our subsidiary s common stock to Wachovia in exchange for cash in December 2001.

**Commitments**

Our commercial loan portfolio includes unfunded loan commitments and standby and commercial letters of credit that are provided in the normal course of business. For commercial customers, loan commitments generally take the form of revolving credit arrangements to finance customers working capital requirements. These instruments are not recorded on the balance sheet until funds are advanced under the commitment. For lending commitments, the contractual amount of a commitment represents the maximum potential credit risk if the entire commitment is funded and the borrower does not perform according to the terms of the contract. A large majority of these commitments expire without being funded, and accordingly, total contractual amounts are not representative of our actual future credit exposure or liquidity requirements. The Risk Governance and Administration Credit Risk Management section below describes how the Bank, which originates and services the loans, manages credit risk when extending credit.

Loan commitments and letters of credit create credit risk in the event that the counterparty draws on the commitment and subsequently fails to perform under the terms of the lending agreement. This risk is incorporated into an overall evaluation of credit risk and to the extent necessary, reserves are recorded on these commitments. Uncertainties around the timing and amount of funding under these commitments may create liquidity risk. The Risk Governance and Administration Liquidity Risk Management section below describes the way we manage liquidity and fund these commitments, to the extent funding is required. At September 30, 2002, commitments to extend credit and letters of credit were $1.5 billion and $216 million, respectively. At December 31, 2001, commitments to extend credit and letters of credit were $1.2 billion and $39 million, respectively.

**Liquidity and Capital Resources**

Our internal sources of liquidity generally include cash generated from our operations and principal repaid on loans. In addition, any necessary liquidity could be obtained by drawing on the line of credit that we have with the Bank. Under the terms of that facility, we can borrow up to $2.0 billion under a revolving demand note at a rate of interest equal to the Federal funds rate. Further, we could issue additional common or preferred stock, subject to any pre-approval rights of our shareholders. We believe that our existing sources of liquidity are sufficient to meet our funding needs.

**Risk Governance and Administration**

*Credit Risk Management*

Credit risk is the risk of loss due to adverse changes in a borrower s ability to meet its financial obligations under agreed upon terms. We incur credit risk by investing in lending and lending-related assets. The nature and amount of credit risk depends on the types of transactions pursued, the structure of those transactions and the parties involved. Credit risk is central to the profit strategy in lending. Since our assets are primarily participation interests in loans originated by the Bank, the following is a discussion of the Bank s credit risk management strategies.

Credit risk is managed through a combination of policies and procedures and risk-taking or commitment authorities that are tracked and regularly updated in a centralized database. All credit authorities

**Table of Contents**

are delegated through the independent risk management organization. Most officers who are authorized to incur credit exposure are in the risk management organization and are independent of the officers who are responsible for generating new business.

The maximum level of credit exposure to individual commercial borrowers is limited by policy guidelines, or house limits . These limits are based on the default probabilities associated with the credit facilities extended to each borrower or related group of borrowers. Concentration risk is managed through geographic and industry diversification, country limits and loan quality factors.

*Commercial Credit.* All commercial loans are assigned internal risk ratings reflecting the probability of the borrower defaulting on any obligation, the probability of a default on any particular Wachovia credit facility and the probable loss in the event of a default.

Commercial credit extensions are also evaluated using a Risk Adjusted Return on Capital model that considers pricing, internal risk ratings, loan structure and tenor, among other variables. This produces a risk/return analysis, enabling the efficient use of economic capital attributable to credit risk. Economic capital is allocated to all credit commitments, whether fully funded or not. The same credit processes and checks and balances are used for unfunded commitments as well as for funded exposures.

Economic capital for all credit risk assets is calculated by the portfolio management group within the risk management organization. As part of their annual capital level review, this group analyzes factors that are used to determine the amount of economic capital needed to support credit risk in the loan portfolio.

Credit Risk Review is an independent unit that performs risk process reviews and evaluates a representative sample of credit extensions after the fact. Credit Risk Review has the authority to change internal risk ratings and is responsible for assessing the adequacy of credit underwriting and servicing practices. This unit reports directly to the Credit and Finance Committee of the Wachovia board of directors.

Credit approvals are based, among other things, on the financial strength of the borrower, assessment of the borrower s management, industry sector trends, the type of exposure, the transaction structure and the general economic outlook. There are two processes for approving credit risk exposures. The first involves standard approval structures for use in retail, certain small business lending and most trading activities. The second, and more prevalent approach, involves individual approval of exposures consistent with the authority delegated to officers experienced in the industries and loan structures over which they have responsibility.

In commercial lending, servicing of credit exposure may be as often as weekly for certain types of asset-based lending, to annually for certain term loans. Some term loans having characteristics similar to retail loans are monitored for delinquencies only. In general, quarterly servicing is normal for all significant exposures. The internal risk ratings are confirmed with each major servicing event. In addition portfolio modeling is employed to verify default probabilities and to estimate losses.

Borrower exposures may be designated as watch list accounts when warranted by either environmental factors or individual company performance. Such accounts are subjected to additional quarterly reviews by the business line management, risk management and credit risk review staff and our chief risk management officer in order to adequately assess the borrower s credit status and to take appropriate action. In addition projections of both nonperforming assets and losses for future quarters are performed monthly. This process is considered essential to the effective management of our credit risk.

The Bank has also established special teams composed of skilled and experienced lenders to manage problem credits. These teams handle commercial recoveries, workouts and problem loan sales.

Commercial credit checks and balances, the independence of risk management functions and specialized processes are all designed to avoid problems where possible and to recognize and address problems early in the cycle when they do occur.

*Retail Credit.* In retail lending, the Bank manages credit risk from a portfolio view rather than by specific borrower as in commercial lending. The risk management division, working with the line of business, determines the appropriate risk/return profile for each portfolio, utilizing a variety of tools including quantitative models and scorecards tailored to meet the Bank s specific needs.

By incorporating these models and policies into computer programs or decisioning engines , much of the underwriting is automated. Once a line of credit or other retail loan is extended, it is included in the overall portfolio, which is continuously monitored for changes in delinquency trends and other asset quality indicators. Delinquency action on individual credits is taken monthly or as needed if collection efforts are necessary. The independent credit risk review unit also has a retail component to ensure adequacy and timeliness of retail credit processes.

*Concentration of Credit Risk*

Concentration of credit risk generally arises with respect to our participation interests when a significant number of underlying loans have borrowers that engage in similar business activities or activities in the same geographical region. Concentration of credit risk indicates the relative sensitivity of performance to both positive and negative developments affecting a particular industry.

*Interest Rate Risk Management*

Interest rate risk is the sensitivity of earnings to changes in interest rates. Our income consists primarily of interest income on our variable rate loans. If there is a further decline in market interest rates, we may experience a reduction in interest income on our loan portfolio and a corresponding decrease in funds available to be distributed to our stockholders. The reduction in interest income may result from downward adjustments of the indices upon which the interest rates on loans are based and from prepayments of loans with fixed interest rates, resulting in reinvestment of the proceeds in lower yielding assets. In December 2001, the Bank contributed receive-fixed interest rate swaps to us in exchange for common stock. Subsequent to the contribution, we entered into pay-fixed interest rate swaps that serve as an economic hedge to the receive-fixed interest rate swaps. Currently, we do not expect to enter into additional derivative transactions.

At September 30, 2002, approximately 6.9% of the loans in our portfolio had fixed interest rates. Such loans tend to increase our interest rate risk. Management monitors the rate sensitivity of assets acquired. Our methods for evaluating interest rate risk include an analysis of interest-rate sensitivity gap , which is defined as the difference between interest-earning assets and interest-bearing liabilities maturing or repricing within a given time period. A gap is considered positive when the amount of interest-rate-sensitive assets exceeds the amount of interest-rate-sensitive liabilities. A gap is considered negative when the amount of interest-rate-sensitive liabilities exceeds interest-rate-sensitive assets.

During a period of rising interest rates, a negative gap would tend to adversely affect net interest income, while a positive gap would tend to result in an increase in interest income. During a period of falling interest rates, a negative gap would tend to result in an increase in net interest income, while a positive gap would tend to affect net interest income adversely. Because different types of assets and liabilities with the same or similar maturities may react differently to changes in overall market rates or conditions, changes in interest rates may affect net interest income positively or negatively even if an institution is perfectly matched in each maturity category.

As of September 30, 2002, $5.1 billion, or 85% of our assets, were variable rate and could be expected to reprice with changes in interest rates. As of September 30, 2002, our liabilities were $607 million, or 10% of our assets, while stockholders equity was $5.5 billion, or 90% of our assets. This positive gap between our assets and liabilities indicates that an increase in interest rates would result in an increase in net interest income and a decrease in interest rates would result in a decrease in net interest income.

**Table of Contents**

Our rate-sensitive assets and liabilities at September 30, 2002, are presented below. Assets that immediately reprice are placed in the overnight column. The fair value of the $336 million of fixed rate loans and loan participations was approximately $337 million at September 30, 2002. The fair value of the $4.0 billion of variable rate loans and loan participations approximated their book value at September 20, 2002.

| **(In thousands)** | **Overnight** | **Within One Year** | **One to Three Years** | **Three to Five Years** | **Over Five Years** | **Total** |
|---|---|---|---|---|---|---|
| Rate-sensitive assets | | | | | | |
| Interest bearing deposits in banks | $ 1,154,451 | | | | | 1,154,451 |
| Loans and loan participations: | | | | | | |
| Fixed rate | | 41,217 | 1,697 | 14,075 | 278,939 | 335,928 |
| Variable rate | 966,059 | 2,983,750 | 11,543 | | | 3,961,352 |
| Total rate-sensitive assets | $ 2,120,510 | 3,024,967 | 13,240 | 14,075 | 278,939 | 5,451,731 |
| Total rate-sensitive liabilities | $ 599,570 | | | | | |

At September 30, 2002, our position in interest rate swaps was an asset of $1.2 billion and a liability of $579 million, which is recorded on our balance sheet at fair value. The following table presents interest rate swap maturities.

| **(In thousands)** | **1 Year or Less** | **1-2 Years** | **2-5 Years** | **5-10 Years** | **After 10 Years** | **Total** |
|---|---|---|---|---|---|---|
| **Interest Rate Swap Assets** | | | | | | |
| Notional amount | $ | | 150,000 | 4,100,000 | | 4,250,000 |
| Weighted average receive rate (a) | % | | 6.10 | 7.46 | | 7.41 |
| Weighted average pay rate (a) | % | | 1.74 | 1.82 | | 1.82 |
| **Interest Rate Swap Liabilities** | | | | | | |
| Notional amount | $ | | 150,000 | 4,100,000 | | 4,250,000 |
| Weighted average receive rate (a) | % | | 1.74 | 1.82 | | 1.82 |
| Weighted average pay rate (a) | % | | 4.84 | 5.72 | | 5.69 |

(a) All of the interest rate swaps have variable pay or receive rates based on one- to six-month LIBOR, and they are the pay or receive rates in effect at September 30, 2002.

*Market Risk Management*

Market risk is the risk of loss from adverse changes in market prices and interest rates. Market risk arises primarily from interest rate risk inherent in lending, investing in marketable securities, deposit taking and borrowing activities.

At September 30, 2002, our receive-fixed interest rate swaps with a notional amount of $4.25 billion had a weighted average maturity of 9.50 years, weighted average receive rate of 7.41% and weighted average pay rate of 1.82%. Our pay-fixed interest rate swaps with a notional amount of $4.25 billion had a weighted average maturity of 9.50 years, weighted average receive rate of 1.82% and weighted average pay rate of 5.69% at September 30, 2002. All of the interest rate swaps have variable pay or receive rates based on three- or six-month LIBOR, and they are the pay or receive rates in effect at September 30, 2002.

Due to the difference in fixed rates in our interest rate swaps, volatility is expected given certain interest rate fluctuations. If market rates were to decrease 100 basis points or 200 basis points, we would realize short-term net gains on our interest rate swaps of $28 million or $57 million, respectively. If market rates were to increase 100 basis points or 200 basis points, we would realize short-term net losses on our interest rate swaps of $26 million or $50 million, respectively. These short-term fluctuations will eventually offset over the life of the interest rate swaps, with no change in cash flow occurring for the net positions. The changes in value of the net swap positions were calculated under the assumption there was a parallel shift in the LIBOR curve using 100 basis point and 200 basis point shifts, respectively.

*Liquidity Risk Management*

Liquidity risk involves the risk of being unable to fund assets with the appropriate duration and rate-based liability, as well as the risk of not being able to meet unexpected cash needs. Liquidity planning and management are necessary to ensure we maintain the ability to fund operations cost-effectively and to meet current and future potential obligations. In managing liquidity, we take into account various legal limitations placed on us.

Our principal liquidity needs are to pay operating expenses and dividends, fund commitments under our loans, and acquire additional participation interests as the underlying loans mature or prepay. Operating expenses and dividends are expected to be funded through cash generated by operations, while funding commitments and the acquisition of additional participation interests in loans is intended to be funded with the proceeds obtained from repayment of principal balances by individual borrowers. We do not have and do not anticipate having any material capital expenditures.

To the extent that our board of directors determines that additional funding is required, we may raise funds through additional equity offerings, debt financings, or retention of cash flow, or a combination of these methods. However, any cash flow retention must be consistent with the provisions of the Code requiring the distribution by a REIT of at least 90% of its REIT taxable income, excluding capital gains, and must take into account taxes that would be imposed on undistributed income.

At September 30, 2002, our liabilities consist of cash collateral held on the receive-fixed interest rate swaps that we have invested in eurodollar investments. Our certificate of incorporation does not contain any limitation on the amount or percentage of debt, funded or otherwise, we may incur, except the incurrence of debt for borrowed money or our guarantee of debt for borrowed money in excess of amounts borrowed or guaranteed.

**Transactions with Related Parties**

We are subject to certain income and expense allocations from affiliated parties for various services received. In addition, we enter into transactions with affiliated parties in the normal course of business. The nature of the transactions with affiliated parties is discussed below. Further information, including amounts involved, is presented in Note 5 of our consolidated financial statements.

Affiliates of Wachovia service our loans on our behalf. We are also subject to Wachovia s management fee policy and therefore reimburse Wachovia for general overhead expenses paid on our behalf. We did not meet Wachovia s criteria for being assessed a fee in 2001, and therefore no fee was charged. We also have a swap servicing and fee arrangement with the Bank, whereby the Bank provides operations, back office, book entry, record keeping and valuation services related to our interest rate swaps, for which we pay a fee to the Bank.

Interest-bearing and noninterest-bearing deposits with the Bank are our primary cash management vehicle. In addition, we have certain eurodollar investments with the Bank. In 2001, we entered into certain loan participations with affiliates and are allocated a portion of all income associated with these loans.

The Bank acts as our collateral custodian in connection with collateral pledged to us related to our interest rate swaps. For this service, we pay the Bank a fee based on the value of the collateral. In addition, the Bank is permitted to rehypothecate and use as its own the collateral held by the Bank as our custodian. The Bank pays us a fee based on the value of the collateral involved for this right. The Bank also provides a guaranty of our obligations under the interest rate swaps, for which we pay a monthly fee based on the absolute value of the net notional amount of the interest rate swaps.

Table of Contents

**Accounting and Regulatory Matters**

The following information addresses new or proposed accounting pronouncements related to our industry as well as legislation that has had a significant impact on our industry.

*Derivatives and Hedging.* In 1998 the Financial Accounting Standards Board issued SFAS 133, *Accounting for Derivative Instruments and Hedging Activities*, which was subsequently amended by SFAS 137 and SFAS 138. These standards establish the accounting and reporting model for derivatives and hedging activities. SFAS 133 requires that all derivatives be recognized as assets or liabilities on the balance sheet and that these instruments be measured at fair value through adjustments to either other comprehensive income or to current earnings, depending on the purpose for which the derivative is held.

*Regulatory Matters.* On July 30, 2002, President Bush signed the Sarbanes-Oxley Act of 2002 into law. The intent of this law is to reform specific matters pertaining to public accounting oversight, auditor independence and corporate responsibility. Requirements in the act will affect certain of Wachovia s corporate governance policies and certain of Wachovia s business lines, such as securities analysis. We do not believe we will need to make material modifications to our corporate governance policies in response to the act or do we believe the act will negatively affect our financial condition or results of operations.

Various legislative and regulatory proposals concerning the financial services industry are pending in Congress, the legislatures in states in which we conduct operations and before various regulatory agencies that supervise our operations. Given the uncertainty of the legislative and regulatory process, we cannot assess the impact of any such legislation or regulations on our financial condition or results of operations.

**Table 1**

**Performance and Dividend Payout Ratios**

| | Nine Months Ended September 30, | | Years Ended December 31, | |
|---|---|---|---|---|
| | **2002** | **2001** | **2001** | **2000** |
| **Ratios** | | | | |
| Return on assets | 5.12% | 3.08 | (0.71) | 3.83 |
| Return on stockholders equity | 5.76 | 3.09 | (0.80) | 3.83 |
| Stockholders equity to assets | 88.80 | 99.65 | 88.96 | 97.82 |
| Dividend payout ratio | % | 0.04 | | 0.03 |

71

Table of Contents

**Table 2**

**Loan Losses and Recoveries and Past Due Loans**

| | Nine Months Ended September 30, | | Years Ended December 31, | |
|---|---|---|---|---|
| **(In thousands)** | **2002** | **2001** | **2001** | **2000** |
| **Allowance for Loan Losses** | | | | |
| Balance, beginning of period | $ 37,158 | 3,833 | 3,833 | 1,285 |
| Provision for loan losses | 7,033 | 6,290 | 5,262 | 3,602 |
| Allowance relating to loans contributed from the Bank | | | 33,681 | |
| Allowance related to loans transferred or sold | (2,005) | (482) | (515) | (673) |
| Net charge-offs | (4,851) | (3,986) | (5,103) | (381) |
| Balance, end of period | $ 37,335 | 5,655 | 37,158 | 3,833 |
| **Loan Losses** | | | | |
| Commercial and commercial real estate loans | $ | | | |
| Residential mortgages | | | | 36 |
| Home equity | 5,168 | 4,012 | 5,155 | 386 |
| Total loan losses | 5,168 | 4,012 | 5,155 | 422 |
| **Loan Recoveries** | | | | |
| Commercial and commercial real estate loans | | | | |
| Residential mortgages | | | | 39 |
| Home equity | 317 | 26 | 52 | 2 |
| Total loan recoveries | 317 | 26 | 52 | 41 |
| Net charge-offs | $ 4,851 | 3,986 | 5,103 | 381 |
| Total net charge-offs as % of average loans, net | 0.15% | 1.05 | 0.62 | 0.08 |
| Accruing loans past due 90 days | $ 3,945 | 6,511 | 3,419 | 6,504 |

As of September 30, 2002, we did not have serious doubts as to the ability of our borrowers to comply with their current loan repayment terms.

**Allocation of the Allowance for Loan Losses**

| | September 30, 2002 | | | | September 30, | | December 31, | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | Actual | | Pro Forma(a) | | 2001 | | 2001 | | 2000 | |
| **(In millions)** | **Amt.** | **Loans % of Total Loans** | **Amt.** | **Loans % of Total Loans** | **Amt.** | **Loans % of Total Loans** | **Amt.** | **Loans % of Total Loans** | **Amt.** | **Loans % of Total Loans** |
| Commercial and commercial real estate loans | $ 23,970 | 93% | $ 62,824 | 90% | $ | % | $ 22,651 | 91% | $ | % |
| Residential mortgages | 59 | 2 | 59 | 1 | 161 | 28 | 87 | 2 | 218 | 25 |
| Home equity loans | 2,165 | 5 | 11,295 | 9 | 3,405 | 72 | 2,068 | 7 | 2,708 | 75 |
| Unallocated | 11,141 | | 27,052 | | 2,089 | | 12,352 | | 907 | |
| Total | $ 37,335 | 100% | $ 101,230 | 100% | $ 5,655 | 100% | $ 37,158 | 100% | $ 3,833 | 100% |

(a) The pro forma amounts reflect the following:

Table of Contents

$866 million of participation interests in home equity loans received by us as collateral for an intercompany loan to the Bank in October 2002. The underlying home equity loans were originated by the Bank; and

the issuance of three new series of preferred securities (Series A, B and C ) to Wachovia Preferred Holding in exchange for participations in commercial and commercial real estate loans prior to this offering. The commercial and commercial real estate loans were originated by the Bank and contributed to Wachovia Preferred Holding. We will issue the preferred securities to Wachovia Preferred Holding in exchange for participations in the loans prior to this offering.

Table of Contents

# MANAGEMENT

## Directors and Executive Officers

We currently have two executive officers. Our executive officers are also executive officers of Wachovia. We estimate that our executive officers will devote less than 5% of their time to managing our business. Executive officers of Wachovia are generally elected to their offices for one-year terms at a Wachovia board meeting in April of each year. The names of our executive officers, their ages, their positions with Wachovia, and their business experience during the past five years, are as follows:

*G. Kennedy Thompson* (51). Chief Executive Officer of Wachovia, since April 2000, and President, since December 1999. Previously, Chairman of Wachovia, from March 2001 to September 2001; Vice Chairman, from October 1998 to December 1999; and Executive Vice President, from November 1996 to October 1998. Also, a director of Wachovia.

*Robert P. Kelly* (48). Senior Executive Vice President and Chief Financial Officer of Wachovia since September 2001. Previously, Executive Vice President and Chief Financial Officer of Wachovia, from November 2000 to September 2001; and Vice Chairman-Group Office from February 2000 to July 2000, Vice Chairman-Retail Banking from 1997 to February 2000, and Vice Chairman from 1996 to 1997, all of Toronto Dominion Bank.

None of our executive officers owns any shares of our capital stock.

## Directors

Presently, our board of directors is composed of one member, Robert L. Andersen. Mr. Andersen is an employee of Wachovia where he has been Senior Vice President and Deputy General Counsel since March 2000. Prior to March 2000, Mr. Andersen was Senior Vice President and Assistant General Counsel of Wachovia. Mr. Andersen does not own any shares of our capital stock.

Prior to the offering of the Series A preferred securities, we will elect three additional directors, two of which shall be Independent Directors, as discussed below under Independent Directors .

Each of our directors will serve until their successors are duly elected and qualified. There is no current intention to further alter the number of directors comprising our board of directors after the sale of the Series A preferred securities in this offering.

## Independent Directors

Our certificate of incorporation requires that, so long as any Series A preferred securities are outstanding, certain actions by us must be approved by a majority of our Independent Directors satisfying the definition of being independent as set forth in the corporate governance standards of the New York Stock Exchange. Prior to this offering, we will elect two Independent Directors. The actions requiring Independent Director approval are described in more detail under the heading Description of the Series A Preferred Securities Independent Director Approval . In addition, although not restricted from doing so, our board of directors does not currently intend to approve the following transactions without the approval of a majority of our Independent Directors:

the modification of the general distribution policy or the authorization or declaration of any distribution in respect of shares of our common stock for any year if, after taking into account any such proposed distribution, total distributions on our preferred securities and our shares of common stock would exceed an amount equal to the sum of 105% of our REIT taxable income, excluding capital gains, for such year plus our net capital gains for that year; and

Table of Contents

the redemption of any of our shares of common stock.

If we fail to pay, or declare and set aside for payment, dividends on the Series A preferred securities and any Parity Stock for six quarters, the number of our directors will be increased by two and holders of the Series A preferred securities, voting together as a class with the holders of any Parity Stock with the same voting rights, will have the right to elect such additional directors.

**Audit Committee**

Upon completion of this offering, we will establish an audit committee consisting of two Independent Directors.

The primary purpose of the audit committee will be to assist our board of directors in its oversight of internal controls, the financial statements and the audit process. To that end, the audit committee shall:

retain and terminate our independent certified public accountants;

review reports prepared by management and the independent certified public accountants on systems of internal control and the audit and compliance process; and

review the financial statements, which are prepared by management and audited by the independent certified public accountants.

**Limitations on Liability of Directors and Officers**

Section 145 of the Delaware General Corporation Law (the DGCL ) provides that a corporation may indemnify directors and officers as well as other employees and individuals against expenses (including attorneys fees), judgments, fines and amounts paid in settlement actually and reasonably incurred by such person in connection with any threatened, pending or completed actions, suits or proceedings in which such person is made a party by reason of such person being or having been a director, officer, employee or agent of the corporation, subject to certain limitations. The statute provides that it is not exclusive of other rights to which those seeking indemnification may be entitled under any by-law, agreement, vote of shareholders or disinterested directors or otherwise.

Section 102 (b)(7) of the DGCL permits a corporation to provide in its charter that a director of the corporation shall not be personally liable to the corporation or its shareholders for monetary damages for breach of fiduciary duty as a director, except for liability:

for any breach of the director s duty of loyalty to the corporation or its shareholders;

- for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law;

- for payments of unlawful dividends or unlawful stock purchases or redemptions; or

- for any transaction from which the director derived an improper personal benefit.

Our by-laws provide for the indemnification of our directors and executive officers by us against liabilities arising out of his or her status as such, excluding any liability relating to activities which were at the time taken known or believed by such person to be clearly in conflict with our best interests. Our certificate of incorporation provides for the elimination of the personal liability of each of our directors, to the fullest extent permitted by the provisions of the DGCL, as the same may from time to time be in effect.

We maintain directors and officers liability insurance. In general, the policy insures:

- our directors and officers against loss by reason of any of their wrongful acts; and

- Wachovia Funding against loss arising from claims against the directors and officers by reason of their wrongful acts, all subject to the terms and conditions contained in the policy.

75

Table of Contents

## CERTAIN RELATIONSHIPS AND RELATED PARTY TRANSACTIONS

Our current director and executive officers are also executive officers or employees of Wachovia and one of our executive officers is also a director of Wachovia. In addition, some of our directors and executive officers are customers of Wachovia s affiliated financial and lending institutions and have transactions with such affiliates in the ordinary course of business. Transactions with directors and executive officers have been on substantially the same terms, including interest rates and collateral on loans, as those prevailing at the time for comparable transactions with third parties and do not involve more than the normal risk of collectibility or present other unfavorable features. We may hold a participation interest in some of these loans.

The Bank administers our day-to-day activities under the terms of participation and servicing agreements between the Bank and us. These agreements reflect what we believe to be terms consistent with those resulting from arms-length negotiations and contain the following fees: (a) with respect to the commercial, commercial real estate and home equity loans an annual service fee of 0.03% multiplied by the outstanding principal balance of each loan, and (b) with respect to residential mortgages, $48.00 per loan. Additionally we are subject to Wachovia s management fee policy and thus reimburse Wachovia on a monthly basis for general overhead expenses. We are dependent on the Bank and others for servicing the loans in our portfolio. All of our officers and certain directors are also either officers and/or directors of Wachovia or the Bank or their affiliates.

We also have a swap servicing and fee arrangement with the Bank, whereby the Bank provides operations, back office, book entry, record keeping and valuation services related to our interest rate swaps, for which we pay a fee to the Bank. In addition, the Bank acts as our collateral custodian in connection with collateral pledged to us in relation to our interest rate swaps. For this service, we pay the Bank a fee based on the value of the collateral. In addition, the Bank is permitted to rehypothecate and use as its own the collateral held by the Bank as our custodian. The Bank pays us a fee based on the value of the collateral involved for this right. The Bank also provides a guaranty of our obligations under the interest rate swaps, for which we pay a monthly fee based on the absolute value of the net notional amount of the interest rate swaps.

Interest-bearing and noninterest-bearing deposits with the Bank are our primary cash management vehicle. In addition, we have certain eurodollar investments with the Bank. In 2001, we entered into certain loan participations with affiliates and are allocated a portion of all income associated with these loans.

After this offering, Wachovia, the Bank and Wachovia Preferred Holding will continue to control a substantial majority of our outstanding voting shares.

Table of Contents

## BENEFICIAL OWNERSHIP OF OUR CAPITAL STOCK

By the completion of this offering, we will have 99,999,900 shares of common stock issued and outstanding. The following table sets forth, as of the time of this offering, the expected number of shares and percentage of ownership beneficially owned by all persons known by us to own more than five percent of the shares of our common stock.

| Name and Address of Beneficial Owner | Number of Shares of Common Stock Beneficially Owned | Percentage of Class |
|---|---|---|
| Wachovia Preferred Funding Holding Corp.<br>1620 East Roseville Parkway<br>Roseville, California 95661 | 99,851,752 | 99.85% |

In addition to the foregoing, by completion of this offering, Wachovia Preferred Holding will own:

- 12,000,000 (or 40%) of our outstanding Series A preferred securities;
- 40,000,000 (or 100%) of our outstanding Series B preferred securities;
- 4,233,754 (or 100%) of our outstanding Series C preferred securities; and
- 800 (or approximately 88%) of our outstanding Series D preferred securities.

Wachovia Preferred Holding may choose to sell its remaining 12,000,000 Series A preferred securities to the public in the near future.

None of our directors or executive officers owns any of our common stock. Each Series A, B, and C preferred security will have 1/10th of a vote per share. The Series D preferred securities are non-voting. Certain of our executive officers each own one of the Series D preferred securities.

## DESCRIPTION OF THE SERIES A PREFERRED SECURITIES

The following summary describes the material terms and provisions of the Series A preferred securities. This description is qualified in its entirety by reference to the terms and provisions of our certificate of incorporation. Our certificate of incorporation has been filed with the SEC as an exhibit to the registration statement that we filed in connection with this offering. Please see Where You Can Find More Information about Wachovia Funding for information on how to obtain a copy of our certificate of incorporation.

**General**

The Series A preferred securities are validly issued, fully paid and non-assessable. The holders of the Series A preferred securities will have no preemptive rights with respect to any of our capital stock or any of our other securities convertible into or carrying rights or options to purchase any such capital stock. The Series A preferred securities are perpetual and will not be convertible into our common stock or any other class or series of our securities and will not be subject to any sinking fund or other obligation for its repurchase or retirement.

The Bank will be the transfer agent, registrar and dividend disbursement agent for the Series A preferred securities. The registrar for our Series A preferred securities will send notices to shareholders of any meetings at which holders of the Series A preferred securities have the right to elect directors or to vote on any other matter.

The Series A preferred securities are not obligations of, or guaranteed by, the Bank, Wachovia Preferred Holding, Wachovia or any of their respective affiliates or any other entity. The Series A preferred securities solely represent an interest in us and do not represent an interest in any of the foregoing entities.

Table of Contents

**Dividends**

Holders of Series A preferred securities will be entitled to receive, if, when, and as authorized and declared by our board of directors out of our legally available funds, non-cumulative cash dividends at the rate of 7.25% per annum of the initial liquidation preference, which is $25.00 per security. Dividends on the Series A preferred securities will be payable, if authorized and declared, quarterly in arrears on March 31, June 30, September 30, and December 31 of each year or, if any such day is not a business day, on the next business day without interest, unless the next business day falls in a different calendar year, in which case the dividend will be paid on the preceding business day, commencing on December 31, 2002. We refer to each such quarter of a calendar year as a dividend period . Quarterly dividend periods will commence on a dividend payment date, and end on the day preceding the immediately following dividend payment date; *provided*, *however*, that the first dividend period will commence on and include the original issue date of the Series A preferred securities and will end on and include December 31, 2002. The record date for the payment of dividends, if declared, will be the fifteenth day of the month in which the relevant dividend payment occurs or, if any such day is not a business day, the next day that is a business day. Dividends payable on the Series A preferred securities for any period greater or less than a full dividend period will be computed on the basis of twelve 30-day months, a 360-day year, and the actual number of days elapsed in the period; *provided*, *however*, that in the event of a Conditional Exchange, any authorized, declared, but unpaid dividends on the Series A preferred securities as of the time of exchange will be deemed to be authorized, declared, but unpaid dividends on the depositary shares representing the Wachovia Series G, Class A preferred stock into which the Series A preferred securities are exchanged. No interest will be paid on any dividend payment of Series A preferred securities or depositary shares of Wachovia Series G, Class A preferred stock.

The right of holders of Series A preferred securities to receive dividends is non-cumulative. If our board of directors does not declare a dividend on the Series A preferred securities or declares less than a full dividend in respect of any dividend period, you will have no right to receive any dividend or a full dividend, as the case may be, for that dividend period, and we will have no obligation to pay a dividend or to pay full dividends for that dividend period, whether or not dividends are declared and paid for any future dividend period with respect either to the Series A preferred securities, other series of preferred securities or the common stock. If we fail to pay, or declare and set aside for payment, dividends on the Series A preferred securities and any Parity Stock for six dividend periods, holders of the Series A preferred securities, voting together as a class with the holders of other Parity Stock with the same voting rights, will be entitled to elect two directors in addition to the directors then in office. These voting rights are described in more detail below under the heading Voting Rights .

Payment of dividends on the Series A preferred securities will be subject to the rights of holders of any securities ranking senior to the Series A preferred securities as to dividend rights. If full dividends on the Series A preferred securities for any dividend period have not been declared and paid, or a sum sufficient for such payment has not been set apart for such payment, no dividends will be declared or paid or set aside for payment and no other distribution will be declared or made or set aside for payment upon our common stock, Series C preferred securities or other stock ranking subordinate to our Series A preferred securities, which we collectively refer to as Junior Stock, nor will any Junior Stock be redeemed, purchased, or otherwise acquired for any consideration, nor will any monies be paid to or made available for a sinking fund for the redemption of any such securities by us, except by conversion into or exchange for other Junior Stock, until such time as dividends on all outstanding Series A preferred securities have been:

- declared and paid for three consecutive dividend periods; and
- declared and paid or declared and a sum sufficient for such payment has been set apart for payment for the fourth consecutive dividend period.

**Table of Contents**

When dividends are not paid in full on, or a sum sufficient for such full payment is not set apart for, the Series A preferred securities and any non-cumulative Parity Stock, all dividends declared upon the Series A preferred securities and any non-cumulative Parity Stock will be declared pro rata. Thus, the amount of dividends declared per Series A preferred security and such other non-cumulative Parity Stock will in all cases bear to each other the same ratio that (a) full dividends per Series A preferred security for the then-current dividend period, which will not include any accumulation in respect of unpaid dividends for prior dividend periods, and (b) full dividends, which will not include any accumulation in respect of unpaid dividends for prior dividend periods, on such other non-cumulative capital stock, bear to each other.

Under certain circumstances, if the OCC determines that the Bank is operating with an insufficient level of capital or is engaged in, or its relationship with us results in, an unsafe and unsound banking practice, the OCC could restrict our ability to pay dividends, including dividends to the holders of the Series A preferred securities. See Business Dividend Policy .

**Conditional Exchange**

Each Series A preferred security will be exchanged automatically for one newly issued depositary share representing a one-sixth interest in one share of Wachovia Series G, Class A preferred stock if the OCC so directs in writing upon or after the occurrence of a Supervisory Event. A Supervisory Event will occur when:

- the Bank becomes undercapitalized under the OCC s prompt corrective action regulations;
- the Bank is placed into conservatorship or receivership; or
- the OCC, in its sole discretion, anticipates the Bank becoming undercapitalized in the near term or takes supervisory action that limits the payment of dividends by us and in connection therewith directs an exchange.

If the OCC so directs upon the occurrence of a Supervisory Event, each holder of Series A preferred securities will be unconditionally obligated to surrender to Wachovia any certificates representing the Series A preferred securities owned by such holder, and Wachovia will be unconditionally obligated to issue to such holder in exchange for each such Series A preferred security a depositary receipt representing a depositary share of Wachovia Series G, Class A preferred stock on a share-for-share basis. Any Series A preferred securities purchased or redeemed by us prior to the time of exchange will not be deemed outstanding and will not be subject to Conditional Exchange.

The exchange will occur as of 8:00 a.m. Eastern Time on the date for such exchange set forth in the applicable OCC directive, or, if such date is not set forth in the directive, as of 8:00 a.m. on the earliest possible date such exchange could occur consistent with the directive, as evidenced by the issuance by Wachovia of a press release prior to such time. As of the time of exchange, all of the Series A preferred securities will be deemed cancelled without any further action by us, all rights of the holders of Series A preferred securities as our shareholders will cease, and such persons will be, for all purposes, the holders of depositary shares representing Wachovia Series G, Class A preferred stock.

We will mail notice of the issuance of an OCC directive after the occurrence of a Supervisory Event to each holder of Series A preferred securities within 30 days, and Wachovia will deliver to each such holder depositary receipts for depositary shares representing the Wachovia Series G, Class A preferred stock upon surrender of certificates for the Series A preferred securities. Until such replacement certificates are delivered or in the event such replacement certificates are not delivered, any certificates previously representing Series A preferred securities will be deemed for all purposes to represent depositary shares of Wachovia Series G, Class A preferred stock. All corporate action necessary for

Wachovia to issue the depositary shares and the Wachovia Series G, Class A preferred stock as of the time of exchange will be completed prior to or upon completion of this offering. Accordingly, once the OCC directs a Conditional Exchange after the occurrence of a Supervisory Event, no action will be required to be taken by holders of Series A preferred securities, by Wachovia, by the Bank (other than to inform the OCC), or by us in order to effect the automatic exchange as of the time of exchange.

Table of Contents

Holders of Series A preferred securities, by purchasing such securities, whether in this offering or in the secondary market after this offering, will be deemed to have agreed to be bound by the unconditional obligation to exchange such Series A preferred securities for depositary shares representing the Wachovia Series G, Class A preferred stock upon the OCC s direction after the occurrence of a Supervisory Event. Our certificate of incorporation provides that the holders of Series A preferred securities will be unconditionally obligated to surrender such preferred securities. In accordance with an Exchange Agreement, dated November 25, 2002, among Wachovia, the Bank and us, Wachovia is unconditionally obligated to issue depositary shares representing the Wachovia Series G, Class A preferred stock in exchange for our Series A preferred securities upon the OCC s direction after the occurrence of a Supervisory Event.

Holders of Series A preferred securities cannot exchange their Series A preferred securities for depositary shares representing the Wachovia Series G, Class A preferred stock voluntarily. Absent an OCC directive after the occurrence of a Supervisory Event, no exchange of the Series A preferred securities for depositary shares representing the Wachovia Series G, Class A preferred stock will occur. Upon the issuance of an OCC directive on or after the occurrence of a Supervisory Event, the depositary shares representing the Wachovia Series G, Class A preferred stock to be issued as part of the automatic exchange would constitute a newly issued series of preferred stock of Wachovia and would have substantially similar terms and provisions with respect to dividends, liquidation, and redemption as the Series A preferred securities, except that the depositary shares representing Wachovia Series G, Class A preferred stock will not:

- be listed on any national securities exchange or national quotation system;
- have any voting rights, except as required by law;
- be redeemable upon the occurrence of an Investment Company Event or a Tax Event;
- have any right to elect directors if dividends are missed; or
- be subject to a Conditional Exchange.

Any authorized, declared, but unpaid dividends on Series A preferred securities as of the time of exchange would be deemed to be authorized, declared, but unpaid dividends on the depositary shares representing Wachovia Series G, Class A preferred stock. Wachovia Series G, Class A preferred stock would rank on an equal basis in terms of dividend payment and liquidation preference with any then-outstanding preferred stock of Wachovia. Wachovia has registered the depositary shares representing Wachovia Series G, Class A preferred stock with the SEC pursuant to this prospectus. Absent an OCC directive after the occurrence of a Supervisory Event, however, Wachovia will not issue any depositary shares representing the Wachovia Series G, Class A preferred stock, although Wachovia will be able to issue preferred stock in classes or series other than Wachovia Series G, Class A preferred stock. Since the depositary shares representing Wachovia Series G, Class A preferred stock will not be listed, it is highly unlikely that an active public market for the depositary shares representing Wachovia Series G, Class A preferred stock would develop or be maintained.

Absent the occurrence of a Conditional Exchange, holders of Series A preferred securities will have no dividend, liquidation preference, or other rights with respect to any security of the Bank, Wachovia Preferred Holding or Wachovia; such rights as are conferred by the Series A preferred securities exist solely as to us.

**Rank**

The Series A preferred securities will rank senior to our shares of common stock and to all of our other Junior Stock. We may also issue stock ranking senior to our Series A preferred stock as to dividend rights and rights upon liquidation, winding up, or dissolution, which we refer to as Senior Stock . As of the date of this prospectus, there are no shares of Senior Stock authorized, issued, or outstanding. Our Series B and D preferred securities will constitute Parity Stock with respect to the Series A preferred securities.

Our board of directors has the power to create and issue Junior Stock without any approval or consent of the holders of Series A preferred securities. So long as any Series A preferred securities remain outstanding, we may not issue Senior Stock without the approval of the holders of at least two-thirds of the outstanding

Table of Contents

Series A preferred securities. So long as any Series A preferred securities remain outstanding, additional shares of Parity Stock may be issued without your approval, but such issuance requires the approval of a majority of our Independent Directors.

**Voting Rights**

Holders of Series A preferred securities are entitled to 1/10th of one vote per security on all matters to be voted on by shareholders, voting as a single class with the holders of our common stock and the holders of any other class of securities entitled to vote as a single class with the holders of our common stock.

If we fail to pay, or declare and set aside for payment, full dividends on the Series A preferred securities for six dividend periods, the authorized number of our directors will be increased by two. Subject to compliance with any requirement for regulatory approval of, or non-objection to, persons serving as directors, the holders of Series A preferred securities, voting together as a single and separate class with the holders of any other Parity Stock upon which the same voting rights as those of the Series A preferred securities have been conferred and are irrevocable, will have the right to elect two directors in addition to the directors then in office at our next annual meeting of shareholders. This right will continue at each subsequent annual meeting until we pay dividends for three consecutive periods and pay or declare and set aside for payment dividends for the fourth consecutive dividend period.

The term of such additional directors will terminate, and the total number of directors will be decreased by two, at the first annual meeting of shareholders after we pay dividends for three consecutive periods and declare and pay or set aside for payment dividends on the Series A preferred securities for the fourth consecutive dividend period or, if earlier, upon the redemption of all Series A preferred securities or upon a Conditional Exchange. After the term of such additional directors terminates, the holders of the Series A preferred securities will not be able to elect additional directors unless dividends on the Series A preferred securities and any other Parity Stock have again not been paid or declared and set aside for payment for six future dividend periods.

Any additional director elected by the holders of Series A preferred securities may only be removed by the vote of the holders of record of the outstanding Series A preferred securities and any Parity Stock entitled to vote, voting together as a single and separate class, at a meeting of our shareholders called for that purpose. As long as dividends on the Series A preferred securities have not been paid for six dividend periods, (a) any vacancy created by the removal of any such director may be filled only by the vote of the holders of the outstanding Series A preferred securities and any other Parity Stock entitled to vote, voting together as a single and separate class, at the same meeting at which such removal is considered, and (b) any other vacancy in the office of any such director as a result of the director s death or resignation or for any other reason may be filled by an instrument in writing signed by any such remaining director and filed with us.

So long as any Series A preferred security is outstanding, we will not, without the consent or vote of the holders of at least two-thirds of the outstanding Series A preferred securities, voting separately as a single class:

- amend, alter, or repeal or otherwise change any provision of our certificate of incorporation, including the terms of the Series A preferred securities, if such amendment, alteration, repeal, or change would materially and adversely affect the preferences, conversion, or other rights, voting powers, restrictions, limitations as to dividends or other distributions, qualifications, or terms or conditions of redemption of the Series A preferred securities;

authorize, create, or increase the authorized amount of or issue any class or series of any of our equity securities, or any warrants, options, or other rights exercisable for or convertible or exchangeable into any class or series of any of our equity securities, ranking senior to the Series A preferred securities, either as to dividend rights or rights on our liquidation, dissolution, or winding up; or

Table of Contents

effect our consolidation, conversion, or merger with or into, or a share exchange with, another entity except that we may consolidate or merge with or into, or enter into a share exchange with, another entity if:

such entity is an entity that is controlled by or under common control with the Bank;

such entity is a corporation, business trust, limited liability company or other entity organized under the laws of the United States or a political subdivision of the United States that is not regulated as an investment company under the Investment Company Act and that, according to an opinion of counsel rendered by a firm experienced in such matters, is a REIT for United States Federal income tax purposes;

such other entity expressly assumes all of our obligations and commitments pursuant to such consolidation, merger, or share exchange;

the outstanding Series A preferred securities are exchanged for or converted into securities of the surviving entity having preferences, limitations, and relative voting and other rights substantially identical to those of the Series A preferred securities, including limitations on personal liability of the shareholders;

after giving effect to such merger, consolidation, or share exchange, no breach, or event which, with the giving of notice or passage of time or both, could become a breach by us of obligations under our certificate of incorporation, will have occurred and be continuing; and

we have received written notice from each of the rating agencies rating the Series A preferred securities, and delivered a copy of such written notice to the transfer agent, confirming that such merger, consolidation, or share exchange will not result in a reduction of the rating assigned by any of such rating agencies to the Series A preferred securities or the preferred interests of any surviving corporation, trust, or entity issued in replacement of the Series A preferred securities.

As a condition to effecting any merger, consolidation, or share exchange described above, we will mail to the holders of record of the Series A preferred securities a notice of such merger, consolidation or share exchange. The notice will be mailed at least 15 days prior to such transaction becoming effective and will contain a description of such transaction together with a certificate of one of our executive officers stating that such transaction complies with the requirements set forth in our certificate of incorporation and that all conditions precedent provided therein relating to such transaction have been fulfilled.

The creation or issuance of Parity Stock or Junior Stock, or an amendment to our certificate of incorporation that increases the number of authorized preferred stock, Series A preferred securities, Junior Stock, or Parity Stock, will not be deemed to be a material and adverse change requiring a vote of the holders of Series A preferred securities. However, the issuance of any Parity Stock requires the approval of a majority of our Independent Directors.

Our certificate of incorporation provides certain covenants in favor of the holders of the Series A preferred securities. Except with the consent or affirmative vote of the holders of at least two-thirds of the Series A preferred securities, voting as a separate class, we agree not to:

make or permit to be made any payment to the Bank or its affiliates relating to our indebtedness or beneficial interests in us when we are precluded, as described under Dividends above, from making payments in respect of our common stock or other Junior Stock, or make such payment or permit such payment to be made in anticipation of any liquidation, dissolution, or winding up;

incur indebtedness, including any guarantees of indebtedness, at any time other than indebtedness in an aggregate amount not exceeding 20% of our shareholders equity as determined in accordance with accounting principles generally accepted in the United States;

Table of Contents

pay dividends on our common stock or other Junior Stock unless our FFO for the four prior fiscal quarters equals or exceeds 150% of the amount that would be required to pay full annual dividends on the Series A preferred securities as well as any other Parity Stock, except as may be necessary to maintain our status as a REIT;

make any payment of interest or principal with respect to our indebtedness to the Bank or its affiliates unless FFO for the four prior fiscal quarters equals or exceeds 150% of the amount that would be required to pay full annual dividends on the Series A preferred securities as well as any other Parity Stock, except as may be necessary to maintain our status as a REIT;

amend or otherwise change our policy of reinvesting the proceeds of our assets in other interest-earning assets such that our FFO over any period of four fiscal quarters will be anticipated to equal or exceed 150% of the amount that would be required to pay full annual dividends on the Series A preferred securities as well as any other Parity Stock, except as may be necessary to maintain our status as a REIT;

issue any additional shares of our common stock in an amount that would result in the Bank or its affiliates owning less than 100% of the outstanding shares of common stock; or

remove Wachovia from our name unless the name of either Wachovia or the Bank changes and we change our name to be consistent with the new name of either Wachovia or the Bank.

Wachovia s articles of incorporation do not contain similar covenants regarding the Wachovia Series G, Class A preferred stock following an exchange of our Series A preferred securities. Therefore, following a Conditional Exchange, you would no longer have any voting rights, except as provided by North Carolina law. See below under Description of Wachovia Series G, Class A Preferred Stock Voting Rights .

**Redemption**

Except upon the occurrence of a Special Event, which may be a Tax Event, an Investment Company Act Event, or a Regulatory Capital Event, the Series A preferred securities will not be redeemable prior to December 31, 2022. On or after such date, we may redeem the Series A preferred securities for cash, in whole or in part, at any time and from time to time at our option with the prior approval of the OCC at the redemption price of $25.00 per security, plus authorized, declared, but unpaid dividends to the date of redemption, without interest, from funds legally available for such purpose.

After December 31, 2022, our board of directors may determine that it should redeem fewer than all the outstanding Series A preferred securities. In that event, the Series A preferred securities to be redeemed will be determined by lot, pro rata, or by such other method as the board of directors in its sole discretion determines to be equitable. The method selected by the board of directors must satisfy any applicable requirements of the New York Stock Exchange or any securities exchange on which the Series A preferred securities are then listed.

Prior to December 31, 2022, upon the occurrence of a Special Event, with the prior approval of the OCC, we have the right to redeem the outstanding Series A preferred securities, in whole, but not in part, at a redemption price of $25.00 per security, plus all authorized, declared, but unpaid dividends to the date of redemption, without interest, from funds legally available for such purpose.

A Special Event means:

- a Tax Event;
- an Investment Company Event; or
- a Regulatory Capital Event.

Tax Event means our determination, based on the receipt by us of an opinion of counsel, rendered by a law firm experienced in such matters, in form and substance satisfactory to us, which states that there is a

Table of Contents

significant risk that dividends paid or to be paid by us with respect to our capital stock are not or will not be fully deductible by us for United States Federal income tax purposes or that we are or will be subject to additional taxes, duties, or other governmental charges, in an amount we reasonably determine to be significant as a result of:

any amendment to, clarification of, or change in, the laws, treaties, or related regulations of the United States or any of its political subdivisions or their taxing authorities affecting taxation; or

any judicial decision, official administrative pronouncement, published or private ruling, technical advice memorandum, Chief Counsel Advice, as such term is defined in the Code, regulatory procedure, notice, or official announcement, which we refer to collectively as Administrative Actions ;

which amendment, clarification, or change is effective, or such official pronouncement or decision is announced, on or after the date of issuance of the Series A preferred securities.

Investment Company Act Event means our determination, based on the receipt by us of an opinion of counsel, rendered by a law firm experienced in such matters, in form and substance satisfactory to us, which states that there is a significant risk that we are or will be considered an investment company that is required to be registered under the Investment Company Act, as a result of the occurrence of a change in law or regulation or a written change in interpretation or application of law or regulation by any legislative body, court, governmental agency, or regulatory authority.

Regulatory Capital Event means our determination, based on the receipt by us of an opinion of counsel, rendered by a law firm experienced in such matters, in form and substance satisfactory to us, which states that there is a significant risk that the Series A preferred securities will no longer constitute Tier 1 capital of the Bank or Wachovia for purposes of the capital adequacy guidelines or policies of the OCC or the Federal Reserve Board, or their respective successor as the Bank s and Wachovia s, respectively, primary Federal banking regulator, as a result of:

any amendments to, clarification of, or change in applicable laws or related regulations or official interpretations or policies; or

any official administrative pronouncement or judicial decision interpreting or applying such laws or regulations.

Dividends will cease to accrue on the Series A preferred securities called for redemption on and as of the date fixed for redemption, and such Series A preferred securities will be deemed to cease to be outstanding, provided that the redemption price, including any authorized, declared, but unpaid dividends to the date fixed for redemption, without interest, has been duly paid or provision has been made for such payment.

Notice of any redemption will be mailed at least 30 days, but not more than 60 days, prior to any redemption date to each holder of Series A preferred securities to be redeemed at such holder s registered address.

Our ability to redeem any Series A preferred security is subject to compliance with applicable regulatory requirements, including the prior approval of the OCC, relating to the redemption of capital instruments. Under current policies of the OCC, such approval would be granted only if the redemption were to be made out of the proceeds of the issuance of another capital instrument or if the OCC were to determine that the conditions and circumstances of Wachovia and the Bank warrant the reduction of a source of permanent capital.

**Rights upon Liquidation**

In the event we voluntarily or involuntarily liquidate, dissolve, or wind up, the holders of Series A preferred securities at the time outstanding will be entitled to receive liquidating distributions in the amount of $25.00 per security, plus any authorized, declared, but unpaid dividends to the date of liquidation, out of our assets legally available for distribution to shareholders, before any distribution of assets is made to holders of Junior Stock and subject to the rights of the holders of any class or series of Senior Stock upon liquidation and the rights of general creditors.

Table of Contents

After payment of the full amount of the liquidating distributions to which they are entitled, the holders of Series A preferred securities will have no right or claim to any of our remaining assets. In the event that, upon any such voluntary or involuntary liquidation, dissolution, or winding up, the available assets are insufficient to pay the amount of the liquidation distributions on all outstanding Series A preferred securities and the corresponding amounts payable on any other Parity Stock, then the holders of Series A preferred securities and any other Parity Stock will share ratably in any such distribution of assets in proportion to the full liquidating distributions to which they would otherwise be respectively entitled.

For such purposes, our consolidation or merger with or into any other entity, the consolidation or merger of any other entity with or into us, or the sale of all or substantially all of our property or business, will not be deemed to constitute our liquidation, dissolution, or winding up. However, Wachovia Preferred Holding, as the holder of substantially all of our shares of common stock, will have the ability to cause us to liquidate, dissolve or wind up at any time and for any reason without the consent or approval of the holders of the Series A preferred securities.

**Independent Director Approval**

Our certificate of incorporation requires that, so long as any Series A preferred security is outstanding, certain actions by us are to be approved by a majority of our Independent Directors. In addition, any members of our board of directors elected by holders of preferred stock, including the Series A preferred securities, will be deemed to be Independent Directors for purposes of approving actions requiring the approval of a majority of the Independent Directors.

The actions which may not be taken without the approval of a majority of our Independent Directors include:

- the issuance of additional Parity Stock;
- the termination, amendment or modification of, or the election not to renew, the participation and servicing agreements or the subcontracting of any duties under these agreements to third parties unaffiliated with the Bank;
- a change in our policy of limiting authorized investments which are not Qualifying Interests to no more than 20% of the value of our total assets or a change in the investment policy that would be inconsistent with an exemption under the Investment Company Act;
- any consolidation, conversion, or merger or share exchange that is not tax-free to holders of the Series A preferred securities unless such transaction is required to be approved by a two-thirds vote of the holders of Series A preferred securities;
- the determination to revoke our REIT status or any amendment to the REIT-related transfer restrictions on our securities; or
- Wachovia Funding s dissolution, liquidation, or termination prior to December 31, 2022.

Our certificate of incorporation requires that, in assessing the benefits to us of any proposed action requiring their consent, the Independent Directors take into account the interests of holders of both common stock and the preferred securities, including holders of the Series A preferred securities. Our certificate of incorporation provides that in considering the interests of the holders of preferred securities, including the holders of the Series A preferred securities, the Independent Directors owe the same duties which the Independent Directors owe to the holders of common stock.

**Restrictions on Ownership and Transfer**

For information regarding restrictions on ownership of the Series A preferred securities, see Description of Other Wachovia Funding Capital Stock Restrictions on Ownership and Transfer .

Table of Contents

## DESCRIPTION OF OTHER WACHOVIA FUNDING CAPITAL STOCK

The following summary describes the material terms and provisions of our authorized capital stock. This description is qualified in its entirety to the applicable provisions of the Delaware corporate law and our certificate of incorporation and by-laws. Our certificate of incorporation and by-laws have been filed with the SEC as an exhibit to the registration statement which we filed in connection with this offering. Please see Where You Can Find More Information about Wachovia Funding for information on how to obtain a copy of these documents.

We have two types of authorized capital stock: common stock and preferred securities. Currently only our common stock and Series D preferred securities are outstanding. Our Series B and C preferred securities will be issued concurrently with this offering of our Series A preferred securities.

### Common Stock

*General.* All outstanding shares of common stock are fully paid and non-assessable. There is no established trading market for our common stock. Wachovia Preferred Holding owns 99.85% of our common stock and Wachovia owns the remaining. Holders of common stock have no preemptive rights. There are no redemption or sinking fund provisions with respect to the common stock.

*Voting.* Holders of common stock are entitled to one vote per share on all matters to be voted on by shareholders. There are no cumulative voting rights. As the holder of substantially all of our common stock, Wachovia Preferred Holding, and the Bank indirectly, will be able, subject to the rights of the holders of preferred securities, to elect and remove directors, amend our certificate of incorporation, and approve other actions requiring shareholder approval.

*Dividends.* The holders of common stock are entitled to receive such dividends, if any, as may be declared from time to time by our board of directors, subject to any preferential dividend rights of holders of any outstanding preferred securities. In order to remain qualified as a REIT, we must distribute annually at least 90% of our annual REIT Taxable Income to shareholders.

*Liquidation Rights.* Upon our dissolution or liquidation, holders of common stock will be entitled to receive all of our assets which are available for distribution to our shareholders, subject to any preferential rights of holders of then outstanding preferred securities.

### Preferred Securities

*Series B Preferred Securities*

*General.* The Series B preferred securities rank senior to our common stock and our Series C preferred securities as to dividends and in liquidation and rank on parity with our Series A preferred securities and Series D preferred securities. Holders of the Series B preferred securities have no preemptive rights with respect to any shares of our capital stock.

*Voting*. Holders of the Series B preferred securities are entitled to 1/10th of one vote per security on all matters to be voted on by shareholders, voting as a single class with the holders of our common stock and the holders of any other class of securities entitled to vote as a single class with the holders of our common stock.

*Dividends*. The holders of Series B preferred securities are entitled to receive dividends at the rate equal to three-month LIBOR plus 1.83% per annum per security. Should all or a portion of the Series B preferred securities be transferred to a non-affiliate of Wachovia, through an initial public offering, private placement or otherwise, such dividend rate will change to a fixed dividend rate equal to the then applicable dividend rate on the Series B preferred securities. Dividends on the Series B preferred securities are not cumulative and, accordingly, if we do not declare a dividend or declare less than a full dividend on the Series B preferred securities for a quarterly dividend period, holders of the Series B preferred securities will have no right to receive a dividend or the full dividend, as the case may be, for that period, and we will have no obligation to pay a dividend for that period, whether or not dividends are declared and paid for any future period with respect to either the Series B preferred securities or our common stock. Payment of dividends on the Series B preferred securities will be subject to the rights of holders of any securities ranking senior to the Series B preferred securities as to dividend rights.

*Conditional Exchange.* Each Series B preferred security will be exchanged automatically for one newly issued depositary share representing a one-eighth interest in one share of Series H, Class A Wachovia preferred stock if the OCC so directs in writing upon or after the occurrence of a Supervisory Event.

*Redemption.* Except upon the occurrence of a Special Event, which may be a Tax Event, an Investment Company Act Event, or a Regulatory Capital Event, the Series B preferred securities will not be redeemable prior to the fifth anniversary of the initial issuance of the Series B preferred securities. On or after such date, we may redeem the Series B preferred securities for cash, in whole or in part, at any time and from time to time at our option with the prior approval of the OCC at the redemption price of $25.00 per security, plus authorized, declared, but unpaid dividends to the date of redemption.

*Liquidation Rights.* In the event we voluntarily or involuntarily liquidate, dissolve, or wind up, the holders of Series B preferred securities at the time outstanding will be entitled to receive liquidating distributions in the amount of $25.00 per security, plus any authorized, declared and unpaid dividends for the then-current dividend period to the date of liquidation, out of our assets legally available for distribution to shareholders, before any distribution of assets is made to holders of Junior Stock and subject to the rights of the holders of any class or series of Senior Stock upon liquidation and the rights of general creditors. After payment of the full amount of the liquidating distributions to which they are entitled, the holders of Series B preferred securities will have no right or claim to any of our remaining assets. In the event that, upon any such voluntary or involuntary liquidation, dissolution, or winding up, the available assets are insufficient to pay the amount of the liquidation distributions on all outstanding Series B preferred securities and the corresponding amounts payable on any other Parity Stock, then the holders of Series B preferred securities and any other Parity Stock will share ratably in any such distribution of assets in proportion to the full liquidating distributions to which they would otherwise be respectively entitled.

*Series C Preferred Securities*

*General.* The Series C preferred securities rank senior to our common stock as to dividends and in liquidation and rank subordinate to our Series A, Series B and Series D preferred securities. Holders of the Series C preferred securities have no preemptive rights with respect to any shares of our capital stock.

*Voting.* Holders of the Series C preferred securities are entitled to 1/10th of one vote per security on all matters to be voted on by shareholders, voting as a single class with the holders of our common stock and the holders of any other class of securities entitled to vote as a single class with the holders of our common stock.

*Dividends.* The holders of Series C preferred securities are entitled to receive dividends at the rate equal to three-month LIBOR plus 0.85% per annum per security during the first seven years after the initial issuance of Series C preferred securities. After the seventh anniversary of the initial issuance of Series C preferred securities, the holders of Series C preferred securities will be entitled to receive dividends at the rate equal to three-month LIBOR plus 2.25% per annum per security. Notwithstanding the previous two sentences, should all or a portion of the Series C preferred securities be transferred to a non-affiliate of Wachovia, through an initial public offering, private placement or otherwise, such dividend rate will change to a fixed dividend rate equal to the then applicable dividend rate on the Series C preferred securities. Dividends on the Series C preferred securities are cumulative and, accordingly, even if we do not declare a dividend or declare less than a full dividend on the Series C preferred securities for a quarterly dividend period, holders of the Series C preferred securities will have the right to receive the full dividend, for each period, whether past or current, whether or not dividends are declared and paid for any future period with respect to our Series C preferred securities or common stock. Payment of dividends on the Series C preferred securities will be subject to the rights of holders of any securities ranking senior to the Series C preferred securities as to dividend rights.

*Redemption.* Except upon the occurrence of a Tax Event or an Investment Company Act Event, the Series C preferred securities will not be redeemable prior to the seventh anniversary of their initial issuance. On or after such date, we may redeem the Series C preferred securities for cash, in whole or in part, at any time and from time to time at our option with the prior approval of the OCC at the redemption price of $1,000 per security, plus authorized, declared and unpaid dividends, including any accumulation in respect of any unpaid dividends, to the date of redemption.

*Liquidation Rights.* In the event we voluntarily or involuntarily liquidate, dissolve, or wind up, the holders of Series C preferred securities at the time outstanding will be entitled to receive liquidating distributions in the amount of $1,000 per security, plus any authorized, declared and unpaid dividends, including any accumulation in respect of any unpaid dividends, to the date of liquidation, out of our assets legally available for distribution to shareholders, before any distribution of assets is made to holders of any stock ranking subordinate to our Series C preferred securities and subject to the rights of the holders of any class or series of stock ranking senior to our Series C preferred securities upon liquidation and the rights of general creditors. After payment of the full amount of the liquidating distributions to which they are entitled, the holders of Series C preferred securities will have no right or claim to any of our remaining assets. In the event that, upon any such voluntary or involuntary liquidation, dissolution, or winding up, the available assets are insufficient to pay the amount of the liquidation distributions on all outstanding Series C preferred securities and the corresponding amounts payable on any other stock ranking on parity with our Series C preferred securities, then the holders of Series C preferred securities and any other stock ranking on parity with our Series C preferred securities will share ratably in any such distribution of assets in proportion to the full liquidating distributions to which they would otherwise be respectively entitled.

*Series D Preferred Securities*

*General.* The Series D preferred securities rank senior to our common stock and our Series C preferred securities as to dividends and in liquidation and rank on parity with our Series A and Series B preferred securities. Holders of the Series D preferred securities have no preemptive rights with respect to any shares of our capital stock. The Series D preferred securities are not convertible or exchangeable into any of our other securities.

*Voting.* Holders of the Series D preferred securities are not entitled to vote at shareholder meetings and are not entitled to notice of such meetings, except where specifically required by law.

*Dividends.* The holders of Series D preferred securities are entitled to receive dividends in the amount of 8.5% per annum per security. Dividends on the Series D preferred securities are not cumulative and, accordingly, if we do not declare a dividend or declare less than a full dividend on the Series D preferred securities for a dividend period, holders of the Series D preferred securities will have no right to receive a dividend or the full dividend, as the case may be, for that period, and we will have no obligation to pay a dividend for that period, whether or not dividends are declared and paid for any future period with respect to either the Series D preferred securities or our common stock.

*Liquidation Rights.* In the event we voluntarily or involuntarily liquidate, dissolve, or wind up, the holders of Series D preferred securities at the time outstanding will be entitled to receive liquidating distributions in the amount of $1,000 per security, plus any authorized, declared and unpaid dividends for the then-current dividend period to the date of liquidation, out of our assets legally available for distribution to shareholders, before any distribution of assets is made to holders of Junior Stock and subject to the rights of the holders of any class or series of Senior Stock upon liquidation and the rights of general creditors. After

Table of Contents

payment of the full amount of the liquidating distributions to which they are entitled, the holders of Series D preferred securities will have no right or claim to any of our remaining assets. In the event that, upon any such voluntary or involuntary liquidation, dissolution, or winding up, the available assets are insufficient to pay the amount of the liquidation distributions on all outstanding Series D preferred securities and the corresponding amounts payable on any other Parity Stock, then the holders of Series D preferred securities and any other Parity Stock will share ratably in any such distribution of assets in proportion to the full liquidating distributions to which they would otherwise be respectively entitled.

*Redemption*. We can redeem the Series D preferred securities in whole or in part at any time at $1,000 per security plus authorized, declared and unpaid dividends.

**Ability to Issue Additional Preferred Securities**

In addition to our Series A preferred securities and Series B, C and D preferred securities, our certificate of incorporation authorizes our board of directors to issue, in the aggregate, up to 75,001,000 shares of preferred securities from time to time in one or more series with such designations, preferences, conversion, or other rights, restrictions, limitations as to dividends or other distributions, qualifications, and terms and conditions of redemption as are determined by our board of directors without shareholder approval. The specific terms of a particular class or series of preferred securities that is issued, if any, will be described in an amendment to our certificate of incorporation relating to that class or series. As of the date of this prospectus, we have no present plans to issue any other shares of preferred securities.

We believe that the power of the board of directors to issue additional authorized but unissued preferred securities and to classify or reclassify unissued preferred securities and cause us to issue such classified or reclassified preferred securities will provide us with increased flexibility in structuring possible future financings and acquisitions and in meeting other needs which might arise. The additional preferred securities will be available for issuance without further action by our shareholders, unless such action is required by applicable law or the rules of the New York Stock Exchange, except that as long as any Series A, B or C preferred security remains outstanding:

- additional preferred securities ranking senior to the Series A, B or C preferred securities may not be issued without the approval of the holders of at least two-thirds of the Series A, Series B or Series C preferred securities, respectively, each voting as a separate class; and

- additional preferred securities ranking on a parity with the Series A, B or C preferred securities, may not be issued without the approval of the Independent Directors.

**Restrictions on Ownership and Transfer**

To qualify as a REIT under the Code:

- no more than 50% of the value of our outstanding shares of capital stock may be owned, directly or indirectly, by five or fewer individuals during the last half of a taxable year, other than the first year. This is known as the Five or Fewer Test ; and our capital stock must be beneficially owned by 100 or more persons during at least 335 days of a taxable year or during a proportionate part of a shorter taxable year, other than the first year. This is known as the One Hundred Persons Test .

Neither the collective ownership by Wachovia Preferred Holding and Wachovia of 100% of our outstanding common stock nor the ownership by Wachovia Preferred Holding of 100% of the Series B and C preferred securities will adversely affect our REIT qualification because each shareholder of Wachovia, whose capital stock is widely held, counts as a separate beneficial owner of us for purposes of the Five or Fewer Test. Further, the certificate of designation for the Series D preferred securities contains restrictions on the transfer of these preferred securities that are intended to ensure compliance with the One Hundred Persons Test. We may deny any proposed transfer of Series D preferred securities that, in our reasonable judgment, may adversely impact our ability to maintain our status as a REIT.

Table of Contents

Our certificate of incorporation provides that a transfer of shares that would otherwise result in more than 50% in value of our outstanding shares of capital stock being owned by five or fewer individuals, under the applicable attribution rules of the Code, or which would cause the shares of our capital stock to be beneficially owned by fewer than 100 persons, will be null and void and the purported transferee will acquire no rights or economic interest in such shares. In addition, if our board of directors determines in good faith that a transfer of shares of capital stock has taken place in violation of the preceding sentence or any person intends to acquire or has attempted to acquire beneficial ownership of any Series A preferred securities in violation of the preceding sentence, our board of directors may take such action as it may deem advisable to refuse to give effect to or to prevent such transfer of shares, including, but not limited to, refusing to give effect to such transfer on our books, and/or instituting proceedings to enjoin such transfer.

All persons who own, directly or by virtue of the applicable attribution rules of the Code, more than 2% of the outstanding preferred securities of any series must give a written notice to us containing the information specified in our certificate of incorporation by January 31 of each year. In addition, each shareholder shall upon demand be required to disclose to us such information as we may request, in good faith, in order to determine our status as a REIT or to comply with Treasury Regulations promulgated under the REIT provisions of the Code.

There are no ownership limitations of Wachovia Series G, Class A preferred stock following an exchange of our Series A preferred securities upon the occurrence of a Supervisory Event.

**Anti-Takeover Effects of Delaware Laws**

Some provisions of Delaware law could make the following more difficult:

- the acquisition of us by means of a tender offer;
- the acquisition of us by means of a proxy contest or otherwise; or
- the removal of our incumbent officers and directors.

These provisions are designed to discourage coercive takeover practices and inadequate takeover bids. These provisions are also designed to encourage persons seeking to acquire control of us to first negotiate with our board of directors. We believe that the benefits of increased protection give us the potential ability to negotiate with the proponent of an unfriendly or unsolicited proposal to acquire or restructure us, and that the benefits of this increased protection outweigh the disadvantages of discouraging those proposals, because negotiation of those proposals could result in an improvement of their terms.

More specifically, under Section 203 of the DGCL, certain business combinations (defined generally to include mergers or consolidations between the Delaware corporation and an interested stockholder and transactions with an interested stockholder involving the assets or stock of the corporation or its majority-owned subsidiaries and transactions which increase the interested stockholder s percentage ownership of stock) between a publicly held Delaware corporation and an interested stockholder (defined generally as those stockholders who become beneficial owners of 15% or more of a Delaware corporation s voting stock or their affiliates) are prohibited for a three-year period following the date that such stockholder becomes an interested stockholder, unless the corporation has elected in its certificate of incorporation not to be so governed;

either the business combination or the proposed transaction which resulted in the person becoming an interested stockholder was approved by the board of directors of the corporation before the other party to the business combination became an interested stockholder;

upon consummation of the transaction that made it an interested stockholder, the interested stockholder owned at least 85% of the voting stock of the corporation outstanding at the commencement of the transaction (excluding voting stock owned by officers who are also directors or held in employee benefit plans in which the employees do not have a confidential right to tender or vote stock held by the plan); or

Table of Contents

the business combination was approved by the board of directors of the corporation and also ratified by two-thirds of the voting stock (excluding the stock owned by the interested stockholder).

Under certain circumstances, Section 203 makes it more difficult for a person who would be an interested stockholder to effect various business combinations with a corporation for a three-year period, although the stockholders may elect to exclude a corporation from the restrictions imposed thereunder. Our certificate of incorporation does not exclude us from restrictions imposed under Section 203. The provisions of Section 203 may encourage companies interested in acquiring us to negotiate in advance with our board of directors, since the restrictions contained in Section 203 would be avoided if a majority of the directors then in office approved either the business combination or the transaction which results in the stockholder becoming an interested stockholder. Such provisions also may have the effect of preventing changes in our management. It is possible that such provisions could make it more difficult to accomplish transactions which stockholders may otherwise deem to be in their best interests.

## DESCRIPTION OF WACHOVIA SERIES G, CLASS A PREFERRED STOCK

The following summary describes the material terms and provisions of the Wachovia Series G, Class A preferred stock. This description is qualified in its entirety by reference to the terms and provisions of Wachovia s articles of incorporation and articles of amendment. Wachovia s articles of incorporation and articles of amendment have been filed with the SEC by Wachovia as exhibits to the registration statement in connection with this offering. Please see Where You Can Find More Information about Wachovia for information on how to obtain copies of these documents.

### General

The Wachovia Series G, Class A preferred stock, if and when issued, will be represented by depositary shares of Wachovia, each representing one-sixth of a share of Wachovia Series G, Class A preferred stock. If and when issued, Wachovia s depositary shares will be validly issued, fully paid, and non-assessable. The holders of the Wachovia Series G, Class A preferred stock will have no preemptive rights with respect to any shares of Wachovia s capital stock or any of its other securities convertible into or carrying rights or options to purchase any such capital stock. The Wachovia Series G, Class A preferred stock is perpetual and will not be convertible into shares of Wachovia common stock or any other class or series of its capital stock, and will not be subject to any sinking fund or other obligation for their repurchase or retirement.

### Rank

The Wachovia Series G, Class A preferred stock would rank senior to its common stock and to any other securities which Wachovia may issue in the future that are subordinate to the Wachovia Series G, Class A the preferred stock. As of the date of this prospectus, there are no shares of securities that would rank senior to the Wachovia Series G, Class A preferred stock authorized, issued or outstanding. Wachovia may authorize and issue additional shares of preferred stock that may rank junior to, on parity with or senior to the Series G, Class A preferred stock as to dividend rights and rights upon liquidation, winding up, or dissolution without the consent of the holders of the Series G, Class A preferred stock. Wachovia has also authorized, but not issued, 5,000,000 shares of Series H, Class A preferred stock. The Series H, Class A preferred stock would rank on parity with the Series G, Class A preferred stock and may be issued in exchange for our Series B preferred securities in the event that the OCC so directs upon or after the occurrence of a Supervisory Event.

**Dividends**

Holders of the Wachovia Series G, Class A preferred stock will be entitled to receive, if, when, and as declared by its board of directors out of legally available assets, non-cumulative cash dividends at the rate of 7.25% per annum of the liquidation preference, which is $150.00 per share of the Wachovia Series G, Class A preferred stock. Holders of depositary shares will receive one-sixth of any such dividend and one-sixth of any such liquidation preference. If authorized and declared, dividends on the Wachovia Series G, Class A preferred stock will be payable quarterly in arrears on March 31, June 30, September 30, and December 31 of each year or, if any such day is not a business day, on the next business day without interest, unless the next business day falls in a different calendar year, in which case the dividend will be paid on the preceding business day. Wachovia refers to each such quarter of a calendar year as a dividend period . Dividends in each quarterly period will accrue from the first day of such period. The record date for payment of dividends on the Series G, Class A preferred stock and Wachovia s depositary shares will be the 15th calendar day of the last calendar month of the applicable dividend period. Upon a Conditional Exchange any authorized, declared and unpaid dividends for the most recent quarter on our Series A preferred securities as of the time of the exchange will be deemed to be authorized, declared and unpaid dividends for the most recent quarter on the depositary shares representing the Wachovia Series G, Class A preferred stock. No interest will be paid on any dividend payment of depositary shares representing the Wachovia Series G, Class A preferred stock.

The right of holders of the Wachovia Series G, Class A preferred stock to receive dividends is non-cumulative. If Wachovia s board of directors does not declare a dividend on the Wachovia Series G, Class A preferred stock or declares less than a full dividend in respect of any dividend period, the holders of the Wachovia Series G, Class A preferred stock will have no right to receive any dividend or a full dividend, as the case may be, for that dividend period, and Wachovia will have no obligation to pay a dividend or to pay full dividends for that dividend period, whether or not dividends are declared and paid for any future dividend period with respect to the Wachovia Series G, Class A preferred stock or Wachovia s common stock or any other class or series of Wachovia s preferred stock.

Unless full dividend payments on the Series G, Class A preferred stock have been declared and paid for the immediately preceding dividend period:

- no cash dividend or distribution may be paid by Wachovia on stock junior to the Series G, Class A preferred stock, other than distributions or dividends payable in such junior stock,
- no such junior stock may be redeemed by Wachovia for any consideration, and
- no monies shall be paid by Wachovia or made available for a sinking fund for the redemption of such junior stock.

Under an indenture between Wachovia and Wilmington Trust Company, as trustee, Wachovia has agreed not to pay any dividends on, or make a liquidation payment relating to, any of Wachovia s common stock or preferred stock, including its Series G, Class A preferred stock, if, at that time, there is a default under the indenture or a related Wachovia guarantee or Wachovia has delayed interest payments on trust preferred securities issued under the indenture. Currently, there are $1.3 billion aggregate principal amount of trust preferred securities outstanding under such indenture.

Wachovia is subject to various general regulatory policies and requirements relating to the payment of dividends, including requirements to maintain adequate capital above regulatory minimums. The Federal Reserve Board is authorized to determine, under certain circumstances relating to the financial condition of a bank holding company, such as Wachovia, that the payment of dividends would be an unsafe or unsound practice and to prohibit payment thereof.

**Redemption**

Except for certain limited circumstances described below, the Wachovia Series G, Class A preferred stock will not be redeemable prior to December 31, 2022. On or after such date, Wachovia may redeem the Wachovia Series G, Class A preferred stock for cash, in whole or in part, at any time and from time to time at its option at the redemption price of $150.00 per share, plus authorized, declared and unpaid dividends for the current dividend period, if any, to the date of redemption. Prior to December 31, 2022, the Series G, Class A preferred stock may be redeemed in whole, but not in part, at the redemption price of $150.00 per share, plus authorized, declared and unpaid dividends for the current dividend period, if any, to the date of redemption, at Wachovia s discretion in the event that Wachovia receives a letter or opinion of counsel which states that there is a significant risk that the Series G, Class A preferred stock will no longer constitute Tier 1 capital of Wachovia for purposes of the capital adequacy guidelines or policies of the Federal Reserve as a result of any

Table of Contents

changes in applicable laws, related regulations, official interpretations or policies, any official administrative pronouncement or judicial decision interpreting or applying such laws or regulations. For redemptions after December 31, 2022, if Wachovia s board of directors determines that Wachovia should redeem fewer than all of the outstanding Wachovia Series G, Class A preferred stock, the securities to be redeemed will be determined by lot, pro rata, or by such other method as Wachovia s board of directors in its sole discretion determines to be equitable.

Dividends will cease to accrue on the Wachovia Series G, Class A preferred stock called for redemption on and as of the date fixed for redemption and such Wachovia Series G, Class A preferred stock will be deemed to cease to be outstanding, *provided*, that the redemption price, including any authorized and declared but unpaid dividends for the current dividend period, if any, to the date fixed for redemption, has been duly paid or provision has been made for such payment.

Notice of any redemption will be mailed at least 30 days, but not more than 60 days, prior to any redemption date to each holder of the Wachovia Series G, Class A preferred stock to be redeemed at such holder s registered address.

**Rights upon Liquidation**

In the event Wachovia voluntarily or involuntarily liquidates, dissolves, or winds up, the holders of the Wachovia Series G, Class A preferred stock at the time outstanding will be entitled to receive liquidating distributions in the amount of $150.00 per share, or $25.00 per depositary share representing a one-sixth interest in the Wachovia Series G, Class A preferred stock, plus any authorized, declared, and unpaid dividends for the then-current dividend period to the date of liquidation, out of Wachovia s assets legally available for distribution to its shareholders, before any distribution of assets is made to holders of Wachovia s common stock or any securities ranking junior to the Wachovia Series G, Class A preferred stock and subject to the rights of the holders of any class or series of securities ranking senior to or on a parity with the Wachovia Series G, Class A preferred stock upon liquidation and the rights of its depositors and or series of securities ranking senior to or on a parity with the Wachovia Series G, Class A preferred stock upon liquidation and the rights of its depositors and creditors.

After payment of the full amount of the liquidating distributions to which they are entitled, the holders of the Wachovia Series G, Class A preferred stock will have no right or claim to any of Wachovia s remaining assets. In the event that, upon any such voluntary or involuntary liquidation, dissolution, or winding up, Wachovia s available assets are insufficient to pay the amount of the liquidation distributions on all outstanding Wachovia Series G, Class A preferred stock and the corresponding amounts payable on any other securities of equal ranking, then the holders of the Wachovia Series G, Class A preferred stock and any other securities of equal ranking will share ratably in any such distribution of assets in proportion to the full liquidating distributions to which they would otherwise be respectively entitled.

For such purposes, Wachovia s consolidation or merger with or into any other entity, the consolidation or merger of any other entity with or into it, or the sale of all or substantially all of Wachovia s property or business, will not be deemed to constitute its liquidation, dissolution, or winding up.

Under an indenture between Wachovia and Wilmington Trust Company, as trustee, Wachovia has agreed not to pay any dividends on, or make a liquidation payment relating to, any of Wachovia s common stock or preferred stock, including its Class A preferred stock, if, at that time, there is a default under the indenture or a related Wachovia guarantee or Wachovia has delayed interest payments on trust preferred securities issued under the indenture. Currently, there are $1.3 billion aggregate principal amount of trust preferred securities outstanding under such indenture.

**Voting Rights**

Holders of the Wachovia Series G, Class A preferred stock will not have any voting rights, except as required by law, and will not be entitled to elect any directors.

Table of Contents

North Carolina law attaches mandatory voting rights to classes or series of shares that are affected by certain amendments to the articles of incorporation, whether made by filing articles of amendment or by a merger or share exchange. The holders of the outstanding shares of a class or series are entitled to vote as a separate voting group on any amendment that would:

- change the aggregate number of authorized shares of that class or series;
- effect an exchange or reclassification of any shares of that class or series into shares of another class or series;
- effect an exchange (or create a right of exchange) or reclassification of any shares of another class or series into shares of that class or series;
- change the designation, rights, preferences, or limitations of any shares of that class or series;
- change any shares of that class or series into a different number of shares of the same class or series;
- create a new class or series of shares having rights or preferences with respect to distributions or to dissolution that are prior, superior, or substantially equal to the shares of that class or series;
- increase the rights, preferences or number of authorized shares of any class or series that, after giving effect to the amendment, would have rights or preferences with respect to distributions or to dissolution that are prior, superior, or substantially equal to the shares of that class or series;
- limit or deny an existing preemptive right of any shares of that class or series;
- cancel or otherwise affect rights to distributions or dividends that have accumulated but not yet been declared on any shares of that class or series; or
- change the corporation into a nonprofit corporation or a cooperative organization.

These mandatory voting rights apply regardless of whether the change is favorable or unfavorable to the affected shares. A mandatory voting right is also given to a class or series of shares for approval of a share dividend payable in the shares of that class or series or the shares of another class or series.

**Conditional Exchange**

For a description on how an exchange of our Series A preferred securities into depositary shares representing the Wachovia Series G, Class A preferred stock would occur upon a Supervisory Event, you should read  Description of the Series A Preferred Securities  Conditional Exchange above.

## DESCRIPTION OF WACHOVIA DEPOSITARY SHARES

The following summary describes the material terms and provisions of the depositary shares. This description is qualified in its entirety by reference to the terms and provisions of the deposit agreement, the form of depositary receipts, which contain the terms and provisions of the depositary shares, and Wachovia s articles of incorporation and articles of amendment, each of which has been filed with the SEC by Wachovia as an exhibit to the registration statement in connection with this offering. Please see Where You Can Find More Information about Wachovia for information on how to obtain copies of these documents. Copies of these documents are also available for inspection at the offices of the depositary.

### General

Each Wachovia depositary share will represent a one-sixth interest in one share of Wachovia Series G, Class A preferred stock. The depositary shares will be evidenced by depositary receipts. The shares of Wachovia Series G, Class A preferred stock underlying the depositary shares will, upon an exchange as a result of a Supervisory Event, be deposited with the Bank, as depositary, under a deposit agreement between Wachovia, the depositary and all holders from time to time of depositary receipts issued by the depositary thereunder. Wachovia does not intend to list or quote the depositary shares or the Wachovia Series G, Class A preferred stock on any national securities exchange or national quotation system. Accordingly, there will be no public trading market for the depositary shares or the Wachovia Series G, Class A preferred stock.

Subject to the terms of the deposit agreement, each owner of six depositary shares will be entitled, through the depositary, to all the rights, preferences and privileges of a share of the Wachovia Series G, Class A preferred stock. Owners of a single depositary share, representing a one-sixth interest in the Wachovia Series G, Class A preferred stock, will be subject to all of the limitations of the fractional share represented thereby, which are summarized above under Description of Wachovia Series G, Class A Preferred Stock .

The depositary will act as transfer agent and registrar and paying agent with respect to the depositary shares.

The depositary s office at which the depositary receipts will be administered is located at One Wachovia Center, Charlotte, North Carolina 28288.

You may hold depositary shares either directly or indirectly through your broker or other financial institution. If you hold depositary shares directly, by having depositary shares registered in your name on the books of the depositary, you are a depositary receipt holder. If you hold the depositary shares through your broker or financial institution nominee, you must rely on the procedures of such broker or financial institution to assert the rights of a depositary receipt holder described in this section. You should consult with your broker or financial institution to find out what those procedures are.

**Issuance of Depositary Receipts**

Automatically upon a Supervisory Event, Wachovia will issue the shares of Wachovia Series G, Class A preferred stock, and Wachovia will deposit such shares of the Wachovia Series G, Class A preferred stock with the depositary, which will then issue and deliver the depositary receipts to Wachovia. Wachovia will, in turn, deliver the depositary receipts to the holders of Series A preferred securities as of the date of a Conditional Exchange. Depositary receipts will be issued evidencing only whole depositary shares. Upon the occurrence of a Conditional Exchange, each Series A preferred security will be exchanged for one depositary receipt. See Description of the Series A Preferred Securities Conditional Exchange .

**Dividends and Other Distributions**

The depositary will distribute all cash dividends, dividends paid in depositary shares representing fully paid and non-assessable shares of Wachovia Series G, Class A preferred stock or other cash distributions received in respect of the Wachovia Series G, Class A preferred stock to the record holders of depositary shares representing such Wachovia Series G, Class A preferred stock in proportion to the numbers of such depositary shares owned by such holders on the relevant record date. In the event of a distribution other than in cash, the depositary will distribute property received by it to the record holders of depositary shares entitled thereto, unless the depositary determines that it is not feasible to make such distribution, in which case the depositary may, after consultation with Wachovia, sell such property and distribute the net proceeds from such sale to such holders.

**Redemption of Depositary Shares**

If the Wachovia Series G, Class A preferred stock underlying the depositary shares are redeemed, the depositary shares will be redeemed with the proceeds received by the depositary resulting from the redemption, in whole or in part, of such Wachovia Series G, Class A preferred stock held by the depositary. The redemption price per depositary share will be equal to the applicable fraction of the redemption price per share payable with respect to such Wachovia Series G, Class A preferred stock. If less than all the depositary shares are to be redeemed, the depositary shares to be redeemed will be selected by lot or pro rata, in Wachovia s sole discretion.

95

Table of Contents

After the date fixed for redemption (which will be the same date as the redemption date, if any, for the Wachovia Series G, Class A preferred stock), the depositary shares so called for redemption will no longer be deemed to be outstanding and all rights of the holders of the depositary shares will cease, except the right to receive the moneys payable upon such redemption and any money or other property to which the holders of such depositary shares were entitled upon such redemption upon surrender to the depositary of the depositary receipts evidencing such depositary shares.

**Amendment of the Deposit Agreement**

The form of depositary receipt evidencing the depositary shares and any provision of the deposit agreement may at any time be amended by agreement between Wachovia and the depositary. However, any amendment which materially and adversely alters the rights of the holders of depositary receipts will not be effective unless such amendment has been approved by the holders of at least a majority of the depositary shares then outstanding. Every holder of an outstanding depositary receipt at the time any amendment becomes effective will be deemed, by continuing to hold such depositary receipt, to consent and agree to such amendment and to be bound by the deposit agreement as amended thereby.

**Charges of Depositary**

Wachovia will pay the charges of the depositary in connection with the initial deposit of the Wachovia Series G, Class A preferred stock following a Conditional Exchange, and any redemption of the Wachovia Series G, Class A preferred stock. Holders of depositary shares will pay all other transfer and other taxes and governmental charges and, in addition, such other charges as are expressly provided in the deposit agreement to be for their accounts. All other charges and expenses of the depositary and of any registrar incident to the performance of their respective obligations arising from the depositary arrangements will be paid by Wachovia only after prior consultation and agreement between the depositary and Wachovia and consent by Wachovia to the incurrence of such expenses.

**Miscellaneous**

The depositary will forward to the holders of depositary shares all reports and communications from Wachovia which Wachovia would be required to furnish to the holders of the Wachovia Series G, Class A preferred stock.

Neither the depositary nor Wachovia will be liable if it is prevented or delayed by law or any circumstances beyond its control in performing its obligations under the deposit agreement. The obligations of Wachovia and the depositary under the deposit agreement will be limited to performance in good faith of their duties thereunder, and they will not be obligated to prosecute or defend any legal proceedings in respect of any depositary shares or the Wachovia Series G, Class A preferred stock unless satisfactory indemnity is furnished. They may rely upon written advice of counsel or independent accountants, or information provided by persons presenting Wachovia Series G, Class A preferred stock for deposit, holders of depositary shares or other persons believed to be competent and on documents believed to be genuine.

**Resignation and Removal of Depositary; Termination of the Deposit Agreement**

The depositary may resign at any time by delivering to Wachovia notice of its election to do so, and Wachovia may at any time remove the depositary, with any such resignation or removal taking effect upon the appointment of a successor depositary and its acceptance of such appointment. Such successor depositary will be appointed by Wachovia within 60 days after delivery of the notice of resignation or removal.

Upon termination of the deposit agreement, the depositary will discontinue the transfer of depositary receipts, will suspend the distribution of dividends to the holders thereof and will not give any further notices (other than notice of such termination) or perform any further acts under the deposit agreement, except that the depositary will continue

Table of Contents

to collect dividends and other distributions pertaining to the Wachovia Series G, Class A preferred stock, will sell rights, preferences or privileges as provided in the deposit agreement and will continue to deliver Wachovia Series G, Class A preferred stock certificates together with such dividends and distributions and the net proceeds of any sales of rights, preferences, privileges, or other property in exchange for depositary receipts surrendered. At any time after the expiration of three years from the date of termination, the depositary may sell the Wachovia Series G, Class A preferred stock and hold the proceeds of such sale, without interest, for the benefit of the holders of depositary receipts who have not then surrendered their depositary receipts. After making such sale, the depositary will be discharged from all obligations under the deposit agreement except to account for such proceeds.

## DESCRIPTION OF OTHER WACHOVIA CAPITAL STOCK

You should read the description of the capital stock of Wachovia, under the heading Description of First Union Capital Stock , in its registration statement on Form S-4, as amended (Registration Statement File No. 333-59616), filed with the SEC on June 27, 2001, which description is incorporated in this prospectus by reference.

Table of Contents

**GLOBAL SECURITIES**

The Series A preferred securities will be issued in the form of one or more global certificates, or global securities , registered in the name of a depositary or its nominee. The depositary will be The Depository Trust Company, commonly referred to as DTC. DTC has informed us that its nominee will be Cede & Co. Accordingly, we expect Cede & Co. to be the initial registered holder of all Series A preferred securities that are issued in global form. You can hold Series A preferred securities only directly through DTC if you are a participant, or indirectly through a direct participant in DTC. DTC participants include securities brokers and dealers, banks, trust companies and clearing corporations, and may include other organizations. Indirect access to the DTC system is also available to others such as banks, brokers, dealers and trust companies that clear through or maintain a custodial relationship with a participant, either directly or indirectly, and who are referred to as indirect participants. The rules applicable to DTC and DTC participants are on file with the SEC.

No person that acquires a beneficial interest in those Series A preferred securities will be entitled to receive a certificate representing that person s interest in the Series A preferred securities except as mentioned herein. Unless and until definitive securities are issued under the limited circumstances described below, all references to actions by holders of Series A preferred securities issued in global form shall refer to actions taken by DTC upon instructions from its participants, and all references to payments and notices to holders shall refer to payments and notices to DTC or Cede & Co., as the registered holder of these Series A preferred securities.

DTC has informed us that it is a limited-purpose trust company organized under the New York Banking Law, a Banking organization within the meaning of the New York Banking Law, a member of the Federal Reserve System, a clearing corporation within the meaning of the New York Uniform Commercial Code, and a clearing agency registered pursuant to the provisions of Section 17A of the Exchange Act. DTC holds securities that DTC participants deposit with DTC. DTC also facilitates the settlement among DTC participants of securities transactions, such as transfers and pledges, in deposited securities through electronic computerized book-entry changes in DTC participants accounts, thereby eliminating the need for physical movement of certificates. DTC is owned by a number of its direct participants and by the New York Stock Exchange, Inc., the American Stock Exchange, LLC and the National Association of Securities Dealers, Inc.

Persons that are not participants or indirect participants but desire to purchase, sell or otherwise transfer ownership of, or other interests in, Series A preferred securities may do so only through participants and indirect participants in DTC. Under a book-entry format, holders may experience some delay in their receipt of payments, as such payments will be forwarded by a designated agent to Cede & Co., as nominee for DTC. DTC will forward such payments to its participants, who will then forward them to indirect participants or holders. Holders will not be recognized by the transfer agent as registered holders of the Series A preferred securities. Beneficial owners that are not participants will be permitted to exercise their rights only indirectly through and according to the procedures of participants and, if applicable, indirect participants.

Under the rules, regulations and procedures creating and affecting DTC and its operations as currently in effect, DTC will be required to make book-entry transfers of Series A preferred securities among participants and to receive and transmit payments to participants. DTC rules require participants and indirect participants with which beneficial securities owners have accounts to make book-entry transfers and receive and transmit payments on behalf of their respective account holders.

Because DTC can act only on behalf of

participants, who in turn act only on behalf of participants or indirect participants, and certain banks, trust companies and other persons approved by it,

the ability of a beneficial owner of Series A preferred securities issued in global form to pledge such securities to persons or entities that do not participate in the DTC system may be limited due to the unavailability of physical certificates for these securities.

DTC has advised us that DTC will take any action permitted to be taken by a registered holder of any securities under our certificate of incorporation only at the direction of one or more participants to whose accounts with DTC such securities are credited.

A global security will be exchangeable for the relevant definitive securities registered in the names of persons other than DTC or its nominee only if

- DTC notifies us that it is unwilling or unable to continue as depositary for the Series A preferred securities or if DTC ceases to be a clearing agency registered under the Exchange Act when DTC is required to be so registered,
- we execute and deliver to the transfer agent an order complying with the requirements of our certificate of incorporation that this global security shall be so exchangeable, or
- there has occurred and is continuing a default in the payment of any amount due in respect of the Series A preferred securities.

Any global security that is exchangeable under the preceding sentence will be exchangeable for the Series A preferred securities registered in such names as DTC directs.

Upon the occurrence of any event described in the above paragraph, DTC is generally required to notify all participants of the availability of definitive securities. Upon DTC surrendering the global security representing the Series A preferred securities and delivery of instructions for re-registration, the transfer agent will reissue the Series A preferred securities as definitive securities, and then such persons will recognize the holders of such definitive securities as registered holders of Series A preferred securities entitled to the benefits of our certificate of incorporation.

Except as described above, the global security may not be transferred except as a whole by DTC to a nominee of DTC or by a nominee of DTC to DTC or another nominee of DTC or to a successor depositary we appoint. Except as described above, DTC may not sell, assign, transfer or otherwise convey any beneficial interest in a global security evidencing all or part of any securities unless the beneficial interest is in an amount equal to an authorized denomination for these securities.

We, the transfer agent, and any of our or its agents, will have no responsibility or liability for any aspect of DTC s or any participant s records relating to, or for payments made on account of, beneficial interests in a global security, or for maintaining, supervising or reviewing any records relating to such beneficial interests.

Beneficial interests in a global security, in some cases, may trade in the DTC s same-day funds settlement system, in which secondary market trading activity in those beneficial interests would be required by DTC to settle in immediately available funds. There is no assurance as to the effect, if any, that settlement in immediately available funds would have on trading activity in such beneficial interests. Also, settlement for purchases of beneficial interests in a global security upon the original issuance of the Series A preferred securities may be required to be made in immediately available funds.

99

Table of Contents

## FEDERAL INCOME TAX CONSIDERATIONS

The following discussion summarizes our taxation and the material Federal income tax consequences to holders of our Series A preferred securities. Because the tax treatment of a holder of our Series A preferred securities will vary depending upon the holder s particular situation, you should consult your own tax advisors regarding the tax consequences to you of acquiring, owning and selling our Series A preferred securities. This discussion addresses only holders that hold preferred stock as capital assets and does not deal with all aspects of taxation that may be relevant to particular holders in light of their personal investment or tax circumstances. This section also does not deal with all aspects of taxation that may be relevant to certain types of holders to which special provisions of the Federal income tax laws apply, including:

- dealers in securities or currencies;
- traders in securities that elect to use a mark-to-market method of accounting for their securities holdings;
- banks;
- tax-exempt organizations;
- certain insurance companies;
- persons liable for the alternative minimum tax;
- persons that hold securities that are a hedge, that are hedged against currency risks or that are part of a straddle or conversion transaction; and
- persons whose functional currency is not the United States dollar.

This summary is based on the Code, its legislative history, existing and proposed regulations under the Code, published rulings and court decisions. This summary describes the provisions of these sources of law only as they are currently in effect. All of these sources of law may change at any time, and any change in the law may apply retroactively.

**We urge you to consult with your own tax advisors regarding the tax consequences to you of acquiring, owning and selling preferred stock, including the United States Federal, state, local and foreign tax consequences of acquiring, owning and selling common stock in your particular circumstances and potential changes in applicable laws.**

### Our Taxation as a REIT

In the opinion of Sullivan & Cromwell, commencing with our taxable year ending December 31, 2002, we have been organized and operated in conformity with the requirements for qualification and taxation as a REIT under the Code, and our proposed method of operation will enable us to continue to meet the requirements for qualification and taxation as a REIT under the Code. Investors should be aware, however, that opinions of counsel are not binding upon the Internal Revenue Service or any court.

In providing its opinion, Sullivan & Cromwell is relying as to certain factual matters upon the statements and representations contained in certificates provided to Sullivan & Cromwell by us and our subsidiary, Wachovia Real Estate Investment Corp.

Our qualification as a REIT will depend upon the continuing satisfaction by us and, given our current ownership interest in Wachovia Real Estate Investment Corp., by Wachovia Real Estate Investment Corp., of the requirements of the Code relating to qualification for REIT status. Some of these requirements depend upon actual operating results, distribution levels, diversity of stock ownership, asset composition, source of income and recordkeeping. Accordingly, while we intend to continue to qualify to be taxed as a REIT, our actual results and those of Wachovia Real Estate Investment Corp.  s operations for any particular year might not satisfy these requirements. Sullivan & Cromwell will not monitor our compliance or that of Wachovia Real Estate Investment Corp. with the requirements for REIT qualification on an ongoing basis.

Table of Contents

The sections of the Code applicable to REITs are highly technical and complex. The following discussion summarizes material aspects of these sections of the Code.

As a REIT, we generally will not have to pay Federal corporate income taxes on our net income that we currently distribute to shareholders. This treatment substantially eliminates the double taxation at the corporate and shareholder levels that generally results from investment in a regular corporation.

However, we will have to pay Federal income tax as follows:

First, we will have to pay tax at regular corporate rates on any undistributed real estate investment trust taxable income, including undistributed net capital gains.

Second, under certain circumstances, we may have to pay the alternative minimum tax on our items of tax preference.

Third, if we have (a) net income from the sale or other disposition of foreclosure property, as defined in the Code, which is held primarily for sale to customers in the ordinary course of business, or (b) other non-qualifying income from foreclosure property, we will have to pay tax at the highest corporate rate on that income.

Fourth, if we have net income from prohibited transactions, as defined in the Code, we will have to pay a 100% tax on that income. Prohibited transactions are, in general, certain sales or other dispositions of property, other than foreclosure property, held primarily for sale to customers in the ordinary course of business.

Fifth, if we should fail to satisfy the 75% gross income test or the 95% gross income test, as discussed below under Requirements for Qualification Income Tests, but have nonetheless maintained our qualification as a REIT because we have satisfied some other requirements, we will have to pay a 100% tax on an amount equal to (a) the gross income attributable to the greater of (i) 75% of our gross income over the amount of gross income that is qualifying income for purposes of the 75% test, and (ii) 90% of our gross income (95% for taxable years ending before January 1, 2001) over the amount of gross income that is qualifying income for purposes of the 95% test, multiplied by (b) a fraction intended to reflect our profitability.

Sixth, if we should fail to distribute during each calendar year at least the sum of (a) 85% of our real estate investment trust ordinary income for that year, (b) 95% of our real estate investment trust capital gain net income for that year, and (c) any undistributed taxable income from prior periods, we will have to pay a 4% excise tax on the excess of that required distribution over the amounts actually distributed.

Seventh, if we acquire any asset from a C corporation in certain transactions in which we must adopt the basis of the asset or any other property in the hands of the C corporation as the basis of the asset in our hands, and we recognize gain on the disposition of that asset during the 10-year period beginning on the date on which we acquire that asset, then we will have to pay tax on the built-in gain at the highest regular corporate rate. A C corporation means generally a corporation that has to pay full corporate-level tax.

Eighth, if we receive certain non-arms length income from a taxable REIT subsidiary (as defined under Requirements for Qualification Asset Tests ), or as a result of services provided by a taxable REIT subsidiary to our tenants, we will be subject to a 100% tax on the amount of our non-arms length income.

*Requirements for Qualification*

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

which is managed by one or more trustees or directors;

Table of Contents

- the beneficial ownership of which is evidenced by transferable shares, or by transferable certificates of beneficial interest;
- which would otherwise be taxable as a domestic corporation, but for Sections 856 through 859 of the Code;
- which is neither a financial institution nor an insurance company to which certain provisions of the Code apply;
- the beneficial ownership of which is held by 100 or more persons;
- during the last half of each taxable year, not more than 50% in value of the outstanding stock of which is owned, directly or constructively, by five or fewer individuals, as defined in the Code to include certain entities; and
- which meets certain other tests, described below, regarding the nature of its income and assets.

The Code provides that the conditions described in the first through fourth bullet points above must be met during the entire taxable year and that the condition described in the fifth bullet point above must be met during at least 335 days of a taxable year of 12 months, or during a proportionate part of a taxable year of less than 12 months, other than the first 12 months.

We have satisfied the conditions described in the first through fifth bullet points of the first paragraph of this section and believe that we have also satisfied the condition described in the sixth bullet point of the preceding paragraph. In addition, our certificate of incorporation provides for restrictions regarding the transfer of our shares. These restrictions are intended to assist us in continuing to satisfy the share ownership requirements described in the fifth and sixth bullet points of the preceding paragraph. The ownership and transfer restrictions pertaining to the shares are described above in this prospectus under the heading Description of Other Wachovia Funding Capital Stock Restrictions on Ownership and Transfer .

*Income Tests*. In order to maintain our qualification as a REIT, we annually must satisfy two gross income requirements.

- First, we must derive at least 75% of our gross income, excluding gross income from prohibited transactions, for each taxable year directly or indirectly from investments relating to real property or mortgages on real property, including interest on loans secured by real estate and rents from real property , as defined in the Code, or from certain types of temporary investments.
- Second, at least 95% of our gross income, excluding gross income from prohibited transactions, for each taxable year must be derived from real property investments as described in the preceding bullet point, dividends, interest and gain from the sale or disposition of stock or securities, or from any combination of these types of source.

As of the date of this prospectus, we do not own any rental income generating property nor do we have any plans to acquire any such property.

The term interest generally does not include any amount received or accrued, directly or indirectly, if the determination of that amount depends in whole or in part on the income or profits of any person. However, an amount received or accrued generally will not be wholly excluded from the term interest solely because it is based on a fixed percentage or percentages of receipts or sales.

If we fail to satisfy one or both of the 75% or 95% gross income tests for any taxable year, we may nevertheless qualify as a REIT for that year if we satisfy the requirements of other provisions of the Code that allow relief from disqualification as a REIT. These relief provisions will generally be available if:

- our failure to meet the income tests was due to reasonable cause and not due to willful neglect;
- we attach a schedule of the sources of our income to our Federal income tax return; and
- any incorrect information on the schedule was not due to fraud with intent to evade tax.

102

**Table of Contents**

We might not be entitled to the benefit of these relief provisions, however. As discussed in Requirements for Qualification Annual Distribution Requirements below, even if these relief provisions apply, we would have to pay a tax on the excess income.

*Asset Tests*. At the close of each quarter of our taxable year, we must also satisfy three tests relating to the nature of our assets.

First, at least 75% of the value of our total assets must be represented by real estate assets, including (a) stock issued by another REIT, (b) for a period of one year from the date of our receipt of proceeds of an offering of our shares of beneficial interest or publicly offered debt with a term of at least five years, stock or debt instruments purchased with these proceeds, and (c) cash, cash items and government securities.

Second, not more than 25% of the value of our total assets may be represented by securities other than those in the 75% asset class.

Third, not more than 20% of the value of our total assets may constitute securities issued by taxable REIT subsidiaries and of the investments included in the 25% asset class, the value of any one issuer s securities, other than securities issued by another REIT or by a taxable REIT subsidiary, owned by us may not exceed 5% of the value of our total assets. Moreover, we may not own more than 10% of the vote or value of the outstanding securities of any one issuer, except for issuers that are REITs, qualified REIT subsidiaries or taxable REIT subsidiaries, or debt instruments that are considered straight debt under a safe harbor provision of the Code. For these purposes, a taxable REIT subsidiary is any corporation in which we own an interest that joins with us in making an election to be treated as a taxable REIT subsidiary and certain subsidiaries of a taxable REIT subsidiary, if the subsidiaries do not engage in certain activities.

Since November 25, 1996, we have owned more than 10% of the voting securities of Wachovia Real Estate Investment Corp. Our ownership interest in Wachovia Real Estate Investment Corp. will not cause us to fail to satisfy the asset tests for REIT status so long as Wachovia Real Estate Investment Corp. qualifies as a REIT for its first taxable year and each subsequent taxable year. We believe that Wachovia Real Estate Investment Corp. will qualify as a REIT.

Since October 7, 2002, we have also owned more than 10% of the voting securities of Wachovia Preferred Realty, LLC ( WPR ). Our ownership interest in WPR will not cause us to fail to satisfy the asset tests for REIT status so long as WPR qualifies as a taxable REIT subsidiary for its taxable year ending in 2002 and each subsequent year. We believe that WPR will qualify as a taxable REIT subsidiary.

*Annual Distribution Requirements*. In order to qualify as a REIT, we are required to distribute dividends, other than capital gain dividends, to our shareholders in an amount at least equal to (a) the sum of (i) 90% of our real estate investment trust taxable income , computed without regard to the dividends paid deduction and our net capital gain, and (ii) 90% of the net after-tax income, if any, from foreclosure property, minus (b) the sum of certain items of non-cash income.

In addition, if we dispose of any asset within 10 years of acquiring it, we will be required to distribute at least 90% of the after-tax built-in gain, if any, recognized on the disposition of the asset.

These distributions must be paid in the taxable year to which they relate, or in the following taxable year if declared before we timely file our tax return for the year to which they relate and if paid on or before the first regular dividend payment after the declaration.

To the extent that we do not distribute or are not treated as having distributed all of our net capital gain or distribute or are treated as having distributed at least 90%, but less than 100%, of our real estate investment trust taxable income, as adjusted, we will have to pay tax on those amounts at regular ordinary

Table of Contents

and capital gain corporate tax rates. Furthermore, if we fail to distribute during each calendar year at least the sum of (a) 85% of our ordinary income for that year, (b) 95% of our capital gain net income for that year, and (c) any undistributed taxable income from prior periods, we would have to pay a 4% excise tax on the excess of the required distribution over the amounts that are actually distributed or are taxed at regular ordinary and capital gain corporate rates.

We intend to satisfy the annual distribution requirements.

From time to time, we may not have sufficient cash or other liquid assets to meet the 90% distribution requirement due to timing differences between (a) when we actually receive income and when we actually pay deductible expenses, and (b) when we include the income and deduct the expenses in arriving at our taxable income. If timing differences of this kind occur, in order to meet the 90% distribution requirement, we may find it necessary to arrange for short-term, or possibly long-term, borrowings or to pay dividends in respect of our common stock in the form of taxable stock dividends.

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

*Failure to Qualify as a REIT*

If we fail to qualify for taxation as a REIT in any taxable year, and the statutory relief provisions do not apply, we will have to pay tax, including any applicable alternative minimum tax, on our taxable income at regular corporate rates. In addition, we might be taxed as a member of the consolidated group that includes Wachovia and the Bank. We will not be able to deduct distributions to shareholders in any year in which we fail to qualify, nor will we be required to make distributions to shareholders. In this event, to the extent of current and accumulated earnings and profits, all distributions to shareholders will be taxable to the shareholders as ordinary income and corporate distributees may be eligible for the dividends received deduction if they satisfy the relevant provisions of the Code. Unless entitled to relief under specific statutory provisions, we will also be disqualified from taxation as a REIT for the four taxable years following the year during which qualification was lost. We might not be entitled to such statutory relief in all circumstances.

**Taxation of Holders of Preferred Stock**

*U.S. Shareholders*

As used in this section, the term U.S. shareholder means a holder of common stock who, for United States Federal income tax purposes, is:

- a citizen or resident of the United States;

- a domestic corporation;
- an estate whose income is subject to United States Federal income taxation regardless of its source; or
- a trust if a U.S. court can exercise primary supervision over the trust s administration and one or more United States persons have authority to control all substantial decisions of the trust.

As long as we qualify as a REIT, distributions made by us out of our current or accumulated earnings and profits, and not designated as capital gain dividends, will constitute dividends taxable to our taxable U.S. shareholders as ordinary income. Distributions of this kind will not be eligible for the dividends received deduction in the case of U.S. shareholders that are corporations. Distributions made by us that we properly

**Table of Contents**

designate as capital gain dividends will be taxable to U.S. shareholders as gain from the sale of a capital asset held for more than one year, to the extent that they do not exceed our actual net capital gain for the taxable year, without regard to the period for which a U.S. shareholder has held his shares. Thus, with certain limitations, capital gain dividends received by an individual U.S. shareholder may be eligible for reduced rates of taxation. U.S. shareholders that are corporations may, however, be required to treat up to 20% of certain capital gain dividends as ordinary income. Because we do not expect, however, to recognize substantial capital gains, we expect most of our dividends to be ordinary income.

To the extent that we make distributions, not designated as capital gain dividends, in excess of our current and accumulated earnings and profits, these distributions will be treated first as a tax-free return of capital to each U.S. shareholder. Thus, these distributions will reduce the adjusted basis which the U.S. shareholder has in his shares for tax purposes by the amount of the distribution, but not below zero. Distributions in excess of a U.S. shareholder s adjusted basis in his shares will be taxable as capital gains, provided that the shares have been held as a capital asset. For purposes of determining the portion of distributions on separate classes of shares that will be treated as dividends for Federal income tax purposes, current and accumulated earnings and profits will be allocated to distributions resulting from priority rights of preferred shares before being allocated to other distributions.

Dividends authorized by us in October, November or December of any year and payable to a shareholder of record on a specified date in any of these months will be treated as both paid by us and received by the shareholder on December 31 of that year, provided that we actually pay the dividend on or before January 31 of the following calendar year. Shareholders may not include in their own income tax returns any of our net operating losses or capital losses.

U.S. shareholders holding shares at the close of our taxable year will be required to include, in computing their long-term capital gains for the taxable year in which the last day of our taxable year falls, the amount that we designate in a written notice mailed to our shareholders. We may not designate amounts in excess of our undistributed net capital gain for the taxable year. Each U.S. shareholder required to include the designated amount in determining the shareholder s long-term capital gains will be deemed to have paid, in the taxable year of the inclusion, the tax paid by us in respect of the undistributed net capital gains. U.S. shareholders to whom these rules apply will be allowed a credit or a refund, as the case may be, for the tax they are deemed to have paid. U.S. shareholders will increase their basis in their shares by the difference between the amount of the includible gains and the tax deemed paid by the shareholder in respect of these gains.

Distributions made by us and gain arising from a U.S. shareholder s sale or exchange of shares will not be treated as passive activity income. As a result, U.S. shareholders generally will not be able to apply any passive losses against that income or gain.

When a U.S. shareholder sells or otherwise disposes of shares, the shareholder will recognize gain or loss for Federal income tax purposes in an amount equal to the difference between (a) the amount of cash and the fair market value of any property received on the sale or other disposition, and (b) the holder s adjusted basis in the shares for tax purposes. This gain or loss will be capital gain or loss if the U.S. shareholder has held the shares as a capital asset. The gain or loss will be long-term gain or loss if the U.S. shareholder has held the shares for more than one year. Capital gain of an individual U.S. shareholder is generally taxed at a maximum rate of 20% where the property is held for more than one year, and 18% where the property is held for more than 5 years. In general, any loss recognized by a U.S. shareholder when the shareholder sells or otherwise disposes of shares of ours that the shareholder has held for six months or less, after applying certain holding period rules, will be treated as a long-term capital loss, to the extent of distributions received by the shareholder from us which were required to be treated as long-term capital gains.

*Backup Withholding.* We will report to our U.S. shareholders and the IRS the amount of dividends paid during each calendar year, and the amount of tax withheld, if any. Under the backup withholding rules,

**Table of Contents**

backup withholding may apply to a shareholder with respect to dividends paid unless the holder (a) is a corporation or comes within certain other exempt categories and, when required, demonstrates this fact, or (b) provides a taxpayer identification number, certifies as to no loss of exemption from backup withholding, and otherwise complies with applicable requirements of the backup withholding rules. The IRS may also impose penalties on a U.S. shareholder that does not provide us with his correct taxpayer identification number. A shareholder may credit any amount paid as backup withholding against the shareholder s income tax liability. In addition, we may be required to withhold a portion of capital gain distributions, if any, to shareholders who fail to certify their non-foreign status to us.

*Taxation of Tax-Exempt Shareholders*. The IRS has ruled that amounts distributed as dividends by a REIT generally do not constitute unrelated business taxable income when received by a tax-exempt entity. Based on that ruling, provided that a tax-exempt shareholder is not one of the types of entity described in the next paragraph and has not held its shares as debt financed property within the meaning of the Code, and the shares are not otherwise used in a trade or business, the dividend income from shares will not be unrelated business taxable income to a tax-exempt shareholder. Similarly, income from the sale of shares will not constitute unrelated business taxable income unless the tax-exempt shareholder has held the shares as debt financed property within the meaning of the Code or has used the shares in a trade or business.

Income from an investment in our shares will constitute unrelated business taxable income for tax-exempt shareholders that are social clubs, voluntary employee benefit associations, supplemental unemployment benefit trusts, and qualified group legal services plans exempt from Federal income taxation under the applicable subsections of Section 501(c) of the Code, unless the organization is able to properly deduct amounts set aside or placed in reserve for certain purposes so as to offset the income generated by our shares. Prospective investors of the types described in the preceding sentence should consult their own tax advisors concerning these set aside and reserve requirements.

Notwithstanding the foregoing, however, a portion of the dividends paid by a pension-held REIT will be treated as unrelated business taxable income to any trust which:

- is described in Section 401(a) of the Code;
- is tax exempt under Section 501(a) of the Code; and
- holds more than 10% (by value) of the equity interests in the REIT.

Tax-exempt pension, profit-sharing and stock bonus funds that are described in Section 401(a) of the Code are referred to below as qualified trusts . A REIT is a pension-held REIT if:

- it would not have qualified as a REIT but for the fact that Section 856(h)(3) of the Code provides that stock owned by qualified trusts will be treated, for purposes of the not closely held requirement, as owned by the beneficiaries of the trust (rather than by the trust itself); and
- either (a) at least one qualified trust holds more than 25% by value of the interests in the REIT, or (b) one or more qualified trusts, each of which owns more than 10% by value of the interests in the REIT, hold in the aggregate more than 50% by value of the interests in the REIT.

The percentage of any REIT dividend treated as unrelated business taxable income to a qualifying trust is equal to the ratio of (a) the gross income of the REIT from unrelated trades or businesses, determined as though the REIT were a qualified trust, less direct expenses related to this gross income, to (b) the total gross income of the REIT, less direct expenses related to the total gross income. A de minimis exception applies where this percentage is less than 5% for any year. We do not expect to be classified as a pension-held REIT.

The rules described above under the heading U.S. shareholders concerning the inclusion of our designated undistributed net capital gains in the income of our shareholders will apply to tax-exempt entities. Thus, tax-exempt entities will be allowed a credit or refund of the tax deemed paid by these entities in respect of the includible gains.

**Table of Contents**

*Non-U.S. Shareholders*

The rules governing U.S. Federal income taxation of nonresident alien individuals, foreign corporations, foreign partnerships and estates or trusts that in either case are not subject to United States Federal income tax on a net income basis, which we call non-U.S. shareholders , are complex. The following discussion is only a limited summary of these rules. Prospective non-U.S. shareholders should consult with their own tax advisors to determine the impact of U.S. Federal, state and local income tax laws with regard to an investment in Series A preferred securities, including any reporting requirements.

*Ordinary Dividends*. Distributions, other than distributions that are treated as attributable to gain from sales or exchanges by us of U.S. real property interests, as discussed below, and other than distributions designated by us as capital gain dividends, will be treated as ordinary income to the extent that they are made out of our current or accumulated earnings and profits. A withholding tax equal to 30% of the gross amount of the distribution will ordinarily apply to distributions of this kind to non-U.S. shareholders, unless an applicable tax treaty reduces that tax. However, if income from the investment in the shares is treated as effectively connected with the non-U.S. shareholder s conduct of a U.S. trade or business or is attributable to a permanent establishment that the non-U.S. shareholder maintains in the U.S., if that is required by an applicable income tax treaty as a condition for subjecting the non-U.S. shareholder to U.S. taxation on a net income basis, tax at graduated rates will generally apply to the non-U.S. shareholder in the same manner as U.S. shareholders are taxed with respect to dividends, and the 30% branch profits tax may also apply if the shareholder is a foreign corporation. We expect to withhold U.S. tax at the rate of 30% on the gross amount of any dividends, other than dividends treated as attributable to gain from sales or exchanges of U.S. real property interests and capital gain dividends, paid to a non-U.S. shareholder, unless (a) a lower treaty rate applies and the required form evidencing eligibility for that reduced rate is filed with us or the appropriate withholding agent, or (b) the non-U.S. shareholder files an IRS Form W-8 ECI or a successor form with us or the appropriate withholding agent claiming that the distributions are effectively connected with the non-U.S. shareholder s conduct of a U.S. trade or business.

Distributions to a non-U.S. shareholder that are designated by us at the time of distribution as capital gain dividends which are not attributable to or treated as attributable to the disposition by us of a U.S. real property interest generally will not be subject to U.S. Federal income taxation, except as described below.

*Return of Capital*. Distributions in excess of our current and accumulated earnings and profits, which are not treated as attributable to the gain from our disposition of a U.S. real property interest, will not be taxable to a non-U.S. shareholder to the extent that they do not exceed the adjusted basis of the non-U.S. shareholder s shares. Distributions of this kind will instead reduce the adjusted basis of the shares. To the extent that distributions of this kind exceed the adjusted basis of a non-U.S. shareholder s shares, they will give rise to tax liability if the non-U.S. shareholder otherwise would have to pay tax on any gain from the sale or disposition of our shares, as described below. If it cannot be determined at the time a distribution is made whether the distribution will be in excess of current and accumulated earnings and profits, withholding will apply to the distribution at the rate applicable to dividends. However, the non-U.S. shareholder may seek a refund of these amounts from the IRS if it is subsequently determined that the distribution was, in fact, in excess of our current accumulated earnings and profits.

*Capital Gain Dividends*. For any year in which we qualify as a REIT, distributions that are attributable to gain from sales or exchanges by us of U.S. real property interests (which, unlike the definition of real estate assets for REIT qualification purposes, does not include interest on many loans secured by real property) will be taxed to a non-U.S. shareholder under the provisions of the Foreign Investment in Real Property Tax Act of 1980, as amended. Under this statute, these distributions are taxed to a non-U.S. shareholder as if the gain were effectively connected with a U.S. business. Thus, non-U.S. shareholders will be taxed on the distributions at the normal capital gain rates applicable to U.S. shareholders, subject to any applicable alternative minimum tax and special alternative minimum tax in the case of individuals. We are required by applicable Treasury regulations under this statute to withhold 35% of any distribution that we could designate as a capital gain

Table of Contents

dividend. However, if we designate as a capital gain dividend a distribution made before the day we actually effect the designation, then although the distribution may be taxable to a non-U.S. shareholder, withholding does not apply to the distribution under this statute. Rather, we must effect the 35% withholding from distributions made on and after the date of the designation, until the distributions so withheld equal the amount of the prior distribution designated as a capital gain dividend. The non-U.S. shareholder may credit the amount withheld against its U.S. tax liability.

*Sales of Shares*. Gain recognized by a non-U.S. shareholder upon a sale or exchange of common stock generally will not be taxed under the Foreign Investment in Real Property Tax Act if we are a domestically controlled REIT , defined generally as a REIT, less than 50% in value of whose stock is and was held directly or indirectly by foreign persons at all times during a specified testing period. We believe that we are and will continue to be a domestically controlled REIT, and, therefore, that taxation under this statute generally will not apply to the sale of our shares. However, gain to which this statute does not apply will be taxable to a non- U.S. shareholder if investment in the shares is treated as effectively connected with the non-U.S. shareholder s U.S. trade or business or is attributable to a permanent establishment that the non-U.S. shareholder maintains in the U.S. if that is required by an applicable income tax treaty as a condition for subjecting the non-U.S. shareholder to U.S. taxation on a net income basis. In this case, the same treatment will apply to the non-U.S. shareholder as to U.S. shareholders with respect to the gain. In addition, gain to which the Foreign Investment in Real Property Tax Act does not apply will be taxable to a non-U.S. shareholder if the non-U.S. shareholder is a nonresident alien individual who was present in the United States for 183 days or more during the taxable year and has a tax home in the United States, or maintains an office or a fixed place of business in the United States to which the gain is attributable. In this case, a 30% tax will apply to the nonresident alien individual s capital gains. A similar rule will apply to capital gain dividends to which this statute does not apply.

If we were not a domestically controlled REIT, tax under the Foreign Investment in Real Property Tax Act would apply to a non-U.S. shareholder s sale of shares only if the selling non-U.S. shareholder owned more than 5% of the class of shares sold at any time during a specified period. This period is generally the shorter of the period that the non-U.S. shareholder owned the shares sold or the five-year period ending on the date when the shareholder disposed of the shares. If tax under this statute applies to the gain on the sale of shares, the same treatment would apply to the non-U.S. shareholder as to U.S. shareholders with respect to the gain, subject to any applicable alternative minimum tax and a special alternative minimum tax in the case of nonresident alien individuals.

**Federal Estate Taxes**

Preferred shares held by a non-U.S. shareholder at the time of death will be included in the shareholder s gross estate for United States Federal estate tax purposes, unless an applicable estate tax treaty provides otherwise.

**Backup Withholding and Information Reporting**

If you are a non-U.S. shareholder, you are generally exempt from backup withholding and information reporting requirements with respect to:

dividend payments and

the payment of the proceeds from the sale of preferred shares effected at a United States office of a broker, as long as:

the income associated with these payments is otherwise exempt from United States Federal income tax; and

108

Table of Contents

the payor or broker does not have actual knowledge or reason to know that you are a United States person and you have furnished to the payor or broker:

a valid IRS Form W-8BEN or an acceptable substitute form upon which you certify, under penalties of perjury, that you are a non-United States person, or

other documentation upon which it may rely to treat the payments as made to a non-United States person in accordance with U.S. Treasury regulations; or

you otherwise establish an exemption.

Payment of the proceeds from the sale of preferred shares effected at a foreign office of a broker generally will not be subject to information reporting or backup withholding. However, a sale of preferred shares that is effected at a foreign office of a broker will be subject to information reporting and backup withholding if:

the proceeds are transferred to an account maintained by you in the United States;

the payment of proceeds or the confirmation of the sale is mailed to you at a United States address; or

the sale has some other specified connection with the United States as provided in U.S. Treasury regulations;

unless the broker does not have actual knowledge or reason to know that you are a United States person and the documentation requirements described above are met or you otherwise establish an exemption.

In addition, a sale of preferred shares will be subject to information reporting if it is effected at a foreign office of a broker that is:

a United States person;

a controlled foreign corporation for United States tax purposes;

a foreign person 50% or more of whose gross income is effectively connected with the conduct of a United States trade or business for a specified three-year period; or

a foreign partnership, if at any time during its tax year:

one or more of its partners are U.S. persons , as defined in U.S. Treasury regulations, who in the aggregate hold more than 50% of the income or capital interest in the partnership; or such foreign partnership is engaged in the conduct of a United States trade or business;

unless the broker does not have actual knowledge or reason to know that you are a United States person and the documentation requirements described above are met or you otherwise establish an exemption. Backup withholding will apply if the sale is subject to information reporting and the broker has actual knowledge that you are a United States person.

You generally may obtain a refund of any amounts withheld under the backup withholding rules that exceed your income tax liability by filing a refund claim with the IRS.

**Other Tax Consequences**

State or local taxation may apply to us and our shareholders in various state or local jurisdictions, including those in which we or they transact business or reside. The state and local tax treatment of us and our shareholders may not conform to the Federal income tax consequences discussed above. Consequently, prospective shareholders should consult their own tax advisors regarding the effect of state and local tax laws on an investment in us.

Table of Contents

**ERISA CONSIDERATIONS**

The fiduciary standards of the Employee Retirement Income Security Act of 1974, as amended ( ERISA ), should be considered by the fiduciary of a pension, profit-sharing or other employee benefit plan subject to Title I of ERISA (an ERISA Plan ) in the context of the ERISA Plan s particular circumstances before authorizing an investment in the Series A preferred securities (and the depositary shares representing the Wachovia Series G, Class A preferred stock into which the Series A preferred securities are exchangeable upon the occurrence of a Conditional Exchange). Among other factors, the fiduciary should consider whether such an investment is in accordance with the documents governing the ERISA Plan and whether an investment is appropriate for the ERISA Plan in view of its overall investment policy and the composition and diversification of its portfolio.

Section 406 of ERISA and Section 4975 of the Code prohibit ERISA Plans, as well as individual retirement accounts, self-employment retirement plans and other pension and profit-sharing plans subject to Section 4975 of the Code (together with ERISA Plans, the Plans ) from engaging in certain transactions involving plan assets with persons who are parties in interest under ERISA or disqualified persons under the Code with respect to the Plan. Therefore, fiduciaries of ERISA Plans and persons making investment decisions for other Plans should also consider whether an investment in the Series A preferred securities (and the depositary shares representing the Wachovia Series G, Class A preferred stock into which the Series A preferred securities are exchangeable upon the occurrence of a Conditional Exchange) might constitute or give rise to a prohibited transaction under ERISA and the Code. We and Wachovia may each be considered a party in interest or disqualified person with respect to a Plan to the extent we or certain of our affiliates are engaged in businesses which provide services to such Plan. If so, the acquisition and holding by such Plan of the Series A preferred securities (or the depositary shares representing the Wachovia Series G, Class A preferred stock into which the Series A preferred securities are exchangeable upon the occurrence of a Conditional Exchange) could be a prohibited transaction.

There are five prohibited transaction class exemptions ( PTCEs ) issued by the Department of Labor which could exempt the acquisition and holding of the Series A preferred securities (or the depositary shares representing the Wachovia Series G, Class A preferred stock into which the Series A preferred securities are exchangeable upon the occurrence of a Conditional Exchange) from the prohibited transaction provisions of ERISA and the Code PTCE 84-14, for certain transactions determined by qualified professional asset managers, PTCE 90-1, for certain transactions involving insurance company pooled separate accounts, PTCE 91-38, for certain transactions involving bank collective investment funds, PTCE 95-60 for certain transactions involving insurance company general accounts, and PTCE 96-23, for certain transactions determined by in-house asset managers.

Under a regulation issued by the U.S. Department of Labor (referred to as the Plan Asset Regulation ), which governs what constitutes the assets of a Plan, our assets will not be treated as assets of a Plan if the Series A preferred securities are publicly-offered securities . This will be the case under the Plan Asset Regulation if the Series A preferred securities are:

- widely held (that is, owned by 100 or more investors independent of us and of each other);
- freely transferable; and
- sold as part of an offering pursuant to an effective registration statement under the Securities Act of 1933, as amended (the Securities Act ) and then timely registered under Section 12(b) or 12(g) of the Exchange Act.

We expect (although no assurances can be given) that (a) the Series A preferred securities will be held by at least 100 independent investors at the conclusion of the offering, (b) there are no restrictions imposed on the transfer of the Series A preferred securities and the Series A preferred securities will be sold as part of an offering pursuant to an effective registration statement under the Securities Act, and (c) the Series A preferred securities will be timely registered under the Exchange Act. Based on the foregoing, it is expected that the Series A preferred securities will meet the requirements for publicly-offered securities .

Table of Contents

The Plan Asset Regulation provides an additional exception for operating companies (i.e., an entity that is primarily engaged, directly or through one or more majority owned subsidiaries, in the production or sale of a product or service other than the investment of capital). Assuming that Wachovia qualifies as an operating company at the time of the exchange, a Plan s ownership of the depositary shares representing the Wachovia Series G, Class A preferred stock would not cause the assets of Wachovia to be treated as assets of the Plan.

Regardless of whether our assets or Wachovia s assets are deemed to be plan assets of Plans investing in the securities, the acquisition and holding of the Series A preferred securities (or the depositary shares representing the Wachovia Series G, Class A preferred stock) with plan assets could itself result in a prohibited transaction. Accordingly, each purchaser and transferee of the Series A preferred securities (and each holder of the depositary shares representing the Wachovia Series G, Class A preferred stock upon the occurrence of a Conditional Exchange) is deemed to represent that either the Series A preferred securities (and the depositary shares representing the Wachovia Series G, Class A preferred stock) are not acquired with assets of a Plan, or that the acquisition and holding of the Series A preferred securities (or the depositary shares representing the Wachovia Series G, Class A preferred stock upon the occurrence of a Conditional Exchange) is eligible for the relief available under PTCE 84-14, PTCE 90-1, PTCE 91-38, PTCE 95-60 or PTCE 96-23.

Due to the complexity of these rules and the penalties imposed upon persons involved in prohibited transactions, it is important that a Plan considering an investment in the Series A preferred securities (and the depositary shares representing the Wachovia Series G, Class A preferred stock into which the Series A preferred securities are exchangeable upon the occurrence of a Conditional Exchange) consult with its counsel regarding the consequences under ERISA and the Code of such investment. Plans that are governmental plans (as defined in Section 3(32) of ERISA) and certain church plans (as defined in Section 3(33) of ERISA) generally are not subject to the requirements of ERISA or the prohibited transaction provisions of Section 4975 of the Code; however, any such plan subject to Federal, state or local law substantially similar to the foregoing provisions will be deemed to represent its acquisition and holding of the Series A preferred securities (and the depositary shares representing the Wachovia Series G, Class A preferred stock into which the Series A preferred securities are exchangeable upon the occurrence of a Conditional Exchange) is not prohibited or is eligible for exemptive relief.

Table of Contents

## PLAN OF DISTRIBUTION

This prospectus, together with any applicable prospectus supplements, will be used by broker-dealer affiliates of Wachovia Funding, including, without limitation, Wachovia Securities, Inc., in connection with offers and sales of the Series A preferred securities or depositary shares representing one-sixth of a share of Wachovia Series G, Class A preferred stock in market-making transactions, including block positioning and block trades, at negotiated prices related to the prevailing market price at the time of sale. Any of Wachovia Funding s broker-dealer affiliates, including, without limitation, Wachovia Securities, Inc., may act as principal or agent in such transactions. None of Wachovia Funding s broker-dealer affiliates, including, without limitation, Wachovia Securities, Inc., have any obligation to make a market in any of the Series A preferred securities or the depositary shares and any such affiliate may discontinue any market-making activities at any time without notice, at its sole discretion. Broker-dealers purchasing Series A preferred securities or the depositary shares from affiliates of Wachovia Funding or Wachovia, respectively, including, without limitation, Wachovia Securities, Inc., may be deemed to be underwriters as that term is defined in the Securities Act and subject to applicable prospectus delivery requirements.

Neither Wachovia Funding nor Wachovia Preferred Holding expects to receive any proceeds from market-making transactions undertaken by their broker-dealer affiliates, including, without limitation, Wachovia Securities, Inc.

Information about trade and settlement dates, as well as the purchase price, for market-making transactions will be provided to the purchaser in a separate confirmation of sale.

Wachovia Securities, Inc. is an affiliate of ours and of Wachovia Preferred Holding.

Certain underwriters involved in the original offering of our Series A preferred securities and their affiliates have in the past provided, and may in the future provide, investment banking services to Wachovia, the Bank, or their affiliates in the ordinary course of business.

Wachovia Preferred Holding, which will own 99.85% of our shares of common stock, is affiliated with us. The Bank owns 99.95% of Wachovia Preferred Holding s common stock. Thus, the Bank may be deemed to beneficially own the Series A preferred securities being offered to the public even though Wachovia Preferred Holding will be the sole record owner. As described in more detail under Business in this prospectus, we acquired, and in the future will acquire, assets from the Bank and its affiliates and have made arrangements with the Bank and its affiliates for the servicing of the loans in our portfolio.

The participation of Wachovia Securities, Inc. in the offer and sale of the Series A preferred securities must comply with the requirements of Rule 2720 of the National Association of Securities Dealers, Inc. regarding underwriting securities of an affiliate . Wachovia Securities, Inc. will not execute a transaction in the Series A preferred securities in a discretionary account without the prior specific written approval of such member s customer.

## EXPERTS

The consolidated financial statements of Wachovia Funding as of December 31, 2001 and 2000, and for each of the years in the three-year period ended December 31, 2001, have been included herein in reliance upon the report of KPMG LLP, independent accountants, appearing elsewhere herein, and upon the authority of said firm as experts in accounting and auditing.

Table of Contents

The consolidated financial statements of Wachovia as of December 31, 2001 and 2000, and for each of the years in the three-year period ended December 31, 2001, have been incorporated by reference herein in reliance upon the report of KPMG LLP, independent accountants, incorporated by reference herein, and upon the authority of said firm as experts in accounting and auditing.

The restated audited financial statements of former Wachovia Corporation at December 31, 2000 and 1999, and for each of the three years in the period ended December 31, 2000, included in Wachovia s Current Report on Form 8-K dated June 5, 2002 and incorporated by reference herein, have been incorporated by reference herein in reliance upon the report of Ernst & Young LLP, independent auditors. The restated audited financial statements referred to above are included in reliance upon such report given on the authority of such firm as experts in accounting and auditing.

## VALIDITY OF SECURITIES

The validity of our Series A preferred securities and the depositary shares representing an interest in shares of Wachovia Series G, Class A preferred stock will be passed upon for us and Wachovia by Ross E. Jeffries, Jr., Esq., Senior Vice President and Assistant General Counsel of Wachovia, and by Sullivan & Cromwell, New York, New York. Sullivan & Cromwell will rely upon the opinion of Mr. Jeffries as to matters of North Carolina law, and Mr. Jeffries will rely upon the opinion of Sullivan & Cromwell as to matters of New York law. Mr. Jeffries owns shares of Wachovia s common stock and holds options to purchase additional shares of Wachovia s common stock. Sullivan & Cromwell regularly performs legal services for Wachovia. Certain members of Sullivan & Cromwell performing these legal services own shares of Wachovia s common stock. The validity of our Series A preferred securities and the depositary shares representing an interest in shares of Wachovia Series G, Class A preferred stock will be passed upon for the underwriters by Cleary, Gottlieb, Steen & Hamilton.

## WHERE YOU CAN FIND MORE INFORMATION ABOUT WACHOVIA FUNDING

We have filed with the SEC a registration statement on Form S-3 under the Securities Act, with respect to our Series A preferred securities. This prospectus, which forms a part of that registration statement, does not contain all the information set forth in the registration statement, certain portions of which have been omitted as permitted by the rules and regulations of the SEC. Statements contained in this prospectus as to the content of any contract or other document are not necessarily complete, and in each instance reference is made to the copy of such contract or other document filed as an exhibit to the registration statement, each such statement being qualified in all respects by such reference. We refer you to the registration statement and its exhibits for further information regarding us and the Series A preferred securities offered by this prospectus.

The registration statement and its exhibits which were filed by us with the SEC can be inspected at, and copies can be obtained from, the SEC s public reference room, Room 1024, 450 Fifth Street, N.W., Washington, D.C. 20549. Please call the SEC at 1-800-SEC-0330 for further information on the public reference room. Such material may also be accessed electronically by means of the SEC s home page on the Internet at http://www.sec.gov.

While we are a reporting company, we intend to file with the SEC and furnish to our shareholders annual reports containing audited consolidated financial statements certified by independent auditors and file with the SEC quarterly reports containing unaudited consolidated financial statements for the first three quarters of each fiscal year.

The SEC allows us to incorporate by reference into this prospectus the information in documents that we file with it. This means that we can disclose important information to you by referring you to those documents. The information incorporated by reference is considered to be a part of this prospectus and should be read with the same care. When we update the information contained in documents that have been incorporated by reference by making future filings with the SEC, the information incorporated by reference in this prospectus is considered to be automatically updated and superseded. In other words, in case of a conflict or inconsistency between information with respect to us contained in this prospectus and information incorporated by reference into this prospectus, you should rely on the information contained in the document that was filed later. We incorporate by reference any documents we file with the SEC in the future under Sections 13(a), 13(c), 14 or 15(d) of the Exchange Act until this offering is completed.

You may request a copy of our filings, other than an exhibit to a filing unless that exhibit is specifically incorporated by reference into that filing, at no cost, by writing to or telephoning us at the following address:

Wachovia Preferred Funding Corp.

1620 East Roseville Parkway

Roseville, California 95661

(877) 867-7378

**WHERE YOU CAN FIND MORE INFORMATION ABOUT WACHOVIA**

Wachovia has filed with the SEC a registration statement on Form S-3 under the Securities Act, with respect to the depositary shares representing an interest in the Wachovia Series G, Class A preferred stock. This prospectus, which forms a part of that registration statement, does not contain all the information set forth in the registration statement, certain portions of which have been omitted as permitted by the rules and regulations of the SEC. Statements contained in this prospectus as to the content of any contract or other document are not necessarily complete, and in each instance reference is made to the copy of such contract or other document filed as an exhibit to the registration statement, each such statement being qualified in all respects by such reference. Wachovia refers you to the registration statement and its exhibits for further information regarding Wachovia and the depositary shares representing an interest in the Wachovia Series G, Class A preferred stock.

Wachovia files annual quarterly and current reports, proxy statements and other information with the SEC. You may read and copy any document that Wachovia files at the SEC s public reference room in Washington, D.C. Please call the SEC at 1-800-SEC-0330 for further information on the public reference room. In addition, Wachovia s SEC filings are available to the public at the SEC s web site at http://www.sec.gov. You can also inspect reports, proxy statements and other information about Wachovia at the offices of the New York Stock Exchange, 20 Broad Street, New York, New York.

The SEC allows Wachovia to incorporate by reference into this prospectus the information in documents that Wachovia files with it. This means that Wachovia can disclose important information to you by referring you to those documents. The information incorporated by reference is considered to be a part of this prospectus and should be read with the same care. When Wachovia updates the information contained in documents that have been incorporated by reference by making future filings with the SEC, the information incorporated by reference in this prospectus is considered to be automatically updated and superseded. In other words, in the case of a conflict or inconsistency between information with respect to Wachovia contained in this prospectus and information incorporated by reference into this prospectus, you should rely on the information contained in the document that was filed later. Wachovia incorporates by reference the documents listed below and any documents it files with the SEC in the future under Sections 13(a), 13(c), 14, or 15(d) of the Exchange Act until this offering is completed:

Description of Wachovia s capital stock under the heading Description of First Union Capital Stock contained in the Registration Statement on Form S-4, as amended (Registration Statement File No. 333-59616), as filed with the SEC on June 27, 2001;

Annual Report on Form 10-K for the year ended December 31, 2001;

Table of Contents

Quarterly Reports on Form 10-Q for the quarters ended March 31, 2002, June 30, 2002 and September 30, 2002; and

Current Reports on Form 8-K dated January 23, 2002, April 18, 2002, June 5, 2002, July 18, 2002, August 13, 2002, August 20, 2002, October 16, 2002 and November 20, 2002.

You may request a copy of these filings, other than an exhibit to a filing unless that exhibit is specifically incorporated by reference into that filing, at no cost, by writing to or telephoning Wachovia at the following address:

Corporate Relations

Wachovia Corporation

One Wachovia Center

301 South College Street

Charlotte, North Carolina 28288-0206

(704) 374-6782

115

Table of Contents

## GLOSSARY

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

commercial loan means a loan for commercial, financial, or industrial purposes, whether secured or unsecured, single-payment or installment.

commercial mortgage loan means a whole loan secured by a mortgage or deed of trust on a multi-family residential or commercial real estate property.

Conditional Exchange means the exchange of our Series A preferred securities for depositary shares representing Wachovia Series G, Class A preferred stock upon the issuance of an OCC directive after the occurrence of a Supervisory Event.

dividend payment date means each quarterly date upon which dividends are paid by us to the holders of the Series A preferred securities.

dividend period means any quarterly dividend period.

FFO means funds from operations on a consolidated basis and is equal to net income, plus depreciation of real or personal property used to generate income, less any gain on the sale of real estate plus any loss on the sale of real estate, all as calculated according to accounting principles generally accepted in the United States.

home equity loan means a fixed-rate, closed-end loan secured by residential real estate that can be in a first or second lien position.

Investment Company Act Event means our determination, based on the receipt by us of an opinion of counsel, rendered by a law firm experienced in such matters, in form and substance satisfactory to us, which states that there is a significant risk that we are or will be considered an investment company that is required to be registered under the Investment Company Act, as a result of the occurrence of a change in law or regulation or a written change in interpretation or application of law or regulation by any legislative body, court, governmental agency, or regulatory authority.

LIBOR means the London Interbank Offered Rate, which is the short-term rate of interest for United States dollar deposits overseas and is sometimes used as an index upon which loan interest rates are based.

Loan-to-Value Ratio means, with respect to any mortgage loan, the ratio (expressed as a percentage) of the original principal amount of such mortgage loan to the lesser of (a) the appraised value at origination of the mortgaged property underlying such mortgage loan and (b) if the mortgage loan was made to finance the acquisition of property, the purchase price of the mortgaged property.

mortgage-backed securities means securities either issued or guaranteed by agencies of the Federal government or government sponsored agencies or that are rated by at least one nationally recognized independent rating organization and that represent interests in or obligations backed by pools of mortgage loans.

mortgage loans means whole loans secured by single-family, one-to-four-unit, residential, multi-family residential, or commercial real estate properties.

One Hundred Persons Test means the Code requirement that our capital stock be owned by 100 or more persons during at least 335 days of a taxable year or during a proportionate part of a shorter taxable year, other than the first 12 months.

Table of Contents

other authorized investments means non-mortgage-related securities authorized by Section 856(c)(5)(B) of the Code, in an amount which will not exceed 20% of the value of our total assets. Non-mortgage-related security is defined in the Investment Company Act. Under the Investment Company Act, the term security means, in part, any note, stock, treasury stock, debenture, evidence of indebtedness, or certificate of interest or participation in any profit sharing agreement or a group or index of securities.

Regulatory Capital Event means our determination, based on the receipt by us of an opinion of counsel, rendered by a law firm experienced in such matters, in form and substance satisfactory to us, which states that there is a significant risk that the Series A preferred securities will no longer constitute Tier 1 capital of the Bank or Wachovia for purposes of the capital adequacy guidelines or policies of the OCC or the Federal Reserve, or their respective successor as the Bank s and Wachovia s, respectively, primary federal banking regulator, as a result of:

- any amendments to, clarification of, or change in applicable laws or related regulations or official interpretations or policies, or
- any official administrative pronouncement or judicial decision interpreting or applying such laws or regulations.

REIT means a real estate investment trust as defined pursuant to Sections 856 through 860 of the Code, or any successor provisions of the Code, and the applicable Treasury regulations.

REIT taxable income means the taxable income of a REIT, which generally is computed in the same fashion as the taxable income of any corporation, except that (a) certain deductions are not available, such as the deduction for dividends received, (b) it may deduct dividends paid (or deemed paid) during the taxable year, (c) net capital gains and losses are excluded, and (d) certain other adjustments are made.

residential mortgage loan means a whole loan secured by a mortgage or deed of trust on a residential real estate property.

Special Event means

- a Tax Event;
- an Investment Company Event; or
- a Regulatory Capital Event.

Supervisory Event means the occurrence of one of the following:

- the Bank becomes undercapitalized under the OCC s prompt corrective action regulations;

the Bank is placed into conservatorship or receivership; or

the OCC, in its sole discretion, anticipates the Bank becoming undercapitalized in the near term or takes supervisory action that limits the payment of dividends by us and in connection therewith directs an exchange.

Tax Event means our determination, based on the receipt by us of an opinion of counsel, rendered by a law firm experienced in such matters, in form and substance satisfactory to us, which states that there is a significant risk that dividends paid or to be paid by us with respect to our capital stock are not or will not be fully deductible by us for United States Federal income tax purposes or that we are or will be subject to additional taxes, duties, or other governmental charges, in an amount we reasonably determine to be significant as a result of:

any amendment to, clarification of, or change in, the laws, treaties, or related regulations of the United States or any of its political subdivisions or their taxing authorities affecting taxation, or

Table of Contents

any judicial decision, official administrative pronouncement, published or private ruling, technical advice memorandum, Chief Counsel Advice, as such term is defined in the Code, regulatory procedure, notice, or official announcement, which we refer to collectively as Administrative Actions ,

which amendment, clarification, or change is effective, or such official pronouncement or decision is announced, on or after the date of issuance of the Series A preferred securities.

Table of Contents

**WACHOVIA PREFERRED FUNDING CORP. AND SUBSIDIARY**

**INDEX TO CONSOLIDATED FINANCIAL STATEMENTS**


| | Page |
|---|---|
| **Audited Consolidated Financial Statements** | |
| Independent Auditors Report | F-3 |
| Consolidated Balance Sheets as of December 31, 2001 and 2000 | F-4 |
| Consolidated Statements of Operations for the years ended December 31, 2001, 2000 and 1999 | F-5 |
| Consolidated Statements of Changes in Stockholders Equity for the years ended December 31, 2001, 2000 and 1999 | F-6 |
| Consolidated Statements of Cash Flows for the years ended December 31, 2001, 2000 and 1999 | F-7 |
| Notes to Consolidated Financial Statements | F-8 |
| **Unaudited Consolidated Financial Statements** | |
| Consolidated Balance Sheets as of September 30, 2002 and 2001 | F-17 |
| Consolidated Statements of Income for the nine months ended September 30, 2002 and 2001 | F-18 |
| Consolidated Statements of Changes in Stockholders Equity for the nine months ended September 30, 2002 and 2001 | F-19 |
| Consolidated Statements of Cash Flows for the nine months ended September 30, 2002 and 2001 | F-20 |
| Notes to Consolidated Financial Statements | F-21 |
| **Wachovia Corporation and Subsidiaries Supplementary Consolidating Financial Information** | F-22 |
| Independent Auditors Report on Supplementary Consolidating Financial Information | F-23 |
| Supplementary Consolidating Balance Sheets | |
| September 30, 2002 | F-24 |
| December 31, 2001 | F-25 |
| December 31, 2000 | F-26 |
| Supplementary Consolidating Statements of Income | |
| Nine Months Ended September 30, 2002 | F-27 |
| Nine Months Ended September 30, 2001 | F-28 |
| Year Ended December 31, 2001 | F-29 |
| Year Ended December 31, 2000 | F-30 |
| Supplementary Consolidating Statements of Changes in Stockholders Equity | |
| Nine Months Ended September 30, 2002 | F-31 |
| Nine Months Ended September 30, 2001 | F-32 |
| Year Ended December 31, 2001 | F-33 |
| Year Ended December 31, 2000 | F-34 |
| Supplementary Consolidating Statements of Changes in Cash Flows | |
| Nine Months Ended September 30, 2002 | F-35 |
| Nine Months Ended September 30, 2001 | F-36 |
| Year Ended December 31, 2001 | F-37 |
| Year Ended December 31, 2000 | F-38 |

Table of Contents

**WACHOVIA PREFERRED FUNDING CORP.**

**AND SUBSIDIARY**

**Consolidated Financial Statements**

**December 31, 2001, 2000 and 1999**

**(With Independent Auditors Report Thereon)**

F-2

**INDEPENDENT AUDITORS REPORT**

Board of Directors

Wachovia Preferred Funding Corp.

We have audited the accompanying consolidated balance sheets of Wachovia Preferred Funding Corp. (a subsidiary of Wachovia Bank, National Association, which is a wholly-owned subsidiary of Wachovia Corporation) and subsidiary as of December 31, 2001 and 2000 and the related consolidated statements of operations, changes in stockholders' equity and cash flows for each of the years in the three-year period ended December 31, 2001. These consolidated financial statements are the responsibility of Wachovia Preferred Funding Corp. s management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall consolidated financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Wachovia Preferred Funding Corp. and subsidiary as of December 31, 2001 and 2000, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2001, in conformity with accounting principles generally accepted in the United States of America.

KPMG LLP

Charlotte, North Carolina

August 26, 2002

**Table of Contents**

**WACHOVIA PREFERRED FUNDING CORP.**

**AND SUBSIDIARY**

**CONSOLIDATED BALANCE SHEETS**

**December 31, 2001 and 2000**

| (In thousands, except share data) | 2001 | 2000 |
|---|---|---|
| **ASSETS** | | |
| Cash and cash equivalents | **$ 957,454** | 183,223 |
| Loans, net of unearned income | **4,378,961** | 558,756 |
| Allowance for loan losses | **(37,158)** | (3,833) |
| Loans, net | **4,341,803** | 554,923 |
| Current income taxes receivable | | 7 |
| Deferred income tax assets | | 1,196 |
| Interest rate swaps | **573,620** | |
| Other assets | **16,789** | 7,454 |
| Total assets | **$ 5,889,666** | 746,803 |
| **LIABILITIES AND STOCKHOLDERS EQUITY** | | |
| Liabilities | | |
| Collateral held on interest rate swaps | **570,340** | |
| Current income taxes payable | **20,784** | |
| Deferred income tax liabilities | **124,112** | |
| Accounts payable affiliates | **9,359** | 176 |
| Other liabilities | **7,651** | 107 |
| Total liabilities | **732,246** | 283 |
| Stockholders equity | | |
| Common stock, $0.01 par value, 100,000,000 shares authorized, 99,999,900 and 14,814,800 shares issued and outstanding in 2001 and 2000, respectively | **1,000** | 148 |
| Paid-in capital | **5,085,674** | 652,069 |
| Retained earnings | **70,746** | 94,303 |
| Total stockholders equity | **5,157,420** | 746,520 |
| Total liabilities and stockholders equity | **$ 5,889,666** | 746,803 |

See accompanying notes to consolidated financial statements.

Table of Contents

**WACHOVIA PREFERRED FUNDING CORP.**

**AND SUBSIDIARY**

**CONSOLIDATED STATEMENTS OF OPERATIONS**

**Years Ended December 31, 2001, 2000 and 1999**

| (In thousands, except per share data and average shares) | 2001 | 2000 | 1999 |
|---|---|---|---|
| **INTEREST INCOME** | **$ 68,179** | 57,257 | 47,060 |
| **INTEREST EXPENSE** | **857** | | 55 |
| Net interest income | **67,322** | 57,257 | 47,005 |
| Provision for loan losses | **5,262** | 3,602 | 1,034 |
| Net interest income after provision for loan losses | **62,060** | 53,655 | 45,971 |
| **OTHER INCOME** | | | |
| Loss on interest rate swaps | **(95,890)** | | |
| Other income | | 395 | 96 |
| Total other income | **(95,890)** | 395 | 96 |
| **NONINTEREST EXPENSE** | | | |
| Loan servicing costs | **602** | 1,383 | 1,890 |
| Management fees | | 824 | 1,059 |
| Other | **1,792** | | 129 |
| Total noninterest expense | **2,394** | 2,207 | 3,078 |
| Income (loss) before income tax expense (benefit) | **(36,224)** | 51,843 | 42,989 |
| Income tax expense (benefit) | **(12,679)** | 19,409 | 15,038 |
| Net income (loss) | **$ (23,545)** | 32,434 | 27,951 |
| **PER COMMON SHARE DATA** | | | |
| Basic earnings (loss) | **$ (1.07)** | 2.19 | 1.89 |
| Diluted earnings (loss) | **$ (1.07)** | 2.19 | 1.89 |
| **AVERAGE SHARES** | | | |
| Basic | **21,925,904** | 14,814,800 | 14,814,800 |
| Diluted | **21,925,904** | 14,814,800 | 14,814,800 |

See accompanying notes to consolidated financial statements.

F-5

Table of Contents

**WACHOVIA PREFERRED FUNDING CORP.**

**AND SUBSIDIARY**

**CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS EQUITY**

**Years Ended December 31, 2001, 2000 and 1999**

| (In thousands) | Common Stock | Paid-in Capital | Retained Earnings | Total |
|---|---|---|---|---|
| Balance, December 31, 1998 | $ 148 | 652,069 | 33,937 | 686,154 |
| Net income | | | 27,951 | 27,951 |
| Cash dividends paid | | | (8) | (8) |
| Balance, December 31, 1999 | 148 | 652,069 | 61,880 | 714,097 |
| Net income | | | 32,434 | 32,434 |
| Cash dividends paid | | | (11) | (11) |
| Balance, December 31, 2000 | 148 | 652,069 | 94,303 | 746,520 |
| Net loss | | | **(23,545)** | **(23,545)** |
| Issuance of common stock in exchange for loans and interest rate swaps, net of deferred income tax liability of $177,029 | **852** | **4,433,605** | | **4,434,457** |
| Cash dividends paid | | | **(12)** | **(12)** |
| **Balance, December 31, 2001** | **$ 1,000** | **5,085,674** | **70,746** | **5,157,420** |

See accompanying notes to consolidated financial statements.

Table of Contents

**WACHOVIA PREFERRED FUNDING CORP.**

**AND SUBSIDIARY**

**CONSOLIDATED STATEMENTS OF CASH FLOWS**

**Years Ended December 31, 2001, 2000 and 1999**

| (In thousands) | 2001 | 2000 | 1999 |
|---|---|---|---|
| **OPERATING ACTIVITIES** | | | |
| Net income (loss) | $ (23,545) | 32,434 | 27,951 |
| Adjustments to reconcile net income (loss) to net cash provided (used) by operating activities | | | |
| Provision for loan losses | 5,262 | 3,602 | 1,034 |
| Current income taxes, net | 20,791 | (7) | (2,225) |
| Deferred income tax benefits | (51,721) | (799) | (107) |
| Loss on interest rate swaps | 95,890 | | |
| Interest rate swaps and other assets, net | (5,876) | (1,724) | (1,271) |
| Accounts payable affiliates and other liabilities, net | 16,727 | 283 | (115) |
| Net cash provided by operating activities | 57,528 | 33,789 | 25,267 |
| **INVESTING ACTIVITIES** | | | |
| (Increase) decrease in loans, net | 146,375 | (46,952) | 73,160 |
| Net cash provided (used) by investing activities | 146,375 | (46,952) | 73,160 |
| **FINANCING ACTIVITIES** | | | |
| Increase (decrease) in cash realized from | | | |
| Collateral held on interest rate swaps | 570,340 | | |
| Cash dividends paid | (12) | (11) | (8) |
| Net cash provided (used) by financing activities | 570,328 | (11) | (8) |
| Increase (decrease) in cash and cash equivalents | 774,231 | (13,174) | 98,419 |
| Cash and cash equivalents, beginning of year | 183,223 | 196,397 | 97,978 |
| Cash and cash equivalents, end of year | $ 957,454 | 183,223 | 196,397 |
| **CASH PAID FOR** | | | |
| Interest | $ 857 | | 55 |
| Taxes | 18,250 | 17,733 | 19,548 |
| **NONCASH ITEMS** | | | |
| Commercial loans, net contributed in exchange for common stock, net of deferred income tax asset of $14,573 | 3,953,090 | | |
| | $ 481,367 | | |

Receive-fixed interest rate swaps contributed in exchange for common stock, net of deferred income tax liability of $191,602

See accompanying notes to consolidated financial statements.

F-7

Table of Contents

**WACHOVIA PREFERRED FUNDING CORP.**

**AND SUBSIDIARY**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**December 31, 2001, 2000 and 1999**

**NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING AND REPORTING POLICIES**

***General***

Wachovia Preferred Funding Corp. (known prior to July 2002 as First Union Real Estate Asset Company of Connecticut) and its subsidiary (the Company), is a subsidiary of Wachovia Bank, National Association, formerly named First Union National Bank (the Parent Company), which is a wholly-owned subsidiary of Wachovia Corporation, formerly named First Union Corporation (Wachovia). The Company and its subsidiary invest in a variety of financial assets derived from lending and lending-related activities.

The accounting and reporting policies of the Company are in accordance with accounting principles generally accepted in the United States of America. The more significant of these policies used in preparing the consolidated financial statements are described in this summary. Management of the Company has made a number of estimates and assumptions relating to the reporting of assets and liabilities and to the disclosure of contingent assets and liabilities used to prepare these consolidated financial statements in conformity with accounting principles generally accepted in the United States of America. Actual results could differ from those estimates.

***Consolidation***

The consolidated financial statements include the accounts of the Company and its subsidiary. All significant intercompany accounts and transactions have been eliminated in consolidation.

***Cash and Cash Equivalents***

Cash and cash equivalents include cash and due from banks and interest-bearing bank balances. Generally, both cash and cash equivalents have maturities of three months or less, and accordingly, the carrying amount of these instruments is deemed to be a reasonable estimate of fair value.

***Loans***

Loans are recorded at the principal balance outstanding, net of unearned income. Interest income is recognized on an accrual basis. Loan origination fees and direct costs as well as unearned premiums and discounts are amortized as an adjustment to the yield over the term of the loan.

A loan is considered to be impaired when based on current information, it is probable the Company will not receive all amounts due in accordance with the contractual terms of a loan agreement. Impaired loans are measured based on either the present value of expected future cash flows discounted at the loan s effective interest rate, the loan s observable market price or the fair value of the collateral if the loan is collateral dependent. A loan is also considered impaired if its terms are modified in a troubled debt restructuring.

When the ultimate collectibility of the principal balance of an impaired loan is in doubt, all cash receipts are applied to principal. Once the recorded principal balance has been reduced to zero, future cash receipts are applied to interest income, to the extent any interest has been foregone, and then they are recorded as recoveries of any amounts previously charged off.

The accrual of interest is generally discontinued on loans, except consumer loans, that become 90 days past due as to principal or interest unless collection of both principal and interest is assured by way of collateralization, guarantees or other security. Generally, loans past due 180 days or more are placed on nonaccrual status regardless of security. Consumer loans that become 120 days past due are generally charged to

Table of Contents

**WACHOVIA PREFERRED FUNDING CORP.**

**AND SUBSIDIARY**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

the allowance for loan losses. When borrowers demonstrate over an extended period the ability to repay a loan in accordance with the contractual terms of a loan classified as nonaccrual, the loan is returned to accrual status.

On December 3, 2001, the Parent Company contributed commercial loans with a book value of $4.0 billion and a fair value of $3.7 billion to the Company in exchange for the issuance of common stock with a fair value of $3.7 billion and a related increase in paid-in capital of $300 million. The Parent Company and the Company are under common control and therefore the contributed commercial loans were recorded by the Company at their book value of $4.0 billion. The excess of the book value of the loans over the fair market value of the loans was recorded as an increase in paid-in capital.

***Allowance For Loan Losses***

The allowance for loan losses is maintained at a level that the Company believes is adequate to absorb probable losses. The Company employs a variety of tools as well as seasoned judgment in assessing the adequacy of the allowance. The Company s methodology for assessing the adequacy of the allowance establishes both an allocated and an unallocated component. The allocated component of the allowance for commercial loans is based principally on current loan grades and historical loss rates. For consumer loans, it is based on loan payment status and historical loss rates.

The unallocated component of the allowance represents the results of analyses that estimate probable losses inherent in the portfolio that are not fully captured in the allocated allowance. These analyses include industry concentrations, model imprecision and the estimated impact of current economic conditions on historical loss rates. The Company continuously monitors trends in loan portfolio qualitative and quantitative factors, including trends in the levels of past due, criticized and nonperforming loans. The trends in these factors are used to evaluate the reasonableness of the unallocated component.

The Company believes it has developed appropriate policies and processes in the determination of an allowance for loan losses reflective of the Company s assessment of credit risk after careful consideration of known relevant facts. In developing this assessment, the Company must necessarily rely on estimates and exercise judgments regarding matters where the ultimate outcome is unknown. Depending on changes in circumstances, future assessments of credit risk may yield materially different results, which may require increases or decreases in the allowance for loan losses at that time.

***Comprehensive Income***

The Company has no comprehensive income other than net income.

***Derivative Financial Instruments***

The Company accounts for derivative financial instruments in accordance with Statement of Financial Accounting Standards (SFAS) No. 133, *Accounting for Derivative Instruments and Hedging Activities*, as subsequently amended by SFAS 137 and SFAS 138, which establishes accounting and reporting standards for derivatives and hedging activities. Under SFAS 133, all derivatives (currently consisting of interest rate swaps) are recorded at fair value in the balance sheet. Realized and unrealized gains and losses are included as a gain (loss) on interest rate swaps.

On December 4, 2001, the Parent Company contributed receive-fixed interest rate swaps with a notional amount of $4.25 billion and a fair value of $673 million to the Company in exchange for common stock. After the contribution, the Company entered into pay-fixed interest rate swaps with a notional amount of $4.25 billion that serve as an economic hedge of the contributed swaps. All interest rate swaps are transacted with an unaffiliated third party.

At December 31, 2001, receive-fixed interest rate swaps with a notional amount of $4.25 billion had a weighted average maturity of 10.24 years, weighted average receive rate of 7.41 percent and weighted average

Table of Contents

**WACHOVIA PREFERRED FUNDING CORP.**

**AND SUBSIDIARY**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

pay rate of 1.93 percent. Pay-fixed interest rate swaps with a notional amount of $4.25 billion had a weighted average maturity of 10.24 years, weighted average receive rate of 1.88 percent and weighted average pay rate of 5.69 percent at December 31, 2001. All of the interest rate swaps have variable pay or receive rates based on three- or six-month LIBOR, and they are the pay or receive rates in effect at December 31, 2001.

***Collateral***

Amounts recorded as collateral represent cash pledged to the Company by an unaffiliated counterparty to the interest rate swaps. Interest is paid at a market rate and is accounted for on an accrual basis.

***Income Taxes***

The Company s subsidiary, Wachovia Real Estate Investment Corp. (WREIC), is taxed as a real estate investment trust (REIT) and as such files its own separate federal income tax return. The Company calculates its provision for income tax expense (benefit) on a separate return basis, which is in accordance with Wachovia s policy on the allocation of income taxes. Through the year ended December 31, 2001, the Company filed as part of Wachovia s consolidated federal income tax return. Current federal income taxes are calculated for each consolidated subsidiary having taxable income and paid to Wachovia. Tax benefits, when applicable, are calculated for each consolidated subsidiary having a taxable loss, and they are remitted by Wachovia to the extent that tax benefits are realized from filing a consolidated federal income tax return. State income tax laws do not generally permit consolidated income tax returns; accordingly, applicable state income tax returns are filed for each of the companies.

Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date.

For the tax year ending December 31, 2002, the Company will be taxed as a REIT and intends to comply with the relevant provisions of the Internal Revenue Code to be taxed as a REIT. Accordingly, the Company will not be subject to federal income tax to the extent it meets these provisions, including distributing the majority of its earnings to stockholders and as long as certain asset, income and stock ownership tests are met. As a result of the Company s change in tax status from a taxable corporation to a REIT, the Company s net deferred tax liability as of December 31, 2001, was written off as a benefit to income tax expense in January 2002. In addition, since the Company will be filing its own separate federal income tax return for the tax year 2002 and forward, it will no longer be part of Wachovia s federal consolidated income tax return or be subject to the allocation of the tax liability (benefit) of the consolidated group.

**NOTE 2: LOANS**

| **(In thousands)** | **2001** | 2000 |
|---|---|---|
| **COMMERCIAL** | | |
| Commercial and commercial real estate | **$ 3,990,356** | |
| **CONSUMER** | | |
| Real estate mortgage | **110,258** | 141,147 |
| Home equity loans | **286,385** | 417,706 |
| Total loans | **4,386,999** | 558,853 |
| Unearned income | **8,038** | 97 |
| Total loans, net of unearned income | **$ 4,378,961** | 558,756 |

F-10

Table of Contents

**WACHOVIA PREFERRED FUNDING CORP.**

**AND SUBSIDIARY**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

At December 31, 2001 and 2000, nonaccrual loans amounted to $5.0 million and $2.7 million, respectively. In 2001, 2000 and 1999, $141,000, $285,000 and $168,000, respectively, in gross interest income would have been recorded if all nonaccrual and restructured loans had been performing in accordance with their original terms and if they had been outstanding throughout the entire period, or since origination if held for part of the period. Interest collected on these loans and included in interest income in 2001, 2000 and 1999 amounted to $70,000, $68,000 and $100,000, respectively. Nonaccrual loans greater than $1 million are reviewed for impairment. At December 31, 2001 and 2000, all nonaccrual loans were each less than $1 million, and therefore, were not reviewed for impairment. Consequently, there were no impaired loans at December 31, 2001 and 2000.

**NOTE 3: ALLOWANCE FOR LOAN LOSSES**

| **(In thousands)** | **2001** | 2000 | 1999 |
|---|---|---|---|
| Balance, beginning of year | **$ 3,833** | 1,285 | 192 |
| Provision for loan losses | **5,262** | 3,602 | 1,034 |
| Allowance related to loans contributed from the Parent Company | **33,681** | | |
| Allowance related to loans transferred or sold | **(515)** | (673) | |
| Subtotal | **42,261** | 4,214 | 1,226 |
| Loan losses | **5,155** | 422 | (59) |
| Loan recoveries | **52** | 41 | |
| Loan losses, net | **5,103** | 381 | (59) |
| Balance, end of year | **$ 37,158** | 3,833 | 1,285 |

**NOTE 4: COMMON STOCK RECAPITALIZATION**

In July 2002, the par value of the Company s common stock was changed from $1.00 to $0.01 per share. Each shareholder received 148,148 shares for each share held prior to the recapitalization. As a result of this recapitalization, common stock, paid-in capital, share and per share information for each period presented has been restated.

**NOTE 5: INCOME TAX EXPENSE (BENEFIT)**

The provision for income tax expense (benefit) for each of the years in the three-year period ended December 31, 2001, is presented below.

| (In thousands) | 2001 | 2000 | 1999 |
| --- | --- | --- | --- |
| **CURRENT INCOME TAX EXPENSE** | | | |
| Federal | **$ 39,042** | 19,889 | 15,145 |
| State | | 319 | |
| Total | **39,042** | 20,208 | 15,145 |
| **DEFERRED INCOME TAX BENEFIT** | | | |
| Federal | **(51,721)** | (799) | (107) |
| State | | | |
| Total | **(51,721)** | (799) | (107) |
| Total | **$ (12,679)** | 19,409 | 15,038 |

F-11

Table of Contents

**WACHOVIA PREFERRED FUNDING CORP.**

**AND SUBSIDIARY**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The reconciliation of federal income tax rates and amounts with the effective income tax rates and amounts for each of the years in the three-year period ended December 31, 2001, is presented below.

| | **2001** | | 2000 | | 1999 | |
|---|---|---|---|---|---|---|
| **(In thousands)** | **Amount** | **Percent of Pre-tax Income** | Amount | Percent of Pre-tax Income | Amount | Percent of Pre-tax Income |
| Income (loss) before income tax expense (benefit) | **$ (36,224)** | | $ 51,843 | | $ 42,989 | |
| Tax at federal income tax rate | **$ (12,678)** | **(35.0)%** | $ 18,145 | 35.0% | $ 15,046 | 35.0% |
| Reasons for differences in federal income tax rate and effective tax rate | | | | | | |
| State income taxes, net | | | 207 | 0.4 | | |
| Other | **(1)** | | 1,057 | 2.0 | (8) | |
| Total | **$ (12,679)** | **(35.0)%** | $ 19,409 | 37.4% | $ 15,038 | 35.0% |

The sources and tax effects of temporary differences that give rise to significant portions of the deferred tax assets and liabilities for each of the years in the three-year period ended December 31, 2001, are presented below.

| **(In thousands)** | **2001** | 2000 | 1999 |
|---|---|---|---|
| **DEFERRED INCOME TAX ASSETS** | | | |
| Provision for losses, net | **$ 13,005** | 1,342 | 366 |
| Deferred loan fees | **2,785** | | |
| Loans | **1,991** | | 83 |
| Total deferred income tax assets | **17,781** | 1,342 | 449 |
| **DEFERRED INCOME TAX LIABILITIES** | | | |
| Interest rate swap contracts | **141,799** | | |
| Other | **94** | 146 | 52 |

| | | | |
|---|---|---|---|
| Total deferred income tax liabilities | **141,893** | 146 | 52 |
| Net deferred income tax (liabilities) assets | **$ (124,112)** | 1,196 | 397 |

A portion of the current year change in the net deferred tax liability relates to temporary differences on assets contributed to the Company by the Parent Company in 2001. The net increase to the deferred tax liability as a result of these asset contributions in 2001 is $177 million and has been recorded in the consolidated statements of changes in stockholders' equity as a component of paid-in capital.

The realization of net deferred tax assets may be based on utilization of carrybacks to prior taxable periods, anticipation of future taxable income in certain periods and the utilization of tax planning strategies. Management has determined that it is more likely than not that the net deferred tax asset can be supported by carrybacks to federal taxable income in the five-year federal carryback period and by expected future taxable income which will exceed amounts necessary to fully realize remaining deferred tax assets resulting from the scheduling of temporary differences.

Table of Contents

**WACHOVIA PREFERRED FUNDING CORP.**

**AND SUBSIDIARY**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

For the tax year ending December 31, 2002, the Company will be taxed as a REIT and intends to comply with the relevant provisions of the Internal Revenue Code to be taxed as a REIT. Accordingly, the Company will not be subject to federal income tax to the extent it meets these provisions, including distributing the majority of its earnings to stockholders and as long as certain asset, income and stock ownership tests are met. As a result of the Company s change in tax status from a taxable corporation to a REIT, the Company s net deferred tax liability as of December 31, 2001, was written off as a benefit to income tax expense in January 2002. In addition, since the Company will be filing its own separate federal income tax return for the tax year 2002 and forward, it will no longer be part of Wachovia s federal consolidated income tax return or be subject to the allocation of the tax liability (benefit) of the consolidated group.

The Internal Revenue Service (the IRS) is currently examining First Union Corporation s federal income tax returns for the years 1997 through 1999. In addition, in November 2001, the IRS issued reports related to the examination of First Union Corporation s 1994 through 1996 federal income tax returns. Although the amount of any ultimate liability with respect to such examinations cannot be determined, in the opinion of management, any such liability will not have a material impact on the Company s financial position or results of operations. In 1999, the IRS examination of First Union Corporation s federal income tax returns for the years 1991 through 1993 was settled with no significant impact on the Company s financial position or results of operations.

**NOTE 6: TRANSACTIONS WITH AFFILIATED PARTIES**

The Company, as a subsidiary, is subject to certain income and expense allocations from affiliated parties for various services received. In addition, the Company enters into transactions with affiliated parties in the normal course of business. The principal items related to transactions with affiliated parties included in the accompanying consolidated balance sheets and consolidated statements of operations are described below. Due to the nature of common ownership of the Company and the affiliated parties by Wachovia, the following transactions could differ from those conducted with unaffiliated parties.

Loan servicing costs paid to affiliates were $383,000 in 2001, $1.2 million in 2000 and $1.8 million in 1999. The Company is subject to Wachovia s management fee policy and therefore reimburses Wachovia for general overhead expenses paid on behalf of the Company by Wachovia. These overhead expenses include general accounting, tax accounting, legal, and balance sheet management services, along with officer salaries. Affiliates with greater than $10 million in assets and $2 million in estimated annualized expenses are assessed a management fee; if an affiliate does not meet both of these criteria, no management fee is allocated. If an affiliate qualifies for an allocation, the affiliate is assessed management fees based on its relative percentage of total consolidated assets and non-interest expense. We believe this allocation method represents a reasonable basis for allocating general overhead expenses. These expenses amounted to $824,000 in 2000 and $1.1 million in 1999. The Company did not meet the criteria for being assessed a management fee in 2001, and therefore no fee was charged.

At December 31, 2001 and 2000, noninterest-bearing cash deposits due from the Parent Company included in cash and cash equivalents were $161.4 million and $20.4 million, respectively. The Company also has interest-bearing cash deposits with the Parent Company. These cash deposits are the primary cash management vehicle of the Company. Excess funds are placed with the Parent Company; shortages of funds are borrowed from the Parent Company. Such cash deposits due from the Parent Company were $570 million (see collateral related to the interest rate swaps discussed below) at December 31, 2001, and $24.0 million at December 31, 2000. The related interest receivable was $857,000 at December 31, 2001. The related interest income for 2001, 2000 and 1999 was $4.1 million, $2.9 million and $1.1 million, respectively.

At December 31, 2001 and 2000, eurodollar investments due from an affiliate of the Parent Company included in cash and cash equivalents were $226 million and $139 million, respectively, and the related interest receivable was $11,000 and $76,000, respectively. Interest income earned on eurodollar investments included in interest income was $6.8 million in 2001, $14.1 million in 2000 and $7.9 million in 1999.

**WACHOVIA PREFERRED FUNDING CORP.**

**AND SUBSIDIARY**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

In addition to the funding provided by the deposits as noted above, intercompany payables and receivables are often used to record intercompany transactions in which cash cannot be settled on the same business day. These intercompany transactions are settled for cash within 30 days and no interest is charged due to the short-lived nature of the transaction. At December 31, 2001 and 2000, the Company had a net accounts payable due to affiliates of $9.4 million and $176,000, respectively. The average balance of amounts outstanding was a net receivable of $324,000 in 2001 and a net payable of $336,000 in 2000.

In 2001, the Company had loan participations with affiliates. The Company is allocated a portion of all income associated with these loans. The participations consist of commercial and consumer loans. Net loan participations were $4.0 billion at December 31, 2001, and the related interest receivable was $9.4 million. Interest income on loan participations was $12.5 million in 2001.

The Company has a swap servicing and fee agreement with the Parent Company, dated December 4, 2001, whereby the Parent Company provides operational, back office, book entry, record keeping and valuation services related to the Company s interest rate swaps. In consideration of these services, the Company pays the Parent Company 0.015 percent multiplied by the net amount actually paid under the interest rate swaps on the swaps payment date. Amounts paid under this agreement were less than $1,000 in 2001, and were included in interest expense.

The Parent Company acts as collateral custodian for the Company in connection with collateral pledged to the Company related to the interest rate swaps. For this service, the Company pays the Parent Company a fee equal to the sum of 0.05 percent multiplied by the fair market value of noncash collateral and 0.05 percent multiplied by the amount of cash collateral. Amounts paid under this agreement were $21,000 in 2001. In addition, the Parent Company is permitted to rehypothecate and use as its own the collateral held by the Parent Company as custodian for the Company. The Parent Company pays the Company a fee equal to the sum of 0.05 percent multiplied by the fair market value of the noncash collateral the Parent Company holds as custodian and the amount of cash collateral held multiplied by a market rate of interest. The collateral agreement with the counterparty allows the Company to repledge the collateral free of any right of redemption or other right of the counterparty in such collateral without any obligation on the Company s part to maintain possession or control of equivalent collateral. Pursuant to the rehypothecation agreement, the Company has deposited cash collateral of $570 million with the Parent Company. Amounts paid under this agreement were $857,000 in 2001, and were included in interest income.

The Parent Company also provides a guaranty of the Company s obligations under the interest rate swaps. In consideration, the Company pays the Parent Company a monthly fee in arrears equal to 0.03 percent multiplied by the absolute value of the net notional amount of the interest rate swaps. Amounts paid under this agreement were $975,000 in 2001, and were included in other noninterest expense.

**NOTE 7: COMMITMENTS AND OTHER MATTERS**

The Company s commercial loan portfolio includes unfunded loan commitments and standby and commercial letters of credit that are provided in the normal course of business. For commercial customers, loan commitments generally take the form of revolving credit arrangements to finance customers working capital requirements. These instruments are not recorded on the balance sheet until funds are advanced under the commitment. For lending commitments, the contractual amount of a commitment represents the maximum potential credit risk if the entire commitment is funded and the borrower does not perform according to the terms

Table of Contents

**WACHOVIA PREFERRED FUNDING CORP.**

**AND SUBSIDIARY**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

of the contract. A large majority of these commitments expire without being funded, and accordingly, total contractual amounts are not representative of actual future credit exposure or liquidity requirements.

Loan commitments and letters of credit create credit risk in the event that the counterparty draws on the commitment and subsequently fails to perform under the terms of the lending agreement. This risk is incorporated into an overall evaluation of credit risk, and to the extent necessary, reserves are recorded on these commitments. Uncertainties around the timing and amount of funding under these commitments may create liquidity risk.

The estimated fair value of commitments to extend credit at December 31, 2001, was $1.4 million. The contract or notional amount of commitments to extend credit at December 31, 2001, was $1.2 billion. The estimated fair value of standby and commercial letters of credit at December 31, 2001, was less than $1,000. The contract or notional amount of standby and commercial letters of credit at December 31, 2001, was $39 million. The fair value of commitments to extend credit and letters of credit is estimated using the fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the current creditworthiness of the counterparties.

The Company and its subsidiary are not the subject of any litigation. The Company (including its subsidiary), Wachovia and the Parent Company are not currently involved in nor, to their knowledge, currently threatened with, any material litigation with respect to the assets included in the Company s portfolio, other than routine litigation arising in the ordinary course of business.

**NOTE 8: CARRYING AMOUNTS AND FAIR VALUE OF FINANCIAL INSTRUMENTS**

Information about the fair value of on-balance sheet financial instruments at December 31, 2001 and 2000, is presented below.

| | | **2001** | | 2000 |
|---|---|---|---|---|
| **(In thousands)** | **Carrying Amount** | **Estimated Fair Value** | Carrying Amount | Estimated Fair Value |
| **FINANCIAL ASSETS** | | | | |
| Cash and cash equivalents | **$ 957,454** | **957,454** | 183,223 | 183,223 |
| Loans, net of unearned income and allowance for loan losses | **4,341,803** | **4,037,965** | 554,923 | 556,311 |
| Interest rate swaps | **573,620** | **573,620** | | |
| Other assets | **$ 16,789** | **16,789** | 7,454 | 7,454 |
| **FINANCIAL LIABILITIES** | | | | |

| | | | | |
|---|---|---|---|---|
| Collateral held on interest rate swaps | **570,340** | **570,340** | | |
| Accounts payable affiliates and other liabilities | **$ 17,010** | **17,010** | 283 | 283 |

The fair values of loans are calculated by discounting estimated cash flows through expected maturity dates using estimated market yields that reflect the credit and interest rate risks inherent in each category of loans and prepayment assumptions. Estimated fair values for the commercial loan portfolio were based on weighted average discount rates ranging from 3.60 percent to 7.65 percent and 6.97 percent to 8.54 percent at December 31, 2001 and 2000, respectively, and for the consumer portfolio from 5.39 percent to 10.40 percent and 7.00 percent to 9.67 percent, respectively.

Table of Contents

**WACHOVIA PREFERRED FUNDING CORP.**

**AND SUBSIDIARY**

**Consolidated Financial Statements**

**As of and For the Nine Months Ended September 30, 2002 and 2001**

**(Unaudited)**

F-16

Table of Contents

**WACHOVIA PREFERRED FUNDING CORP.**

**AND SUBSIDIARY**

**CONSOLIDATED BALANCE SHEETS**

**(Unaudited)**

**September 30, 2002 and 2001**

| (In thousands, except share data) | 2002 | 2001 |
|---|---|---|
| **ASSETS** | | |
| Cash and cash equivalents | **$ 1,169,380** | 327,057 |
| Loans, net of unearned income | **4,297,280** | 440,040 |
| Allowance for loan losses | **(37,335)** | (5,655) |
| Loans, net | **4,259,945** | 434,385 |
| Deferred income tax assets | | 1,847 |
| Interest rate swaps | **605,438** | |
| Accounts receivable affiliates | **22,274** | 93 |
| Other assets | **14,049** | 11,657 |
| Total assets | **$ 6,071,086** | 775,039 |
| **LIABILITIES AND STOCKHOLDERS EQUITY** | | |
| Liabilities | | |
| Collateral held on interest rate swaps | **599,570** | |
| Current income taxes payable | | 4,993 |
| Other liabilities | **7,368** | 89 |
| Total liabilities | **606,938** | 5,082 |
| Stockholders equity | | |
| Preferred Stock | | |
| Series A preferred securities, $0.01 par value, $25.00 liquidation preference, non-cumulative and conditionally exchangeable, 30,000,000 shares authorized, none issued | | |
| Series B preferred securities, $0.01 par value, $25.00 liquidation preference, non-cumulative and conditionally exchangeable, 40,000,000 shares authorized, none issued | | |
| Series C preferred securities, $0.01 par value, $1,000 liquidation preference, cumulative, 5,000,000 shares authorized, none issued | | |
| Series D preferred securities, $0.01 par value, $1,000 liquidation preference, non-cumulative, 913 shares authorized, issued and outstanding in 2002, none issued in 2001 | | |
| Common stock, $0.01 par value, 100,000,000 shares authorized, 99,999,900 shares issued and outstanding in 2002 and 14,814,800 shares in 2001 | **1,000** | 148 |
| Paid-in capital | **5,086,474** | 652,069 |

| | | |
|---|---|---|
| Retained earnings | **376,674** | 117,740 |
| Total stockholders equity | **5,464,148** | 769,957 |
| Total liabilities and stockholders equity | **$ 6,071,086** | 775,039 |

See accompanying notes to consolidated financial statements.

Table of Contents

**WACHOVIA PREFERRED FUNDING CORP.**

**AND SUBSIDIARY**

**CONSOLIDATED STATEMENTS OF INCOME**

**(Unaudited)**

**Nine Months Ended September 30, 2002 and 2001**

| (In thousands, except per share data and average shares) | 2002 | 2001 |
|---|---|---|
| **INTEREST INCOME** | $ 135,385 | 43,374 |
| **INTEREST EXPENSE** | 8,287 | |
| Net interest income | 127,098 | 43,374 |
| Provision for loan losses | 7,033 | 6,290 |
| Net interest income after provision for loan losses | 120,065 | 37,084 |
| **OTHER INCOME** | | |
| Gain on interest rate swaps | 68,352 | |
| Other income | 4 | |
| Total other income | 68,356 | |
| **NONINTEREST EXPENSE** | | |
| Loan servicing costs | 1,082 | 431 |
| Management fees | 4,371 | |
| Other | 1,144 | 582 |
| Total noninterest expense | 6,597 | 1,013 |
| Income before income tax expense (benefit) | 181,824 | 36,071 |
| Income tax expense (benefit) | (124,112) | 12,625 |
| Net income | $ 305,936 | 23,446 |
| **PER COMMON SHARE DATA** | | |
| Basic earnings | $ 3.06 | 1.58 |
| Diluted earnings | $ 3.06 | 1.58 |
| **AVERAGE SHARES** | | |
| Basic | 99,999,900 | 14,814,800 |
| Diluted | 99,999,900 | 14,814,800 |

See accompanying notes to consolidated financial statements.

Table of Contents

**WACHOVIA PREFERRED FUNDING CORP.**

**AND SUBSIDIARY**

**CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS EQUITY**

**(Unaudited)**

**Nine Months Ended September 30, 2002 and 2001**

| (In thousands) | Preferred Stock | Common Stock | Paid-in Capital | Retained Earnings | Total |
|---|---|---|---|---|---|
| Balance, December 31, 2001 | $ | 1,000 | 5,085,674 | 70,746 | 5,157,420 |
| Net income | | | | **305,936** | **305,936** |
| Issuance of Series D preferred securities | | | **800** | | **800** |
| Cash dividends paid | | | | **(8)** | **(8)** |
| Balance, September 30, 2002 | **$** | **1,000** | **5,086,474** | **376,674** | **5,464,148** |

| (In thousands) | | Common Stock | Paid-in Capital | Retained Earnings | Total |
|---|---|---|---|---|---|
| Balance, December 31, 2000 | $ | 148 | 652,069 | 94,303 | 746,520 |
| Net income | | | | 23,446 | 23,446 |
| Cash dividends paid | | | | (9) | (9) |
| Balance, September 30, 2001 | $ | 148 | 652,069 | 117,740 | 769,957 |

See accompanying notes to consolidated financial statements.

Table of Contents

**WACHOVIA PREFERRED FUNDING CORP.**

**AND SUBSIDIARY**

**CONSOLIDATED STATEMENTS OF CASH FLOWS**

**(Unaudited)**

**Nine Months Ended September 30, 2002 and 2001**

| (In thousands) | 2002 | 2001 |
|---|---|---|
| **OPERATING ACTIVITIES** | | |
| Net income | $ 305,936 | 23,446 |
| Adjustments to reconcile net income to net cash provided (used) by operating activities | | |
| Provision for loan losses | 7,033 | 6,290 |
| Current income taxes, net | (20,784) | 5,000 |
| Deferred income taxes, net | (124,112) | (651) |
| Interest rate swaps, net | (31,818) | |
| Accounts receivable affiliates and other assets, net | (19,534) | (4,296) |
| Accounts payable affiliates and other liabilities, net | (9,642) | (194) |
| Net cash provided by operating activities | 107,079 | 29,595 |
| **INVESTING ACTIVITIES** | | |
| Decrease in loans, net | 74,825 | 114,248 |
| Net cash provided by investing activities | 74,825 | 114,248 |
| **FINANCING ACTIVITIES** | | |
| Increase (decrease) in cash realized from | | |
| Collateral held on interest rate swaps | 29,230 | |
| Issuance of preferred stock | 800 | |
| Cash dividends paid | (8) | (9) |
| Net cash used by financing activities | 30,022 | (9) |
| Increase in cash and cash equivalents | 211,926 | 143,834 |
| Cash and cash equivalents, beginning of period | 957,454 | 183,223 |
| Cash and cash equivalents, end of period | $ 1,169,380 | 327,057 |

See accompanying notes to consolidated financial statements.

Table of Contents

**WACHOVIA PREFERRED FUNDING CORP.**

**AND SUBSIDIARY**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

**September 30, 2002 and 2001**

**NOTE 1: FINANCIAL STATEMENTS**

Wachovia Preferred Funding Corp. (known prior to July 2002 as First Union Real Estate Asset Company of Connecticut) is a subsidiary of Wachovia Bank, National Association, formerly named First Union National Bank and its subsidiaries, which is a wholly-owned subsidiary of Wachovia Corporation.

The unaudited consolidated financial statements of Wachovia Preferred Funding Corp. include, in the opinion of management, all adjustments (consisting only of normal recurring adjustments) necessary for fair presentation of such financial statements for the periods indicated in accordance with accounting principles generally accepted in the United States of America.

**NOTE 2: INCOME TAX EXPENSE (BENEFIT)**

For the tax year ending December 31, 2002, the Company will be taxed as a REIT and intends to comply with the relevant provisions of the Internal Revenue Code to be taxed as a REIT. Accordingly, with the exception of the income of its newly-formed taxable REIT subsidiary, Wachovia Preferred Realty, LLC ( WPR ), the Company will not be subject to Federal income tax on net income currently distributed to stockholders to the extent it meets these provisions, including distributing the majority of its earnings to stockholders and satisfying certain asset, income and stock ownership tests. As a result of the Company s change in tax status from a taxable corporation to a REIT, the Company s net deferred tax liability as of December 31, 2001, was written off as a benefit to income tax expense in January 2002. Due to the establishment of WPR in October 2002, a deferred tax expense will be recorded to establish the initial deferred tax liability on the book versus tax basis differences of the assets contributed to the subsidiary. In addition, the Company will incur Federal income tax to the extent of the earnings of WPR. Since the Company will be filing its own separate Federal income tax return for the year 2002 and forward, it will no longer be part of Wachovia s Federal consolidated income tax return or be subject to the allocation of the tax liability (benefit) of the consolidated group.

**NOTE 3: PREFERRED SECURITIES AND COMMON STOCK RECAPITALIZATION**

In 2002, the Company issued 913 shares of Series D preferred securities, $0.01 par value and $1,000 liquidation preference per security, to the Bank and 113 employees of Wachovia or its affiliates for cash.

At the same time, the par value of the Company s common stock was changed from $1.00 to $0.01 per share. Each shareholder received 148,148 shares for each share held prior to the recapitalization. As a result of this recapitalization, common stock and paid-in capital for each period presented, has been restated to reflect this change.

**WACHOVIA CORPORATION AND SUBSIDIARIES**

**Supplementary Consolidating Financial Information**

**As of and For the Nine Months Ended September 30, 2002 and 2001 and**

**the Years Ended December 31, 2001 and 2000**

**(Unaudited)**

**Table of Contents**

**INDEPENDENT AUDITORS REPORT ON SUPPLEMENTARY**

**CONSOLIDATING FINANCIAL INFORMATION**

The Board of Directors

Wachovia Corporation

We have audited, in accordance with auditing standards generally accepted in the United States of America, the consolidated financial statements of Wachovia Corporation and subsidiaries as of December 31, 2001 and 2000, and for each of the years in the three-year period ended December 31, 2001, and have issued our report thereon dated January 23, 2002. Our unqualified audit report on the consolidated financial statements of Wachovia Corporation and subsidiaries dated January 23, 2002, refers to the fact that effective July 1, 2001, Wachovia Corporation adopted the provisions of Statement of Financial Accounting Standards ( SFAS ) No. 141, *Business Combinations* and certain provisions of SFAS No. 142, *Goodwill and Other Intangible Assets* as required for goodwill and intangible assets resulting from business combinations consummated after June 30, 2001.

Our audits were made for the purpose of forming an opinion on the consolidated financial statements of Wachovia Corporation and subsidiaries taken as a whole. The accompanying supplementary consolidating financial information as of and for the years ended December 31, 2001 and 2000, is presented for purposes of additional analysis of the consolidated financial statements rather than to present the financial position, results of operations and cash flows of the individual companies. The supplementary consolidating financial information has been subjected to the auditing procedures applied in the audits of the consolidated financial statements and, in our opinion, is fairly stated in all material respects in relation to the consolidated financial statements taken as a whole.

/s/ KPMG LLP

Charlotte, North Carolina

January 23, 2002

Table of Contents

**WACHOVIA CORPORATION AND SUBSIDIARIES**

**Supplementary Consolidating Balance Sheet**

**(Unaudited)**

| | September 30, 2002 | | |
|---|---|---|---|
| **(In millions)** | **The Bank** | **Other Subsidiaries and Eliminations** | **Wachovia Consolidated** |
| **ASSETS** | | | |
| Cash and due from banks | $ 13,236 | (1,306) | 11,930 |
| Interest-bearing bank balances | 688 | 2,873 | 3,561 |
| Federal funds sold and securities purchased under resale agreements | 3,858 | 3,274 | 7,132 |
| Total cash and cash equivalents | 17,782 | 4,841 | 22,623 |
| Trading account assets | 26,499 | 9,403 | 35,902 |
| Securities | 68,147 | 3,924 | 72,071 |
| Loans, net of unearned income | 163,767 | (6,225) | 157,542 |
| Allowance for loan losses | (2,823) | (24) | (2,847) |
| Loans, net | 160,944 | (6,249) | 154,695 |
| Premises and equipment | 3,186 | 2,236 | 5,422 |
| Due from customers on acceptances | 1,080 | | 1,080 |
| Goodwill | 9,421 | 1,389 | 10,810 |
| Intangible assets | 1,869 | (194) | 1,675 |
| Other assets | 23,008 | 6,594 | 29,602 |
| Total assets | $ 311,936 | 21,944 | 333,880 |
| **LIABILITIES AND STOCKHOLDERS' EQUITY** | | | |
| Deposits | | | |
| Noninterest-bearing deposits | 32,759 | 11,427 | 44,186 |
| Interest-bearing deposits | 162,602 | (19,003) | 143,599 |
| Total deposits | 195,361 | (7,576) | 187,785 |
| Short-term borrowings | 28,578 | 12,568 | 41,146 |
| Bank acceptances outstanding | 1,093 | | 1,093 |
| Trading account liabilities | 19,670 | (1,910) | 17,760 |
| Other liabilities | 13,830 | 403 | 14,233 |
| Long-term debt | 21,865 | 17,893 | 39,758 |
| Total liabilities | 280,397 | 21,378 | 301,775 |
| **STOCKHOLDERS' EQUITY** | | | |
| Preferred stock | | 2 | 2 |

| | | | |
|---|---|---|---|
| Common stock | 455 | 4,122 | 4,577 |
| Paid-in capital | 24,930 | (6,697) | 18,233 |
| Retained earnings | 4,071 | 3,150 | 7,221 |
| Accumulated other comprehensive income, net | 2,083 | (11) | 2,072 |
| Total stockholders' equity | 31,539 | 566 | 32,105 |
| Total liabilities and stockholders' equity | $ 311,936 | 21,944 | 333,880 |

F-24

Table of Contents

**WACHOVIA CORPORATION AND SUBSIDIARIES**

**Supplementary Consolidating Balance Sheet**

| | December 31, 2001 | | | | |
|---|---|---|---|---|---|
| **(In millions)** | **FUNB(a)** | **WBNA(a)** | **Combined** | **Other Subsidiaries and Eliminations** | **Wachovia Consolidated** |
| **ASSETS** | | | | | |
| Cash and due from banks | $ 10,660 | 3,765 | 14,425 | (508) | 13,917 |
| Interest-bearing bank balances | 6,638 | 651 | 7,289 | (414) | 6,875 |
| Federal funds sold and securities purchased under resale agreements | 5,188 | 167 | 5,355 | 8,564 | 13,919 |
| Total cash and cash equivalents | 22,486 | 4,583 | 27,069 | 7,642 | 34,711 |
| Trading account assets | 19,071 | 722 | 19,793 | 5,593 | 25,386 |
| Securities | 47,596 | 7,419 | 55,015 | 3,452 | 58,467 |
| Loans, net of unearned income | 123,754 | 46,997 | 170,751 | (6,950) | 163,801 |
| Allowance for loan losses | (2,222) | (756) | (2,978) | (17) | (2,995) |
| Loans, net | 121,532 | 46,241 | 167,773 | (6,967) | 160,806 |
| Premises and equipment | 2,628 | 921 | 3,549 | 2,170 | 5,719 |
| Due from customers on acceptances | 732 | 13 | 745 | | 745 |
| Goodwill | 2,253 | 6,973 | 9,226 | 1,390 | 10,616 |
| Intangible assets | 336 | 2,018 | 2,354 | (198) | 2,156 |
| Other assets | 16,151 | 2,665 | 18,816 | 13,030 | 31,846 |
| Total assets | $ 232,785 | 71,555 | 304,340 | 26,112 | 330,452 |
| **LIABILITIES AND STOCKHOLDERS' EQUITY** | | | | | |
| Deposits | | | | | |
| Noninterest-bearing deposits | 24,578 | 9,947 | 34,525 | 8,939 | 43,464 |
| Interest-bearing deposits | 123,171 | 36,364 | 159,535 | (15,546) | 143,989 |
| Total deposits | 147,749 | 46,311 | 194,060 | (6,607) | 187,453 |
| Short-term borrowings | 27,762 | 3,812 | 31,574 | 12,811 | 44,385 |
| Bank acceptances outstanding | 749 | 13 | 762 | | 762 |
| Trading account liabilities | 15,559 | 634 | 16,193 | (4,756) | 11,437 |
| Other liabilities | 10,172 | 1,453 | 11,625 | 4,602 | 16,227 |
| Long-term debt | 14,661 | 5,661 | 20,322 | 21,411 | 41,733 |
| Total liabilities | 216,652 | 57,884 | 274,536 | 27,461 | 301,997 |

| | | | | | |
|---|---|---|---|---|---|
| **STOCKHOLDERS' EQUITY** | | | | | |
| Preferred stock | 161 | | 161 | (144) | 17 |
| Common stock | 455 | 53 | 508 | 4,031 | 4,539 |
| Paid-in capital | 13,302 | 13,345 | 26,647 | (8,736) | 17,911 |
| Retained earnings | 1,847 | 210 | 2,057 | 3,494 | 5,551 |
| Accumulated other comprehensive income, net | 368 | 63 | 431 | 6 | 437 |
| Total stockholders' equity | 16,133 | 13,671 | 29,804 | (1,349) | 28,455 |
| Total liabilities and stockholders' equity | $ 232,785 | 71,555 | 304,340 | 26,112 | 330,452 |

(a) "FUNB" refers to First Union National Bank, "WBNA" refers to the former Wachovia Bank, National Association.

See accompanying Independent Auditors Report on Supplementary Consolidating Financial Information.

F-25

Table of Contents

**WACHOVIA CORPORATION AND SUBSIDIARIES**

**Supplementary Consolidating Balance Sheet**

| (In millions) | FUNB(a) | Other Subsidiaries and Eliminations | Wachovia Consolidated |
|---|---|---|---|
| | December 31, 2000 | | |
| **ASSETS** | | | |
| Cash and due from banks | $ 10,052 | (146) | 9,906 |
| Interest-bearing bank balances | 3,207 | 32 | 3,239 |
| Federal funds sold and securities purchased under resale agreements | 6,010 | 5,230 | 11,240 |
| Total cash and cash equivalents | 19,269 | 5,116 | 24,385 |
| Trading account assets | 16,578 | 5,052 | 21,630 |
| Securities | 47,713 | 1,533 | 49,246 |
| Loans, net of unearned income | 131,252 | (7,492) | 123,760 |
| Allowance for loan losses | (1,706) | (16) | (1,722) |
| Loans, net | 129,546 | (7,508) | 122,038 |
| Premises and equipment | 2,849 | 2,175 | 5,024 |
| Due from customers on acceptances | 873 | 1 | 874 |
| Goodwill | 2,414 | 1,067 | 3,481 |
| Intangible assets | 377 | (194) | 183 |
| Other assets | 12,218 | 15,091 | 27,309 |
| Total assets | $ 231,837 | 22,333 | 254,170 |
| **LIABILITIES AND STOCKHOLDERS' EQUITY** | | | |
| Deposits | | | |
| Noninterest-bearing deposits | 21,074 | 9,241 | 30,315 |
| Interest-bearing deposits | 125,892 | (13,539) | 112,353 |
| Total deposits | 146,966 | (4,298) | 142,668 |
| Short-term borrowings | 36,990 | 2,456 | 39,446 |
| Bank acceptances outstanding | 879 | 1 | 880 |
| Trading account liabilities | 9,919 | (2,444) | 7,475 |
| Other liabilities | 8,310 | 4,235 | 12,545 |
| Long-term debt | 13,569 | 22,240 | 35,809 |
| Total liabilities | 216,633 | 22,190 | 238,823 |
| **STOCKHOLDERS' EQUITY** | | | |
| Preferred stock | 161 | (161) | |
| Common stock | 455 | 2,812 | 3,267 |

| | | | |
|---|---|---|---|
| Paid-in capital | 13,306 | (7,034) | 6,272 |
| Retained earnings | 1,467 | 4,554 | 6,021 |
| Accumulated other comprehensive income, net | (185) | (28) | (213) |
| Total stockholders' equity | 15,204 | 143 | 15,347 |
| Total liabilities and stockholders' equity | $ 231,837 | 22,333 | 254,170 |

(a) "FUNB" refers to First Union National Bank.

See accompanying Independent Auditors Report on Supplementary Consolidating Financial Information.

Table of Contents

**WACHOVIA CORPORATION AND SUBSIDIARIES**

**Supplementary Consolidating Statement of Income**

**(Unaudited)**

| (In millions) | The Bank | Other Subsidiaries and Eliminations | Wachovia Consolidated |
|---|---|---|---|
| | Nine Months Ended September 30, 2002 | | |
| **INTEREST INCOME** | | | |
| Interest and fees on loans | $ 7,966 | (208) | 7,758 |
| Interest and dividends on securities | 2,579 | 118 | 2,697 |
| Trading account interest | 293 | 214 | 507 |
| Other interest income | 191 | 556 | 747 |
| Total interest income | 11,029 | 680 | 11,709 |
| **INTEREST EXPENSE** | | | |
| Interest on deposits | 2,648 | (50) | 2,598 |
| Interest on borrowings | 1,184 | 574 | 1,758 |
| Total interest expense | 3,832 | 524 | 4,356 |
| Net interest income | 7,197 | 156 | 7,353 |
| Provision for loan losses | 1,137 | 34 | 1,171 |
| Net interest income after provision for loan losses | 6,060 | 122 | 6,182 |
| **FEE AND OTHER INCOME** | | | |
| Service charges and fees | 1,498 | 488 | 1,986 |
| Commissions | 586 | 817 | 1,403 |
| Fiduciary and asset management fees | 497 | 873 | 1,370 |
| Principal investing | (130) | (31) | (161) |
| Other income | 2,011 | (582) | 1,429 |
| Total fee and other income | 4,462 | 1,565 | 6,027 |
| **NONINTEREST EXPENSE** | | | |
| Salaries and employee benefits | 3,104 | 1,812 | 4,916 |
| Occupancy and equipment | 999 | 276 | 1,275 |
| Goodwill and other intangible amortization | 477 | 4 | 481 |
| Sundry expense | 2,483 | (515) | 1,968 |
| Total noninterest expense | 7,063 | 1,577 | 8,640 |

| | | | |
|---|---|---|---|
| Income before income taxes | 3,459 | 110 | 3,569 |
| Income taxes | 816 | 69 | 885 |
| Net income | 2,643 | 41 | 2,684 |
| Dividends on preferred stock | | 15 | 15 |
| Net income available to common stockholders | $ 2,643 | 26 | 2,669 |

Table of Contents

**WACHOVIA CORPORATION AND SUBSIDIARIES**

**Supplementary Consolidating Statement of Income**

**(Unaudited)**

| | Nine Months Ended September 30, 2001 | | | | |
|---|---|---|---|---|---|
| **(In millions)** | **FUNB(a)** | **WBNA(a)** | **Combined** | **Other Subsidiaries and Eliminations** | **Wachovia Consolidated** |
| **INTEREST INCOME** | | | | | |
| Interest and fees on loans | $ 7,602 | 3,112 | 10,714 | (3,147) | 7,567 |
| Interest and dividends on securities | 2,501 | 370 | 2,871 | (213) | 2,658 |
| Trading account interest | 415 | 3 | 418 | 176 | 594 |
| Other interest income | 252 | 32 | 284 | 686 | 970 |
| Total interest income | 10,770 | 3,517 | 14,287 | (2,498) | 11,789 |
| **INTEREST EXPENSE** | | | | | |
| Interest on deposits | 3,665 | 1,156 | 4,821 | (1,193) | 3,628 |
| Interest on borrowings | 2,019 | 528 | 2,547 | 271 | 2,818 |
| Total interest expense | 5,684 | 1,684 | 7,368 | (922) | 6,446 |
| Net interest income | 5,086 | 1,833 | 6,919 | (1,576) | 5,343 |
| Provision for loan losses | 1,395 | 629 | 2,024 | (458) | 1,566 |
| Net interest income after provision for loan losses | 3,691 | 1,204 | 4,895 | (1,118) | 3,777 |
| **FEE AND OTHER INCOME** | | | | | |
| Service charges and fees | 1,040 | 367 | 1,407 | 88 | 1,495 |
| Commissions | 518 | 80 | 598 | 522 | 1,120 |
| Fiduciary and asset management fees | 408 | 164 | 572 | 593 | 1,165 |
| Principal investing | (260) | (4) | (264) | (422) | (686) |
| Other income | 1,382 | 872 | 2,254 | (1,112) | 1,142 |
| Total fee and other income | 3,088 | 1,479 | 4,567 | (331) | 4,236 |
| **NONINTEREST EXPENSE** | | | | | |
| Salaries and employee benefits | 2,354 | 848 | 3,202 | 945 | 4,147 |
| Occupancy and equipment | 847 | 238 | 1,085 | 67 | 1,152 |
| Goodwill and other intangible amortization | 181 | 100 | 281 | (9) | 272 |
| Sundry expense | 1,815 | 829 | 2,644 | (1,414) | 1,230 |
| Total noninterest expense | 5,197 | 2,015 | 7,212 | (411) | 6,801 |

| | | | | | |
|---|---|---|---|---|---|
| Income before income taxes | 1,582 | 668 | 2,250 | (1,038) | 1,212 |
| Income taxes | 588 | 235 | 823 | (494) | 329 |
| Net income | $ 994 | 433 | 1,427 | (544) | 883 |

(a) "FUNB" refers to First Union National Bank, "WBNA" refers to the former Wachovia Bank, National Association.

Table of Contents

**WACHOVIA CORPORATION AND SUBSIDIARIES**

**Supplementary Consolidating Statement of Income**

| | Year Ended December 31, 2001 | | | | |
|---|---|---|---|---|---|
| (In millions) | FUNB(a) | WBNA(a) | Combined | Other Subsidiaries and Eliminations | Wachovia Consolidated |
| **INTEREST INCOME** | | | | | |
| Interest and fees on loans | $ 9,856 | 3,905 | 13,761 | (3,224) | 10,537 |
| Interest and dividends on securities | 3,254 | 450 | 3,704 | (170) | 3,534 |
| Trading account interest | 505 | 3 | 508 | 252 | 760 |
| Other interest income | 311 | 43 | 354 | 915 | 1,269 |
| Total interest income | 13,926 | 4,401 | 18,327 | (2,227) | 16,100 |
| **INTEREST EXPENSE** | | | | | |
| Interest on deposits | 4,600 | 1,361 | 5,961 | (1,217) | 4,744 |
| Interest on borrowings | 2,461 | 616 | 3,077 | 504 | 3,581 |
| Total interest expense | 7,061 | 1,977 | 9,038 | (713) | 8,325 |
| Net interest income | 6,865 | 2,424 | 9,289 | (1,514) | 7,775 |
| Provision for loan losses | 1,767 | 638 | 2,405 | (458) | 1,947 |
| Net interest income after provision for loan losses | 5,098 | 1,786 | 6,884 | (1,056) | 5,828 |
| **FEE AND OTHER INCOME** | | | | | |
| Service charges and fees | 1,476 | 495 | 1,971 | 196 | 2,167 |
| Commissions | 577 | 142 | 719 | 849 | 1,568 |
| Fiduciary and asset management fees | 564 | 213 | 777 | 866 | 1,643 |
| Principal investing | (351) | (4) | (355) | (352) | (707) |
| Other income | 1,872 | 967 | 2,839 | (1,214) | 1,625 |
| Total fee and other income | 4,138 | 1,813 | 5,951 | 345 | 6,296 |
| **NONINTEREST EXPENSE** | | | | | |
| Salaries and employee benefits | 3,146 | 1,098 | 4,244 | 1,566 | 5,810 |
| Occupancy and equipment | 1,123 | 303 | 1,426 | 183 | 1,609 |
| Goodwill and other intangible amortization | 240 | 272 | 512 | 11 | 523 |
| Sundry expense | 2,528 | 929 | 3,457 | (1,568) | 1,889 |
| Total noninterest expense | 7,037 | 2,602 | 9,639 | 192 | 9,831 |

| | | | | | |
|---|---|---|---|---|---|
| Income before income taxes | 2,199 | 997 | 3,196 | (903) | 2,293 |
| Income taxes | 564 | 350 | 914 | (240) | 674 |
| Net income | 1,635 | 647 | 2,282 | (663) | 1,619 |
| Dividends on preferred stock | | | | 6 | 6 |
| Net income available to common stockholders | $ 1,635 | 647 | 2,282 | (669) | 1,613 |

(a) "FUNB" refers to First Union National Bank, "WBNA" refers to the former Wachovia Bank, National Association.

See accompanying Independent Auditors Report on Supplementary Consolidating Financial Information.

Table of Contents

**WACHOVIA CORPORATION AND SUBSIDIARIES**

**Supplementary Consolidating Statement of Income**

| (In millions) | FUNB(a) | Other Subsidiaries and Eliminations | Wachovia Consolidated |
|---|---|---|---|
| | Year Ended December 31, 2000 | | |
| **INTEREST INCOME** | | | |
| Interest and fees on loans | $ 11,840 | (594) | 11,246 |
| Interest and dividends on securities | 3,784 | 119 | 3,903 |
| Trading account interest | 417 | 403 | 820 |
| Other interest income | 225 | 1,340 | 1,565 |
| Total interest income | 16,266 | 1,268 | 17,534 |
| **INTEREST EXPENSE** | | | |
| Interest on deposits | 5,471 | (202) | 5,269 |
| Interest on borrowings | 3,357 | 1,471 | 4,828 |
| Total interest expense | 8,828 | 1,269 | 10,097 |
| Net interest income | 7,438 | (1) | 7,437 |
| Provision for loan losses | 1,057 | 679 | 1,736 |
| Net interest income after provision for loan losses | 6,381 | (680) | 5,701 |
| **FEE AND OTHER INCOME** | | | |
| Service charges and fees | 1,290 | 630 | 1,920 |
| Fiduciary and asset management fees | 1,017 | 494 | 1,511 |
| Other income | 1,620 | 1,661 | 3,281 |
| Total fee and other income | 3,927 | 2,785 | 6,712 |
| **NONINTEREST EXPENSE** | | | |
| Salaries and employee benefits | 3,132 | 2,527 | 5,659 |
| Occupancy and equipment | 1,130 | 362 | 1,492 |
| Sundry expense | 5,559 | (1,000) | 4,559 |
| Total noninterest expense | 9,821 | 1,889 | 11,710 |
| Income before income taxes and cumulative effect of a change in accounting principle | 487 | 216 | 703 |
| Income taxes | 428 | 137 | 565 |
| Income before cumulative effect of a change in accounting principle | 59 | 79 | 138 |

| | | | |
|---|---|---|---|
| Cumulative effect of a change in the accounting for beneficial interests, net of income taxes | (46) | | (46) |
| Net income | $ 13 | 79 | 92 |

(a) "FUNB" refers to First Union National Bank.

See accompanying Independent Auditors Report on Supplementary Consolidating Financial Information.

Table of Contents

**WACHOVIA CORPORATION AND SUBSIDIARIES**

**Supplementary Consolidating Statement of Changes in Stockholders Equity**

**(Unaudited)**

| | Nine Months Ended September 30, 2002 | | |
|---|---|---|---|
| **(In millions)** | **The Bank** | **Other Subsidiaries and Eliminations** | **Wachovia Consolidated** |
| **PREFERRED STOCK** | | | |
| Balance, December 31, 2001 | $ 161 | (144) | 17 |
| Changes incident to business combinations | (161) | 161 | |
| Cash dividends | | (15) | (15) |
| Balance, September 30, 2002 | | 2 | 2 |
| **COMMON STOCK** | | | |
| Balance, December 31, 2001 | 455 | 4,084 | 4,539 |
| Common stock issued for Stock options and restricted stock | | 33 | 33 |
| Acquisitions | | 5 | 5 |
| Balance, September 30, 2002 | 455 | 4,122 | 4,577 |
| **PAID-IN CAPITAL** | | | |
| Balance, December 31, 2001 | 13,302 | 4,609 | 17,911 |
| Common stock issued for Stock options and restricted stock | | 199 | 199 |
| Acquisitions | 11,628 | (11,582) | 46 |
| Deferred compensation, net | | 77 | 77 |
| Balance, September 30, 2002 | 24,930 | (6,697) | 18,233 |
| **RETAINED EARNINGS** | | | |

| | | | |
|---|---|---|---|
| Balance, December 31, 2001 | 1,847 | 3,704 | 5,551 |

| | Common Stock Shares Issued | Common Stock Amount | Additional Paid-In Capital | Retained Earnings | Accumulated Other Comprehensive Income (loss) | Treasury Stock | Stockholders Equity Attributable to Lannett Co., Inc. | Noncontrolling Interest | Total Stockholders Equity |
|---|---|---|---|---|---|---|---|---|---|
| **Balance, June 30, 2014** | 36,088 | $ 36 | $ 216,793 | $ 83,654 | $ (54) | $ (5,959) | $ 294,470 | $ 295 | $ 294,765 |
| Shares issued in connection with share-based compensation plans | 695 | 1 | 4,937 | | | | 4,938 | | 4,938 |
| Share-based compensation | | | 6,397 | | | | 6,397 | | 6,397 |
| Excess tax benefits on share-based compensation awards | | | 8,051 | | | | 8,051 | | 8,051 |
| Purchase of treasury stock | | | | | | (121) | (121) | | (121) |
| Distribution to noncontrolling interests | | | | | | | | (15) | (15) |
| Other comprehensive income (loss), net of income tax | | | | | (241) | | (241) | | (241) |
| Net income | | | | 149,919 | | | 149,919 | 73 | 149,992 |
| **Balance, June 30, 2015** | 36,783 | $ 37 | $ 236,178 | $ 233,573 | $ (295) | $ (6,080) | $ 463,413 | $ 353 | $ 463,766 |
| Shares issued in connection with share-based compensation plans | 367 | | 4,134 | | | | 4,134 | | 4,134 |
| Share-based compensation | | | 11,562 | | | | 11,562 | | 11,562 |
| Excess tax benefits on share-based compensation awards | | | 1,507 | | | | 1,507 | | 1,507 |
| Purchase of treasury stock | | | | | | (1,269) | (1,269) | | (1,269) |
| Issuance of warrant | | | 29,920 | | | | 29,920 | | 29,920 |
| Distribution to noncontrolling interests | | | | | | | | (20) | (20) |
| Net income | | | | 44,782 | | | 44,782 | 75 | 44,857 |
| **Balance, June 30, 2016** | 37,150 | $ 37 | $ 283,301 | $ 278,355 | $ (295) | $ (7,349) | $ 554,049 | $ 408 | $ 554,457 |
| Shares issued in connection with share-based compensation plans | **378** | | **2,818** | | | | **2,818** | | **2,818** |
| Share-based compensation | | | **7,719** | | | | **7,719** | | **7,719** |
| Purchase of noncontrolling interest | | | **(1,058)** | | | | **(1,058)** | **(442)** | **(1,500)** |
| Purchase of treasury stock | | | | | | **(1,898)** | **(1,898)** | | **(1,898)** |
| Other comprehensive income, net of income tax | | | | | **73** | | **73** | | **73** |
| Net income (loss) | | | | **(581)** | | | **(581)** | **34** | **(547)** |
| **Balance, June 30, 2017** | **37,528** | **$ 37** | **$ 292,780** | **$ 277,774** | **$ (222)** | **$ (9,247)** | **$ 561,122** | **$** | **$ 561,122** |

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

Table of Contents

**LANNETT COMPANY, INC.**

**CONSOLIDATED STATEMENTS OF CASH FLOWS**

(In thousands)

| | Fiscal Year Ended June 30, 2017 | 2016 | 2015 |
|---|---|---|---|
| **OPERATING ACTIVITIES:** | | | |
| **Net income (loss)** | **$ (547)** | $ 44,857 | $ 149,992 |
| **Adjustments to reconcile net income to net cash provided by operating activities:** | | | |
| Depreciation and amortization | **55,340** | 33,433 | 5,583 |
| Deferred income tax benefit | **(305)** | (19,497) | (3,266) |
| Share-based compensation | **7,719** | 11,562 | 6,397 |
| Excess tax benefits on share-based compensation awards | | (1,507) | (8,051) |
| Intangible assets impairment charges | **88,084** | 8,000 | |
| Loss (gain) on sale of assets | **290** | 92 | (33) |
| Loss (gain) on investment securities | **(2,914)** | 11 | (705) |
| Loss on extinguishment of debt | | 3,009 | |
| Amortization of debt discount and other debt issuance costs | **20,577** | 12,484 | 110 |
| Other noncash expenses | **1,889** | 523 | |
| **Changes in assets and liabilities which provided (used) cash; net of acquisitions:** | | | |
| Accounts receivable, net | **1,701** | 15,149 | (25,382) |
| Inventories | **(7,700)** | 15,296 | 1,358 |
| Prepaid income taxes/Income taxes payable | **(17,748)** | 1,717 | 5,127 |
| Other current assets and other assets | **1,916** | 7,719 | (1,673) |
| Rebates payable | **14,369** | 4,525 | 2,995 |
| Royalties payable | **(2,112)** | 1,524 | |
| Restructuring liability | **1,301** | 4,130 | |
| Settlement liability | **1,000** | 18,598 | |
| Accounts payable | **5,000** | (3,723) | (2,498) |
| Accrued expenses | **3,252** | (1,760) | 1,027 |
| Accrued payroll and payroll-related expenses | **(5,739)** | (20,865) | (2,463) |
| Net cash provided by operating activities | **165,373** | 135,277 | 128,518 |
| **INVESTING ACTIVITIES:** | | | |
| Purchases of property, plant and equipment | **(48,694)** | (24,267) | (31,676) |
| Proceeds from sale of property, plant and equipment | **112** | 16 | 94 |
| Purchases of intangible assets | | | (300) |
| Acquisitions, net of cash acquired | | (934,178) | (41,862) |
| Proceeds from sale of investment securities | **67,828** | 39,895 | 75,770 |
| Purchase of investment securities | **(77,911)** | (40,533) | (47,839) |
| Net cash used in investing activities | **(58,665)** | (959,067) | (45,813) |
| **FINANCING ACTIVITIES:** | | | |
| Proceeds from issuance of debt | | 1,048,610 | |
| Short-term borrowings under revolving credit facility | | 125,000 | |
| Repayments of short-term borrowings and long-term debt | **(178,233)** | (295,033) | (129) |
| Purchase of noncontrolling interest | **(1,500)** | | |
| Acquisition-related contingent consideration | **(35,000)** | | |
| Proceeds from issuance of stock | **2,818** | 4,134 | 4,938 |
| Payment of debt issuance costs | | (34,710) | (435) |
| Excess tax benefits on share-based compensation awards | | 1,507 | 8,051 |
| Purchase of treasury stock | **(1,898)** | (1,269) | (121) |

| | | | | | | |
|---|---|---|---|---|---|---|
| Distributions to noncontrolling shareholders | | | | (20) | | (15) |
| Net cash provided by (used in) financing activities | | **(213,813)** | | 848,219 | | 12,289 |
| Effect on cash and cash equivalents of changes in foreign exchange rates | | **73** | | | | (241) |
| **NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS** | | **(107,032)** | | 24,429 | | 94,753 |
| **CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD** | | **224,769** | | 200,340 | | 105,587 |
| **CASH AND CASH EQUIVALENTS, END OF PERIOD** | **$** | **117,737** | $ | 224,769 | $ | 200,340 |
| **SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:** | | | | | | |
| Interest paid (net of amounts capitalized) | **$** | **67,115** | $ | 52,916 | $ | 206 |
| Income taxes paid, net | **$** | **19,150** | $ | 35,141 | $ | 75,569 |
| Credits issued pursuant to Settlement Agreement | **$** | **5,000** | $ | | $ | |
| Issuance of unsecured 12.0% Senior Notes to finance KUPI acquisition | **$** | | $ | 200,000 | $ | |
| Issuance of a warrant to finance KUPI acquisition | **$** | | $ | 29,920 | $ | |
| Acquisition-related contingent consideration | **$** | | $ | 35,000 | $ | |

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

Table of Contents

**LANNETT COMPANY, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

## Note 1. The Business And Nature of Operations

Lannett Company, Inc. (a Delaware corporation) and its subsidiaries (collectively, the Company or Lannett ) develop, manufacture, package, market and distribute solid oral and extended release (tablets and capsules), topical, nasal and oral solution finished dosage forms of drugs, that address a wide range of therapeutic areas. Certain of these products are manufactured by others and distributed by the Company, most notably under the Jerome Stevens Distribution Agreement. The Company also manufactures active pharmaceutical ingredients through its Cody Laboratories, Inc. ( Cody Labs ) subsidiary, providing a vertical integration benefit.

On November 25, 2015, the Company completed the acquisition of Kremers Urban Pharmaceuticals, Inc. ( KUPI ), the former U.S. specialty generic pharmaceuticals subsidiary of global biopharmaceuticals company UCB S.A ( UCB ). KUPI is a specialty pharmaceuticals manufacturer focused on the development of products that are difficult to formulate or utilize specialized delivery technologies. Strategic benefits of the acquisition include expanded manufacturing capacity, a diversified product portfolio and pipeline and complementary research and development expertise.

The Company operates pharmaceutical manufacturing plants in Philadelphia, Pennsylvania; Cody, Wyoming; Carmel, New York and Seymour, Indiana. The Company s customers include generic pharmaceutical distributors, drug wholesalers, chain drug stores, private label distributors, mail-order pharmacies, other pharmaceutical manufacturers, managed care organizations, hospital buying groups, governmental entities and health maintenance organizations.

## Note 2. Summary of Significant Accounting Policies

***Basis of Presentation***

The Consolidated Financial Statements have been prepared in conformity with generally accepted accounting principles in the United States. ( U.S. GAAP )

***Principles of consolidation***

The Consolidated Financial Statements include the accounts of Lannett Company, Inc. and its wholly-owned subsidiaries, as well as Cody LCI Realty, LLC ( Realty ), a variable interest entity ( VIE ) in which the Company had a 50% ownership interest until November 30, 2016, when the

Company acquired the remaining 50% interest. Noncontrolling interest in Realty was recorded net of tax as net income attributable to the noncontrolling interest. Additionally, all intercompany accounts and transactions have been eliminated.

***Business Combinations***

Acquired businesses are accounted for using the acquisition method of accounting, which requires that the assets acquired and liabilities assumed be recorded at the date of acquisition at their respective estimated fair values. The fair values and useful lives assigned to each class of assets acquired and liabilities assumed are based on, among other factors, the expected future period of benefit of the asset, the various characteristics of the asset and projected future cash flows. Significant judgment is employed in determining the assumptions utilized as of the acquisition date and for each subsequent measurement period. Accordingly, changes in assumptions described above, could have a material impact on our consolidated results of operations.

***Reclassifications***

Certain prior year amounts have been reclassified to conform to the current year financial statement presentation.

***Use of estimates***

The preparation of financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Significant estimates and assumptions are required in the determination of revenue recognition and sales deductions for estimated chargebacks, rebates, returns and other adjustments including a provision for the Company s liability under the Medicare Part D program. Additionally, significant estimates and assumptions are required when determining the fair value of long-lived assets, including goodwill and intangible assets, income taxes, contingencies, share-based compensation and contingent consideration.

Table of Contents

Because of the inherent subjectivity and complexity involved in these estimates and assumptions, actual results could differ from those estimates.

***Foreign currency translation***

The Consolidated Financial Statements are presented in U.S. Dollars, the reporting currency of the Company. The financial statements of the Company s foreign subsidiary are maintained in local currency and translated into U.S. dollars at the end of each reporting period. Assets and liabilities are translated at period-end exchange rates, while revenues and expenses are translated at average exchange rates during the period. The adjustments resulting from the use of differing exchange rates are recorded as part of stockholders equity in accumulated other comprehensive income (loss). Gains and losses resulting from transactions denominated in foreign currencies are recognized in the Consolidated Statements of Operations under Other income (loss). Amounts recorded due to foreign currency fluctuations are immaterial to the Consolidated Financial Statements.

***Cash and cash equivalents***

The Company considers all highly liquid investments with original maturities less than or equal to three months at the date of purchase to be cash and cash equivalents. Cash and cash equivalents are stated at cost, which approximates fair value, and consist of bank deposits and certificates of deposit that are readily convertible into cash. The Company maintains its cash deposits and cash equivalents at well-known, stable financial institutions. Such amounts frequently exceed insured limits.

***Investment securities***

The Company s investment securities consist of publicly-traded equity securities which are classified as trading investments. Investment securities are recorded at fair value based on quoted market prices from broker or dealer quotations or transparent pricing sources at each reporting date. Realized and unrealized gains and losses are included in the Consolidated Statements of Operations under Other income (loss).

***Allowance for doubtful accounts***

The Company continuously monitors collections and payments from its customers and maintains a provision for estimated credit losses. The Company determines its allowance for doubtful accounts by considering a number of factors, including the length of time balances are past due, the Company s previous loss history, the customer s current ability to pay its obligations to the Company and the condition of the general economy and the industry as a whole. The Company writes off accounts receivable when they are determined to be uncollectible.

***Inventories***

Inventories are stated at the lower of cost and net realizable value by the first-in, first-out method. Inventories are regularly reviewed and provisions for excess and obsolete inventory are recorded based primarily on current inventory levels and estimated sales forecasts.

***Property, Plant and Equipment***

Property, plant and equipment are stated at cost less accumulated depreciation. Depreciation is computed on a straight-line basis over the assets estimated useful lives.

***Intangible Assets***

Definite-lived intangible assets are stated at cost less accumulated amortization. Amortization of definite-lived intangible assets is computed on a straight-line basis over the assets estimated useful lives, generally for periods ranging from 10 to 15 years. The Company continually evaluates the reasonableness of the useful lives of these assets. Indefinite-lived intangible assets are not amortized, but instead are tested at least annually for impairment. Costs to renew or extend the term of a recognized intangible asset are expensed as incurred.

***Valuation of Long-Lived Assets, including Intangible Assets***

The Company s long-lived assets primarily consist of property, plant and equipment and definite and indefinite-lived intangible assets. Property, plant and equipment and definite-lived intangible assets are reviewed for impairment whenever events or changes in circumstances ( triggering events ) indicate that the carrying amount of the asset may not be recoverable. If a triggering event is determined to have occurred, the asset s carrying value is compared to the future undiscounted cash flows expected to be generated by the asset. If the carrying value exceeds the undiscounted cash flow of the asset, then impairment exists. Indefinite-lived intangible assets are tested for impairment at least annually during the fourth quarter of each fiscal year or more frequently if events or changes in circumstances indicate that the asset might be impaired.

Table of Contents

An impairment loss is measured as the excess of the asset s carrying value over its fair value, which in most cases is calculated using a discounted cash flow model. Discounted cash flow models are highly reliant on various assumptions which are considered Level 3 inputs, including estimates of future cash flows (including long-term growth rates), discount rates and the probability of achieving the estimated cash flows.

***In-Process Research and Development***

Amounts allocated to in-process research and development ( IPR&D ) in connection with a business combination are recorded at fair value and are considered indefinite-lived intangible assets subject to impairment testing in accordance with the Company s impairment testing policy for indefinite-lived intangible assets. As products in development are approved for sale, amounts will be allocated to product rights and will be amortized over their estimated useful lives. Definite-lived intangible assets are amortized over the expected life of the asset. The judgments made in determining the estimated fair value of in-process research and development, as well as asset lives, can materially impact our results of operations. The Company s fair value assessments are highly reliant on various assumptions which are considered Level 3 inputs, including estimates of future cash flows (including long-term growth rates), discount rates and the probability of achieving the estimated cash flows.

***Goodwill***

Goodwill, which represents the excess of purchase price over the fair value of net assets acquired, is carried at cost. Goodwill is tested for impairment on an annual basis on the first day of the fourth quarter of each fiscal year or more frequently if events or changes in circumstances indicate that the asset might be impaired. The Company first performs a qualitative assessment to determine if the quantitative impairment test is required. If changes in circumstances indicate an asset may be impaired, the Company performs the quantitative impairment test. The Company first determines the fair value of our reporting unit (generic pharmaceuticals). If the net book value of our reporting unit exceeds its fair value, the difference will be recorded as a goodwill impairment, not to exceed the carrying amount of goodwill. The Company s fair value assessments are highly reliant on various assumptions which are considered Level 3 inputs, including estimates of future cash flows (including long-term growth rates), discount rates and the probability of achieving the estimated cash flows. The judgments made in determining the estimated fair value of goodwill can materially impact our results of operations.

***Segment Information***

The Company operates in one reportable segment, generic pharmaceuticals. As such, the Company aggregates its financial information for all products. The following table identifies the Company s net sales by medical indication for fiscal years ended June 30, 2017, 2016 and 2015:

| **(In thousands)** | **Fiscal Year Ended June 30,** | | |
|---|---|---|---|
| **Medical Indication** | **2017** | **2016** | **2015** |
| Antibiotic | $ 16,748 | $ 14,558 | $ 12,306 |
| Anti-Psychosis | 58,625 | 5,462 | 2,260 |
| Cardiovascular | 50,628 | 53,541 | 55,166 |
| Central Nervous System | 39,451 | 36,291 | |
| Gallstone | 48,600 | 67,348 | 65,262 |

| | | | |
|---|---|---|---|
| Gastrointestinal | 71,887 | 52,699 | |
| Glaucoma | 18,763 | 25,336 | 21,145 |
| Migraine | 29,014 | 21,776 | 25,729 |
| Muscle Relaxant | 13,636 | 5,403 | 8,779 |
| Obesity | 3,956 | 3,809 | 4,004 |
| Pain Management | 26,135 | 29,804 | 27,461 |
| Respiratory | 10,516 | 9,982 | |
| Thyroid Deficiency | 174,005 | 162,411 | 153,460 |
| Urinary | 14,695 | 17,398 | 212 |
| Other | 43,240 | 38,230 | 31,053 |
| Contract manufacturing revenue | 17,442 | 22,043 | |
| Net sales | 637,341 | 566,091 | 406,837 |
| Settlement agreement | (4,000) | (23,598) | |
| Total net sales | $ 633,341 | $ 542,493 | $ 406,837 |

105

Table of Contents

***Customer, Supplier and Product Concentration***

The following table presents the percentage of total net sales, for the fiscal years ended June 30, 2017, 2016 and 2015, for certain of the Company s products, defined as products containing the same active ingredient or combination of ingredients, which accounted for at least 10% of total net sales in any of those periods:

| | June 30, 2017 | June 30, 2016 | June 30, 2015 |
|---|---|---|---|
| Product 1 | 27% | 30% | 38% |
| Product 2 | 8% | 12% | 16% |
| Product 3 | 2% | 4% | 12% |

The following table presents the percentage of total net sales, for the fiscal years ended June 30, 2017, 2016 and 2015, for certain of the Company s customers which accounted for at least 10% of total net sales in any of those periods:

| | June 30, 2017 | June 30, 2016 | June 30, 2015 |
|---|---|---|---|
| Customer A | 28% | 25% | 30% |
| Customer B | 21% | 16% | 11% |

The Company s primary finished product inventory supplier is Jerome Stevens Pharmaceuticals, Inc. ( JSP ), in Bohemia, New York. Purchases of finished goods inventory from JSP accounted for 36%, 52% and 68% of the Company s inventory purchases in fiscal years 2017, 2016 and 2015, respectively. See Note 21 Material Contracts with Suppliers for more information.

***Revenue Recognition***

The Company recognizes revenue when title and risk of loss have transferred to the customer and provisions for rebates, promotional adjustments, price adjustments, returns, chargebacks and other potential adjustments are reasonably determinable and collection is reasonably assured. The Company also considers all other relevant criteria specified in Securities and Exchange Commission Staff Accounting Bulletin No. 104, Topic No. 13, *Revenue Recognition* , in determining when to recognize revenue.

***Net Sales Adjustments***

When revenue is recognized a simultaneous adjustment to gross sales is made for chargebacks, rebates, returns, promotional adjustments and other potential adjustments. These provisions are primarily estimated based on historical experience, future expectations, contractual arrangements with wholesalers and indirect customers and other factors known to management at the time of accrual. Accruals for provisions are presented in the Consolidated Financial Statements as a reduction to gross sales with the corresponding reserve presented as a reduction of accounts receivable or included as rebates payable, depending on the nature of the reserve. The reserves, presented as a reduction of accounts receivable, totaled $175.8 million and $176.1 million at June 30, 2017 and 2016, respectively. Rebates payable at June 30, 2017 and 2016 included $44.6 million and $21.9 million, respectively, for certain rebate programs, primarily related to Medicare Part D, Medicaid and certain sales allowances and other adjustments paid to indirect customers.

***Cost of Sales, including Amortization of Intangibles***

Cost of sales includes all costs related to bringing products to their final selling destination, which includes direct and indirect costs, such as direct material, labor and overhead expenses. Additionally, cost of sales includes product royalties, depreciation, amortization and costs to renew or extend recognized intangible assets, freight charges and other shipping and handling expenses.

***Research and Development***

Research and development costs are expensed as incurred, including all production costs until a drug candidate is approved by the Food and Drug Administration ( FDA ). Research and development expenses include costs associated with internal projects as well as costs associated with third-party research and development contracts.

Table of Contents

***Contingencies***

Loss contingencies, including litigation-related contingencies, are included in the Consolidated Statements of Operations when the Company concludes that a loss is both probable and reasonably estimable. Legal fees related to litigation-related matters are expensed as incurred and are included in the Consolidated Statements of Operations under the Selling, general and administrative line item.

***Contingent Consideration***

Contingent consideration resulting from the KUPI acquisition was recorded at its estimated fair value on the acquisition date. The Company agreed to a 50/50 split of the additional tax liabilities UCB will incur associated with the IRS Section 338(H)(10) tax election, up to $35.0 million. These fair value measurements represent Level 3 measurements, as they are based on significant inputs not observable in the market. In the third quarter of Fiscal 2017, the Company paid UCB $35.0 million in connection with the 338(H)(10) election.

***Restructuring Costs***

The Company records charges associated with approved restructuring plans to remove duplicative headcount and infrastructure associated with business acquisitions or to simplify business processes. Restructuring charges can include severance costs to eliminate a specified number of employees, infrastructure charges to vacate facilities and consolidate operations and contract cancellation costs. The Company records restructuring charges based on estimated employee terminations, site closure and consolidation plans. The Company accrues severance and other employee separation costs under these actions when it is probable that a liability exists and the amount is reasonably estimable.

***Share-based Compensation***

Share-based compensation costs are recognized over the vesting period, using a straight-line method, based on the fair value of the instrument on the date of grant less an estimate for expected forfeitures. The Company uses the Black-Scholes valuation model to determine the fair value of stock options and the stock price on the grant date to value restricted stock. The Black-Scholes valuation model includes various assumptions, including the expected volatility, the expected life of the award, dividend yield and the risk-free interest rate. These assumptions involve inherent uncertainties based on market conditions which are generally outside the Company s control. Changes in these assumptions could have a material impact on share-based compensation costs recognized in the financial statements.

***Self-Insurance***

Effective January 1, 2017, the Company self-insures for certain employee medical and prescription benefits. The Company also maintains stop loss coverage with third party insurers to limit our total liability exposure. The liability for self-insured risks is primarily calculated using independent third party actuarial valuations which take into account actual claims, claims growth and claims incurred but not yet reported. Actual experience, including claim frequency and severity as well as health-care inflation, could result in different liabilities than the amounts currently recorded. The liability for self-insured risks under this plan as of June 30, 2017 was not material to the financial position of the Company.

***Income Taxes***

The Company uses the liability method to account for income taxes as prescribed by Accounting Standards Codification ( ASC ) 740, *Income Taxes*. Deferred tax assets and liabilities are determined based on the difference between the financial statement and tax bases of assets and liabilities as measured by the enacted tax rates which will be in effect when these differences reverse. Deferred tax expense (benefit) is the result of changes in deferred tax assets and liabilities. Deferred income tax assets and liabilities are adjusted to recognize the effects of changes in tax laws or enacted tax rates in the period during which they are signed into law. The factors used to assess the likelihood of realization are the Company s forecast of future taxable income and available tax planning strategies that could be implemented to realize the net deferred tax assets. Under ASC 740, *Income Taxes*, a valuation allowance is required when it is more likely than not that all or some portion of the deferred tax assets will not be realized through generating sufficient future taxable income. Failure to achieve forecasted taxable income in applicable tax jurisdictions could affect the ultimate realization of deferred tax assets and could result in an increase in the Company s effective tax rate on future earnings.

The Company may recognize the tax benefit from an uncertain tax position claimed on a tax return only if it is more likely than not that the tax position will be sustained on examination by the taxing authorities, based on the technical merits of the position. The tax benefits recognized in the financial statements from such a position should be measured based on the largest benefit that has a greater than 50% likelihood of being realized upon ultimate settlement.

Table of Contents

The authoritative accounting standards also provide guidance on de-recognition, classification, interest and penalties on income taxes, accounting in interim periods and requires increased disclosures.

***Earnings Per Common Share***

Basic earnings per common share attributable to Lannett Company, Inc. is computed by dividing net income attributable to Lannett Company, Inc. common stockholders by the weighted average number of shares outstanding during the period. Diluted earnings per common share attributable to Lannett Company, Inc. is computed by dividing net income attributable to Lannett Company, Inc. common stockholders by the weighted average number of shares outstanding during the period including additional shares that would have been outstanding related to potentially dilutive securities. These potentially dilutive securities consist of stock options, unvested restricted stock and an outstanding warrant. Anti-dilutive securities are excluded from the calculation. Dilutive shares are also excluded in the calculation in periods of net loss because the effect of including such securities would be anti-dilutive.

***Comprehensive Income (Loss)***

Comprehensive income (loss) includes all changes in equity during a period except those that resulted from investments by or distributions to the Company s stockholders. Other comprehensive income (loss) refers to gains and losses that are included in comprehensive income (loss), but excluded from net income as these amounts are recorded directly as an adjustment to stockholders equity.

***Recent Accounting Pronouncements***

In May 2014, the FASB issued ASU 2014-09, Revenue from Contracts with Customers. The core principle of the guidance is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. The authoritative guidance is effective for annual reporting periods beginning after December 15, 2017. Based on a preliminary review of the contracts representing a substantial portion of our revenues, the Company does not expect the guidance to have a material impact on the timing and recognition of our revenues. The Company is still evaluating the adoption method it will elect upon implementation.

In July 2015, the FASB issued ASU 2015-11, *Inventory Simplifying the Measurement of Inventory*. ASU 2015-11 requires inventory to be subsequently measured using the lower of cost and net realizable value, thereby eliminating the market value approach. Net realizable value is defined as the estimated selling prices in the ordinary course of business, less reasonably predictable costs of completion, disposal and transportation. ASU 2015-11 is effective for reporting periods beginning after December 15, 2016 and is applied prospectively. The adoption of ASU 2015-11 did not result in a material impact on the consolidated financial statements.

In November 2015, the FASB issued ASU 2015-17, *Income Taxes Balance Sheet Classification of Deferred Taxes.* ASU 2015-17 requires all deferred tax assets and liabilities to be classified as noncurrent on the balance sheet. The guidance may be applied either prospectively or retrospectively. ASU 2015-17 is effective for fiscal years and interim periods within those fiscal years beginning after December 15, 2016.

Early adoption is permitted.  The Company does not believe this guidance will have a material impact on the consolidated financial statements.

In February 2016, the FASB issued ASU 2016-02, *Leases.*  ASU 2016-02 requires an entity to recognize right-of-use assets and liabilities on its balance sheet for all leases with terms longer than 12 months.  Lessees and lessors are required to disclose quantitative and qualitative information about leasing arrangements to enable a user of the financial statements to assess the amount, timing and uncertainty of cash flows arising from leases.  ASU 2016-02 is effective for annual reporting periods beginning after December 15, 2018, including interim periods within that reporting period and requires a modified retrospective application, with early adoption permitted.  The Company is currently in the process of assessing the impact this guidance will have on the consolidated financial statements.

In March 2016, the FASB issued ASU 2016-09, *Compensation     Stock Compensation: Improvements to Employee Share-Based Payment Accounting*.  ASU 2016-09 clarifies several aspects of accounting for share-based compensation including the accounting for excess tax benefits and deficiencies, accounting for forfeitures and the classification of excess tax benefits on the cash flow statement.  The Company has elected to early adopt this ASU in the fourth quarter of Fiscal 2017 which did not result in a material impact on the consolidated financial statements.  As a result of our election to early adopt, all excess tax benefits are now reflected in the provision for income taxes rather than paid-in capital.  The Company has also elected to continue to estimate forfeitures related to share-based payment awards at the time of grant.  In addition, the Company has elected to apply the presentation requirements for cash flows related to excess tax benefits prospectively.  As such, all tax-related cash flows resulting from share-based payments in Fiscal 2017 are reflected as operating activities on the statement of cash flows.

Table of Contents

In August 2016, the FASB issued ASU 2016-15, *Statement of Cash Flows Classification of Certain Cash Receipts and Cash Payments.* ASU 2016-15 addresses how certain cash receipts and cash payments are presented and classified in the statement of cash flows. ASU 2016-15 is effective for annual reporting periods, and interim periods therein, beginning after December 15, 2017. The Company is currently in the process of assessing the impact this guidance will have on the consolidated financial statements.

In January 2017, the FASB issued ASU 2017-04, *Intangibles Goodwill and Other Simplifying the Test for Goodwill Impairment.* ASU 2017-04 simplifies the subsequent measurement of goodwill by eliminating Step 2 from the goodwill impairment test which previously required measurement of any goodwill impairment loss by comparing the implied fair value of a reporting unit s goodwill with the carrying amount of that goodwill. Under ASU 2017-04, an entity should perform its annual, or interim, goodwill impairment test by comparing the fair value of a reporting unit with its carrying value and recognize an impairment charge for the amount by which the carrying amount exceeds the reporting unit s fair value; without exceeding the total amount of goodwill allocated to that reporting unit. This guidance is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2019, with early adoption permitted. The Company has elected to early adopt this guidance in the fourth quarter of Fiscal 2017 and will apply it on a prospective basis. The Company does not believe that the adoption will have a material impact on its consolidated financial statements.

## Note 3. Acquisitions

***Kremers Urban Pharmaceuticals Inc.***

On November 25, 2015, the Company completed the acquisition of KUPI, the former U.S. specialty generic pharmaceuticals subsidiary of global biopharmaceuticals company UCB S.A., pursuant to the terms and conditions of a Stock Purchase Agreement. KUPI is a specialty pharmaceuticals manufacturer focused on the development of products that are difficult to formulate or utilize specialized delivery technologies. Strategic benefits of the acquisition include expanded manufacturing capacity, a diversified product portfolio and pipeline and complementary research and development expertise.

Pursuant to the terms of the Stock Purchase Agreement, Lannett purchased 100% of the outstanding equity interests of KUPI for total consideration of approximately $1.2 billion.

The following table summarizes the fair value of total consideration transferred to KUPI shareholders at the acquisition date of November 25, 2015:

| **(In thousands)** | | |
|---|---|---|
| Cash purchase price paid to KUPI shareholders | $ | 1,030,000 |
| Working capital adjustment | | (41,605) |
| Certain amounts reimbursed by UCB | | (37,340) |
| Total cash consideration transferred to KUPI shareholders | | 951,055 |
| 12.0% Senior Notes issued to UCB | | 200,000 |
| Acquisition-related contingent consideration | | 35,000 |
| Warrant issued to UCB | | 29,920 |

| | | |
|---|---|---|
| Total consideration to KUPI shareholders | $ | 1,215,975 |

The Company funded the acquisition and transaction expenses with proceeds from the issuance of the $910.0 million of term loans, $22.8 million borrowings from a revolving credit facility, the issuance of $250.0 million Senior Notes (see Note 11 Long-term Debt ) and cash on hand of $94.6 million. Lannett also issued a warrant with an estimated fair value of $29.9 million.

As part of the acquisition, the Company and UCB agreed to jointly make an election under Section 338(h)(10) of the Internal Revenue Code of 1986, as amended and under the corresponding provisions of state law, to treat the acquisition as a deemed purchase and sale of assets for income tax purposes. The Company agreed to reimburse UCB for 50% of the incremental tax cost of making such election, subject to a reimbursement cap of $35.0 million. This liability was recorded as acquisition-related contingent consideration on the Consolidated Balance Sheet. In the third quarter of Fiscal 2017, the Company paid UCB $35.0 million in connection with this election.

The Company also agreed to contingent payments related to Methylphenidate Hydrochloride Extended Release tablets ( Methylphenidate ER ) provided the FDA reinstates the AB-rating for such product and certain sales thresholds are met. On October 18, 2016, the Company received notice from the FDA that it will seek to withdraw approval of the Company s ANDA for Methylphenidate ER. See Note 10 Goodwill and Intangible Assets for more information.

Table of Contents

The Company used the acquisition method of accounting to account for this transaction. Under the acquisition method of accounting, the assets acquired and liabilities assumed in the transaction were recorded at the date of acquisition at their respective fair values.

The purchase price has been allocated to the assets acquired and liabilities assumed for the KUPI business as follows:

| (In thousands) | | Purchase Price Allocation |
|---|---|---|
| Cash and cash equivalents | $ | 16,877 |
| Accounts receivable, net of revenue-related reserves | | 129,408 |
| Inventories | | 84,009 |
| Other current assets | | 11,238 |
| Property, plant and equipment | | 111,849 |
| Product rights | | 427,000 |
| Trade name | | 2,920 |
| Other intangible assets | | 19,000 |
| In-process research and development | | 125,000 |
| Goodwill | | 339,425 |
| Deferred tax assets | | 4,186 |
| Other assets | | 10,218 |
| Total assets acquired | | 1,281,130 |
| Accounts payable | | (19,249) |
| Accrued expenses | | (6,079) |
| Accrued payroll and payroll-related expenses | | (21,040) |
| Rebates payable | | (9,816) |
| Royalties payable | | (3,602) |
| Other liabilities | | (5,369) |
| Total net assets acquired | $ | 1,215,975 |

In the first quarter of Fiscal 2017, the Company recorded a $6.0 million measurement-period adjustment to the Returns reserve related to the KUPI acquisition.

Included in the purchase price allocation above are indemnification assets totaling approximately $20.7 million, of which $10.4 million relates to compensation-related payments, $4.9 million relates to unrecognized tax benefits and $5.4 million for chargeback and rebate-related items. The inventory balance above includes $19.1 million to reflect fair value step-up adjustments. KUPI s intangible assets primarily consist of product rights and in-process research and development. See Note 10 Goodwill and Intangible Assets.

Amounts allocated to acquired in-process research and development represent the fair value of purchased in-process technology for research projects that, as of the closing date of the acquisition, had not yet reached technological feasibility and had no alternative future use. The fair value of in-process research and development was based on the excess earnings method, which utilizes forecasts of expected cash inflows (including estimates for ongoing costs) and other contributory charges, on a project-by-project basis at the appropriate discount rate for the inherent risk in each project and will be tested for impairment in accordance with the Company s policy for testing indefinite-lived intangible assets.

Goodwill of $339.4 million arising from the acquisition consists primarily of the value of the employee workforce and the value of products to be developed in the future. The goodwill was assigned to the Company s only reporting unit. Goodwill recognized is expected to be fully deductible for income tax purposes.

Table of Contents

*Unaudited Pro Forma Financial Results*

The following supplemental unaudited pro forma information presents the financial results as if the acquisition of KUPI had occurred on July 1, 2014 for the fiscal years ended June 30, 2016 and 2015. This supplemental pro forma information has been prepared for comparative purposes and does not purport to be indicative of what would have occurred had the acquisition been made on July 1, 2014, nor are they indicative of any future results:

| | For the fiscal year ended June 30, | | | |
|---|---|---|---|---|
| **(In thousands, except per share data)** | | **2016** | | **2015** |
| Total net sales | $ | 689,754 | $ | 809,379 |
| Net income attributable to Lannett Company, Inc. | | 61,916 | | 116,119 |
| Earnings per common share attributable to Lannett Company, Inc.: | | | | |
| Basic | $ | 1.70 | $ | 3.24 |
| Diluted | $ | 1.66 | $ | 3.13 |

The supplemental pro forma earnings for the fiscal year ended June 30, 2016 were adjusted to exclude $28.9 million of acquisition-related costs, of which $21.5 million was incurred by Lannett and $7.4 million was incurred by KUPI and $17.0 million of expense related to the amortization of fair value adjustments to acquisition-date inventory.

The supplemental pro forma earnings for the fiscal year ended June 30, 2015 were adjusted to include $28.9 million of acquisition-related costs, of which $21.5 million was incurred by Lannett and $7.4 million was incurred by KUPI, as well as $18.9 million of expense related to the amortization of fair value step-up adjustments to acquisition-date inventory.

***Silarx***

On June 1, 2015, the Company completed the acquisition of Silarx Pharmaceuticals, Inc., a New York corporation and Stoneleigh Realty, LLC, a New York limited liability company (together Silarx ), pursuant to the terms and conditions of a Stock Purchase Agreement. Silarx manufactures and markets high-quality liquid pharmaceutical products, including generic prescription and over-the-counter products. Silarx operates within a manufacturing facility located in Carmel, New York. Strategic benefits of the acquisition include an FDA-approved manufacturing facility, research and development expertise and added diversity to Lannett s portfolio of existing and pipeline products.

Pursuant to the terms of the Stock Purchase Agreement, Lannett purchased 100% of the outstanding equity interests of Silarx for cash consideration totaling $42.5 million. The Company used the acquisition method of accounting to account for this transaction. Under the acquisition method of accounting, the assets acquired and liabilities assumed in the transaction were recorded at the date of acquisition at their respective fair values using assumptions that were subject to change.

The purchase price has been allocated to the assets acquired and liabilities assumed for the Silarx business as follows:

| **(In thousands)** | | |
|---|---|---|
| Cash | $ | 664 |
| Accounts receivable, net of revenue-related reserves | | 4,396 |
| Inventories | | 2,705 |
| Other current assets | | 467 |
| Property, plant and equipment | | 7,247 |
| Product rights | | 10,000 |
| In-process research and development | | 18,000 |
| Goodwill | | 141 |
| Other current assets | | 9 |
| Total assets acquired | | 43,629 |
| Accounts payable | | (711) |
| Income taxes payable | | (392) |
| Total net assets acquired | $ | 42,526 |

Amounts allocated to acquired in-process research and development represent an estimate of the fair value of purchased in-process technology for research projects that, as of the closing date of the acquisition, had not yet reached technological feasibility and had no alternative future use. The fair value of in-process research and development was based on the excess earnings method, which utilizes forecasts of expected cash inflows (including estimates for ongoing costs) and other contributory charges, on a project-by-project basis at the appropriate discount rate for the inherent risk in each project and will be tested for impairment in accordance with the Company s policy for testing indefinite-lived intangible assets.

Table of Contents

Product rights totaling $10.0 million are comprised of currently marketed products that have an estimated useful life of 15 years. The goodwill of $141 thousand arising from the acquisition consists primarily of the value of the employee workforce and the value of products to be developed in the future. The goodwill was assigned to the Company s only reporting unit. Goodwill recognized is expected to be fully deductible for income tax purposes.

## Note 4. Restructuring Charges

***2016 Restructuring Program***

On February 1, 2016, in connection with the acquisition of KUPI, the Company announced a plan related to the future integration of KUPI and the Company s operations. The plan focuses on the closure of KUPI s corporate functions and the consolidation of manufacturing, sales, research and development and distribution functions. The Company estimates that it will incur an aggregate of up to approximately $21.0 million in restructuring charges for actions that have been announced or communicated since the 2016 Restructuring Program began. Of this amount, approximately $12.0 million relates to employee separation costs, approximately $1.0 million relates to contract termination costs and approximately $8.0 million relates to facility closure costs and other actions. The 2016 Restructuring Program is expected to be completed by the end of Fiscal 2019. The expenses associated with the restructuring program included in restructuring expenses during the twelve months ended June 30, 2017 and 2016 were as follows:

| (In thousands) | Twelve Months Ended June 30, 2017 | Twelve Months Ended June 30, 2016 |
|---|---|---|
| Employee separation costs | $ 3,486 | $ 5,789 |
| Contract termination costs | | 701 |
| Facility closure costs | 3,682 | 676 |
| Total | $ 7,168 | $ 7,166 |

A reconciliation of the changes in restructuring liabilities associated with the 2016 Restructuring Program from June 30, 2015 through June 30, 2017 is set forth in the following table:

| (In thousands) | Employee Separation Costs | Contract Termination Costs | Facility Closure Costs | Total |
|---|---|---|---|---|
| Balance at June 30, 2015 | $ | $ | $ | $ |
| Restructuring Charges | 5,789 | 701 | 676 | 7,166 |
| Payments | (1,956) | (404) | (676) | (3,036) |
| Balance at June 30, 2016 | 3,833 | 297 | | 4,130 |
| Restructuring Charges | 3,486 | | 3,682 | 7,168 |
| Payments | (1,888) | (297) | (3,682) | (5,867) |
| Balance at June 30, 2017 | $ 5,431 | $ | $ | $ 5,431 |

## Note 5. Accounts Receivable

Accounts receivable consisted of the following components at June 30, 2017 and 2016:

| (In thousands) | June 30, 2017 | June 30, 2016 |
|---|---|---|
| Gross accounts receivable | $ 380,653 | $ 388,460 |
| Less Chargebacks reserve | (79,537) | (86,495) |
| Less Rebates reserve | (43,023) | (32,189) |
| Less Returns reserve | (42,135) | (40,593) |
| Less Other deductions | (11,096) | (16,851) |
| Less Allowance for doubtful accounts | (796) | (610) |
| Accounts receivable, net | $ 204,066 | $ 211,722 |

Table of Contents

For the fiscal year ended June 30, 2017, the Company recorded a provision for chargebacks, rebates, returns and other deductions of $881.3 million, $297.0 million, $25.4 million and $53.4 million, respectively. For the fiscal year ended June 30, 2016, the Company recorded a provision for chargebacks, rebates, returns and other deductions of $646.9 million, $189.2 million, $21.3 million and $50.0 million, respectively. For the fiscal year ended June 30, 2015, the Company recorded a provision for chargebacks, rebates, returns and other deductions of $338.7 million, $83.4 million, $17.7 million and $30.7 million, respectively.

**Note 6. Inventories**

Inventories at June 30, 2017 and 2016 consisted of the following:

| (In thousands) | | June 30, 2017 | | June 30, 2016 |
|---|---|---|---|---|
| Raw Materials | $ | 57,442 | $ | 47,881 |
| Work-in-process | | 15,676 | | 20,207 |
| Finished Goods | | 49,486 | | 46,816 |
| Total | $ | 122,604 | $ | 114,904 |

During the fiscal years ended June 30, 2017, 2016 and 2015, the Company recorded write-downs for excess and obsolete inventory of $10.4 million, $9.4 million and $6.7 million, respectively. Inventories were reduced by $4.5 million and $6.9 million at June 30, 2017 and 2016, respectively for excess and obsolete inventory amounts.

**Note 7. Property, Plant and Equipment**

Property, plant and equipment at June 30, 2017 and 2016 consisted of the following:

| (In thousands) | Useful Lives | | June 30, 2017 | | June 30, 2016 |
|---|---|---|---|---|---|
| Land | | $ | 6,191 | $ | 6,191 |
| Building and improvements | 10 - 39 years | | 108,730 | | 103,496 |
| Machinery and equipment | 5 - 10 years | | 142,086 | | 120,272 |
| Furniture and fixtures | 5 - 7 years | | 2,953 | | 2,904 |
| Less accumulated depreciation | | | (71,461) | | (53,598) |
| | | | 188,499 | | 179,265 |
| Construction in progress | | | 54,649 | | 37,373 |
| Property, plant and equipment, net | | $ | 243,148 | $ | 216,638 |

Depreciation expense for the fiscal years ended June 30, 2017, 2016 and 2015 was $21.8 million, $13.9 million and $5.4 million, respectively.

During the fiscal years ended June 30, 2017, 2016 and 2015, the Company had no impairment charges related to property, plant and equipment. Property, plant and equipment, net included amounts held in foreign countries in the amount of $1.0 million at June 30, 2017 and June 30, 2016.

**Note 8. Fair Value Measurements**

The Company s financial instruments recorded in the Consolidated Balance Sheets include cash and cash equivalents, accounts receivable, investment securities, accounts payable, accrued expenses and debt obligations. Included in cash and cash equivalents are certificates of deposit with maturities less than or equal to three months at the date of purchase and money market funds. The carrying value of certain financial instruments, primarily cash and cash equivalents, accounts receivable, accounts payable and accrued expenses, approximate their estimated fair values based upon the short-term nature of their maturity dates. The carrying amount of the Company s debt obligations approximates fair value based on current interest rates available to the Company on similar debt obligations.

The Company follows the authoritative guidance of ASC Topic 820 Fair Value Measurements and Disclosures. Fair value is defined as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. The authoritative guidance also establishes a fair value hierarchy which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The Company s financial assets and liabilities measured at fair value are entirely within Level 1 of the hierarchy as defined below:

Table of Contents

Level 1 Quoted prices (unadjusted) in active markets for identical assets or liabilities that the reporting entity can access at the measurement date.

Level 2 Directly or indirectly observable inputs, other than quoted prices, such as quoted prices for similar assets or liabilities; quoted prices for identical or similar instruments in markets that are not active; or model-derived valuations whose inputs are observable or whose significant value drivers are observable.

Level 3 Unobservable inputs that are supported by little or no market activity and that are material to the fair value of the asset or liability. Financial instruments whose values are determined using pricing models, discounted cash flow methodologies, or similar techniques, as well as instruments for which the determination of fair value requires significant judgment or estimation are examples of Level 3 assets and liabilities.

If the inputs used to measure the financial assets and liabilities fall within more than one level described above, the categorization is based on the lowest level input that is significant to the fair value measurement of the instrument.

The Company s financial assets and liabilities measured at fair value at June 30, 2017 and June 30, 2016 were as follows:

| | June 30, 2017 | | | |
|---|---|---|---|---|
| **(In thousands)** | **Level 1** | **Level 2** | **Level 3** | **Total** |
| **Assets** | | | | |
| Equity securities | $ 27,091 | $ | $ | $ 27,091 |
| Total Assets | $ 27,091 | $ | $ | $ 27,091 |

| | June 30, 2016 | | | |
|---|---|---|---|---|
| **(In thousands)** | **Level 1** | **Level 2** | **Level 3** | **Total** |
| **Assets** | | | | |
| Equity securities | $ 14,094 | $ | $ | $ 14,094 |
| Total Assets | $ 14,094 | $ | $ | $ 14,094 |
| | | | | |
| **Liabilities** | | | | |
| Acquisition-related contingent consideration | $ | $ | $ 35,000 | $ 35,000 |
| Total Liabilities | $ | $ | $ 35,000 | $ 35,000 |

**Note 9. Investment Securities**

The Company uses the specific identification method to determine the cost of securities sold, which consisted entirely of securities classified as trading.

The Company had a net gain on investment securities of $2.9 million during the fiscal year ended June 30, 2017, which included an unrealized gain related to securities still held at June 30, 2017 of $964 thousand.

The Company had a net loss on investment securities of $11 thousand during the fiscal year ended June 30, 2016, which included an unrealized loss related to securities still held at June 30, 2016 of $51 thousand.

The Company had a net gain on investment securities of $705 thousand during the fiscal year ended June 30, 2015, which included an unrealized loss related to securities still held at June 30, 2015 of $1.1 million.

**Note 10. Goodwill and Intangible Assets**

The changes in the carrying amount of goodwill for the twelve months ended June 30, 2016 and 2017 are as follows:

| **(In thousands)** | | **Generic Pharmaceuticals** |
|---|---|---|
| Balance at June 30, 2015 | $ | 141 |
| Goodwill acquired | | 333,470 |
| Balance at June 30, 2016 | | 333,611 |
| Measurement-period adjustments | | 5,955 |
| Balance at June 30, 2017 | $ | 339,566 |

Table of Contents

Intangible assets, net as of June 30, 2017 and June 30, 2016, consisted of the following:

| (In thousands) | Weighted Avg. Life (Yrs.) | Gross Carrying Amount June 30, 2017 | Gross Carrying Amount June 30, 2016 | Accumulated Amortization June 30, 2017 | Accumulated Amortization June 30, 2016 | Intangible Assets, Net June 30, 2017 | Intangible Assets, Net June 30, 2016 |
|---|---|---|---|---|---|---|---|
| Definite-lived: | | | | | | | |
| Cody Labs import license | 15 | $ 582 | $ 582 | $ (347) | $ (309) | $ 235 | $ 273 |
| KUPI product rights | 15 | 434,000 | 427,000 | (43,286) | (17,119) | 390,714 | 409,881 |
| KUPI trade name | 2 | 2,920 | 2,920 | (2,338) | (878) | 582 | 2,042 |
| KUPI other intangible assets | 15 | 19,000 | 19,000 | (2,028) | (762) | 16,972 | 18,238 |
| Silarx product rights | 15 | 10,000 | 10,000 | (1,389) | (722) | 8,611 | 9,278 |
| Other product rights | 14 | 653 | 653 | (355) | (311) | 298 | 342 |
| Total definite-lived | | $ 467,155 | $ 460,155 | $ (49,743) | $ (20,101) | $ 417,412 | $ 440,054 |
| | | | | | | | |
| Indefinite-lived: | | | | | | | |
| KUPI in-process research and development | | $ 18,000 | $ 117,000 | $ | $ | $ 18,000 | $ 117,000 |
| Silarx in-process research and development | | 18,000 | 18,000 | | | 18,000 | 18,000 |
| Other product rights | | 449 | 449 | | | 449 | 449 |
| Total indefinite-lived | | 36,449 | 135,449 | | | 36,449 | 135,449 |
| Total intangible assets, net | | $ 503,604 | $ 595,604 | $ (49,743) | $ (20,101) | $ 453,861 | $ 575,503 |

For the fiscal years ended June 30, 2017, 2016 and 2015, the Company recorded amortization expense of $33.6 million, $19.5 million and $137 thousand, respectively.

On October 18, 2016, the Company received a notice from the FDA indicating that the FDA will seek to withdraw approval of the Company s Methylphenidate ER ANDA. As a result of the notice, the Company performed an impairment analysis including a review of revised net sales projections for Methylphenidate ER. This analysis resulted in the Company recording a $65.1 million impairment charge in the first quarter of Fiscal 2017.

In the second quarter of Fiscal 2017, the Company abandoned a project within KUPI s in-process research and development portfolio. The value assigned to the project was $23.0 million. Accordingly, the Company recorded a $23.0 million impairment charge in the second quarter.

Future annual amortization expense consists of the following:

| (In thousands) Fiscal Year Ending June 30, | Annual Amortization Expense |
|---|---|
| 2018 | $ 31,530 |
| 2019 | 30,946 |

| | | |
|---|---|---|
| 2020 | | 30,938 |
| 2021 | | 30,938 |
| 2022 | | 30,938 |
| Thereafter | | 262,122 |
| | $ | 417,412 |

**Note 11.  Long-Term Debt**

*Amended Senior Secured Credit Facility*

On November 25, 2015, in connection with its acquisition of KUPI, Lannett entered into a credit and guaranty agreement (the   Credit and Guaranty Agreement  ) among certain of its wholly-owned domestic subsidiaries, as guarantors, Morgan Stanley Senior Funding, Inc., as administrative agent and collateral agent and other lenders providing for a senior secured credit facility (the   Senior Secured Credit Facility  ).  The Senior Secured Credit Facility consisted of a Term Loan A facility in an aggregate principal amount of $275.0 million, a Term Loan B facility in an aggregate principal amount of $635.0 million and a revolving credit facility providing for revolving loans in an aggregate principal amount of up to $125.0 million.  On April 8, 2016, the Company drew down the full $125.0 million Revolving Credit Facility for working capital and other general purposes.

Table of Contents

In the third quarter of Fiscal 2017, the Company made voluntary payments totaling $100.0 million against its outstanding revolving credit facility balance. In the fourth quarter of Fiscal 2017, the Company repaid the remaining $25.0 million revolving credit facility balance. As of June 30, 2017, there was no balance outstanding under the revolving credit facility.

On June 17, 2016, Lannett amended the Senior Secured Credit Facility and the Credit and Guaranty Agreement to raise an incremental term loan in the principal amount of $150.0 million (the Incremental Term Loan ) and amended certain sections of the agreement (the Amended Senior Secured Credit Facility ). The terms of this Incremental Term Loan are substantially the same as those applicable to the Term Loan B facility. The Company used the proceeds of the Incremental Term Loan and cash on hand to repurchase the outstanding $250.0 million aggregate principal amount of Lannett s 12.0% Senior Notes due 2023 (the Senior Notes ) issued in connection with the KUPI acquisition. As a result of the repurchase of the Senior Notes, the Company recorded a $3.0 million loss on extinguishment of debt in the fourth quarter of Fiscal 2016.

The Term Loan A Facility will mature on November 25, 2020. The Term Loan A Facility amortizes in quarterly installments (a) through December 31, 2017 in amounts equal to 1.25% of the original principal amount of the Term Loan A Facility and (b) from January 1, 2018 through September 30, 2020 in amounts equal to 2.50% of the original principal amount of the Term Loan A Facility, with the balance payable on November 25, 2020. The Term Loan B Facility will mature on November 25, 2022. The Term Loan B Facility amortizes in equal quarterly installments in amounts equal to 1.25% of the original principal amount of the Term Loan B Facility with the balance payable on November 25, 2022. Any outstanding Revolving Loans will mature on November 25, 2020.

The Amended Senior Secured Credit Facility is guaranteed by all of Lannett s significant wholly-owned domestic subsidiaries (the Subsidiary Guarantors ) and is collateralized by substantially all present and future assets of Lannett and the Subsidiary Guarantors.

The interest rates applicable to the Amended Term Loan Facility are based on a fluctuating rate of interest of the greater of an adjusted LIBOR and 1.00%, plus a borrowing margin of 4.75% (for Term Loan A Facility) or 5.375% (for Term Loan B Facility). The interest rate applicable to the Revolving Credit Facility is based on a fluctuating rate of interest of an adjusted LIBOR plus a borrowing margin of 4.75%. The interest rate applicable to the unused commitment for the Revolving Credit Facility was initially 0.50%. Beginning March 2016, the interest margins and unused commitment fee on the Revolving Credit Facility are subject to a leveraged based pricing grid.

The Amended Senior Secured Credit Facility contains a number of covenants that, among other things, limit the ability of Lannett and its restricted subsidiaries to: incur more indebtedness; pay dividends; redeem stock or make other distributions of equity; make investments; create restrictions on the ability of Lannett s restricted subsidiaries that are not Subsidiary Guarantors to pay dividends to Lannett or make intercompany transfers; create negative pledges; create liens; transfer or sell assets; merge or consolidate; enter into sale leasebacks; enter into certain transactions with Lannett s affiliates; and prepay or amend the terms of certain indebtedness.

The Amended Senior Secured Credit Facility contains a financial performance covenant that is triggered when the aggregate principal amount of outstanding Revolving Credit Facility and outstanding letters of credit as of the last day of the most recent fiscal quarter is greater than 30% of the aggregate commitments under the Revolving Credit Facility. The covenant provides that Lannett shall not permit its first lien net senior secured leverage ratio as of the last day of any four consecutive fiscal quarters (i) from and after December 31, 2015, to be greater than 4.25:1.00 (ii) from and after December 31, 2017 to be greater than 3.75:1.00 and (iii) from and after December 31, 2019 to be greater than 3.25:1.00.

The Amended Senior Secured Credit Facility also contains a financial performance covenant for the benefit of the Term Loan A Facility lenders which provides that Lannett shall not permit its net senior secured leverage ratio as of the last day of any four consecutive fiscal quarters (i) prior to December 31, 2017, to be greater than 4.25:1.00, (ii) as of December 31, 2017 and prior to December 31, 2019 to be greater than 3.75:1.00 and (iii) as of December 31, 2019 and thereafter to be greater than 3.25:1.00.

The Amended Senior Secured Credit Facility also contains certain affirmative covenants, including financial and other reporting requirements.

In connection with the Senior Secured Credit Facility and the Senior Notes, the Company incurred an initial purchaser s discount of $72.1 million and debt issuance costs of $32.7 million. These costs are recorded as a reduction of long-term debt in the Consolidated Balance Sheet. In connection with the amendment to the Senior Secured Credit Facility and raising the Incremental Term Loan, the Company capitalized $14.0 million of initial purchaser s discount and other fees and expensed $2.2 million of legal and other expenses.

Table of Contents

Long-term debt, net consisted of the following:

| (In thousands) | | June 30, 2017 | | June 30, 2016 |
|---|---|---|---|---|
| Term Loan A due 2020 | | 254,375 | $ | 268,125 |
| Unamortized discount and other debt issuance costs | | (16,238) | | (22,104) |
| Term Loan A, net | | 238,137 | | 246,021 |
| Term Loan B due 2022 | | 727,881 | | 767,226 |
| Unamortized discount and other debt issuance costs | | (63,106) | | (77,273) |
| Term Loan B, net | | 664,775 | | 689,953 |
| Revolving Credit Facility due 2020 | | | | 125,000 |
| Other | | 735 | | 874 |
| Total debt, net | | 903,647 | | 1,061,848 |
| Less short-term borrowings and current portion of long-term debt | | (60,117) | | (178,236) |
| Total long-term debt, net | $ | 843,530 | $ | 883,612 |

Long-term debt amounts due, for the twelve month periods ending June 30 were as follows:

| (In thousands) | | Amounts Payable to Institutions |
|---|---|---|
| 2018 | $ | 60,117 |
| 2019 | | 66,999 |
| 2020 | | 67,006 |
| 2021 | | 218,263 |
| 2022 | | 39,451 |
| Thereafter | | 531,155 |
| Total | $ | 982,991 |

**Note 12. Legal, Regulatory Matters and Contingencies**

*Richard Asherman*

On April 16, 2013, Richard Asherman ( Asherman ), the former President of and a member in Realty, filed a complaint ( Complaint ) in Wyoming state court against the Company and Cody Labs. At the same time, he also filed an application for a temporary restraining order to enjoin certain operations at Cody Labs, claiming, among other things, that Cody Labs was in violation of certain zoning laws and that Cody Labs was required to increase the level of its property insurance and to secure performance bonds for work being performed at Cody Labs. Mr. Asherman claimed Cody Labs was in breach of his employment agreement and was required to pay him severance under his employment agreement, including 18 months of base salary, vesting of unvested stock options and continuation of benefits. Mr. Asherman also asserted that the Company was in breach of the Realty Operating Agreement and, among other requested remedies, he sought to have the Company (i) pay him 50% of the value of 1.66 acres of land that Realty previously agreed to donate to an economic development entity associated with the City of Cody, Wyoming, which contemplated transaction has since been avoided and cancelled. Although Mr. Asherman originally sought to require that Lannett acquire his interest in Realty for an unspecified price and/or to dissolve Realty, those claims have been dismissed. In October 2016, the Company and Mr. Asherman reached a tentative agreement in principle to resolve their disputes. On November 30, 2016, the parties agreed to a settlement payment in full and final satisfaction of the claims filed by Asherman without an admission of liability by either party. As part of this settlement, the Company purchased for $1.5 million the remaining noncontrolling interest in Realty, free and clear of all liens, claims and encumbrances.

*Connecticut Attorney General Inquiry*

In July 2014, the Company received interrogatories and subpoena from the State of Connecticut Office of the Attorney General concerning its investigation into the pricing of digoxin.  According to the subpoena, the Connecticut Attorney General is investigating whether anyone engaged in any activities that resulted in (a) fixing, maintaining or controlling prices of digoxin or (b) allocating and dividing customers or territories relating to the sale of digoxin in violation of Connecticut antitrust law.  In June 2016, the Connecticut Attorney General issued interrogatories and a subpoena to an employee of the Company in order to gain access to documents and responses previously supplied to the Department of Justice.  In December 2016, the Connecticut Attorney General, joined by numerous other State Attorney General, filed a civil complaint alleging that six pharmaceutical companies engaged in anti-competitive behavior related to Doxycycline Hyclate and Gliburide.  The Company was not named in the action and does not compete on the products that formed the basis of the complaint.

The Company maintains that it acted in compliance with all applicable laws and regulations and continues to cooperate with the Connecticut Attorney General s investigation.

*Federal Investigation into the Generic Pharmaceutical Industry*

In fiscal years 2015 and 2016, the Company and certain affiliated individuals each were served with a grand jury subpoena relating to a federal investigation of the generic pharmaceutical industry into possible violations of the Sherman Act. The subpoenas request corporate documents of the Company relating to corporate, financial and employee information, communications or correspondence with competitors regarding the sale of generic prescription medications and the marketing, sale, or pricing of certain products, generally for the period of 2005 through the dates of the subpoenas.

Based on reviews performed to date by outside counsel, the Company currently believes that it has acted in compliance with all applicable laws and regulations and continues to cooperate with the federal investigation.

*Texas Medicaid Investigation*

In August 2015, KUPI received a letter from the Texas Office of the Attorney General alleging that it had inaccurately reported certain price information in violation of the Texas Medicaid Fraud Prevention Act. UCB, KUPI s previous parent company is handling the defense and is evaluating the allegations and cooperating with the Texas Attorney General s Office. Per the terms of the Stock Purchase Agreement between the Company and UCB ( Stock Purchase Agreement ) dated September 2, 2015, the Company is fully indemnified for any pre-acquisition amounts. The Company is currently unable to estimate the timing or the outcome of this matter.

*Government Pricing*

During the quarter ended December 31, 2016, the Company completed a contract compliance review, for the period January 1, 2012 through June 30, 2016, for one of KUPI s government-entity customers. As a result of the review, the Company identified certain commercial customer prices and other terms that were not properly disclosed to the government-entity resulting in potential overcharges. As of June 30, 2017, the Company s best estimate of the liability for potential overcharges is approximately $9.3 million. For the period January 1, 2012 through November 24, 2015 ( the pre-acquisition period ), the Company is fully indemnified per the Stock Purchase Agreement. Accordingly, the Company has recorded an indemnification asset and related liability of $8.3 million related to the pre-acquisition period. The Company does not believe that the ultimate resolution of this matter will have a significant impact on our financial position, results of operations or cash flows.

*AWP Litigation*

The Company and some of our competitors have been named as defendants in lawsuits filed in 2016 alleging that the Company and a number of other generic pharmaceutical manufacturers caused the Average Wholesale Prices (AWPs) of our and their products to be inflated, thereby injuring government programs, entities and persons who reimbursed prescription drugs based on AWPs. The Company stopped using AWP as a basis for establishing prices in or around 2002 and the bulk of prescription drugs manufactured by the Company was sold under private label. The Company disputes these allegations and does not believe that the ultimate resolution of these lawsuits will have a significant impact on our financial position, results of operations or cash flows.

*Private Antitrust and Consumer Protection Litigation*

The Company and certain competitors have been named as defendants in a number of lawsuits filed in 2016 and 2017 alleging that the Company and certain generic pharmaceutical manufacturers have conspired to fix prices of generic digoxin, levothyroxine, ursodiol and baclofen. These cases are part of a larger group of more than 100 lawsuits generally alleging that approximately 50 generic pharmaceutical manufacturers and distributors conspired to fix prices for at least 18 different generic drugs in violation of the federal Sherman Act, various state antitrust laws, and various state consumer protection statutes. The United States also has been granted leave to intervene in the cases. On April 6, 2017, the Judicial Panel on Multidistrict Litigation ordered that all of the cases alleging price-fixing for generic drugs be consolidated for pretrial proceedings in the United States District Court for the Eastern District of Pennsylvania under the caption *In re: Generic Pharmaceuticals Pricing Antitrust Litigation*. The various plaintiffs are grouped into three categories Direct Purchaser Plaintiffs, End Payer Plaintiffs, and Indirect Reseller Purchasers and filed an Consolidated Amended Complaints against the Company and the other defendants on August 15, 2017. Originally, Plaintiffs filed a single lawsuit related to both doxycycline and digoxin naming the Company and other generic pharmaceutical manufacturers as defendants in the combined cases. However, when the multidistrict litigation was established with separate cases for each generic pharmaceutical at issue, the Company was only named as a defendant in the digoxin cases, and not the doxycycline cases.

Table of Contents

The Company believes that it acted in compliance with all applicable laws and regulations.  Accordingly, the Company disputes the allegations set forth in these class actions.  The Company does not believe that the ultimate resolution of these lawsuits will have a significant impact on our financial position, results of operations or cash flows.

*Shareholder Litigation*

In November 2016, a purported class action lawsuit was filed in the United States District Court for the Eastern District of Pennsylvania against the Company and two of its officers claiming that the Company in its securities filings made false and misleading statements in connection with its drug pricing methodologies and internal controls with respect to drug pricing methodologies, causing damage to the purported class.  An amended complaint was filed in May 2017, and at this time the Company anticipates filing a motion to dismiss.  The Company cannot reasonably predict the outcome of the suit at this time.

*Patent Infringement (Paragraph IV Certification)*

There is substantial litigation in the pharmaceutical industry with respect to the manufacture, use and sale of new products which are the subject of conflicting patent and intellectual property claims.  Certain of these claims relate to paragraph IV certifications, which allege that an innovator patent is invalid or would not be infringed upon by the manufacture, use, or sale of the new drug.

*Zomig®*

The Company filed with the Food and Drug Administration an ANDA No. 206350, along with a paragraph IV certification, alleging that the two patents associated with the Zomig® nasal spray product (U.S. Patent No. 6,750,237 and U.S. Patent No. 67,220,767) are invalid.

In July 2014, AstraZeneca AB, AstraZeneca UK Limited and Impax Laboratories, Inc. filed two patent infringement lawsuits in the United States District Court for the District of Delaware, alleging that the Company s filing of ANDA No. 206350 constitutes an act of patent infringement and seeking a declaration that the two patents at issue are valid and infringed.

In September 2014, the Company filed a motion to dismiss one patent infringement lawsuit for lack of standing and responded to the second lawsuit by denying that any valid patent claim would be infringed.  In the second lawsuit, the Company also counterclaimed for a declaratory judgment that the patent claims are invalid and not infringed.  The Court has consolidated the two actions and denied the motion to dismiss the first action without prejudice.

In July 2015, the Company filed with the United States Patent and Trademark Office ( USPTO ) a Petition for Inter Partes Review of each of the patents in suit seeking to reject as invalid all claims of the patents in suit.  The USPTO has issued a decision denying initiation of the Inter Partes

Review.

A trial was conducted in September 2016. The Court issued its decision on March 29, 2017, finding that Lannett did not prove that the patents at issue are invalid. The Company has appealed the decision and filed its opening appeal brief on July 11, 2017. The responsive brief by AstraZeneca AB, AstraZeneca UK Limited and Impax Laboratories, Inc. is due on September 5, 2017. A final decision of the appellate court is expected in late 2017 or early 2018.

*Thalomid®*

The Company filed with the Food and Drug Administration an ANDA No. 206601, along with a paragraph IV certification, alleging that the fifteen patents associated with the Thalomid drug product (U.S. Patent Nos. 6,045,501; 6,315,720; 6,561,976; 6,561,977; 6,755,784; 6,869,399; 6,908,432; 7,141,018; 7,230,012; 7,435,745; 7,874,984; 7,959,566; 8,204,763; 8,315,886; 8,589,188 and 8,626,53) are invalid, unenforceable and/or not infringed. On January 30, 2015, Celgene Corporation and Children s Medical Center Corporation filed a patent infringement lawsuit in the United States District Court for the District of New Jersey, alleging that the Company s filing of ANDA No. 206601 constitutes an act of patent infringement and seeking a declaration that the patents at issue are valid and infringed. The Company filed an answer and affirmative defenses, and an amended answer to the complaint.

A mediation before a magistrate judge was held on March 9, 2017. An agreement in principle was reached regarding settlement of the action. The parties currently are negotiating details of a final agreement.

*SUPREP®*

The Company filed ANDA No. 209941 with the Food and Drug Administration seeking approval to sell a bowel preparation oral solution (the Company s Oral Solution ), along with a paragraph IV certification, alleging that US Patent 6,946,149 associated with the Suprep® bowel preparation kit would not be infringed by the Company s Oral Solution and/or that the patent is invalid.

Table of Contents

On March 20, 2017, Braintree Laboratories, Inc. ( Braintree ) filed a patent infringement lawsuit in the United States District Court for the District of Delaware (C.A. No. 1:17-cv-00293-GMS), alleging that the Company s filing of ANDA No. 209941 constitutes an act of patent infringement and seeking a declaration that the patent at issue was infringed by the submission of ANDA No. 209941. The Company answered the complaint denying infringement and raising invalidity as a defense, and has filed counterclaims seeking a declaration of non-infringement and invalidity. The matter is currently scheduled for a 4-day bench trial beginning on January 22, 2019. On July 28, 2017, the Company filed a motion for judgment on the pleadings, seeking a ruling that its ANDA product does not infringe the Braintree patent and seeking judgment as a matter of law. Braintree s responsive brief is due within 30 days and the court is expected to issue a decision in late 2017 or early 2018 on the motion.

Although the Company cannot currently predict the length or outcome of paragraph IV litigation, legal expenses associated with these lawsuits could have a significant impact on the financial position, results of operations and cash flows of the Company.

*EPA Violation Notice*

On July 13, 2017, the United States Department of Environmental Protection Agency ( EPA ) sent a Finding of Violation to KUPI alleging several violations of national emissions standards for hazardous air pollutants at KUPI s Seymour, Indiana facility. The EPA is giving the company the opportunity to discuss the matter with the agency before filing a formal complaint or assessing fines with respect to the alleged violations. The Company is conducting an investigation into the matter and cannot reasonably predict the outcome of any potential EPA action at this time.

*Other Litigation Matters*

The Company is also subject to various legal proceedings arising out of the normal course of its business including, but not limited to, product liability, intellectual property, patent infringement claims and antitrust matters. It is not possible to predict the outcome of these various proceedings. An adverse determination in any of these proceedings in the future could have a significant impact on the financial position, results of operations and cash flows of the Company.

**Note 13. Commitments**

***Leases***

The Company leases certain manufacturing and office equipment, in the ordinary course of business. These leases are typically renewed annually. Rental and lease expense was not material for all periods presented.

Future minimum lease payments under noncancelable operating leases (with initial or remaining lease terms in excess of one year) for the twelve-month periods ending June 30 thereafter are as follows:

| **(In thousands)** | | **Amounts Due** |
|---|---|---|
| 2018 | $ | 1,159 |
| 2019 | | 1,080 |
| 2020 | | 1,080 |
| 2021 | | 1,080 |
| 2022 | | 1,080 |
| Thereafter | | 5,238 |
| Total | $ | 10,717 |

*Other Commitment*

During the third quarter of Fiscal 2017, the Company signed an agreement with a company operating in the pharmaceutical business, under which the Company agreed to provide up to $15.0 million in revolving loans for the purpose of expansion and other business needs. The decision to provide any portion of the revolving loan is at the Company s sole discretion. At any time after the outstanding revolving loan balance is equal to or greater than $7.5 million, the Company has the option to convert the first $7.5 million into a 50% ownership interest in the entity. As of June 30, 2017, $977 thousand was outstanding under the revolving loan. The board of the entity is comprised of five members, two of which are employees of the Company. Based on the guidance set forth in ASC 810-10 *Consolidation,* the Company has concluded that it has a variable interest in the entity. However, the Company is not the primary beneficiary to the entity and as such, is not required to consolidate the entity s results of operations.

Table of Contents

## Note 14. Accumulated Other Comprehensive Loss

The Company s Accumulated Other Comprehensive Loss was comprised of the following components as of June 30, 2017 and 2016:

| (In thousands) | June 30, 2017 | June 30, 2016 |
|---|---|---|
| **Foreign Currency Translation** | | |
| Beginning Balance | $ (295) | $ (295) |
| Net (loss) on foreign currency translation (net of tax of $0 and $0) | 73 | |
| Reclassifications to net income (net of tax of $0 and $0) | | |
| Other comprehensive (loss), net of tax | | |
| Ending Balance | (222) | (295) |
| **Total Accumulated Other Comprehensive Loss** | $ (222) | $ (295) |

## Note 15. Earnings (Loss) Per Common Share

A dual presentation of basic and diluted earnings per common share is required on the face of the Company s Consolidated Statement of Operations as well as a reconciliation of the computation of basic earnings per common share to diluted earnings per common share. Basic earnings per common share excludes the dilutive impact of potentially dilutive securities and is computed by dividing net income (loss) attributable to Lannett Company, Inc. by the weighted average number of common shares outstanding for the period. Diluted earnings per common share is computed using the treasury stock method and includes the effect of potential dilution from the exercise of outstanding stock options and a warrant and treats unvested restricted stock as if it were vested. Potentially dilutive securities have been excluded in the weighted average number of common shares used for the calculation of earnings per share in periods of net loss because the effect of including such securities would be anti-dilutive. A reconciliation of the Company s basic and diluted earnings per common share was as follows:

| | For Fiscal Year Ended June 30, | | |
|---|---|---|---|
| (In thousands, except share and per share data) | 2017 | 2016 | 2015 |
| Net income (loss) attributable to Lannett Company, Inc. | $ (581) | $ 44,782 | $ 149,919 |
| Basic weighted average common shares outstanding | 36,812,524 | 36,442,782 | 35,827,167 |
| Effect of potentially dilutive options and restricted stock awards | | 946,663 | 1,299,950 |
| Diluted weighted average common shares outstanding | 36,812,524 | 37,389,445 | 37,127,117 |
| Earnings (loss) per common share attributable to Lannett Company, Inc.: | | | |
| Basic | $ (0.02) | $ 1.23 | $ 4.18 |
| Diluted | $ (0.02) | $ 1.20 | $ 4.04 |

The number of anti-dilutive shares that have been excluded in the computation of diluted earnings per share for the fiscal years ended June 30, 2017, 2016 and 2015 were 4.3 million, 3.0 million and 83 thousand, respectively.

**Note 16.  Warrant**

In connection with the KUPI acquisition, Lannett issued to UCB Manufacturing a warrant to purchase up to a total of 2.5 million shares of Lannett s common stock (the Warrant ).

The Warrant has a term of three years (expiring November 25, 2018) and an exercise price of $48.90 per share, subject to customary adjustments, including for stock splits, dividends and combinations. The Warrant also has a weighted average anti-dilution adjustment provision. The fair value included as part of the total consideration transferred to UCB at the acquisition date was $29.9 million. The fair value assigned to the Warrant was determined using the Black-Scholes valuation model. The Company concluded that the warrant was indexed to its own stock and therefore the Warrant has been classified as an equity instrument.

**Note 17.  Share-based Compensation**

At June 30, 2017, the Company had two share-based employee compensation plans (the 2011 Long-Term Incentive Plan LTIP and the 2014 LTIP ). Together these plans authorized an aggregate total of 4.5 million shares to be issued. The plans have a total of 2.1 million shares available for future issuances.

Table of Contents

The Company issues share-based compensation awards with a vesting period ranging up to 3 years and a maximum contractual term of 10 years. The Company issues new shares of stock when stock options are exercised. As of June 30, 2017, there was $6.5 million of total unrecognized compensation cost related to non-vested share-based compensation awards. That cost is expected to be recognized over a weighted average period of 1.8 years.

***Stock Options***

The Company measures share-based compensation cost for options using the Black-Scholes option pricing model. The following table presents the weighted average assumptions used to estimate fair values of the stock options granted during the fiscal years ended June 30, the estimated annual forfeiture rates used to recognize the associated compensation expense and the weighted average fair value of the options granted:

| | June 30, 2017 | June 30, 2016 | June 30, 2015 |
|---|---|---|---|
| Risk-free interest rate | 1.1% | 1.7% | 1.7% |
| Expected volatility | 55.6% | 48.3% | 52.1% |
| Expected dividend yield | | | |
| Forfeiture rate | 6.5% | 6.5% | 6.5% |
| Expected term | 5.2 years | 5.2 years | 5.5 years |
| Weighted average fair value | $ 15.33 | $ 26.24 | $ 17.73 |

Expected volatility is based on the historical volatility of the price of our common shares during the historical period equal to the expected term of the option. The Company uses historical information to estimate the expected term, which represents the period of time that options granted are expected to be outstanding. The risk-free rate for the period equal to the expected life of the option is based on the U.S. Treasury yield curve in effect at the time of grant. The forfeiture rate assumption is the estimated annual rate at which unvested awards are expected to be forfeited during the vesting period. This assumption is based on our actual forfeiture rate on historical awards. Periodically, management will assess whether it is necessary to adjust the estimated rate to reflect changes in actual forfeitures or changes in expectations. Additionally, the expected dividend yield is equal to zero, as the Company has not historically issued and has no immediate plans to issue, a dividend.

A stock option roll-forward as of June 30, 2017, 2016 and 2015 and changes during the years then ended, is presented below:

| (In thousands, except for weighted average price and life data) | Awards | Weighted-Average Exercise Price | Aggregate Intrinsic Value | Weighted Average Remaining Contractual Life (yrs.) |
|---|---|---|---|---|
| Outstanding at June 30, 2014 | 2,205 | 7.84 | | |
| Granted | 513 | 36.71 | | |
| Exercised | (665) | 6.47 | $ 33,201 | |
| Forfeited, expired or repurchased | (78) | 18.33 | | |
| Outstanding at June 30, 2015 | 1,975 | 15.39 | 86,983 | 7.2 |
| Granted | 58 | 59.20 | | |
| Exercised | (254) | 12.62 | $ 6,168 | |
| Forfeited, expired or repurchased | (49) | 32.66 | | |

| | | | | | | |
|---|---|---|---|---|---|---|
| Outstanding at June 30, 2016 | 1,730 | $ | 16.77 | $ | 19,524 | 6.3 |
| Granted | 11 | | 31.30 | | | |
| Exercised | (234) | | 7.38 | $ | 4,849 | |
| Forfeited, expired or repurchased | (32) | | 33.04 | | | |
| Outstanding at June 30, 2017 | 1,475 | $ | 18.02 | $ | 12,212 | 5.7 |
| | | | | | | |
| Vested and expected to vest at June 30, 2017 | 1,473 | $ | 17.98 | $ | 12,212 | 5.7 |
| Exercisable at June 30, 2017 | 1,328 | $ | 15.69 | $ | 12,212 | 5.7 |

Table of Contents

***Restricted Stock***

The Company measures restricted stock compensation costs based on the stock price at the grant date less an estimate for expected forfeitures. The annual forfeiture rate used to calculate compensation expense was 6.5% for fiscal year ended June 30, 2017, 2016 and 2015.

A summary of restricted stock awards as of June 30, 2017, 2016 and 2015 and changes during the fiscal years then ended, is presented below:

| **(In thousands)** | **Awards** | **Weighted Average Grant - date Fair Value** | **Aggregate Intrinsic Value** |
|---|---|---|---|
| Non-vested at June 30, 2014 | 16 | 34.01 | |
| Granted | 103 | 37.97 | |
| Vested | (14) | 36.06 | $ 664 |
| Forfeited | (7) | 36.59 | |
| Non-vested at June 30, 2015 | 98 | 37.83 | |
| Granted | 147 | 54.64 | |
| Vested | (66) | 47.11 | $ 3,511 |
| Forfeited | (12) | 47.67 | |
| Non-vested at June 30, 2016 | 167 | $ 48.22 | |
| Granted | 298 | 24.73 | |
| Vested | (86) | 42.60 | $ 2,564 |
| Forfeited | (45) | 32.90 | |
| Non-vested at June 30, 2017 | 334 | $ 30.71 | |

***Employee Stock Purchase Plan***

In February 2003, the Company s stockholders approved an Employee Stock Purchase Plan ( ESPP ). Employees eligible to participate in the ESPP may purchase shares of the Company s stock at 85% of the lower of the fair market value of the common stock on the first day of the calendar quarter, or the last day of the calendar quarter. Under the ESPP, employees can authorize the Company to withhold up to 10% of their compensation during any quarterly offering period, subject to certain limitations. The ESPP was implemented on April 1, 2003 and is qualified under Section 423 of the Internal Revenue Code. The Board of Directors authorized an aggregate total of 1.1 million shares of the Company s common stock for issuance under the ESPP. During the fiscal years ended June 30, 2017, 2016 and 2015, 57 thousand shares, 47 thousand shares and 12 thousand shares were issued under the ESPP, respectively. As of June 30, 2017, 542 thousand total cumulative shares have been issued under the ESPP.

The following table presents the allocation of share-based compensation costs recognized in the Consolidated Statements of Operations by financial statement line item:

| | | **For Fiscal Year Ended June 30,** | |
|---|---|---|---|
| **(In thousands)** | **2017** | **2016** | **2015** |

| | | | | | | |
|---|---|---|---|---|---|---|
| Selling, general and administrative expenses | $ | 5,855 | $ | 9,529 | $ | 5,145 |
| Research and development expenses | | 661 | | 760 | | 523 |
| Cost of sales | | 1,203 | | 1,273 | | 729 |
| Total | $ | 7,719 | $ | 11,562 | $ | 6,397 |
| | | | | | | |
| Tax benefit at statutory rate | $ | 2,818 | $ | 4,220 | $ | 2,159 |

**Note 18. Employee Benefit Plan**

The Company has a 401k defined contribution plan (the Plan ) covering substantially all employees. Pursuant to the Plan provisions, the Company is required to make matching contributions equal to 50% of each employee s contribution, not to exceed 4% of the employee s compensation for the Plan year. Contributions to the Plan during the fiscal years ended June 30, 2017, 2016 and 2015 were $2.1 million, $1.6 million and $855 thousand, respectively.

Table of Contents

## Note 19. Income Taxes

The provision for income taxes consisted of the following for the fiscal years ended June 30:

| (In thousands) | June 30, 2017 | June 30, 2016 | June 30, 2015 |
|---|---|---|---|
| Current Income Tax Expense (Benefit) | | | |
| Federal | $ 764 | $ 34,932 | $ 80,124 |
| State and Local | 638 | 1,887 | 572 |
| Total Current Income Tax Expense | 1,402 | 36,819 | 80,696 |
| Deferred Income Tax Expense (Benefit) | | | |
| Federal | (2,210) | (17,529) | (5,245) |
| State and Local | 1,905 | (1,968) | 1,979 |
| Total Deferred Income Tax Benefit | (305) | (19,497) | (3,266) |
| Total Income Tax Expense | $ 1,097 | $ 17,322 | $ 77,430 |

A reconciliation of the differences between the effective rates and federal statutory rates was as follows:

| | June 30, 2017 | June 30, 2016 | June 30, 2015 |
|---|---|---|---|
| Federal income tax at statutory rate | 35.0% | 35.0% | 35.0% |
| State and local income tax, net | 293.6% | (0.1)% | 0.1% |
| Nondeductible expenses | 45.4% | 0.8% | |
| Foreign rate differential | 49.9% | 0.5% | 0.1% |
| Income tax credits | (160.9)% | (3.0)% | (0.4)% |
| Domestic production activity deduction | | (5.2)% | (1.3)% |
| Change in tax laws | | | 0.6% |
| Excess tax benefits on share-based compensation | (134.3)% | | |
| Other | 70.8% | (0.1)% | (0.1)% |
| Effective income tax rate | 199.5% | 27.9% | 34.0% |

The principal types of differences between assets and liabilities for financial statement and tax return purposes are accruals, reserves, impairment of intangibles, accumulated amortization, accumulated depreciation and share-based compensation expense. A deferred tax asset is recorded for the future benefits created by the timing of accruals and reserves and the application of different amortization lives for financial statement and tax return purposes. The Company s deferred tax liability is mainly attributable to different depreciation methods for financial statement and tax return purposes. A deferred tax asset valuation allowance is established if it is more likely than not that the Company will be unable to realize certain of the deferred tax assets. As of June 30, 2017 and 2016, temporary differences which give rise to deferred tax assets and liabilities were as follows:

| (In thousands) | June 30, 2017 | June 30, 2016 |
|---|---|---|
| Deferred tax assets: | | |
| Accrued expenses | $ 1,869 | $ 1,636 |
| Share-based compensation expense | 6,031 | 5,074 |
| Reserve for returns | 15,032 | 14,583 |
| Reserves for rebates | 11,194 | 19,235 |
| Reserves for accounts receivable and inventory | 2,026 | 6,305 |
| Intangible impairment | 2,176 | 3,312 |
| Federal net operating loss | 736 | 736 |
| State net operating loss | 2,944 | 1,469 |
| Impairment on Cody note receivable | 1,913 | 1,941 |
| Accumulated amortization on intangible assets | 25,505 | 5,301 |
| Settlement Liability | 6,019 | 7,014 |
| Foreign net operating loss | 736 | 579 |
| Other | 290 | 901 |
| Total deferred tax asset | 76,471 | 68,086 |
| Valuation allowance | (6,391) | (3,927) |
| Total deferred tax asset less valuation allowance | 70,080 | 64,159 |
| Deferred tax liabilities: | | |
| Prepaid expenses | 267 | 263 |
| Property, plant and equipment | 16,807 | 11,381 |
| Other | 253 | 67 |
| Total deferred tax liability | 17,327 | 11,711 |
| Net deferred tax asset | $ 52,753 | $ 52,448 |

The net deferred tax asset as of June 30, 2017 and 2016 is reduced by a valuation allowance of $6.4 million and $3.9 million, respectively, which are primarily related to deferred tax assets for various states, the impairment on the Cody note receivable as well as foreign net operating losses. The Company increased the valuation allowance in Fiscal 2017 primarily related to an increase of state deferred tax assets.

On April 10, 2007, the Company entered into a Stock Purchase Agreement to acquire Cody by purchasing all of the remaining shares of common stock of Cody. As a result of the acquisition, the Company recorded deferred tax assets related to Cody s federal net operation loss (NOL) carry-forwards totaling $3.8 million at the date of acquisition with $1.9 million expiring in 2026 and $1.9 million in 2027.

The Company may recognize the tax benefit from an uncertain tax position claimed on a tax return only if it is more likely than not that the tax position will be sustained on examination by the taxing authorities, based on the technical merits of the position. The tax benefits recognized in the financial statements from such a position should be measured based on the largest benefit that has a greater than 50% likelihood of being realized upon ultimate settlement.

A reconciliation of the beginning and ending amount of gross unrecognized tax benefits (exclusive of interest and penalties) was as follows:

| (In thousands) | Balance |
|---|---|
| Balance at June 30, 2015 | $ 578 |
| Additions for tax positions of the current year | 742 |
| Additions for tax positions of prior years | 109 |
| Additions from acquisitions | 4,858 |

| | | |
|---|---|---|
| Reductions for tax positions of prior years | | |
| Settlements | | |
| Lapse of statute of limitations | | (43) |
| Balance at June 30, 2016 | $ | 6,244 |
| Additions for tax positions of the current year | | 168 |
| Additions for tax positions of prior years | | 16 |
| Additions from acquisitions | | |
| Reductions for tax positions of prior years | | |
| Settlements | | |
| Lapse of statute of limitations | | (486) |
| Balance at June 30, 2017 | $ | 5,942 |

Table of Contents

The amount of unrecognized tax benefits at June 30, 2017, 2016 and 2015 was $5.9 million, $6.2 million and $578 thousand respectively, of which $4.2 million, $4.4 million and $578 thousand would impact the Company s effective tax rate, respectively, if recognized.

The Company has not recorded any interest and penalties for the periods ended June 30, 2017, 2016 and 2015 in the statement of operations and no cumulative interest and penalties have been recorded either in the Company s consolidated balance sheet as of June 30, 2017 and 2016. The Company will recognize interest accrued on unrecognized tax benefits in interest expense and any related penalties in operating expenses. The cumulative amount of unrecognized tax benefits as of June 30, 2017 includes approximately $3.0 million of state reserves related to the acquisition of KUPI, which are expected to be recognized in Fiscal 2018 due to a lapse of statute of limitations.

The Company files income tax returns in the United States federal jurisdiction and various states. The Company s tax returns for Fiscal Year 2013 and prior generally are no longer subject to review as such years generally are closed. The Company believes that an unfavorable resolution for open tax years would not be material to the financial position of the Company.

**Note 20. Related Party Transactions**

The Company had sales of $3.7 million, $3.1 million and $1.9 million during the fiscal years ended June 30, 2017, 2016 and 2015, respectively, to a generic distributor, Auburn Pharmaceutical Company ( Auburn ). Jeffrey Farber, Chairman of the Board, is the owner of Auburn. Accounts receivable includes amounts due from Auburn of $751 thousand and $682 thousand at June 30, 2017 and 2016, respectively.

The Company also had net sales of $1.7 million during the fiscal year ended June 30, 2017 to a generic distributor, KeySource. Albert Paonessa, a current board member, was appointed the CEO of KeySource in May 2017. Accounts receivable includes amounts due from KeySource of $606 thousand as of June 30, 2017.

As part of its review, the Audit Committee noted that the amount of net sales to Auburn approximated 0.6%, 0.6% and 0.5% of total net sales during the fiscal years ended June 30, 2017, 2016 and 2015, respectively. The Audit Committee also noted that the amount of net sales to KeySource approximated 0.3% of total net sales during the fiscal year ended June 30, 2017.

The Audit Committee reviewed an analysis of sales prices charged to Auburn and KeySource, which compared the average sales prices by product for Auburn and KeySource sales to the average sales prices by product to other Lannett customers during the same period. As a result of this analysis, the Audit Committee ratified the net sales made to Auburn and KeySource during the fiscal year ended June 30, 2017 and 2016.

**Note 21. Material Contracts with Suppliers**

Jerome Stevens Pharmaceuticals Distribution Agreement:

The Company s primary finished goods inventory supplier is JSP, in Bohemia, New York. Purchases of finished goods inventory from JSP accounted for 36%, 52% and 68% of the Company s inventory purchases in the fiscal year ending June 30, 2017, 2016 and 2015, respectively.

On August 19, 2013, the Company entered into an agreement with JSP to extend its initial contract to continue as the exclusive distributor in the United States of three JSP products: Butalbital, Aspirin, Caffeine with Codeine Phosphate Capsules USP; Digoxin Tablets USP; and Levothyroxine Sodium Tablets USP. The amendment to the original agreement extends the initial contract, which was due to expire on March 22, 2014, for five years through March 23, 2019. In connection with the amendment, the Company issued a total of 1.5 million shares of the Company s common stock to JSP and JSP s designees. In accordance with its policy related to renewal and extension costs for recognized intangible assets, the Company recorded a $20.1 million expense in cost of sales, which represents the fair value of the shares on August 19, 2013. If the parties agree to a second five year extension from March 23, 2019 to March 23, 2024, the Company is required to issue to JSP or its designees an additional 1.5 million shares of the Company s common stock. Both Lannett and JSP have the right to terminate the contract if one of the parties does not cure a material breach of the contract within thirty (30) days of notice from the non-breaching party.

During the renewal term of the JSP distribution agreement, the Company is required to use commercially reasonable efforts to purchase minimum dollar quantities of JSP products. There is no guarantee that the Company will continue to meet the minimum purchase requirement for Fiscal 2018 and thereafter. If the Company does not meet the minimum purchase requirements, JSP s sole remedy is to terminate the JSP Distribution Agreement.

Table of Contents

**Note 22. Settlement Agreement**

On March 7, 2016, the Company entered into a Settlement Agreement Release and Mutual Release ( Settlement Agreement ) with one of its former customers, pursuant to which Lannett and such customer resolved all disputes between the parties with respect to the termination of the direct sales business relationship by Lannett on December 31, 2013.

Pursuant to the terms of the Settlement Agreement, Lannett paid the former customer $8.0 million in cash in calendar year 2016. Lannett will also pay to the former customer the following amounts: (a) in calendar year 2017, at the discretion of the customer, either $8.0 million in cash or a $10.0 million credit memorandum to be applied against invoices for the purchase of products from Lannett or any of its subsidiaries by such customer; and (b) in calendar year 2018, at the discretion of the customer, either $10.0 million in cash or a $12.0 million credit memorandum to be applied against invoices for the purchase of products from Lannett or any of its subsidiaries by such customer.

As a result of the settlement agreement, the Company recorded a reduction to net sales in the amount of $23.6 million in the third quarter of Fiscal 2016, which represented the net present value of the future cash payments.

In the third quarter of Fiscal 2017, the customer notified the Company that it had elected to receive $10.0 million in credit memorandums in lieu of $8.0 million in cash related to the calendar year 2017 election. As a result of the election, the Company re-assessed the fair value of the settlement agreement which resulted in an increase to the liability and a reduction to net sales of $4.0 million in the third quarter of Fiscal 2017.

Table of Contents

**Note 23. Quarterly Financial Information (Unaudited)**

Lannett s quarterly consolidated results of operations are shown below:

| (In thousands, except per share data) | Fourth Quarter | Third Quarter | Second Quarter | First Quarter |
|---|---|---|---|---|
| **Fiscal 2017** | | | | |
| Net sales | $ 139,118 | $ 165,720 | $ 170,944 | $ 161,559 |
| Settlement agreement | | (4,000) | | |
| Total net sales | 139,118 | 161,720 | 170,944 | 161,559 |
| Cost of sales | 80,240 | 89,290 | 82,891 | 79,707 |
| Gross profit | 58,878 | 72,430 | 88,053 | 81,852 |
| Operating expenses | 30,069 | 28,793 | 53,747 | 102,158 |
| Operating income (loss) | 28,809 | 43,637 | 34,306 | (20,306) |
| Other loss | (19,983) | (21,371) | (22,578) | (21,964) |
| Income tax expense (benefit) | 3,100 | 7,337 | 3,542 | (12,882) |
| Less: Net income attributable to noncontrolling interest | | | 14 | 20 |
| Net income (loss) attributable to Lannett Company, Inc. | $ 5,726 | $ 14,929 | $ 8,172 | $ (29,408) |
| Earnings (loss) per common share attributable to Lannett Company Inc. (1) | | | | |
| Basic | $ 0.16 | $ 0.41 | $ 0.22 | $ (0.80) |
| Diluted | $ 0.15 | $ 0.40 | $ 0.22 | $ (0.80) |

| (In thousands, except per share data) | Fourth Quarter | Third Quarter | Second Quarter | First Quarter |
|---|---|---|---|---|
| **Fiscal 2016** | | | | |
| Net sales | $ 168,887 | $ 163,712 | $ 127,059 | $ 106,433 |
| Settlement agreement | | (23,598) | | |
| Total net sales | 168,887 | 140,114 | 127,059 | 106,433 |
| Cost of sales | 88,957 | 82,623 | 55,414 | 29,006 |
| Gross profit | 79,930 | 57,491 | 71,645 | 77,427 |
| Operating expenses | 49,535 | 38,874 | 41,320 | 26,006 |
| Operating income | 30,395 | 18,617 | 30,325 | 51,421 |
| Other loss | (29,752) | (26,830) | (10,827) | (1,170) |
| Income tax expense (benefit) | (2,948) | (2,743) | 5,958 | 17,055 |
| Less: Net income attributable to noncontrolling interest | 20 | 20 | 20 | 15 |
| Net income (loss) attributable to Lannett Company, Inc. | $ 3,571 | $ (5,490) | $ 13,520 | $ 33,181 |
| Earnings (loss) per common share attributable to Lannett Company Inc. (1) | | | | |
| Basic | $ 0.10 | $ (0.15) | $ 0.37 | $ 0.91 |
| Diluted | $ 0.10 | $ (0.15) | $ 0.36 | $ 0.89 |

| (In thousands, except per share data) | Fourth Quarter | Third Quarter | Second Quarter | First Quarter |
|---|---|---|---|---|
| **Fiscal 2015** | | | | |

| | | | | |
|---|---|---|---|---|
| Net sales | $ 99,276 | $ 99,352 | $ 114,822 | $ 93,387 |
| Cost of sales | 27,326 | 23,714 | 27,621 | 21,820 |
| Gross profit | 71,950 | 75,638 | 87,201 | 71,567 |
| Operating expenses | 20,932 | 21,363 | 20,658 | 16,916 |
| Operating income | 51,018 | 54,275 | 66,543 | 54,651 |
| Other income (loss) | 165 | (42) | 713 | 99 |
| Income tax expense | 17,222 | 17,973 | 22,435 | 19,800 |
| Less: Net income attributable to noncontrolling interest | 18 | 27 | 10 | 18 |
| Net income attributable to Lannett Company, Inc. | $ 33,943 | $ 36,233 | $ 44,811 | $ 34,932 |
| Earnings per common share attributable to Lannett Company Inc. (1) | | | | |
| Basic | $ 0.94 | $ 1.01 | $ 1.26 | $ 0.98 |
| Diluted | $ 0.91 | $ 0.97 | $ 1.21 | $ 0.94 |

(1) Due to differences in weighted average common shares outstanding, quarterly earnings per share may not add up to the totals reported for the full fiscal year.

The decline in operating income in the first and second quarters of Fiscal 2017 is primarily attributable to a $65.1 million and $23.0 million intangible assets impairment charge, respectively. Total net sales in the third and fourth quarters of Fiscal 2017 were negatively impacted by $4.5 million and $5.7 million, respectively, due to the Bipartisan Budget Act of 2015 which required drug manufacturers to pay additional rebates to state Medicaid programs. Total net sales in the third quarter of Fiscal 2017 was also negatively impacted by a $4.0 million adjustment to the Fiscal 2016 settlement agreement amount with a former customer (See Note 22).

The decline in operating income in the third and fourth quarters of Fiscal 2016 is primarily attributable to a $23.6 million settlement agreement with a former customer and an $8.0 million intangible assets impairment charge, respectively. Net income attributable to Lannett Company, Inc. in the fourth quarter of Fiscal 2016 also included a $3.0 million loss on extinguishment of debt.

The decrease in the effective tax rate in the fourth quarter of Fiscal 2016 is primarily due to state deferred tax benefits recorded as a result of the KUPI acquisition. In addition, research and development tax credits and domestic manufacturing deductions relative to pre-tax income also contributed to the lower rate.

The decline in net sales from the second quarter of Fiscal 2015 to the third quarter of Fiscal 2015 was due to lower volumes and increased competition in cardiovascular products.