HEALTHCARE REALTY TRUST INC
Form 10-K
March 01, 2007

Table of Contents

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

Form 10-K

(Mark One)

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

For the fiscal year ended: December 31, 2006

OR

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

For the transition period from ___ to ___

Commission File Number: 1-11852

HEALTHCARE REALTY TRUST INCORPORATED
(Exact name of Registrant as specified in its charter)

Maryland	**62-1507028**
(State or other jurisdiction of incorporation or organization)	*(I.R.S. Employer Identification No.)*

3310 West End Avenue
Suite 700
Nashville, Tennessee 37203
(Address of principal executive offices)
(615) 269-8175
(Registrant s telephone number, including area code)

Securities Registered Pursuant to Section 12(b) of the Act:

Title of Each Class	Name of Each Exchange on Which Registered
Common Stock, $.01 par value per share	New York Stock Exchange

Securities Registered Pursuant to Section 12(g) of the Act:
None
(Title of Class)

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

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

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

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

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer (as defined in Exchange Act Rule 12b-2).

Large accelerated filer þ Accelerated filer o Non-accelerated filer o

Indicate by check mark whether the Registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes o No þ

The aggregate market value of the shares of Common Stock (based upon the closing price of these shares on the New York Stock Exchange, Inc. on June 30, 2006) of the Registrant held by non-affiliates on June 30, 2006 was approximately $1,473,859,865.

As of January 31, 2007, 47,822,516 shares of the Registrant s Common Stock were outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Registrant s 2006 Annual Report to Shareholders are incorporated into Part II of this Report. Portions of the Registrant s definitive Proxy Statement relating to the Annual Meeting of Shareholders to be held on May 15, 2007 are incorporated into Part III of this Report.

Table of Contents

TABLE OF CONTENTS

Table of Contents

PART I

Disclosure Regarding Forward-Looking Statements

This report and other materials the Company has filed or may file with the Securities and Exchange Commission, as well as information included in oral statements or other written statements made, or to be made, by senior management of the Company, contain, or will contain, disclosures that are forward-looking statements. Forward-looking statements include all statements that do not relate solely to historical or current facts and can be identified by the use of words such as may, will, expect, believe, intend, plan, estimate, project, contin other comparable terms. These forward-looking statements are based on the current plans and expectations of management and are subject to a number of risks and uncertainties, including those set forth below, that could significantly affect the Company s current plans and expectations and future financial condition and results.

The Company undertakes no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise. Shareholders and investors are cautioned not to unduly rely on such forward-looking statements when evaluating the information presented in the Company s filings and reports.

Such risks and uncertainties include, among other things, the following risks including those described in more detail under the heading Risk Factors, beginning on page 20 of this report:

Changes in the Company s dividend policy;

Closing of the anticipated sales of the Company s senior living assets;

The ability of the Company to invest its capital on a timely basis;

The availability of debt and equity capital;

Changes in the financial condition or business strategy of the Company s tenants;

Business and general economic conditions;

The federal, state and local regulatory environment;

The possibility of underinsured or uninsured losses;

A failure to maintain an effective system of internal control over financial reporting; and

The ability of the Company to maintain its qualification as a real estate investment trust (REIT).

Item 1. *Business*

Overview

Healthcare Realty Trust Incorporated (Healthcare Realty or the Company) was incorporated in Maryland in 1993 and is a self-managed and self-administered real estate investment trust, or REIT, that integrates owning, acquiring, managing and developing income-producing real estate properties associated with the delivery of healthcare services throughout the United States. Additionally, the Company provides mortgage financing on healthcare facilities.

The Company operates so as to qualify as a REIT for federal income tax purposes. As a REIT, the Company is not subject to corporate federal income tax with respect to net income distributed to its shareholders. See Federal Income Tax Information below.

Table of Contents

As of December 31, 2006, the Company had invested in real estate properties, including investments in unconsolidated limited liability companies (LLCs), as shown in the table below (dollars and square feet in thousands):

	Number of Investments	Investment Amounts		Square Feet
Owned properties:				
Long-term net master leases				
Medical office/outpatient facilities	61	352,201	17.38%	2,302
Assisted living facilities	26	129,802	6.41%	887
Skilled nursing facilities	29	145,345	7.18%	974
Inpatient Rehab facilities	9	156,494	7.72%	643
Independent living facilities	7	64,505	3.18%	726
Other inpatient facilities	4	75,975	3.75%	334
	136	924,322	45.62%	5,866
Financial support agreements				
Medical office/outpatient facilities	15	164,646	8.13%	1,123
	15	164,646	8.13%	1,123
Multi-tenanted with occupancy leases				
Medical office/outpatient facilities	86	828,985	40.91%	5,910
	86	828,985	40.91%	5,910
Corporate property		14,373	0.71%	
		14,373	0.71%	
Total owned properties	237	1,932,326	95.37%	12,899
Mortgage loans:				
Assisted living facilities	5	46,070	2.27%	
Skilled nursing facilities	1	4,887	.24%	
Independent living facilities	1	6,000	.30%	
Medical office/outpatient facilities	2	16,899	.83%	
	9	73,856	3.64%	
Unconsolidated LLC investment:				
Assisted living facilities	1	6,627	.33%	
Medical office/outpatient facilities	2	13,452	.66%	
	3	20,079	0.99%	

Total real estate investments	249	$ 2,026,261	100.00%

4

Table of Contents

At December 31, 2006, the Company provided property management services for 103 healthcare-related properties nationwide, totaling approximately 6.8 million square feet. The Company intends to maintain a portfolio of properties that are focused predominantly on the outpatient services and medical office segments of the healthcare industry, which are diversified by tenant, geographic location and facility type.

As of December 31, 2006, the weighted average remaining lease term pursuant to the long-term master leases, financial support agreements, and multi-tenanted occupancy leases was approximately 6.0 years, with expiration dates ranging from 2007 to 2022.

As of December 31, 2006, the weighted average remaining maturity of the mortgage notes receivable portfolio was approximately 3.59 years with expiration dates ranging from 2007 to 2031. Interest rates on the mortgage notes receivable at December 31, 2006 ranged from 9.83% to 15.00%. Most of the mortgage notes receivable interest rates are constant. The mortgage notes receivable portfolio decreased**,** net, approximately $31.9 million, or 30%, from December 31, 2005 to December 31, 2006. This decrease was the result of several mortgage repayments.

Business Strategy

Healthcare Realty s strategy is to be an owner and operator of quality medical facilities that produce stable and growing rental income. Consistent with this strategy, the Company seeks to provide a broad spectrum of services needed to own, acquire, manage, finance and develop healthcare properties.

In avoiding a significant affiliation with any single healthcare provider, management believes that its diversification reduces the Company s potential exposure to a concentration of credit risk with any one healthcare provider. Only one healthcare provider accounted for 10% or more of the Company s revenues during the year ended December 31, 2006 (HealthSouth Corporation at 10%).

As of December 31, 2006, approximately 54% of the Company s real estate investments consisted of properties leased to unaffiliated lessees pursuant to long-term net master lease agreements or financial support agreements. Approximately 41% were multi-tenanted properties with shorter-term occupancy leases, but without other financial support agreements, with the remaining 5% of investments relating to the Company s mortgage notes receivable portfolio and its investments in unconsolidated limited liability companies which are invested in real estate properties. The Company s master leases and financial support agreements are generally designed to ensure the continuity of revenues and coverage of costs and expenses relating to the properties by the tenants and the sponsoring healthcare operators.

The Company announced on February 26, 2007 its plan to sell its portfolio of senior living assets. At December 31, 2006, the senior living portfolio included 62 real estate properties in which the Company had investments totaling $340.6 million ($269.3 million, net) and 16 mortgage notes and notes receivable in which the Company had investments totaling $71.8 million. The Company is currently in advanced discussions with several buyers regarding these sales. Sales of the properties are expected to close during the first and second quarters of 2007, subject to the terms of definitive agreements customary to these types of transactions. The Company s real estate portfolio, after selling the senior living asset portfolio, will consist predominantly of medical office and outpatient facility types, which management believes will further reduce the business-risk profile of the Company. Following the sales, the Company will have investments of approximately $1.6 billion in 177 real estate properties and mortgages. Proceeds of the sales are expected to fund repayments of debt on the Company s Unsecured Credit Facility due 2009 and the payment of a one-time special dividend to its shareholders. See Note 15 to the Company s Consolidated Financial Statements, incorporated herein by reference to Exhibit 13 to this Annual Report on Form 10-K, for more details of the senior living portfolio.

The Company will remain focused on outpatient-related facilities, whose tenants historically have represented, together with their related acute care hospital providers, more than half of the $2 trillion in national healthcare spending each year. However, due to the high valuations of healthcare properties and the increased interest by non-traditional healthcare real estate investors in owning these types of properties, the Company has found it difficult to make accretive acquisitions. While the Company continues to pursue selective acquisition opportunities, it has increased its efforts to develop outpatient medical facilities. By developing, rather than acquiring, those outpatient medical facilities, the Company expects to earn higher returns with greater growth potential. Management also believes that the diversity of tenants in these properties, which include physicians of nearly two-dozen specialties at surgery, imaging, and diagnostic centers, lowers the risk to the Company of unprofitable tenants. While the time required to construct and lease some of these developments can take two to three years, over the long-term, the Company s ability to efficiently manage and lease these properties is expected to lead to improved results.

Table of Contents

The development investments that the Company pursues fall into one of two categories: they are either relationship-based, such as the properties developed in conjunction with Baylor Health Care in Dallas; or they are market-driven, where the underlying fundamentals in a particular market make the development of medical office and outpatient facilities, without an existing healthcare system relationship, compelling. The Company s relationship-based development pipeline currently represents over half of its opportunities. The Company is also taking advantage of its development expertise to pursue market-driven development opportunities. These opportunities on sites that are most often near acute-care hospitals and in markets with strong population growth are compelling because of fewer use and leasing restrictions, shorter development timelines, and the prospect for higher investment returns.

The Company has six development projects underway three with Baylor Health Care System in Texas, and one each in Colorado, Washington state, and Hawaii totaling 770,000 square feet and with budgets totaling $177.8 million. The Company expects completion of the Texas and Washington state projects in 2007, the Colorado project (which includes two buildings) in 2008, and the Hawaii project in 2009. Management expects its development pipeline, with selective acquisitions and dispositions in the ordinary course, should result in net new investments of approximately $150 - $200 million annually excluding the impact of the sale of the senior living assets discussed above under the heading Business Strategy.

Purchase Options

Certain of the Company s leases include purchase option provisions. The provisions vary from lease to lease but generally allow the lessee to purchase the property covered by the lease at the greater of fair market value or an amount equal to the Company s gross investment. As of December 31, 2006, the Company had a gross investment of approximately $235.5 million in real estate properties that were subject to outstanding, exercisable contractual options to purchase, with various conditions and terms, by the respective operators and lessees that had not been exercised. On a probability-weighted basis, the Company estimates that approximately $39.2 million of the options exercisable at December 31, 2006 may be exercised in the future. During 2007, additional purchase options become exercisable on properties in which the Company has a gross investment of approximately $23.0 million. The Company anticipates, on a probability-weighted basis, that approximately $11.5 million of these additional options may also be exercised in the future. Though other properties may have purchase options exercisable in 2008 and beyond, the Company does not believe it can reasonably estimate the probability of exercise of these purchase options in the future.

Acquisitions, Dispositions and Mortgage Repayments during 2006

2006 Acquisitions

The Company acquired three properties for $75.8 million, mortgage notes in the amount of $37.8 million (of which $16.9 million was non-cash), and $9.0 million in equity interests in unconsolidated limited liability companies which acquired seven properties during 2006. See Note 4 to the Consolidated Financial Statements, incorporated herein by reference to Exhibit 13 to this Annual Report on Form 10-K, for more information on these acquisitions.

Due to the high valuations of healthcare properties and the increased interest by non-traditional healthcare real estate investors in owning these types of properties, the Company expects its acquisitions of existing outpatient properties to be less than $100 million for 2007.

2006 Dispositions

During 2006, the Company sold properties or received payments on mortgage notes resulting in net cash proceeds of approximately $104.3 million. In these transactions, the Company acquired mortgage notes receivable totaling $15.4 million, received mortgage note prepayment penalty fees of approximately $2.2 million and received a lease termination fee of approximately $0.3 million. See Note 4 to the Consolidated Financial Statements, incorporated herein by reference to Exhibit 13 to this Annual Report on Form 10-K, for more information on these dispositions.

Contractual Obligations

As of December 31, 2006, the Company had long-term contractual obligations of approximately $1.5 billion, consisting primarily of $1.1 billion of long-term debt obligations. For a more detailed description of these contractual obligations, see Management s Discussion and Analysis of Financial Condition and Results of Operations Liquidity and Capital Resources Contractual Obligations, incorporated herein by reference to Exhibit 13 to this Annual Report on Form 10-K.

Table of Contents

Competition

The Company competes for the acquisition and development of real estate properties with private investors, healthcare providers, other healthcare-related REITs, real estate partnerships, and financial institutions, among others. The business of acquiring and constructing new healthcare facilities is highly competitive and is subject to price, construction and operating costs, and other competitive pressures.

The financial performance of all of the Company s properties is subject to competition from similar properties. Certain operators of other properties may have capital resources in excess of those of the Company or the operators of the Company s properties. In addition, the extent to which the Company s properties are utilized depends upon several factors, including the number of physicians using the healthcare facilities or referring patients there, competitive systems of healthcare delivery, and the area s population, size and composition. Private, federal and state payment programs and other laws and regulations may also have a significant effect on the utilization of the properties. Virtually all of the Company s properties operate in a competitive environment, and patients and referral sources, including physicians, may change their preferences for a healthcare facility from time to time.

Government Regulation

The healthcare industry continues to face rising costs in the delivery of healthcare services, increased competition for patients, a growing population of uninsured patients and higher bad debt expense, constant evaluation of reimbursement levels by private and governmental payors, and scrutiny by federal and state legislative and administrative authorities, thus presenting the industry and its individual participants with uncertainty. These various changes can affect the economic performance of some or all of its tenants and clients. The Company cannot predict the degree to which these changes may affect the economic performance of the Company, positively or negatively.

The facilities owned by the Company and the manner in which they are operated are affected by changes in the reimbursement, licensing and certification policies of federal, state and local governments. Facilities may also be affected by changes in accreditation standards or procedures of accrediting agencies that are recognized by governments in the certification process. In addition, expansion (including the addition of new beds or services or acquisition of medical equipment) and occasionally the discontinuation of services of healthcare facilities are, in some states, subjected to state regulatory approval through certificate of need laws and regulations.

Although the Company is not a healthcare provider or in a position to influence the referral of patients or ordering of services reimbursable by the federal government, its leases and subleases must be negotiated at arm s length for fair market value rental rates. To the extent that a healthcare provider leases space from the Company and, in turn, subleases space to physicians or other referral sources at less than fair market value rental rate, the Anti-Kickback Statute (a provision of the Social Security Act addressing illegal remuneration) and the Stark Law (the federal physician self-referral law) could be implicated. The Company s leases require the lessees to agree to comply with all applicable laws.

A significant portion of the revenue of healthcare providers is derived from government reimbursement programs, such as the federal Medicare program and the joint federal and state Medicaid program. Although lease payments to the Company are not directly affected by the level of government reimbursement, such changes could have an impact on a tenant s ability to make lease payments to the Company to the extent that changes in these programs adversely affect healthcare providers.

The Medicare and Medicaid programs are highly regulated and subject to frequent evaluation and change. While government healthcare spending has increased over time, changes from year to year in reimbursement methodology, rates and other regulatory requirements have resulted in a challenging operating environment for healthcare providers. Considerable uncertainties surround the future growth of payment levels under government reimbursement programs. Reductions in the growth of government payments could have an adverse impact on healthcare providers financial condition and, therefore, could adversely affect the ability of providers to make rental payments. However, the Company expects healthcare providers to continue to adjust to new operating challenges, as they have in the past, by increasing operating efficiency and modifying their strategies for profitable operations and growth.

The Company believes its strategic focus on the medical office and outpatient sector of the healthcare industry limits risk from changes in public healthcare spending and reimbursement because physician practices generally derive a large portion of their revenue from private insurance and out-of-pocket patient expense. The diversity of the

Company s multi-tenant medical office facilities also provides lower reimbursement risk as payor mix varies from physician to physician, depending on location, specialty, patients, and physician preferences.

Table of Contents

Loss by a facility of its ability to participate in government-sponsored programs because of licensing, certification or accreditation deficiencies or because of program exclusion resulting from violations of law would have material adverse effects on facility revenues.

Legislative Developments

Each year, legislative proposals are introduced in Congress and in some state legislatures. Regulatory changes are proposed by government agencies that could significantly change the delivery of healthcare services, either nationally or at the state level, if implemented. Among the matters under consideration are:

cost controls on state and federal Medicaid and Medicare reimbursements;

healthcare provider cost-containment and quality-control initiatives by public and private payors;

refinements to the hospital inpatient prospective payment system;

the implementation of heightened restrictions on admissions to inpatient rehabilitation facilities and long-term acute care hospitals;

healthcare coverage for the uninsured;

lower reimbursement for diagnostic imaging and ambulatory surgery centers;

revised methodology for the annual update of the physician fee schedule;

increased scrutiny of medical errors;

patient and drug safety efforts;

Medicare Advantage reforms;

pharmaceutical drug pricing under Medicare Part D;

tax credits for Health Savings Accounts and the uninsured;

re-importation of pharmaceutical drugs;

improvements in healthcare information technology; and

limits on damages claimed in physician malpractice lawsuits.

The Company cannot predict whether any proposals will be adopted or, if adopted, what effect, if any, such proposals would have on the Company s business.

Environmental Matters

Under various federal, state and local environmental laws, ordinances and regulations, an owner of real property (such as the Company) may be liable for the costs of removal or remediation of certain hazardous or toxic substances at, under or disposed of in connection with such property, as well as certain other potential costs relating to hazardous or toxic substances (including government fines and injuries to persons and adjacent property). Most, if not all, of these laws, ordinances and regulations contain stringent enforcement provisions including, but not limited to, the authority to impose substantial administrative, civil and criminal fines and penalties upon violators. Such laws often impose liability without regard to whether the owner knew of, or was responsible for, the presence or disposal of such substances and may be imposed on the owner in connection with the activities of an operator of the property. The cost of any required remediation, removal, fines or personal or property damages and the owner s liability therefore could exceed the value of the property and/or the aggregate assets of the owner. In addition, the presence of such substances, or the failure to properly dispose of or remediate such substances, may adversely affect the owner s ability to sell or lease such property or to borrow using such property as collateral. A property can also be negatively impacted either through physical contamination or by virtue of an adverse effect on value, from contamination that has or may have emanated from other properties.

Operations of the properties owned, developed or managed by the Company are and will continue to be subject to numerous federal, state, and local environmental laws, ordinances and regulations, including those relating to the following: the generation, segregation, handling, packaging and disposal of medical wastes; air quality requirements related to operations of generators, incineration devices, or sterilization equipment; facility siting and construction; disposal of non-medical wastes and ash from incinerators; and underground storage tanks. Certain properties owned, developed or managed by the Company contain, and others may contain or at one time may have contained, underground storage tanks that are or were used to store waste oils, petroleum products or other hazardous substances. Such underground storage tanks can be the source of releases of hazardous or toxic materials. Operations of nuclear medicine departments at some properties also involve the use and handling, and subsequent disposal of, radioactive isotopes and similar materials, activities which are closely regulated by the Nuclear Regulatory Commission and state regulatory agencies. In addition, several of the properties were built during the period that asbestos was commonly used in building construction and other such facilities may be acquired by the Company in the future. The presence of such materials could result in significant costs in the event that any asbestos-containing materials requiring immediate removal and/or encapsulation are located in or on any facilities or in the event of any future renovation activities.

The Company has had limited environmental site assessments conducted on substantially all of the properties currently owned. These site assessments are limited in scope and provide only an evaluation of potential environmental conditions associated with the property, not compliance assessments of ongoing operations. The Company is not aware of any environmental condition or liability that management believes would have a material adverse effect on the Company s financial position, earnings, expenditures or continuing operations. While it is the Company s policy to seek indemnification relating to environmental liabilities or conditions, even where sale and purchase agreements do contain such provisions there can be no assurances that the seller will be able to fulfill its indemnification obligations. In addition, the terms of the Company s leases or financial support agreements do not give the Company control over the operational activities of its lessees or healthcare operators, nor will the Company monitor the lessees or healthcare operators with respect to environmental matters.

Table of Contents

Insurance

The Company maintains comprehensive liability insurance and property insurance covering its owned and managed properties. The Company s tenants are required to maintain, at their expense, liability insurance relating to their operations at the leased facilities. In addition, tenants under long-term net master leases are required to carry property insurance covering the Company s interest in the buildings. The Company has also obtained title insurance with respect to each of the properties it owns, insuring that the Company holds title to each of the properties free and clear of all liens and encumbrances except those approved by the Company.

Employees

As of December 31, 2006, the Company employed 201 people. The employees are not members of any labor union, and the Company considers its relations with its employees to be excellent.

Federal Income Tax Information

The Company is and intends to remain qualified as a REIT under the Internal Revenue Code of 1986, as amended (the Code). As a REIT, the Company s net income will be exempt from federal taxation to the extent that it is distributed as dividends to shareholders. Distributions to the Company s shareholders generally will be includable in their income; however, dividends distributed that are in excess of current and/or accumulated earnings and profits will be treated for tax purposes as a return of capital to the extent of a shareholder s basis and will reduce the basis of the shareholder s shares.

Introduction

The Company is qualified and intends to remain qualified as a REIT for federal income tax purposes under Sections 856 through 860 of the Code. The following discussion addresses the material tax considerations relevant to the taxation of the Company and summarizes certain federal income tax consequences that may be relevant to certain shareholders. However, the actual tax consequences of holding particular securities issued by the Company may vary in light of a securities holder s particular facts and circumstances. Certain holders, such as tax-exempt entities, insurance companies and financial institutions, are generally subject to special rules. In addition, the following discussion does not address issues under any foreign, state or local tax laws. The tax treatment of a holder of any of the securities issued by the Company will vary depending upon the terms of the specific securities acquired by such holder, as well as the holder s particular situation, and this discussion does not attempt to address aspects of federal income taxation relating to holders of particular securities of the Company. This summary is qualified in its entirety by the applicable Code provisions, rules and regulations promulgated thereunder, and administrative and judicial interpretations thereof. The Code, rules, regulations, and administrative and judicial interpretations are all subject to change at any time (possibly on a retroactive basis).

The Company is organized and is operating in conformity with the requirements for qualification and taxation as a REIT and intends to continue operating so as to enable it to continue to meet the requirements for qualification and taxation as a REIT under the Code. The Company s qualification and taxation as a REIT depend upon its ability to meet, through actual annual operating results, the various income, asset, distribution, stock ownership and other tests discussed below. Accordingly, the Company cannot guarantee that the actual results of operations for any one taxable year will satisfy such requirements.

If the Company were to cease to qualify as a REIT, and the statutory relief provisions were found not to apply, the Company s income that it distributed to shareholders would be subject to the double taxation on earnings (once at the corporate level and again at the shareholder level) that generally results from an investment in the equity securities of a corporation. However, the distributions would then qualify for the reduced dividend rates created by the Jobs and Growth Tax Relief Reconciliation Act of 2003. Failure to maintain qualification as a REIT would force the Company to significantly reduce its distributions and possibly incur substantial indebtedness or liquidate substantial investments in order to pay the resulting corporate taxes. In addition, the Company, once having obtained REIT status and having thereafter lost such status, would not be eligible to reelect REIT status for the four subsequent taxable years, unless its failure to maintain its qualification was due to reasonable cause and not willful neglect and certain other requirements were satisfied. In order to elect again to be taxed as a REIT, just as with its original election, the Company would be required to distribute all of its earnings and profits accumulated in any non-REIT taxable year.

Table of Contents

Taxation of the Company

As long as the Company remains qualified to be taxed as a REIT, it generally will not be subject to federal income taxes on that portion of its ordinary income or capital gain that is currently distributed to shareholders.

However, the Company will be subject to federal income tax as follows:

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

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

If the Company has (i) net income from the sale or other disposition of foreclosure property that is held primarily for sale to customers in the ordinary course of business, or (ii) other non-qualifying income from foreclosure property, it will be subject to tax on such income at the highest regular corporate rate.

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

If the Company should fail to satisfy either the 75% or 95% gross income test (as discussed below), and has nonetheless maintained its qualification as a REIT because certain other requirements have been met, it will be subject to a percentage tax calculated by the ratio of REIT taxable income to gross income with certain adjustments multiplied by the gross income attributable to the greater of the amount by which the Company fails the 75% or 95% gross income test.

If the Company fails to distribute during each year at least the sum of (i) 85% of its REIT ordinary income for such year, (ii) 95% of its REIT capital gain net income for such year, and (iii) any undistributed taxable income from preceding periods, then the Company will be subject to a 4% excise tax on the excess of such required distribution over the amounts actually distributed.

In the event of a more than de minimis failure of any of the asset tests, as described below under Asset Tests, as long as the failure was due to reasonable cause and not to willful neglect, the Company files a description of each asset that caused such failure with the Internal Revenue Service (IRS), and disposes of the assets or otherwise complies with the asset tests within six months after the last day of the quarter in which the Company identifies such failure, the Company will pay a tax equal to the greater of $50,000 or 35% of the net income from the nonqualifying assets during the period in which the Company failed to satisfy the asset tests.

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

To the extent that the Company recognizes gain from the disposition of an asset with respect to which there existed built-in gain upon its acquisition by the Company from a Subchapter C corporation in a carry-over basis transaction and such disposition occurs within a maximum ten-year recognition period beginning on the date on which it was acquired by the Company, the Company will be subject to federal income tax at the highest regular corporate rate on the amount of its net recognized built-in gain.

To the extent that the Company has net income from a taxable REIT subsidiary (TRS), the TRS will be subject to federal corporate income tax in much the same manner as other non-REIT Subchapter C corporations, with the exceptions that the deductions for interest expense on debt and rental payments made by the TRS to the Company will be limited and a 100% excise tax may be imposed on transactions between the TRS and the Company or the Company s tenants that are not conducted on an arm s length basis. A TRS is a corporation in which a REIT owns stock, directly or indirectly, and for which both the REIT and the corporation have made TRS elections.

Table of Contents

Requirements for Qualification as a REIT

To qualify as a REIT for a taxable year, the Company must have no earnings and profits accumulated in any non-REIT year. The Company also must elect or have in effect an election to be taxed as a REIT and must meet other requirements, some of which are summarized below, including percentage tests relating to the sources of its gross income, the nature of the Company s assets and the distribution of its income to shareholders. Such election, if properly made and assuming continuing compliance with the qualification tests described herein, will continue in effect for subsequent years.

Organizational Requirements and Share Ownership Tests

Section 856(a) of the Code defines a REIT as a corporation, trust or association:

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

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

(3) that would be taxable, but for Sections 856 through 860 of the Code, as a domestic corporation;

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

(5) the beneficial ownership of which is held by 100 or more persons, determined without reference to any rules of attribution (the share ownership test);

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

(7) that meets certain other tests, described below, regarding the nature of its income and assets.

Section 856(b) of the Code provides that conditions (1) through (4), inclusive, must be met during the entire taxable year and that condition (5) 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 fewer than 12 months. The five or fewer test and the share ownership test do not apply to the first taxable year for which an election is made to be treated as a REIT.

The Company is also required to request annually (within 30 days after the close of its taxable year) from record holders of specified percentages of its shares written information regarding the ownership of such shares. A list of shareholders failing to fully comply with the demand for the written statements is required to be maintained as part of the Company s records required under the Code. Rather than responding to the Company, the Code allows the shareholder to submit such statement to the IRS with the shareholder s tax return.

The Company has issued shares to a sufficient number of people to allow it to satisfy the share ownership test and the five or fewer test. In addition, to assist in complying with the five or fewer test, the Company s Articles of Incorporation contain provisions restricting share transfers where the transferee (other than specified individuals involved in the formation of the Company, members of their families and certain affiliates, and certain other exceptions) would, after such transfer, own (a) more than 9.9% either in number or value of the outstanding Common Stock of the Company or (b) more than 9.9% either in number or value of any outstanding preferred stock of the Company. Pension plans and certain other tax-exempt entities have different restrictions on ownership. If, despite this prohibition, stock is acquired increasing a transferee s ownership to over 9.9% in value of either the outstanding Common Stock or any preferred stock of the Company, the stock in excess of this 9.9% in value is deemed to be held in trust for transfer at a price that does not exceed what the purported transferee paid for the stock, and, while held in trust, the stock is not entitled to receive dividends or to vote. In addition, under these circumstances, the Company also has the right to redeem such stock.

For purposes of determining whether the five or fewer test (but not the share ownership test) is met, any stock held by a qualified trust (generally, pension plans, profit-sharing plans and other employee retirement trusts) is, generally, treated as held directly by the trust s beneficiaries in proportion to their actuarial interests in the trust and not as held by the trust.

Table of Contents

Income Tests

In order to maintain qualification as a REIT, two gross income requirements must be satisfied annually.

First, at least 75% of the Company s gross income (excluding gross income from certain sales of property held as inventory or primarily for sale in the ordinary course of business) must be derived from rents from real property; interest on obligations secured by mortgages on real property or on interests in real property; gain (excluding gross income from certain sales of property held as inventory or primarily for sale in the ordinary course of business) from the sale or other disposition of, and certain other gross income related to, real property (including interests in real property and in mortgages on real property); and income received or accrued within one year of the Company s receipt of, and attributable to the temporary investment of, new capital (any amount received in exchange for stock other than through a dividend reinvestment plan or in a public offering of debt obligations having maturities of at least five years).

Second, at least 95% of the Company s gross income (excluding gross income from certain sales of property held as inventory or primarily for sale in the ordinary course of business) must be derived from dividends; interest; rents from real property; gain (excluding gross income from certain sales of property held as inventory or primarily for sale in the ordinary course of business) from the sale or other disposition of, and certain other gross income related to, real property (including interests in real property and in mortgages on real property); and gain from the sale or other disposition of stock and securities.

The Company may temporarily invest its working capital in short-term investments. Although the Company will use its best efforts to ensure that income generated by these investments will be of a type that satisfies the 75% and 95% gross income tests, there can be no assurance in this regard (see the discussion above of the new capital rule under the 75% gross income test).

For an amount received or accrued to qualify for purposes of an applicable gross income test as rents from real property or interest on obligations secured by mortgages on real property or on interests in real property, the determination of such amount must not depend in whole or in part on the income or profits derived by any person from such property (except that such amount may be based on a fixed percentage or percentages of receipts or sales). In addition, for an amount received or accrued to qualify as rents from real property, such amount may not be received or accrued directly or indirectly from a person in which the Company owns directly or indirectly 10% or more of, in the case of a corporation, the total voting power of all voting stock or the total value of all stock, and, in the case of an unincorporated entity, the assets or net profits of such entity (except for certain amounts received or accrued from a TRS in connection with property substantially rented to persons other than a TRS of the Company and other 10%-or-more owned persons). The Company leases and intends to lease property only under circumstances such that substantially all, if not all, rents from such property qualify as rents from real property. Although it is possible that a tenant could sublease space to a sublessee in which the Company is deemed to own directly or indirectly 10% or more of the tenant, the Company believes that as a result of the provisions of the Company s Articles of Incorporation that limit ownership to 9.9%, such occurrence would be unlikely. Application of the 10% ownership rule is, however, dependent upon complex attribution rules provided in the Code and circumstances beyond the control of the Company. Ownership, directly or by attribution, by an unaffiliated third party of more than 10% of the Company s stock and more than 10% of the stock of any tenant or subtenant would result in a violation of the rule.

In addition, the Company must not manage its properties or furnish or render services to the tenants of its properties, except through an independent contractor from whom the Company derives no income or through a TRS unless (i) the Company is performing services that are usually or customarily furnished or rendered in connection with the rental of space for occupancy only and the services are of the sort that a tax-exempt organization could perform without being considered in receipt of unrelated business taxable income or (ii) the income earned by the Company for other services furnished or rendered by the Company to tenants of a property or for the management or operation of the property does not exceed a de minimis threshold generally equal to 1% of the income from such property. The Company self-manages some of its properties, but does not believe it provides services to tenants that are outside the exception.

If rent attributable to personal property leased in connection with a lease of real property is greater than 15% of the total rent received under the lease, then the portion of rent attributable to such personal property will not qualify as rents from real property. Generally, this 15% test is applied separately to each lease. The portion of rental income treated as attributable to personal property is determined according to the ratio of the fair market value of the personal property to the total fair market value of the property that is rented. The determination of what fixtures and other property constitute personal property for federal tax purposes is difficult and imprecise. The Company does not have 15% by value of any of its properties classified as personal property. If, however, rent

12

payments do not qualify, for reasons discussed above, as rents from real property for purposes of Section 856 of the Code, it will be more difficult for the Company to meet the 95% and 75% gross income tests and continue to qualify as a REIT.

The Company is and expects to continue performing third-party management and development services. If the gross income to the Company from this or any other activity producing disqualified income for purposes of the 95% or 75% gross income tests approaches a level that could potentially cause the Company to fail to satisfy these tests, the Company intends to take such corrective action as may be necessary to avoid failing to satisfy the 95% or 75% gross income tests.

The Company may enter into hedging transactions with respect to one or more of its assets or liabilities. The Company s hedging activities may include entering into interest rate swaps, caps and floors, options to purchase such items, and futures and forward contracts. Income and gain from hedging transactions will be excluded from gross income for purposes of the 95% gross income test (but not the 75% gross income test). A hedging transaction includes any transaction entered into in the normal course of the Company s trade or business primarily to manage the risk of interest rate, price changes or currency fluctuations with respect to borrowings made or to be made, or ordinary obligations incurred or to be incurred, to acquire or carry real estate assets. The Company will be required to clearly identify any such hedging transaction before the close of the day on which it was acquired, originated or entered into. The Company intends to structure any hedging or similar transactions so as not to jeopardize its status as a REIT.

If the Company were to fail to satisfy one or both of the 75% or 95% gross income tests for any taxable year, it may nevertheless qualify as a REIT for such year if it is entitled to relief under certain provisions of the Code. These relief provisions would generally be available if (i) the Company s failure to meet such test or tests was due to reasonable cause and not to willful neglect and (ii) following its identification of its failure to meet these tests, the Company files a description of each item of income that fails to meet these tests in a schedule in accordance with Treasury Regulations. It is not possible, however, to know whether the Company would be entitled to the benefit of these relief provisions since the application of the relief provisions is dependent on future facts and circumstances. If these provisions were to apply, the Company would be subjected to tax equal to a percentage tax calculated by the ratio of REIT taxable income to gross income with certain adjustments multiplied by the gross income attributable to the greater of the amount by which the Company failed either of the 75% or the 95% gross income tests.

Asset Tests

At the close of each quarter of its taxable year, the Company must also satisfy four tests relating to the nature of its assets.

At least 75% of the value of the Company s total assets must consist of real estate assets (including interests in real property and interests in mortgages on real property as well as its allocable share of real estate assets held by joint ventures or partnerships in which the Company participates), cash, cash items and government securities.

Not more than 25% of the Company s total assets may be represented by securities other than those includable in the 75% asset class.

Not more than 20% of the Company s total assets may be represented by securities of one or more TRS.

Of the investments included in the 25% asset class, except for TRS, (i) the value of any one issuer s securities owned by the Company may not exceed 5% of the value of the Company s total assets, (ii) the Company may not own more than 10% of any one issuer s outstanding voting securities and (iii) the Company may not hold securities having a value of more than 10% of the total value of the outstanding securities of any one issuer. Securities issued by affiliated qualified REIT subsidiaries (QRS), which are corporations wholly owned by the Company, either directly or indirectly, that are not TRS, are not subject to the 25% of total assets limit, the 5% of total assets limit or the 10% of a single issuer s voting securities limit or the 10% of a single issuer s value limit. Additionally, straight debt and certain other exceptions are not securities for purposes of the 10% of a single issuer s value test. The existence of QRS are ignored, and the assets, income, gain, loss and other attributes of the QRS are treated as being owned or generated by the Company, for federal income tax purposes. The Company currently has 46 subsidiaries and other affiliates that it employs in the conduct of its business.

If the Company meets the asset tests described above at the close of any quarter, it will not lose its status as a REIT because of a change in value of its assets unless the discrepancy exists immediately after the acquisition of any security or other property that is wholly or partly the result of an acquisition during such quarter. Where a failure to satisfy the asset tests results from an acquisition of securities or other property during a quarter, the failure can be cured by disposition of sufficient nonqualifying assets within 30 days after the close of such quarter. The Company maintains adequate records of the value of its assets to maintain compliance with the asset tests and to take such action as may be required to cure any failure to satisfy the test within 30 days after the close of any quarter. Nevertheless, if the Company were unable to cure within the 30-day cure period, the Company may cure a violation of the 5% asset test or the 10% asset test so long as the value of the asset causing such violation does not exceed the lesser of 1% of the Company s assets at the end of the relevant quarter or $10 million and the Company disposes of the asset causing the failure or otherwise complies with the asset tests within six months after the last day of the quarter in which the failure to satisfy the asset test is discovered. For violations due to reasonable cause and not due to willful neglect that are larger than this amount, the Company is permitted to avoid disqualification as a REIT after the 30-day cure period by (i) disposing of an amount of assets sufficient to meet the asset tests, (ii) paying a tax equal to the greater of $50,000 or the highest corporate tax rate times the taxable income generated by the non-qualifying asset and (iii) disclosing certain information to the IRS.

Distribution Requirement

In order to qualify as a REIT, the Company is required to distribute dividends (other than capital gain dividends) to its shareholders in an amount equal to or greater than the excess of (a) the sum of (i) 90% of the Company s real estate investment trust taxable income (computed without regard to the dividends paid deduction and the Company s net capital gain) and (ii) 90% of the net income (after tax on such income), if any, from foreclosure property, over (b) the sum of certain non-cash income (from certain imputed rental income and income from transactions inadvertently failing to qualify as like-kind exchanges). These requirements may be waived by the IRS if the Company establishes that it failed to meet them by reason of distributions previously made to meet the requirements of the 4% excise tax described below. To the extent that the Company does not distribute all of its net long-term capital gain and all of its real estate investment trust taxable income, it will be subject to tax thereon. In addition, the Company will be subject to a 4% excise tax to the extent it fails within a calendar year to make required distributions to its shareholders of 85% of its ordinary income and 95% of its capital gain net income plus the excess, if any, of the grossed up required distribution for the preceding calendar year over the amount treated as distributed for such preceding calendar year. For this purpose, the term grossed up required distribution for any calendar year is the sum of the taxable income of the Company for the taxable year (without regard to the deduction for dividends paid) and all amounts from earlier years that are not treated as having been distributed under the provision. Dividends declared in the last quarter of the year and paid during the following January will be treated as having been paid and received on December 31 of such earlier year. The Company s distributions for 2006 were adequate to satisfy its distribution requirement.

It is possible that the Company, from time to time, may have insufficient cash or other liquid assets to meet the 90% distribution requirement due to timing differences between the actual receipt of income and the actual payment of deductible expenses or dividends on the one hand and the inclusion of such income and deduction of such expenses or dividends in arriving at real estate investment trust taxable income on the other hand. The problem of not having adequate cash to make required distributions could also occur as a result of the repayment in cash of principal amounts due on the Company s outstanding debt, particularly in the case of balloon repayments or as a result of capital losses on short-term investments of working capital. Therefore, the Company might find it necessary to arrange for short-term, or possibly long-term, borrowing or new equity financing. If the Company were unable to arrange such borrowing or financing as might be necessary to provide funds for required distributions, its REIT status could be jeopardized.

Under certain circumstances, the Company 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 the Company s deduction for dividends paid for the earlier year. The Company may be able to avoid being taxed on amounts distributed as deficiency dividends; however, the Company might in certain circumstances remain liable for the 4% excise tax described above.

Federal Income Tax Treatment of Leases

The availability to the Company of, among other things, depreciation deductions with respect to the facilities owned and leased by the Company depends upon the treatment of the Company as the owner of the facilities and the classification of the leases of the facilities as true leases, rather than as sales or financing arrangements, for federal income tax purposes. The Company has not requested nor has it received an opinion that it will be treated as the owner of the portion of the facilities constituting real property and that the leases will be treated as true leases of such real property for federal income tax purposes.

Other Issues

With respect to property acquired from and leased back to the same or an affiliated party, the IRS could assert that the Company realized prepaid rental income in the year of purchase to the extent that the value of the leased property exceeds the purchase price paid by the Company for that property. In litigated cases involving sale-leasebacks which have considered this issue, courts have concluded that buyers have realized prepaid rent where both parties acknowledged that the purported purchase price for the property was substantially less than fair market value and the purported rents were substantially less than the fair market rentals. Because of the lack of clear precedent and the inherently factual nature of the inquiry, the Company cannot give complete assurance that the IRS could not successfully assert the existence of prepaid rental income in such circumstances. The value of property and the fair market rent for properties involved in sale-leasebacks are inherently factual matters and always subject to challenge.

Additionally, it should be noted that Section 467 of the Code (concerning leases with increasing rents) may apply to those leases of the Company that provide for rents that increase from one period to the next. Section 467 provides that in the case of a so-called disqualified leaseback agreement, rental income must be accrued at a constant rate. If such constant rent accrual is required, the Company would recognize rental income in excess of cash rents and, as a result, may fail to have adequate funds available to meet the 90% dividend distribution requirement. Disqualified leaseback agreements include leaseback transactions where a principal purpose of providing increasing rent under the agreement is the avoidance of federal income tax. Since the Section 467 regulations provide that rents will not be treated as increasing for tax avoidance purposes where the increases are based upon a fixed percentage of lessee receipts, additional rent provisions of leases containing such clauses should not result in these leases being disqualified leaseback agreements. In addition, the Section 467 regulations provide that leases providing for fluctuations in rents by no more than a reasonable percentage, which is 15% for long-term real property leases, from the average rent payable over the term of the lease will be deemed to not be motivated by tax avoidance. The Company does not believe it has rent subject to the disqualified leaseback provisions of Section 467.

Subject to a safe harbor exception for annual sales of up to seven properties (or properties with a basis of up to 10% of the REIT s assets) that have been held for at least four years, gain from sales of property held for sale to customers in the ordinary course of business is subject to a 100% tax. The simultaneous exercise of options to acquire leased property that may be granted to certain tenants or other events could result in sales of properties by the Company that exceed this safe harbor. However, the Company believes that in such event, it will not have held such properties for sale to customers in the ordinary course of business.

Depreciation of Properties

For federal income tax purposes, the Company s real property is being depreciated over 31.5, 39 or 40 years using the straight-line method of depreciation and its personal property over various periods utilizing accelerated and straight-line methods of depreciation.

Failure to Qualify as a REIT

If the Company were to fail to qualify for federal income tax purposes as a REIT in any taxable year, and the relief provisions were found not to apply, the Company would be subject to tax on its taxable income at regular corporate rates (plus any applicable alternative minimum tax). Distributions to shareholders in any year in which the Company failed to qualify would not be deductible by the Company nor would they be required to be made. In such event, to the extent of current and/or accumulated earnings and profits, all distributions to shareholders would be taxable as qualified dividend income, including, presumably, subject to the 15% maximum rate on dividends created by the Jobs and Growth Tax Relief Reconciliation Act of 2003, and, subject to certain limitations in the Code, eligible for the 70% dividends received deduction for corporations that are REIT shareholders. Unless entitled to relief under specific statutory provisions, the Company would also be disqualified from taxation as a REIT for the following four taxable years. It is not possible to state whether in all circumstances the Company would be entitled to statutory relief from such disqualification. Failure to qualify for even one year could result in the Company s incurring substantial indebtedness (to the extent borrowings were feasible) or liquidating substantial investments in order to pay the resulting taxes.

Taxation of Tax-Exempt Shareholders

The IRS has issued a revenue ruling in which it held that amounts distributed by a REIT to a tax-exempt employees pension trust do not constitute unrelated business taxable income, even though the REIT may have financed certain of its activities with acquisition indebtedness. Although revenue rulings are interpretive in nature and are subject to revocation or modification by the IRS, based upon the revenue ruling and the analysis therein, distributions made by the Company to a U.S. shareholder that is a tax-exempt entity (such as an individual retirement account (IRA) or a 401(k) plan) should not constitute unrelated business taxable income unless such tax-exempt U.S. shareholder has financed the acquisition of its shares with acquisition indebtedness within the meaning of the Code, or the shares are otherwise used in an unrelated trade or business conducted by such U.S. shareholder.

Special rules apply to certain tax-exempt pension funds (including 401(k) plans but excluding IRAs or government pension plans) that own more than 10% (measured by value) of a pension-held REIT. Such a pension fund may be required to treat a certain percentage of all dividends received from the REIT during the year as unrelated business taxable income. The percentage is equal to the ratio of the REIT s gross income (less direct expenses related thereto) derived from the conduct of unrelated trades or businesses determined as if the REIT were a tax-exempt pension fund (including income from activities financed with acquisition indebtedness), to the REIT s gross income (less direct expenses related thereto) from all sources. The special rules will not require a pension fund to recharacterize a portion of its dividends as unrelated business taxable income unless the percentage computed is at least 5%.

A REIT will be treated as a pension-held REIT if the REIT is predominantly held by tax-exempt pension funds and if the REIT would otherwise fail to satisfy the five or fewer test discussed above. A REIT is predominantly held by tax-exempt pension funds if at least one tax-exempt pension fund holds more than 25% (measured by value) of the REIT s stock or beneficial interests, or if one or more tax-exempt pension funds (each of which owns more than 10% (measured by value) of the REIT s stock or beneficial interests) own in the aggregate more than 50% (measured by value) of the REIT s stock or beneficial interests. The Company believes that it will not be treated as a pension-held REIT. However, because the shares of the Company will be publicly traded, no assurance can be given that the Company is not or will not become a pension-held REIT.

Taxation of Non-U.S. Shareholders

The rules governing United States federal income taxation of any person other than (i) a citizen or resident of the United States, (ii) a corporation or partnership created in the United States or under the laws of the United States or of any state thereof, (iii) an estate whose income is includable in income for U.S. federal income tax purposes regardless of its source or (iv) a trust if a court within the United States is able to exercise primary supervision over the administration of the trust and one or more United States fiduciaries have the authority to control all substantial decisions of the trust (Non-U.S. Shareholders) are highly complex, and the following discussion is intended only as a summary of such rules. Prospective Non-U.S. Shareholders should consult with their own tax advisors to determine the impact of United States federal, state, and local income tax laws on an investment in stock of the Company, including any reporting requirements.

In general, Non-U.S. Shareholders are subject to regular United States income tax with respect to their investment in stock of the Company in the same manner as a U.S. shareholder if such investment is effectively connected with the Non-U.S. Shareholder s conduct of a trade or business in the United States. A corporate Non-U.S. Shareholder that receives income with respect to its investment in stock of the Company that is (or is treated as) effectively connected with the conduct of a trade or business in the United States also may be subject to the 30% branch profits tax imposed by the Code, which is payable in addition to regular United States corporate income tax. The following discussion addresses only the United States taxation of Non-U.S. Shareholders whose investment in stock of the Company is not effectively connected with the conduct of a trade or business in the United States.

Ordinary Dividends

Distributions made by the Company that are not attributable to gain from the sale or exchange by the Company of United States real property interests (USRPI) and that are not designated by the Company as capital gain dividends will be treated as ordinary income dividends to the extent made out of current or accumulated earnings and profits of the Company. Generally, such ordinary income dividends will be subject to United States withholding tax at the rate of 30% on the gross amount of the dividend paid unless reduced or eliminated by an applicable United States income tax treaty. The Company expects to withhold United States income tax at the rate of 30% on the gross amount of any such dividends paid to a Non-U.S. Shareholder unless a lower treaty rate applies and the Non-U.S. Shareholder has filed an IRS Form W-8BEN with the Company, certifying the Non-U.S. Shareholder s entitlement to treaty benefits.

Non-Dividend Distributions

Distributions made by the Company in excess of its current and accumulated earnings and profits to a Non-U.S. Shareholder who holds 5% or less of the stock of the Company (after application of certain ownership rules) will not be subject to U.S. income or withholding tax. If it cannot be determined at the time a distribution is made whether or not such distribution will be in excess of the Company s current and accumulated earnings and profits, the distribution will be subject to withholding at the rate applicable to a dividend distribution. However, the Non-U.S. Shareholder may seek a refund from the IRS of any amount withheld if it is subsequently determined that such distribution was, in fact, in excess of the Company s then current and accumulated earnings and profits.

Capital Gain Dividends

As long as the Company continues to qualify as a REIT, distributions made by the Company after December 31, 2005, that are attributable to gain from the sale or exchange by the Company of any USRPI will not be treated as effectively connected with the conduct of a trade or business in the United States. Instead, such distributions will be treated as REIT dividends that are not capital gains and will not be subject to the branch profits tax as long as the Non-U.S. Shareholder does not hold greater than 5% of the stock of the Company at any time during the one-year period ending on the date of the distribution. Non-U.S. Shareholders who hold more than 5% of the stock of the Company will be treated as if such gains were effectively connected with the conduct of a trade or business in the United States and generally subject to the same capital gains rates applicable to U.S. Shareholders. In addition, corporate Non-U.S. Shareholders may also be subject to the 30% branch profits tax and to withholding at the rate of 35% of the gross distribution.

Disposition of Stock of the Company

Generally, gain recognized by a Non-U.S. Shareholder upon the sale or exchange of stock of the Company will not be subject to United States taxation unless such stock constitutes a USRPI within the meaning of the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA). The stock of the Company will not constitute a USRPI so long as the Company is a domestically controlled REIT. A domestically controlled REIT is a REIT in which at all times during a specified testing period less than 50% in value of its stock or beneficial interests are held directly or indirectly by Non-U.S. Shareholders. The Company believes that it will be a domestically controlled REIT, and therefore that the sale of stock of the Company will generally not be subject to taxation under FIRPTA. However, because the stock of the Company is publicly traded, no assurance can be given that the Company is or will continue to be a domestically controlled REIT.

Under recently enacted wash sale rules applicable to certain dispositions of interests in domestically controlled REITs, a Non-U.S. Shareholder could be subject to taxation under FIRPTA on the disposition of stock of the Company if certain conditions are met. If the Company is a domestically controlled REIT, a Non-U.S. Shareholder will be treated as having disposed of USRPI, if such Non-U.S. Shareholder disposes of an interest in the Company in an applicable wash sale transaction. An applicable wash sale transaction is any transaction in which a Non-U.S. Shareholder avoids receiving a distribution from a REIT by (i) disposing of an interest in a domestically controlled REIT during the 30 day period preceding a distribution, any portion of which distribution would have been treated as gain from the sale of a USRPI if it had been received by the Non-U.S. Shareholder and (ii) acquiring, or entering into a contract or option to acquire, a substantially identical interest in the REIT during the 61 day period beginning the first day of the 30 day period preceding the distribution. The wash sale rule does not apply to a Non-U.S. Shareholder who actually receives the distribution from the Company or, so long as the Company is publicly traded, to any Non-U.S. Shareholder holding greater than 5% of the outstanding stock of the Company at any time during the one year period ending on the date of the distribution.

If the Company did not constitute a domestically controlled REIT, gain arising from the sale or exchange by a Non-U.S. Shareholder of stock of the Company would be subject to United States taxation under FIRPTA as a sale of a USRPI unless (i) the stock of the Company is regularly traded (as defined in the applicable Treasury regulations) and (ii) the selling Non-U.S. Shareholder s interest (after application of certain constructive ownership rules) in the Company is 5% or less at all times during the five years preceding the sale or exchange. If gain on the sale or exchange of the stock of the Company were subject to taxation under FIRPTA, the Non-U.S. Shareholder would be subject to regular United States income tax with respect to such gain in the same manner as a U.S. Shareholder (subject to any applicable alternative minimum tax, a special alternative minimum tax in the case of nonresident alien individuals and the possible application of the 30% branch profits tax in the case of foreign corporations), and the purchaser of the stock of the Company (including the Company) would be required to withhold and remit to the IRS 10% of the purchase price. Additionally, in such case, distributions on the stock of the Company to the extent they represent a return of capital or capital gain from the sale of the stock of the Company, rather than dividends, would be subject to a 10% withholding tax.

Table of Contents

Capital gains not subject to FIRPTA will nonetheless be taxable in the United States to a Non-U.S. Shareholder in two cases:

- if the Non-U.S. Shareholder s investment in the stock of the Company is effectively connected with a U.S. trade or business conducted by such Non-U.S. Shareholder, the Non-U.S. Shareholder will be subject to the same treatment as a U.S. shareholder with respect to such gain, or

- 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, the nonresident alien individual will be subject to a 30% tax on the individual s capital gain.

Information Reporting Requirements and Backup Withholding Tax

The Company will report to its U.S. shareholders and to the IRS the amount of dividends paid during each calendar year and the amount of tax withheld, if any, with respect thereto. Under the backup withholding rules, a U.S. shareholder may be subject to backup withholding, currently at a rate of 28% on dividends paid unless such U.S. shareholder

- is a corporation or falls within certain other exempt categories and, when required, can demonstrate this fact, or

- provides a taxpayer identification number, certifies as to no loss of exemption from backup withholding, and otherwise complies with applicable requirements of the backup withholding rules. A U.S. shareholder who does not provide the Company with his correct taxpayer identification number also may be subject to penalties imposed by the IRS. Any amount paid as backup withholding will be creditable against the U.S. shareholder s federal income tax liability. In addition, the Company may be required to withhold a portion of any capital gain distributions made to U.S. shareholders who fail to certify their non-foreign status to the Company.

Additional issues may arise pertaining to information reporting and backup withholding with respect to Non-U.S. Shareholders, and Non-U.S. Shareholders should consult their tax advisors with respect to any such information reporting and backup withholding requirements.

State and Local Taxes

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

Real Estate Investment Trust Tax Proposals

Investors must recognize that the present federal income tax treatment of the Company may be modified by future legislative, judicial or administrative actions or decisions at any time, which may be retroactive in effect, and, as a result, any such action or decision may affect investments and commitments previously made. The rules dealing with federal income taxation are constantly under review by persons involved in the legislative process and by the IRS and the Treasury Department, resulting in statutory changes as well as promulgation of new, or revisions to existing, regulations and revised interpretations of established concepts. No prediction can be made as to the likelihood of the passage of any new tax legislation or other provisions either directly or indirectly affecting the Company or its shareholders.

Other Legislation

The Jobs and Growth Tax Relief Reconciliation Act of 2003 reduced the maximum individual tax rate for long-term capital gains generally from 20% to 15% (for sales occurring after May 6, 2003 through December 31, 2008) and for dividends generally from 38.6% to 15% (for tax years from 2003 through 2008). These provisions have been extended through the 2010 tax year. Without future congressional action, the maximum tax rate on long-term capital gains will return to 20% in 2011, and the maximum rate on dividends will move to 39.6% in 2011. Because a REIT is not generally subject to federal income tax on the portion of its REIT taxable income or capital gains distributed to its shareholders, distributions of dividends by a REIT are generally not eligible for the

Table of Contents

new 15% tax rate on dividends. As a result, the Company s ordinary REIT dividends will continue to be taxed at the higher tax rates (currently, a maximum of 35%) applicable to ordinary income.

ERISA Considerations

The following is a summary of material considerations arising under ERISA and the prohibited transaction provisions of Section 4975 of the Code that may be relevant to a holder of stock of the Company. This discussion does not propose to deal with all aspects of ERISA or Section 4975 of the Code or, to the extent not preempted, state law that may be relevant to particular employee benefit plan shareholders (including plans subject to Title I of ERISA, other employee benefit plans and IRAs subject to the prohibited transaction provisions of Section 4975 of the Code, and governmental plans and church plans that are exempt from ERISA and Section 4975 of the Code but that may be subject to state law requirements) in light of their particular circumstances.

A fiduciary making the decision to invest in stock of the Company on behalf of a prospective purchaser which is an ERISA plan, a tax-qualified retirement plan, an IRA or other employee benefit plan is advised to consult its own legal advisor regarding the specific considerations arising under ERISA, Section 4975 of the Code, and (to the extent not preempted) state law with respect to the purchase, ownership or sale of stock by such plan or IRA.

Employee Benefit Plans, Tax-Qualified Retirement Plans and IRAs

Each fiduciary of an employee benefit plan subject to Title I of ERISA (an ERISA Plan) should carefully consider whether an investment in stock of the Company is consistent with its fiduciary responsibilities under ERISA. In particular, the fiduciary requirements of Part 4 of Title I of ERISA require (i) an ERISA Plan s investments to be prudent and in the best interests of the ERISA Plan, its participants and beneficiaries, (ii) an ERISA Plan s investments to be diversified in order to reduce the risk of large losses, unless it is clearly prudent not to do so, (iii) an ERISA Plan s investments to be authorized under ERISA and the terms of the governing documents of the ERISA Plan and (iv) that the fiduciary not cause the ERISA Plan to enter into transactions prohibited under Section 406 of ERISA. In determining whether an investment in stock of the Company is prudent for purposes of ERISA, the appropriate fiduciary of an ERISA Plan should consider all of the facts and circumstances, including whether the investment is reasonably designed, as a part of the ERISA Plan s portfolio for which the fiduciary has investment responsibility, to meet the objectives of the ERISA Plan, taking into consideration the risk of loss and opportunity for gain (or other return) from the investment, the diversification, cash flow and funding requirements of the ERISA Plan and the liquidity and current return of the ERISA Plan s portfolio. A fiduciary should also take into account the nature of the Company s business, the length of the Company s operating history and other matters described below under Risk Factors.

The fiduciary of an IRA or of an employee benefit plan not subject to Title I of ERISA because it is a governmental or church plan or because it does not cover common law employees (a Non-ERISA Plan) should consider that such an IRA or Non-ERISA Plan may only make investments that are authorized by the appropriate governing documents, not prohibited under Section 4975 of the Code and permitted under applicable state law.

Status of the Company under ERISA

A prohibited transaction may occur if the assets of the Company are deemed to be assets of the investing Plans and parties in interest or disqualified persons as defined in ERISA and Section 4975 of the Code, respectively, deal with such assets. In certain circumstances where a Plan holds an interest in an entity, the assets of the entity are deemed to be Plan assets (the look-through rule). Under such circumstances, any person that exercises authority or control with respect to the management or disposition of such assets is a Plan fiduciary. Plan assets are not defined in ERISA or the Code, but the United States Department of Labor issued regulations in 1987 (the Regulations) that outline the circumstances under which a Plan s interest in an entity will be subject to the look-through rule.

The Regulations apply only to the purchase by a Plan of an equity interest in an entity, such as common stock or common shares of beneficial interest of a REIT. However, the Regulations provide an exception to the look-through rule for equity interests that are publicly-offered securities.

Under the Regulations, a publicly-offered security is a security that is (i) freely transferable, (ii) part of a class of securities that is widely-held and (iii) either (a) part of a class of securities that is registered under section 12(b) or 12(g) of the Securities Exchange Act of 1934, as amended (the Exchange Act), or (b) sold to a Plan as part of an offering of securities to the public pursuant to an

19

effective registration statement under the Securities Act and the class of securities of which such security is a part is registered under the Exchange Act within 120 days (or such longer period allowed by the Securities and Exchange Commission) after the end of the fiscal year of the issuer during which the offering of such securities to the public occurred. Whether a security is considered freely transferable depends on the facts and circumstances of each case. Generally, if the security is part of an offering in which the minimum investment is $10,000 or less, any restriction on or prohibition against any transfer or assignment of such security for the purposes of preventing a termination or reclassification of the entity for federal or state tax purposes will not of itself prevent the security from being considered freely transferable. A class of securities is considered widely-held if it is a class of securities that is owned by 100 or more investors independent of the issuer and of one another.

The Company believes that the stock of the Company will meet the criteria of the publicly-offered securities exception to the look-through rule in that the stock of the Company is freely transferable, the minimum investment is less than $10,000 and the only restrictions upon its transfer are those required under federal income tax laws to maintain the Company s status as a REIT. Second, stock of the Company is held by 100 or more investors and at least 100 or more of these investors are independent of the Company and of one another. Third, the stock of the Company has been and will be part of offerings of securities to the public pursuant to an effective registration statement under the Securities Act and will be registered under the Exchange Act within 120 days after the end of the fiscal year of the Company during which an offering of such securities to the public occurs. Accordingly, the Company believes that if a Plan purchases stock of the Company, the Company s assets should not be deemed to be Plan assets and, therefore, that any person who exercises authority or control with respect to the Company s assets should not be treated as a Plan fiduciary for purposes of the prohibited transaction rules of ERISA and Section 4975 of the Code.

Available Information

The Company makes available to the public free of charge through its internet website the Company s Proxy Statement, Annual Report on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K, and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended, as soon as reasonably practicable after the Company electronically files such reports with, or furnishes such reports to, the Securities and Exchange Commission. The Company s internet website address is www.healthcarerealty.com.

The public may read and copy any materials that the Company files with the SEC at the SEC s Public Reference Room located at 100 F Street, NE, Washington, DC 20549. The public may obtain information on the operation of the Public Reference Room by calling the SEC at 1-800-SEC-0330. The SEC also maintains electronic versions of the Company s reports on its website at www.sec.gov.

Corporate Governance Principles

The Company has adopted Corporate Governance Principles relating to the conduct and operations of the Board of Directors. The Corporate Governance Principles are posted on the Company s website (www.healthcarerealty.com) and are available in print to any shareholder who requests a copy.

Committee Charters

The Board of Directors has an Audit Committee, Compensation Committee, Corporate Governance Committee and Executive Committee. The Board of Directors has adopted written charters for each committee except for the Executive Committee, which are posted on the Company s website (www.healthcarerealty.com) and are available in print to any shareholder who requests a copy.

Executive Officers

Information regarding the executive officers of the Company is set forth in Part III, Item 10 of this Annual Report on Form 10-K and is incorporated herein by reference.

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

The following are some of the risks and uncertainties that could cause the Company s actual financial condition, results of operations, business and prospects to differ materially from those contemplated by the forward-looking statements contained in this

Table of Contents

report or the Company s other filings with the SEC. If any of the following risks actually occurred, the Company s business, financial condition and operating results could suffer, and the trading price of its Common Stock could decline.

The market price of the Company s stock may be affected adversely by changes in the Company s dividend policy.

The ability of the Company to pay dividends is dependent upon its ability to maintain funds from operations and cash flow and to make accretive new investments. A failure to maintain dividend payments at current levels could result in a reduction of the market price of the Company s stock. Subsequent to the anticipated sales of the Company s senior living portfolio, the Company intends to reset its quarterly dividend to an amount commensurate with the smaller asset base resulting from the sales.

The anticipated sales of the Company s senior living portfolio have not yet closed and are subject to events outside the control of the Company.

The sales of the Company s senior living portfolio are subject to negotiation with third parties and other business risks associated with the ownership of real property, such as casualty loss. If these transactions do not close for any reason, the strategic results that the Company hopes to achieve, including the payment of a one-time special dividend, will not be realized. There can be no assurance that the sales will occur within the timeframe that the Company expects or at all.

At times, the Company may have cash that it is unable to invest in suitable properties, which could adversely affect the Company s future revenues and its ability to maintain or increase dividends to shareholders; there is considerable competition in the Company s market for attractive investments.

From time to time, the Company will have cash available from various sources, including (1) the proceeds of sales of shares of its securities, (2) principal payments on its mortgage investments, and (3) the sale of its properties, including non-elective dispositions under the terms of master leases or similar financial support arrangements. The Company must invest these proceeds, on a timely basis and at comparable yields, in other healthcare investments or in qualified short-term investments. The Company competes for real estate investments with a broad variety of potential investors. This competition for investments may negatively affect the Company s ability to make timely investments on acceptable terms. While funds are unused for property investments, they are invested in short-term obligations which have been at historically low yields. Accordingly, delays in utilizing excess cash to acquire properties will negatively impact revenues and perhaps the Company s ability to maintain or increase its distributions to shareholders.

At times, the Company may have limited access to capital, which would slow the Company s growth.

A REIT is required to make dividend distributions and retains less of its capital for growth. As a result, a REIT is required to grow through the steady investment of new capital in real estate assets. Presently, the Company has sufficient capital availability. However, there will be times when the Company will have limited access to capital from the equity and/or debt markets. During such periods, virtually all of the Company s available capital will be required to meet existing commitments and to reduce existing debt. The Company may not be able to obtain additional equity or debt capital or dispose of assets on favorable terms, if at all, at the time it requires additional capital to acquire healthcare properties on a competitive basis or to meet its obligations.

Adverse trends in the healthcare service industry may negatively affect the Company s lease revenues and the values of its investments.

The healthcare service industry is currently experiencing:

- Changing trends in the method of delivery of healthcare services;
- Increased expense for uninsured patients;
- Increased liability insurance expense;
- Continuing pressure by private and governmental payors to contain costs and reimbursements; and
- Increased scrutiny and formal investigations by federal and state authorities.

These changes can adversely affect the economic performance of some or all of the tenants and sponsors who provide financial support to the Company s investments and, in turn, negatively affect the lease revenues and the value of the Company s property investments.

The Company s revenues depend on the ability of its tenants and sponsors to generate sufficient income from their operations to make loan and rent payments to the Company.

The Company s revenues are subject to the financial strength of its tenants and sponsors. The Company has no operational control over the business of these tenants and sponsors who face a wide range of competitive and regulatory pressures and constraints. Such pressures and constraints could materially impair these tenants and sponsors and prevent them from making their loan and rent payments to the Company which may have a negative effect on the Company s revenues.

If a healthcare tenant loses its licensure or certification, becomes unable to provide healthcare services, cannot meet its financial obligations to the Company or otherwise vacates the facility, the Company would have to obtain another provider for the affected facility.

If the Company loses a tenant or sponsor and is unable to attract another healthcare provider on a timely basis and on acceptable terms the Company s revenues could suffer. In addition, many of the Company s properties are special-purpose facilities that may not be easily adaptable to uses unrelated to healthcare. Transfers of operations of healthcare facilities are often subject to regulatory approvals not required for transfers of other types of commercial operations and real estate.

The Company may experience uninsured or underinsured losses related to casualty or liability.

The Company generally requires its tenants to maintain comprehensive liability and property insurance that covers the Company as well as the tenants. The Company also carries comprehensive liability insurance and property insurance covering its owned and managed properties. Some types of losses, however, either may be uninsurable or too expensive to insure against. Should an uninsured loss or a loss in excess of insured limits occur, the Company could lose all or a portion of the capital it has invested in a property, as well as the anticipated future revenue from the property. In such an event, the Company might nevertheless remain obligated for any mortgage debt or other financial obligation related to the property. The Company cannot give assurance that material losses in excess of insurance proceeds will not occur in the future.

The Company owns facilities that are operated by companies that have experienced regulatory and legal problems.

The Company s tenants and sponsors are subject to a complex system of federal and state regulations relating to the delivery of healthcare services. If a tenant or sponsor experiences regulatory or legal problems, the Company could be at risk for amounts owed to it by the tenant under leases or financial support agreements.

If the Company fails to maintain an effective system of internal control over financial reporting, it may not be able to accurately or timely report its financial results.

Management of the Company is responsible for establishing and maintaining adequate internal control over financial reporting. Internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting for external purposes in accordance with U.S. generally accepted accounting principles. Internal control over financial reporting includes: maintaining records that in reasonable detail accurately and fairly reflect the Company s transactions; providing reasonable assurance that transactions are recorded as necessary for preparation of the financial statements; providing reasonable assurance that the Company s receipts and expenditures of its assets are made in accordance with management authorization; and providing reasonable assurance that unauthorized acquisition, use or disposition of Company assets that could have a material effect on the financial statements would be prevented or detected on a timely basis. Because of its inherent limitations, internal control over financial reporting is not intended to provide absolute assurance that a misstatement of the Company s financial statements would be prevented or detected. Any failure to maintain an effective system of internal control over financial reporting could limit the Company s ability to report financial results accurately and timely or to detect and prevent fraud.

Failure to maintain its status as a REIT, even in one taxable year, could cause the Company to reduce its dividends dramatically.

The Company intends to qualify at all times as a REIT under the Code. If in any taxable year the Company does not qualify as a REIT, it would be taxed as a corporation. As a result, the Company could not deduct its distributions to the shareholders in computing its taxable income. Depending upon the circumstances, a REIT that loses its qualification in one year may not be eligible to re-qualify during the four succeeding years. Further, certain transactions or other events could lead to the Company being taxed at rates ranging from four to 100 percent on certain income or gains.

Item 1B. ***Unresolved Staff Comments***

None.

Item 2. ***Properties***

In addition to the properties described under Item 1, Business and in Schedule III of Item 15 hereto, the Company leases its headquarters office space.

The Company s headquarters, located in offices at 3310 West End Avenue in Nashville, Tennessee, are leased from an unrelated third party. The Company s current lease agreement, which commenced on November 1, 2003, covers approximately 30,934 square feet of rented space and expires on October 31, 2010, with two five-year renewal options. Annual base rent was approximately $596,820 in 2006 and increases approximately 3.25% annually thereafter.

Item 3. ***Legal Proceedings***

On October 9, 2003, HR Acquisition I Corporation (f/k/a Capstone Capital Corporation, Capstone), a wholly-owned affiliate of the Company, was served with the Third Amended Verified Complaint in a shareholder derivative suit which was originally filed on August 28, 2002 in the Jefferson County, Alabama Circuit Court by a shareholder of HealthSouth Corporation. The allegations in the suit relate to activities which occurred before the Company acquired Capstone in 1998. The suit alleges that certain officers and directors of HealthSouth, who were also officers and directors of Capstone, sold real estate properties from HealthSouth to Capstone and then leased the properties back to HealthSouth at artificially high values, in violation of their fiduciary obligations to HealthSouth. The Company acquired Capstone in a merger transaction in October, 1998. None of the Capstone officers and directors remained in his or her position following the Company s acquisition of Capstone. The complaint seeks an accounting and disgorgement of monies obtained by the allegedly wrongful conduct and other unspecified compensatory and punitive damages. There is currently a stay on discovery in the case. The plaintiff and certain defendants in the case reached an agreement to settle a portion of the claim presented in the case and such settlement was approved by the court in January 2007. This settlement did not include the Company or several other defendants. The Company will defend itself vigorously and believes that the claims brought by the plaintiff are not meritorious.

In May, 2006, Methodist Health System Foundation, Inc. (the Foundation) filed suit against a wholly-owned affiliate of the Company in the Civil District Court for Orleans Parish, Louisiana. The Foundation is the sponsor under financial support agreements which support the Company s ownership and operation of two medical office buildings adjoining the Methodist Hospital in east New Orleans. The Foundation received substantial cash proceeds from the sale of the Pendleton Memorial Methodist Hospital to an affiliate of Universal Health Services, Inc. in 2003. The Foundation s assets and income are not primarily dependent upon the operations of Methodist Hospital, which has remained closed since Hurricane Katrina struck in August 2005. The Foundation s suit alleges that Hurricane Katrina and its aftermath should relieve the Foundation of its obligations under the financial support agreements. The agreements do not contain any express provision allowing for termination upon a casualty event. The Company believes the Foundation s claims are not meritorious and will vigorously defend the enforceability of the financial support agreements.

The Company is not aware of any other pending or threatened litigation that, if resolved against the Company, would have a material adverse effect on the Company s financial condition or results of operations.

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

No matter was submitted to a vote of shareholders during the fourth quarter of 2006.

Table of Contents

PART II

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

Shares of the Company s Common Stock are traded on The New York Stock Exchange under the symbol HR. As of December 31, 2006, there were approximately 1,564 shareholders of record. The following table sets forth the high and low sales prices per share of Common Stock and the distributions declared and paid per share of Common Stock during the periods indicated.

	High	Low	Distributions Declared and Paid per Share
2006			
First Quarter	$38.80	$32.96	$ 0.660
Second Quarter	38.90	31.25	0.660
Third Quarter	38.79	31.90	0.660
Fourth Quarter (Payable on March 2, 2007)	42.83	37.30	0.660
2005			
First Quarter	$41.03	$35.25	$ 0.650
Second Quarter	39.91	35.83	0.655
Third Quarter	41.36	37.36	0.660
Fourth Quarter	40.19	31.01	0.660

Future distributions will be declared and paid at the discretion of the Board of Directors and will depend upon cash generated by operating activities, borrowings under the Unsecured Credit Facility due 2009, proceeds from mortgage notes receivable repayments, and proceeds from sales of real estate investments or capital market financings. Subsequent to the anticipated sales of the Company s senior living portfolio, the Company intends to reset its quarterly dividend to an amount commensurate with the smaller asset base resulting from the sales. Management expects that the dividend will be reset for the second quarter of 2007 in an amount of approximately $1.54 per common share, per annum, subject to the determination by the Board of Directors.

Additionally, management expects that the Company would pay a one-time special dividend to shareholders of approximately $4.75 per common share out of the proceeds from the sales of the senior living assets. The payment of this one-time special dividend is dependent on the closing of the sales transactions as currently contemplated. If any of the sales transactions do not close or do not close timely for any reason, the Company may be unable to pay the one-time special dividend or may have to reduce the amount of the dividend.

The dividends paid during 2006 exceeded cash flows from operations. Such amounts in excess of cash flows from operations were funded by the Company s Unsecured Credit Facility due 2009. The Company believes that its liquidity and sources of capital are adequate to satisfy its cash requirements. The Company cannot, however, be certain that these sources of funds will be available at a time and upon terms acceptable to the Company in sufficient amounts to meet its liquidity needs.

Equity Compensation Plan Information

The following table provides information as of December 31, 2006 about the Company s Common Stock that may be issued upon grants of restricted stock and the exercise of options, warrants and rights under all of the Company s existing compensation plans including the 2003 Employees Restricted Stock Incentive Plan, the 2000 Employee Stock Purchase Plan, the 1994 Dividend Reinvestment Plan, and the 1995 Restricted Stock Plan for Non-Employee Directors.

Number of Securities Remaining Available for

Plan Category	Number of Securities to Be Issued upon Exercise of Outstanding Options, Warrants and Rights(1)	Weighted-Average Exercise Price of Outstanding Options, Warrants and Rights(1)	Future Issuance Under Equity Compensation Plans (Excluding Securities Reflected in the First Column) (2)
Equity compensation plans approved by security holders	171,481		1,338,895
Equity compensation plans not approved by security holders	0		2,001,060
Total	171,481		3,339,955

(1) The Company is unable to ascertain with specificity the number of securities to be issued upon exercise of outstanding rights under the 2000 Employee Stock Purchase Plan or the weighted average exercise price of outstanding rights under that plan. The

2000 Employee Stock Purchase Plan provides that shares of Common Stock may be purchased at a per share price equal to 85% of the fair market value of the Common Stock at the beginning of the offering period or a purchase date applicable to such offering period, whichever is lower.

(2) Includes securities available for future issuance under the 2003 Employees Restricted Stock Incentive Plan.

All of the Company s equity compensation plans were approved by the shareholders, except the 2003 Employees Restricted Stock Incentive Plan, which provides for awards of restricted shares of the Company s Common Stock to full-time salaried employees of the Company or its subsidiaries and affiliates on such terms and conditions, and subject to such restrictions, as the Compensation Committee may determine. Such conditions may be based on continuing employment or achievement of pre-established financial objectives or both. The 2003 Employees Restricted Stock Incentive Plan covers a fixed number of shares and terminates on December 1, 2012. Subject to the risk of forfeiture and transfer restrictions, eligible employees shall have all rights as shareholders with respect to the shares issued pursuant to the plan, including the right to vote and receive dividends or other distributions on such shares. For employees under employment agreements, upon certain merger, change in control, or liquidation events involving the Company, all shares covered by outstanding awards under the plan will immediately vest, unless provisions are made in connection with such transaction for the continuance of the plan. Moreover, all shares covered by outstanding awards to employees under employment agreements will immediately vest if a participant s employment with the Company is terminated without cause or, in the case of the Company s executive officers, upon that officer s retirement.

Item 6. ***Selected Financial Data***

The Company s selected financial data, set forth in its 2006 Annual Report to Shareholders under the caption Selected Financial Information, is incorporated herein by reference to Exhibit 13 to this Annual Report on Form 10-K.

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

The Company s information relating to management s discussion and analysis of financial condition and results of operations set forth in the Company s 2006 Annual Report to Shareholders under the caption Management s Discussion and Analysis of Financial Condition and Results of Operations, is incorporated herein by reference to Exhibit 13 to this Annual Report on Form 10-K.

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

See Market Risk in Management s Discussion and Analysis of Financial Condition and Results of Operations, set forth in the Company s 2006 Annual Report to Shareholders, which is incorporated herein by reference to Exhibit 13 to this Annual Report on Form 10-K.

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

The Company s financial statements and the related notes, together with the reports of BDO Seidman, LLP thereon, set forth in the Company s 2006 Annual Report to Shareholders, are incorporated herein by reference to Exhibit 13 to this Annual Report on Form 10-K.

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

None.

Item 9A. ***Controls and Procedures***

Disclosure Controls and Procedures:

The Company maintains disclosure controls and procedures designed to ensure that information required to be disclosed in the Company s reports under the Securities and Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission s rules and forms. These disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that the information required to be disclosed is accumulated and communicated to management, including the Chief Executive Officer and Chief Financial Officer, to allow for timely decisions regarding required disclosure.

The Company s management, with the participation of the Company s Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of the Company s disclosure controls and procedures (as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the Exchange Act)), as of the end of the period covered by this Annual Report on Form 10-K. Based on such evaluation, the Company s Chief Executive Officer and Chief Financial Officer have concluded that, as of the end of such period, the Company s disclosure controls and procedures are effective in recording, processing, summarizing and reporting, on a timely basis, information required to be disclosed by the Company in the reports that it files or submits under the Exchange Act.

Changes in the Company s Internal Control over Financial Reporting:

None.

Management s Annual Report on Internal Control Over Financial Reporting:

Management s Annual Report on Internal Control Over Financial Reporting, set forth in the Company s 2006 Annual Report to Shareholders, is incorporated herein by reference to Exhibit 13 to this Annual Report on Form 10-K.

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

Departure of Senior Executive Officer

The Company s Senior Vice President and Chief Operating Officer, J. D. Carter Steele, will retire from the Company effective March 1, 2007.

PART III

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

Directors

Information with respect to directors, set forth in the Company s Proxy Statement relating to the Annual Meeting of Shareholders to be held on May 15, 2007 under the caption Election of Directors, is incorporated herein by reference.

Executive Officers

The executive officers of the Company are:

Name	Age	Position
David R. Emery	62	Chairman of the Board & Chief Executive Officer
Scott W. Holmes	52	Senior Vice President & Chief Financial Officer
J. D. Carter Steele	58	Senior Vice President & Chief Operating Officer
John M. Bryant, Jr.	40	Senior Vice President & General Counsel
B. Douglas Whitman, II	38	Senior Vice President of Real Estate Investments

Mr. Emery formed the Company and has held his current positions since May 1992. Prior to 1992, Mr. Emery was engaged in the development and management of commercial real estate in Nashville, Tennessee. Mr. Emery has been active in the real estate industry for more than 35 years.

Mr. Holmes is a licensed CPA and has served as the Chief Financial Officer since January 1, 2003 and was the Senior Vice President Financial Reporting (principal accounting officer) from October 1998 until January 1, 2003. Prior to joining the Company, Mr. Holmes was Vice President Finance and Data Services at Trigon HealthCare, Inc., an insurance company located in Virginia. Mr. Holmes was with Ernst & Young LLP for more than 13 years and has considerable audit and financial reporting experience relating to public companies.

Mr. Steele has served as the Chief Operating Officer since January 1, 2003 and has held senior management positions relating to asset administration of the Company since May 1997. He serves as a point of contact for all issues related to real estate investments, due diligence advisory services and property management. Mr. Steele has over 20 years experience in structuring and executing real estate transactions. Mr. Steele is a former partner with the commercial real estate brokerage firm McWilliams & Steele in Nashville, Tennessee. Mr. Steele will retire as the Company s Chief Operating Officer effective as of March 1, 2007.

Mr. Bryant became the Company s Senior Vice President and General Counsel on November 1, 2003. From April 22, 2002 until November 1, 2003, Mr. Bryant was Vice President and Assistant General Counsel. Prior to joining the Company, Mr. Bryant was a shareholder with the law firm of Baker Donelson Bearman & Caldwell in Nashville, Tennessee.

Mr. Whitman joined the Company in 1998, and, as the Company s Senior Vice President of Real Estate Investments, he is responsible for overseeing the acquisition and development of outpatient medical facilities. Prior to joining the Company, Mr. Whitman worked for the University of Michigan Health System and HCA Inc.

Code of Ethics

The Company has adopted a Code of Business Conduct and Ethics (the Code of Ethics) that applies to its principal executive officer, principal financial officer, principal accounting officer and controller, or persons performing similar functions, as well as all directors, officers and employees of the Company. The Code of Ethics is posted on the Company s website (www.healthcarerealty.com) and is available in print free of charge to any shareholder who requests a copy. Interested parties may address a written request for a printed copy of the Code of Ethics to: Investor Relations: Healthcare Realty Trust Incorporated, 3310 West End Avenue, Suite 700, Nashville, Tennessee 37203. The Company intends to satisfy the disclosure requirement regarding any amendment to, or a waiver of, a provision of the Code of Ethics for the Company s principal executive officer, principal financial officer, principal accounting officer or controller, or persons performing similar functions by posting such information on the Company s website.

Section 16(a) Compliance

Information with respect to compliance with Section 16(a) of the Securities Exchange Act of 1934, as amended, set forth in the Company s Proxy Statement relating to the Annual Meeting of Shareholders to be held on May 15, 2007 under the caption Security Ownership of Certain Beneficial Owners and Management Section 16(a) Beneficial Ownership Reporting Compliance, is incorporated herein by reference.

Shareholder Recommendation of Director Candidates

There have been no material changes with respect to the Company s policy relating to shareholder recommendations of director candidates. Such information is set forth in the Company s Proxy Statement relating to the Annual Meeting of Shareholders to be held on May 15, 2007 under the caption Shareholder Recommendation or Nomination of Director Candidates, is incorporated herein by reference.

Audit Committee

Information relating to the Company s Audit Committee, its members and the audit committee s financial expert is set forth in the Company s Proxy Statement relating to the Annual Meeting of Shareholders to be held on May 15, 2007 under the caption Committee Membership, is incorporated herein by reference.

Table of Contents

Item 11. ***Executive Compensation***

Information relating to executive compensation, set forth in the Company s Proxy Statement relating to the Annual Meeting of Shareholders to be held on May 15, 2007 under the captions Compensation Discussion and Analysis, Executive Compensation, Compensation Committee Interlocks and Insider Participation and Compensation Committee Report is incorporated herein by reference.

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

Information relating to the security ownership of management and certain beneficial owners, set forth in the Company s Proxy Statement relating to the Annual Meeting of Shareholders to be held on May 15, 2007 under the caption Security Ownership of Certain Beneficial Owners and Management, is incorporated herein by reference.

Information relating to securities authorized for issuance under the Company s equity compensation plans, set forth in Item 5 of this Annual Report on Form 10-K under the caption Equity Compensation Plan Information, is incorporated herein by reference.

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

Information relating to certain relationships and related transactions, and director independence, set forth respectively, in the Company s Proxy Statement relating to the Annual Meeting of Shareholders to be held on May 15, 2007 under the captions Certain Relationships and Related Transactions, and Independence of Directors, as applicable, are incorporated herein by reference.

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

Information relating to the fees paid to the Company s accountants, set forth in the Company s Proxy Statement relating to the Annual Meeting of Shareholders to be held on May 15, 2007 under the caption Selection of Auditors Audit and Non-Audit Fees, is incorporated herein by reference.

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

(a) *Index to Historical Financial Statements, Financial Statement Schedules and Exhibits*

(1) **Financial Statements:**

The following financial statements of Healthcare Realty Trust Incorporated are incorporated herein by reference to Item 8 of this Annual Report on Form 10-K.

Consolidated Balance Sheets December 31, 2006 and 2005.

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

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

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

Notes to Consolidated Financial Statements.

(2) **Financial Statement Schedules:**

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

Table of Contents

(3) **Exhibits:**

Exhibit Number	Description of Exhibits
3.1	Second Articles of Amendment and Restatement of the Registrant.(1)
3.2	Amended and Restated Bylaws of the Registrant.(4)
4.1	Specimen stock certificate.(1)
4.2	Indenture, dated as of May 15, 2001, by the Company to HSBC Bank USA, National Association, as Trustee, (formerly First Union National Bank, as Trustee).(6)
4.3	First Supplemental Indenture, dated as of May 15, 2001, by the Company to HSBC Bank USA, National Association, as Trustee, (formerly First Union National Bank, as Trustee).(6)
4.4	Form of 8.125% Senior Note Due 2011.(6)
4.5	Second Supplemental Indenture, dated as of March 30, 2004, by the Company to HSBC Bank USA, National Association, as Trustee (formerly Wachovia Bank, National Association, as Trustee).(11)
4.6	Form of 5.125% Senior Note Due 2014.(11)
10.1	1995 Restricted Stock Plan for Non-Employee Directors of Healthcare Realty Trust Incorporated.(3)
10.2	Amended and Restated Executive Retirement Plan.(7)
10.3	Retirement Plan for Outside Directors.(1)
10.4	2000 Employee Stock Purchase Plan.(5)
10.5	Dividend Reinvestment Plan.(2)
10.6	2003 Employees Restricted Stock Incentive Plan.(7)
10.7	Amendment No. 1 to 2003 Employees Restricted Stock Incentive Plan.(10)
10.8	Amended and Restated Employment Agreement by and between David R. Emery and Healthcare Realty Trust Incorporated.(12)
10.9	Employment Agreement by and between John M. Bryant, Jr. and Healthcare Realty Trust Incorporated.(9)
10.10	Employment Agreement by and between Scott W. Holmes and Healthcare Realty Trust Incorporated.(8)
10.11	Employment Agreement by and between J.D. Carter Steele and Healthcare Realty Trust Incorporated.(8)

10.12	Credit Agreement, dated as of January 25, 2006, by and among the Company, Bank of America, N.A., as Administrative Agent, and the other lenders named therein.(13)
10.13	Employment Agreement by and between B. Douglas Whitman, II and Healthcare Realty Trust Incorporated (filed herewith).
11	Statement re computation of per share earnings (contained in Note 11 to the Notes to the Consolidated Financial Statements for the year ended December 31, 2006 filed herewith as Exhibit 12).
13	Annual Report to Shareholders for the year ended December 31, 2006 (filed herewith).
21	Subsidiaries of the Registrant (filed herewith).
23	Consent of BDO Seidman, LLP, independent auditors (filed herewith).
31.1	Certification of the Chief Executive Officer of Healthcare Realty Trust Incorporated pursuant to Rule 13a-14 of the Securities Exchange Act of 1934, as amended, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (filed herewith).

Table of Contents

Exhibit Number	Description of Exhibits
31.2	Certification of the Chief Financial Officer of Healthcare Realty Trust Incorporated pursuant to Rule 13a-14 of the Securities Exchange Act of 1934, as amended, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (filed herewith).
32	Certifications pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (filed herewith).

(1) Filed as an exhibit to the Company s Registration Statement on Form S-11 (Registration No. 33-60506) previously filed pursuant to the Securities Act of 1933 and hereby incorporated by reference.

(2) Filed as an exhibit to the Company s Registration Statement on Form S-11 (Registration No. 33-72860) previously filed pursuant to the Securities Act of 1933 and hereby incorporated by reference.

(3) Filed as an exhibit to the Company s Form 10-K for the year ended December 31, 1995 and hereby

incorporated by reference.

(4) Filed as an exhibit to the Company s Form 10-Q for the quarter ended September 30, 1999 and hereby incorporated by reference.

(5) Filed as an exhibit to the Company s Form 10-K for the year ended December 31, 1999 and hereby incorporated by reference.

(6) Filed as an exhibit to the Company s Form 8-K filed May 17, 2001 and hereby incorporated by reference.

(7) Filed as an exhibit to the Company s Form 10-Q for the quarter ended March 31, 2002 and hereby incorporated by reference.

(8) Filed as an exhibit to the Company s Form 10-K for the year ended December 31, 2002 and hereby incorporated by reference.

(9) Filed as an exhibit to the Company s Form 10-Q for the quarter ended September 30, 2003 and hereby incorporated by reference.

(10) Filed as an exhibit to the Company s Form 10-K for the year ended December 31, 2003 and hereby incorporated by reference.

(11) Filed as an exhibit to the Company s Form 8-K filed March 29, 2004 and hereby incorporated by reference.

(12) Filed as an exhibit to the Company s Form 10-Q for the quarter ended September 30, 2004 and hereby incorporated by reference.

(13) Filed as an exhibit to the Company s Form 8-K filed January 26, 2006 and hereby incorporated by reference.

Executive Compensation Plans and Arrangements

The following is a list of all executive compensation plans and arrangements filed as exhibits to this Annual Report on Form 10-K:

1. 1995 Restricted Stock Plan for Non-Employee Directors of Healthcare Realty Trust Incorporated (filed as Exhibit 10.1)

2. Executive Retirement Plan, as amended (filed as Exhibit 10.2)

3. Retirement Plan for Outside Directors (filed as Exhibit 10.3)

4. 2000 Employee Stock Purchase Plan (filed as Exhibit 10.4)

5. 2003 Employees Restricted Stock Incentive Plan (filed as Exhibit 10.6)

6. Amendment No. 1 to 2003 Employees Restricted Stock Incentive Plan (filed as Exhibit 10.7)

7. Amended and Restated Employment Agreement by and between David R. Emery and Healthcare Realty Trust Incorporated (filed as Exhibit 10.8)

8. Employment Agreement by and between John M. Bryant, Jr. and Healthcare Realty Trust Incorporated (filed as Exhibit 10.9)

9. Employment Agreement by and between Scott W. Holmes and Healthcare Realty Trust Incorporated (filed as Exhibit 10.10)

10. Employment Agreement by and between J. D. Carter Steele and Healthcare Realty Trust Incorporated (filed as Exhibit 10.11)

11. Employment Agreement by and between B. Douglas Whitman, II and Healthcare Realty Trust Incorporated (filed as Exhibit 10.13).

Table of Contents

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Company has duly caused this Report to be signed on its behalf by the undersigned, thereunto duly authorized, in the City of Nashville, State of Tennessee, on February 28, 2007.

HEALTHCARE REALTY TRUST INCORPORATED

By: /s/ David R. Emery

David R. Emery
Chairman of the Board and Chief Executive Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, this Report has been signed by the following persons on behalf of the Company and in the capacities and on the date indicated.

Signature	Title	Date
/s/ David R. Emery David R. Emery	Chairman of the Board and Chief Executive Officer (Principal Executive Officer)	February 28, 2007
/s/ Scott W. Holmes Scott W. Holmes	Senior Vice President and Chief Financial Officer (Principal Financial Officer)	February 28, 2007
/s/ David L. Travis David L. Travis	Vice President and Chief Accounting Officer (Principal Accounting Officer)	February 28, 2007
/s/ Errol L. Biggs, Ph.D. Errol L. Biggs, Ph.D.	Director	February 28, 2007
/s/ Charles Raymond Fernandez, M.D. Charles Raymond Fernandez, M.D.	Director	February 28, 2007
/s/ Batey M. Gresham, Jr. Batey M. Gresham, Jr.	Director	February 28, 2007
/s/ Marliese E. Mooney Marliese E. Mooney	Director	February 28, 2007
/s/ Edwin B. Morris, III Edwin B. Morris, III	Director	February 28, 2007

/s/ John Knox Singleton	Director	February 28, 2007
John Knox Singleton		
/s/ Bruce D. Sullivan	Director	February 28, 2007
Bruce D. Sullivan		
/s/ Dan S. Wilford	Director	February 28, 2007
Dan S. Wilford		

Table of Contents

Report of Independent Registered Public Accounting Firm

Board of Directors and Stockholders
Healthcare Realty Trust Incorporated
Nashville, Tennessee

The audits referred to in our report dated March 1, 2007 relating to the consolidated financial statements of Healthcare Realty Trust Incorporated, which is contained in Item 8 of this Annual Report on Form 10-K included the audit of the financial statement schedules listed in the accompanying index. These financial statement schedules are the responsibility of the Company s management. Our responsibility is to express an opinion on these financial statement schedules based upon our audits.

In our opinion such financial statement schedules present fairly, in all material respects, the information set forth therein.

Memphis, Tennessee	/s/ BDO Seidman, LLP
March 1, 2007	
	BDO Seidman, LLP

34

Table of Contents

Schedule II Valuation and Qualifying Accounts at December 31, 2006
(Dollars in thousands)

	Description	Balance at Beginning of Period	Additions: Charged to costs and expenses	Additions: Charged to other accounts(2)	Deductions(1)	Balance at End of Period
2006	Accounts and notes receivable allowance	$ 1,998	$ 1,256	$ 0	$ 732	$ 2,522
	Preferred stock investment reserve	1,000	0	0	0	1,000
		2,998	1,256	0	732	3,522
2005	Accounts and notes receivable allowance	2,016	1,308	0	1,326	1,998
	Preferred stock investment reserve	1,000	0	0	0	1,000
		3,016	1,308	0	1,326	2,998
2004	Accounts and notes receivable allowance	1,864	(212)	618	254	2,016
	Preferred stock investment reserve	1,000	0	0	0	1,000
		$ 2,864	$ (212)	$ 618	$ 254	$ 3,016

(1) Write-off of related receivable accounts.

(2) Reserve on accounts receivable in a foreclosure in

2004.

Table of Contents

Schedule III Real Estate and Accumulated Depreciation at December 31, 2006
(Dollars in thousands)

	Land			Buildings, Improvements, and CIP								
		Costs Capitalized Subsequent to			Costs Capitalized Subsequent to				(1)			
e	Initial Investment	Acquisition	Total	Initial Investment	Acquisition	Total	Personal Property	(3) Total Assets	Accumulated Depreciation	Encumbrances	Date Acquired	
	$ 103,748	$ 2,515	$ 106,263	$ 1,135,477	$ 102,446	$ 1,237,923	$ 1,646	$ 1,345,832	$ 252,977	$ 51,056	1993-2006	1974
	6,192	0	6,192	118,505	2,415	120,920	2,690	129,802	28,565	0	1998-2005	
	2,969	7	2,976	58,101	2,405	60,506	1,023	64,505	12,238	0	1998-2005	

2,330	0	2,330	154,164	0	154,164	0	156,494	36,650	0	1998-1998
5,832	150	5,982	69,993	0	69,993	0	75,975	8,543	0	1994-2006
5,550	365	5,915	133,138	3,317	136,455	2,975	145,345	30,241	9,005	1993-2005
126,621	3,037	129,658	1,669,378	110,583	1,779,961	8,334	1,917,953	369,214	60,061	
						14,373	14,373	4,492		
$ 126,621	$ 3,037	$ 129,658	$ 1,669,378	$ 110,583	$ 1,779,961	$ 22,707	$ 1,932,326	$ 373,706	$ 60,061	

(1) Depreciation is provided for on a straight-line basis on buildings and improvements over 3.3, 7.0, 15.0, 20.0, 31.5 or 39.0 years, lease intangibles over 13 to 106 months, personal property over 3.0 or 7.0 years, and land improvements over 15.0 years.

(2) Development at 12/31/06.

(3) Total assets at 12/31/06 have an estimated aggregate total cost of approximately $1.8 billion for Federal Income Tax Purposes.

(4) Includes assets held for sale at 12/31/05 of $26.1 million and accumulated depreciation of $4.7 million and at 12/31/04 of $74.9 million and accumulated depreciation of $13.6 million.

Table of Contents

Schedule III Real Estate and Accumulated Depreciation at December 31, 2006 (continued)

(5) Reconciliation of Total Property and Accumulated Depreciation for the twelve months ended December 31, 2006, 2005, and 2004:

	Year to Date Ending 12/31/06		Year to Date Ending 12/31/05 (4)		Year to Date Ending 12/31/04 (4)	
	Total Property	Accumulated Depreciation	Total Property	Accumulated Depreciation	Total Property	Accumulated Depreciation
Beginning Balance	$ 1,859,149	$ 320,487	$ 1,908,195	$ 284,155	$ 1,563,859	$ 232,536
Additions during the period:						
Real Estate	96,231	62,676	82,851	59,352	352,150	54,520
Corporate Property	300	576	997	1,244	1,268	548
Construction in Progress	31,805		6,311		5,709	
Retirements/dispositions:						
Real Estate	(55,106)	(9,980)	(139,187)	(24,247)	(14,631)	(3,335)
Corporate Property	(53)	(53)	(18)	(17)	(160)	(114)
Ending Balance	$ 1,932,326	$ 373,706	$ 1,859,149	$ 320,487	$ 1,908,195	$ 284,155

Table of Contents

Schedule IV Mortgage Loans on Real Estate
As of December 31, 2006
(dollars in thousands)

Description	Interest Rate	Maturity Date	Periodic Payment Terms	Original Face Amount	Carrying Amount (1)	Balloon
Assisted living facility located in California	9.83%	12/1/2005	(4)	5,300	4,632	4,632(5)
Assisted living facility located in Arizona	12.05%	1/1/2007	(4)	4,805	4,462	4,462(5)
Group of assisted living facilities located in various states	10.00%	6/30/2008	(1)	10,800	10,800	10,800(6)
Group of assisted living facilities in various states	10.00%	3/3/2008	(1)	21,426	21,426	21,426(8)
Group of independent living facilities located in Indiana	12.00%	5/7/2009	(9)	6,000	6,000	6,000(10)
Group of assisted living facilities in Georgia	12.50%	10/31/2008	(12)	4,750	4,750	4,750(13)
Ancillary hospital facility located in California	8.30%	5/12/2016	(7)	14,920	14,920	14,920(14)
Group of skilled nursing facilities and one assisted living facility located in Michigan	15.00%	6/29/2009	(1)	3,927	4,887	4,887(11)
Ancillary hospital facility located in Texas	8.50%	9/1/2031	(2)	1,986	1,979	(3)
Total Mortgage Notes Receivable					$ 73,856	

Notes:

(1) Interest only until maturity. Then principal is payable in full.

(2) Paid in monthly installments of principal and interest. Fully amortized over 300 months.

(3)

Prepayment may be made at anytime after July 5, 2010.

(4) Paid in monthly installments of principal and interest. Principal payable in full at maturity date. Amortized over 300 months.

(5) Yield Maintenance Amount is defined generally as a percentage of the Principal amount being prepaid x [(Present value of the principal and interest payments remaining to maturity at a discount rate) (Principal amount outstanding at the time of prepayment)].

(6) Prepayment may be made at any time after January 1, 2007 with at least nine months prior written notice.

(7) Interest only payments until May 2011, then principal balance amortized over 25 years. Amortization

schedule to be determined at that time.

(8) Prepayment may not be made without prior written consent.

(9) Interest only until December 2007, then principal balance amortized over 25 years. Amortization schedule to be determined at that time.

(10) Prepayment may be made at anytime after August 8, 2007.

(11) Prepayment may be made at anytime after June 30, 2008. The Company funded an additional $960 on the note during 2006.

(12) Interest only until February 2007, then principal balance amortized over 25 years. Amortization schedule to be determined at that time.

(13) Prepayment may be made at anytime after

January 31, 2007.

(14) Prepayment may be made at anytime after May 12, 2008.

Table of Contents

Schedule IV Mortgage Loans on Real Estate
As of December 31, 2006
(continued)

	Years Ended December 31,		
	2006	2005	2004
Balance at beginning of period	$ 105,795	$ 40,321	$ 91,835
Additions during period:			
New or acquired mortgages	37,787	71,976	1,260
	37,787	71,976	1,260
Deductions during period:			
Scheduled principal payments	(347)	(2,180)	(562)
Mortgage repayments	(69,124)	(4,073)	(46,397)
Foreclosures and assignments			(6,242)
Amortization	(255)	(249)	427
	(69,726)	(6,502)	(52,774)
Balance at end of period	$ 73,856	$ 105,795	$ 40,321

39