ANDREA ELECTRONICS CORP
Form S-3
September 10, 2001

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AS FILED WITH THE SECURITIES AND EXCHANGE COMMISSION ON SEPTEMBER 10, 2001
REGISTRATION NO. _______________

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

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

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ANDREA ELECTRONICS CORPORATION
(Exact name of registrant as specified in its charter)

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|---|---|
| NEW YORK | 11-0482020 |
| (State or other jurisdiction of incorporation or organization) | (I.R.S. Employer Identification No.) |

45 MELVILLE PARK ROAD
MELVILLE, NEW YORK 11747
(631) 719-1800
(Address, including zip code, and telephone number, including area code, of registrant's principal executive offices)

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|---|---|
| CHRISTOPHER P. SAUVIGNE | with a copy to: |
| CHIEF EXECUTIVE OFFICER AND PRESIDENT | |
| ANDREA ELECTRONICS CORPORATION | LORI M. BERESFORD, ESQ. |
| 45 MELVILLE PARK ROAD | MULDOON MURPHY & FAUCETTE LLP |
| MELVILLE, NEW YORK 11747 | 5101 WISCONSIN AVENUE, N.W. |
| (631) 719-1800 | WASHINGTON, D.C. 20016 |
| (Name, address, including zip code, and telephone number, including area code, of agent for service) | (202) 362-0840 |

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Approximate date of commencement of proposed sale to the public:
From Time To Time After The Effective Date Of This Registration Statement.

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

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

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

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

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

Calculation of Registration Fee

| Title of Each Class of Securities To Be Registered | Amount To Be Registered(1) | Proposed Maximum Offering Price Per Unit(2) | Proposed Maximum Aggregate Offering Price (2) | R |
|---|---|---|---|---|
| Common Stock, par value $.50 per share | 8,748,113 | $0.60 | $5,248,868 | |

(1) Shares of Common Stock that may be offered pursuant to this registration statement consist of shares that may be issuable upon conversion of Series C convertible preferred stock. For purposes of estimating the number of shares of Common Stock to be included in this registration statement, we included 8,748,113 shares, which together with 2,142,298 shares registered under Registration Statement No. 333-51424, initially filed by the Registrant on December 7, 2000, represents 200% of the number of shares of Common Stock issuable upon conversion in full of the outstanding Series C convertible preferred stock as of September 7, 2001 at a conversion price of $1.44 per share, plus shares that may be issued as a result of any stock split, stock dividend or similar transaction as provided by Rule 416 under the Securities Act.

(2) Estimated solely for the purpose of calculating the registration fee pursuant to Rule 457(c) under the Securities Act, on the basis of the average of the high and low prices for shares of Common Stock as reported on the American Stock Exchange on September 7, 2001.

(3) Pursuant to Rule 429 under the Securities Act of 1933, the Prospectus contained in this Registration Statement also relates to an additional 2,463,058 shares previously registered on Registration Statement Number 333-51424, as to which a registration fee in the amount of $2,163 has already been paid.

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

In accordance with Rule 429 under the Securities Act of 1933, as amended, the Prospectus contained in this Registration Statement relates to a total of 11,211,171 shares of the Registrant's Common Stock, 8,748,113 of which are being registered pursuant to this Registration Statement and 2,463,058 of which were registered in the Registrant's Registration Statement No. 333-51424 filed with the Securities and Exchange Commission on December 7, 2000. This Registration Statement, which is a new Registration Statement, also constitutes Post- Effective Amendment No. 1 to Registration Statement No. 333-51424, which shall hereafter become effective concurrently with the effectiveness of this Registration Statement in accordance with Section 8(a) of the Securities Act of 1933, as amended.

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SUBJECT TO COMPLETION, DATED SEPTEMBER 10, 2001.

PROSPECTUS

ANDREA ELECTRONICS CORPORATION
11,211,171 SHARES
COMMON STOCK

This prospectus relates to 11,211,171 shares of our Common Stock which may be sold from time to time by the selling stockholders, including their transferees. Included in the 11,211,171 shares are 2,463,058 shares of our common stock previously covered by an earlier registration statement.

We will not receive any of the proceeds from the sale of these shares, although we have paid the expenses of preparing this prospectus and the related registration statement.

Our Common Stock is quoted on the American Stock Exchange under the symbol "AND." On September 7, 2001, the last reported sale price for the Common Stock on the American Stock Exchange was $0.52 per share.

Investing in the Common Stock involves a high degree of risk. You should carefully read the "Risk Factors" section of this prospectus beginning on page 3 of this prospectus.

Neither the Securities and Exchange Commission nor any state securities commission has approved or disapproved these securities or determined whether this prospectus is truthful or complete. Any representation to the contrary is a criminal offense.

The date of this prospectus is September __, 2001

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PROSPECTUS SUMMARY

This summary may not contain all of the information that may be important to you. You should read the entire prospectus before making an investment decision. Our financial statements and related notes are not included in this prospectus, but are incorporated by reference from the documents listed under the caption "Incorporation of Certain Documents by Reference" located at the end of this prospectus.

ANDREA ELECTRONICS

Andrea Electronics designs, develops and manufacturers state-of-the-art microphone technologies and equipment for enhancing speech-based applications software and communications that require high performance and high quality voice input.

Andrea's products and technologies optimize the performance of speech-based applications software and communications in markets such as:

- voice communication over the Internet;
- speech recognition and dictation to desktop, laptop and hand-held computers;
- audio/video conferencing;
- computer-based automobile monitoring and control systems for use by drivers and passengers;
- electronic equipment for incorporation into home appliances and industrial and commercial office equipment that is activated and controlled by voice;
- electronic intercom systems for incorporation into military and commercial aircraft; and
- interactive games where one or more players participate over the Internet.

Our patented Active Noise Cancellation microphone and Active Noise Reduction earphone technologies help to ensure clear speech in personal computer and telephone headset applications. Active Noise Cancellation microphone technology uses electronic circuits that distinguish a speaker's voice from background noise in the speaker's environment and then cancels the noise from the signal to be transmitted by the microphone. Active Noise Reduction earphone technology uses electronic circuits that distinguish the signal coming through an earphone from background noise in the listener's environment and then reduces the noise heard by the listener. Together with our lower-end noise cancelling headset products, these technologies and related products comprise our Andrea Anti-Noise line of business.

Our patented and patent-pending Andrea Digital Super Directional Array and Andrea Direction Finding and Tracking Array technologies enable the person speaking to be several feet from the microphone, and frees the speaker from having to hold the microphone (we refer to this capability as "far-field" microphone use). Our DSDA and DFTA microphone products convert sound received by the array of microphones in the product into digital signals that are then processed to cancel background noise from the signal to be transmitted. These two technologies represent the core technologies within our portfolio of far-field technologies. We are initially targeting our far-field microphone technologies at the market for personal computers designed for use in automobiles, trucks and buses to control sound systems, mobile telephones, satellite-based navigation systems, and other devices within vehicles. These technologies and related products comprise our Andrea Digital Signal Processing (DSP) Microphone and Software line of business.

In May 1998, we acquired Lamar Signal Processing, Ltd., an Israeli corporation engaged in the development of scalable, digital signal processing-based directional, noise cancellation microphone technologies,



which included primarily DSDA and DFTA. The consideration paid by Andrea for Lamar was approximately 1,800,000 shares of restricted common stock, $1,000,000 in cash and $2,000,000 in notes payable. We recorded the cash at stated value. We discounted the value of the notes payable to $1,615,000 to reflect Andrea's borrowing rate as well as the time value of the payments on the notes, and we discounted the value of the shares to $23,129,532 to reflect, among other things, trading restrictions on the shares. We believe that the acquired technologies, together with the research staff at Lamar, provide Andrea with noise filtering capabilities and performance that is superior to other DSP-based technologies in the marketplace, and unattainable in traditional mechanical-based microphone solutions.

We are incorporated under the laws of the State of New York and have been engaged in the electronic communications industry since 1934. For several decades prior to our entry into the voice-activated computing market in the 1990's, our sole business was selling intercom systems for military and industrial use. We refer to this line of business , which continues to represent a significant portion of Andrea's business, as Aircraft Communications. We are seeking to apply our knowledge of the military and industrial markets to develop applications of our Andrea DSP Microphone and Software technologies.

You should read the following information about Andrea, together with the more detailed information about the securities underlying this offering, contained elsewhere in this prospectus. In particular, you should read the section entitled "Risk Factors," which explains that your investment in shares of our Common Stock involves a high degree of risk.

## RISK FACTORS

AN INVESTMENT IN OUR COMMON STOCK INVOLVES A HIGH DEGREE OF RISK. YOU SHOULD CONSIDER CAREFULLY, ALONG WITH OTHER FACTORS, THE FOLLOWING RISKS AND SHOULD CONSULT WITH YOUR OWN LEGAL, TAX AND FINANCIAL ADVISORS.

BECAUSE OUR OPERATING RESULTS ARE SUBJECT TO SIGNIFICANT FLUCTUATION, PERIOD-TO-PERIOD COMPARISONS OF OUR OPERATING RESULTS MAY NOT NECESSARILY BE MEANINGFUL AND YOU SHOULD NOT RELY ON THEM AS INDICATIONS OF OUR FUTURE PERFORMANCE.

Our results of operations have historically been and are subject to continued substantial annual and quarterly fluctuations. The causes of these fluctuations include, among other things:

- o the volume of sales of our products under our collaborative marketing arrangements;
- o the cost of development of our products under our collaborative development arrangements;
- o the mix of products we sell;
- o the mix of distribution channels we use;
- o the timing of our new product releases and those of our competitors;
- o fluctuations in the computer and communications hardware and software marketplace; and
- o general economic conditions.

We cannot assure that the level of sales and gross profit, if any, that we achieve in any particular fiscal period will not be significantly lower than in other fiscal periods. Our revenues for the 2001 Second Quarter were approximately $2.6 million compared to approximately $3.2 million in the 2000 Second Quarter. For both the 2001 Second Quarter and 2000 Second Quarter, we had a net loss attributable to common shareholders of approximately





$2.5 million. Our revenues for the 2001 First Half were approximately $5.2 million compared to approximately $6.4 million in the 2000 First Half. For the 2001 First Half we had a net loss attributable to common shareholders of approximately $5.2 million compared to a net loss attributable to common shareholders of $5.1 million in the 2000 First Half. We have experienced a significant decline in headset unit shipments, offset to an extent, by an increase in aircraft communication revenues. In response, we are examining opportunities for cost-reduction, production efficiencies and further diversification of our business. But to remain competitive, we intend to continue incurring substantial research and development, marketing and general and administrative expenses. We may not be able to easily and quickly reduce these expenses if our sales revenue falls below our expectations and, therefore, our net income or loss may be disproportionately affected by any reduction in sales revenue. Furthermore, our acquisition in 1998 of Lamar Signal Processing, Ltd. resulted in a substantial amount of goodwill and other intangible assets. The amortization of these intangible assets has, and will continue to have, a negative, non-cash impact on our results of operations. As a result of these factors, we expect to continue to accumulate losses and the market price of our Common Stock could decline.

IF WE FAIL TO OBTAIN ADDITIONAL CAPITAL, WE WILL BE REQUIRED TO SIGNIFICANTLY REDUCE, SELL, OR REFOCUS OUR OPERATIONS AND OUR BUSINESS; RESULTS OF OPERATIONS AND FINANCIAL CONDITION COULD BE MATERIALLY AND ADVERSELY AFFECTED.

From time to time during the past several years, we have raised additional capital from external sources. We expect to continue to have to raise additional capital from external sources. These sources may include private or public financings through the issuance of debt, convertible debt or equity, or collaborative arrangements. Andrea has engaged an investment banker to assist it in seeking additional capital and funding. Additional capital and funding may not be available on favorable terms, if at all. Additionally, we may only be able to obtain additional capital or funds through arrangements that require us to relinquish rights to our products, technologies or potential markets, in whole or in part, or result in the sale of Andrea. In the event we are unsuccessful in raising additional capital or funding, our funding will be primarily reliant upon existing funding sources and gross cash flows from operations which are expected to be insufficient to maintain our operations at current levels. Additionally, Andrea's funding and capital raising efforts could trigger change in control payments due to certain executive officers of Andrea under their employment contracts.

SHARES ELIGIBLE FOR FUTURE SALE MAY HAVE AN ADVERSE EFFECT ON MARKET PRICE; YOU MAY EXPERIENCE SUBSTANTIAL DILUTION.

Sales of a substantial number of shares of our Common Stock in the public market could have the effect of depressing the prevailing market price of our Common Stock. Of the 70,000,000 shares of Common Stock presently authorized, 15,503,866 were outstanding as of September 7, 2001. This does not include 5,915,625 shares of our Common Stock reserved for issuance upon exercise of outstanding awards granted under our 1991 Performance Equity Plan and 1998 Stock Plan and shares of our Common Stock reserved for further awards under the 1998 Stock Plan and 20,496,848 shares of Common Stock reserved for issuance upon conversion of the Series B and Series C convertible preferred stock and exercise of related warrants. In addition, in May 1998, we issued 1,800,000 shares of Common Stock as part of the consideration for our acquisition of Lamar Signal Processing, Ltd. Trading restrictions on these 1,800,000 shares have expired and are subject to demand and piggyback registration rights. To date, 920,880 of the 1,800,000 shares have been registered for sale under the Securities Act of 1933.

CONVERSIONS OF OUR SERIES B CONVERTIBLE PREFERRED STOCK AND SERIES C CONVERTIBLE PREFERRED STOCK MAY RESULT IN SUBSTANTIAL DILUTION TO OTHER HOLDERS OF OUR COMMON STOCK.

As of September 7, 2001, we had 283 shares of Series B convertible preferred stock and 750 shares of Series C convertible preferred stock outstanding. Both the Series B convertible preferred stock and the Series C convertible preferred stock are convertible into shares of Common Stock, subject to ownership limitations that prohibit the holders of the preferred stock from owning more than 4.99% of the outstanding shares of Common



Stock at the time of conversion or 9.99% over the sixty day period prior to the conversion. These restrictions do not prevent purchasers from converting and selling some of their holdings and then later converting the rest of their holdings.

AS THE PRICE OF OUR COMMON STOCK DECREASES, THE NUMBER OF SHARES OF COMMON STOCK ISSUABLE UPON CONVERSION OF OUR SERIES B CONVERTIBLE PREFERRED STOCK AND SERIES C CONVERTIBLE PREFERRED STOCK INCREASES.

The variable conversion price of the Series B convertible preferred stock and any reset of the conversion price of the Series C convertible preferred stock are functions of the market price of our Common Stock. If the price of our Common Stock decreases over time, the number of shares of Common Stock issuable upon conversion of each series will increase. In addition, In accordance with the provisions of Emerging Issues Task Force Issue No. 98-5, "Accounting for Convertible Securities with Beneficial Conversion Features or Contingently Adjustable Conversion Ratios", Andrea may be required to record, at the time of exercise for such additional Preferred Shares, a charge to accumulated deficit as a result of this beneficial conversion right.

The following table illustrates the varying amounts of shares of Common Stock issuable upon conversion of all 283 shares of Series B Convertible Preferred Stock at the indicated conversion prices (without regard to any limitations on conversion) and assuming that the 4% additional amount is paid in cash:

| Assumed Conversion Price | Assumed Number of Shares Converted(1) | Number of Shares Outstanding after Assumed Conversion | Percentage of Outstanding Common Stock(2) |
|---|---|---|---|
| $0.50 | 5,660,000 | 21,163,886 | 27% |
| $1.50 | 1,886,667 | 17,390,553 | 11% |
| $2.50 | 1,132,000 | 16,635,886 | 7% |
| $3.50 | 808,571 | 16,312,457 | 5% |
| $4.50 | 628,889 | 16,132,775 | 4% |
| $5.50 | 514,545 | 16,018,431 | 3% |
| $6.50 | 435,385 | 15,939,271 | 3% |
| $7.50 | 377,333 | 15,881,219 | 2% |

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(1) The Series B Holder is prohibited from converting its holdings of the Series B Convertible Preferred Stock if after giving effect to such conversion it would beneficially own in excess of 4.99% or, over the sixty day period prior to the conversion, 9.99% of the outstanding shares of our Common Stock following such conversion. The numbers in this column do not reflect these limitations.
(2) Based on 15,503,866 shares of Common Stock outstanding as of September 7, 2001.

The following table illustrates, as of any reset date and assuming the conversion price indicated is lower than the then applicable conversion price on that date, the varying amounts of shares of Common Stock that would be issuable upon conversion of all outstanding 750 shares of Series C convertible preferred stock at the indicated



conversion prices (without regard to any limitations on conversion) and assuming that the 5% additional amount is paid in cash:

| Assumed Conversion Price | Assumed Number of Shares Converted(1) | Number of Shares Outstanding after Assumed Conversion | Percentage of Outstanding Common Stock(2) |
|---|---|---|---|
| $0.40 | 18,750,000 | 34,253,886 | 55% |
| $0.55 | 13,636,364 | 29,140,250 | 47% |
| $0.70 | 10,714,286 | 26,218,172 | 41% |

| | | | |
|---|---|---|---|
| $0.85 | 8,823,529 | 24,327,415 | 36% |
| $1.00 | 7,500,000 | 23,003,886 | 33% |
| $1.15 | 6,521,739 | 22,025,625 | 30% |
| $1.30 | 5,769,231 | 21,273,117 | 27% |
| $1.44 | 5,208,333 | 20,712,219 | 25% |

(1) The Series C Holder is prohibited from converting its holdings of the Series C Convertible Preferred Stock if after giving effect to such conversion it would beneficially own in excess of 4.99% or, over the sixty day period prior to the conversion, 9.99% of the outstanding shares of our Common Stock following such conversion. The numbers in this column do not reflect these limitations.

(2) Based on 15,503,866 shares of Common Stock outstanding as of September 7, 2001.

The following table illustrates the varying amounts of shares of Common Stock that would be issuable upon conversion of all 283 outstanding shares of Series B convertible preferred stock and all 750 outstanding shares of Series C convertible preferred stock at the indicated conversion prices (without regard to any limitations on conversion) and assuming that all additional amounts are paid in cash:

| Assumed Conversion Price | Assumed Number of Shares Converted(1)(2)(3) | Number of Shares Outstanding after Assumed Conversion | Percentage of Outstanding Common Stock(4) |
|---|---|---|---|
| $0.50 | 20,660,000 | 36,163,886 | 57% |
| $1.00 | 10,330,000 | 25,833,886 | 40% |
| $1.44 | 7,173,611 | 22,677,497 | 32% |
| $2.50 | 6,340,333 | 21,844,219 | 29% |
| $3.50 | 6,016,905 | 21,520,791 | 28% |
| $4.50 | 5,837,222 | 21,341,108 | 27% |
| $5.50 | 5,722,879 | 21,226,765 | 27% |
| $6.50 | 5,643,718 | 21,147,604 | 27% |
| $7.50 | 5,585,667 | 21,089,553 | 26% |

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(1) The calculation assumes that the conversion price of the Series B and Series C convertible preferred stock are the same at the assumed conversion prices of $.50, $1.00 and $1.44. This could only occur if the market price of Andrea's Common Stock declines, and at a future reset date, the conversion price of the Series C adjusts to the then prevailing market price (the current fixed conversion price of the Series C is $1.44, and such conversion price is fixed unless adjusted downward at a future reset date).

(2) The calculation assumes that for any conversion of the Series B convertible preferred stock when the prevailing market price is above $1.44, the Series C would still be converted at its maximum conversion price of $1.44.

(3) The Series B and Series C holder is prohibited from converting the Series C or Series B convertible preferred stock, or from exercising the warrants

issued in connection with the Series B convertible preferred stock, if after giving effect to such conversion it would beneficially own in excess of 4.99% or, over the sixty day period prior to the conversion, 9.99% of the outstanding shares of our Common Stock following such conversion.

(4) Based on 15,503,866 shares of Common Stock outstanding as of September 7, 2001.

SALES OF AN INCREASED NUMBER OF SHARES OF COMMON STOCK ISSUED UPON CONVERSION OF THE SERIES B CONVERTIBLE PREFERRED STOCK AND THE SERIES C CONVERTIBLE PREFERRED STOCK RESULTING FROM A DECLINING MARKET PRICE FOR OUR COMMON STOCK CAN CAUSE THE MARKET PRICE OF OUR COMMON STOCK TO DECLINE FURTHER.

Disregarding the manner in which the shares of Common Stock issued upon conversion of the Series B convertible preferred stock and the Series C convertible preferred stock are sold as well as any other factors such as reactions to our operating results and general market conditions which may be operative in the market at such time, an increase in the number of shares of Common Stock eligible for sale can cause a decrease in the market price of our Common Stock. This decrease would reduce the conversion prices of the Series B convertible preferred stock and the Series C convertible preferred stock, leading to a further increase in the number of shares of Common Stock issuable upon future conversions and a further decline in our stock price.

SHORT SALES OF OUR COMMON STOCK MAY BE ATTRACTED BY OR ACCOMPANY CONVERSIONS OF SERIES B CONVERTIBLE PREFERRED STOCK AND SERIES C CONVERTIBLE PREFERRED STOCK, WHICH SALES MAY CAUSE DOWNWARD PRESSURE UPON THE PRICE OF OUR COMMON STOCK.

Short sales of our Common Stock may be attracted by or accompany the sale of converted Common Stock, which in the aggregate could cause downward pressure upon the price of the Common Stock, regardless of our operating results, thereby attracting additional short sales of the Common Stock. The result of conversions of the Series B and Series C convertible preferred stock at declining conversion prices would be increasing and substantial dilution of the interests of the other holders of Common Stock.

IF WE FAIL TO MARKET AND COMMERCIALIZE OUR ANDREA ANTI-NOISE AND ANDREA DIGITAL SIGNAL PROCESSING MICROPHONE AND SOFTWARE PRODUCTS AS WELL AS OUR AIRCRAFT COMMUNICATIONS PRODUCTS, OUR REVENUES MAY NOT INCREASE AT A HIGH ENOUGH RATE TO IMPROVE OUR RESULTS OF OPERATIONS OR AT ALL.

Our business, results of operations and financial condition depend on successful commercialization of our Andrea Anti-Noise and Andrea DSP Microphone and Software products and technologies. Since we began sales of the initial Andrea Anti-Noise products in 1995, we have been expanding the number of products in this line. We introduced our first Andrea Digital Super Directional Array products in 1998 and we are initially targeting these and our other Andrea DSP Microphone and Software products at the market for computer-based automobile monitoring and control systems for use by drivers and passengers. This market is commonly referred to as the automobile



telematics market. The success of these products is subject to the risks frequently encountered by companies in an early stage of product commercialization, particularly companies in the computing and communications industries.

IF WE ARE UNABLE TO OBTAIN MARKET ACCEPTANCE OF OUR VOICE INTERFACE AND INTERNET COMMUNICATIONS PRODUCTS AND TECHNOLOGIES, OR IF MARKET ACCEPTANCE OF THESE PRODUCTS AND TECHNOLOGIES OCCURS AT A SLOW RATE, THEN OUR BUSINESS, RESULTS OF OPERATIONS AND FINANCIAL CONDITION WILL BE MATERIALLY AND ADVERSELY AFFECTED.

We and our competitors are focused on developing and commercializing products and technologies that enhance the use of voice, particularly in noisy environments, for a broad range of computer and communications applications. These products and technologies have been rapidly evolving and the number of our competitors has grown, but the markets for these products and technologies are subject to a high level of uncertainty and have been developing slowly. We, alone or together with our industry, may be unsuccessful in obtaining market acceptance of these products and technologies.

IF WE FAIL TO DEVELOP AND SUCCESSFULLY INTRODUCE NEW PRODUCTS AND TECHNOLOGIES IN RESPONSE TO COMPETITION AND EVOLVING TECHNOLOGY, WE MAY NOT BE ABLE TO ATTRACT NEW CUSTOMERS OR RETAIN CURRENT CUSTOMERS.

The markets in which we sell our Andrea Anti-Noise and Andrea DSP Microphone and Software products and our Aircraft Communication products are highly competitive. We may not compete successfully with any of our competitors. Most of our current and potential competitors have significantly greater financial, technology development, marketing, technical support and other resources than we do. Consequently, these competitors may be able to respond more quickly to new or emerging technologies and changes in customer requirements, or devote greater resources to the development, marketing, and sale of their products than we can. One or more of these competitors may independently develop technologies that are substantially equivalent or superior to our technology. The introduction of products incorporating new technologies could render our products obsolete and unmarketable and could exert price pressures on existing products.

We are currently engaged in the development of digital signal processing products and technologies for the voice, speech and natural language interface markets. We may not succeed in developing these new digital signal processing products and technologies, and any of these new digital signal processing products or technologies may not gain market acceptance.

In the markets for our aircraft communications products, we often compete with major defense electronics corporations as well as smaller manufacturing firms which -specialize in supplying products and technologies for specific military initiatives. Further, the markets for our products and technologies are characterized by evolving industry standards and specifications that may require us to devote substantial time and expense to adapt our products and technologies. We may not successfully anticipate and adapt our products and technologies in a cost effective and timely manner to changes in technology and industry standards or to introductions of new products and technologies by others that render our then existing products and technologies obsolete.

IF OUR MARKETING COLLABORATORS DO NOT EFFECTIVELY MARKET THOSE OF THEIR PRODUCTS WITH WHICH OUR PRODUCTS ARE INCLUDED OR INCORPORATED, OUR SALES GROWTH COULD BE ADVERSELY AFFECTED.

We have entered into several collaborative and distribution arrangements with software publishers and computer hardware manufacturers relating to the marketing and sale of Andrea Anti-Noise products and Andrea DSP Microphone and Software products through inclusion or incorporation with the products of our collaborators. Our success will therefore be dependent to a substantial degree on the efforts of these collaborators to market those of their products with which our products are included or incorporated. Our collaborators may not successfully market these products. In addition, our collaborators generally are not contractually obligated to any minimum level of sales of our products or technologies, and we have no control over their marketing efforts. Furthermore, our collaborators may develop their own microphone, earphone or headset products that may replace our products or technologies or to which they may give higher priority.

IF WE FAIL TO MAINTAIN SALES OF ANDREA ANTI-NOISE PRODUCTS AND ANDREA DSP MICROPHONE AND SOFTWARE PRODUCTS TO IBM, WE WOULD EXPERIENCE A MATERIAL ADVERSE EFFECT ON OUR BUSINESS, RESULTS OF OPERATIONS AND FINANCIAL CONDITION.

We are substantially dependent on our product procurement relationship with IBM. During the 2001 Second Quarter, IBM and certain of IBM's affiliates, distributors, licensees and integrators accounted for 25% of our net sales. This represents an approximate 49% decrease from the 2000 Second Quarter. While we are a party to a procurement agreement with IBM covering the purchase by IBM of certain of our Andrea Anti-Noise microphone and earphone products for inclusion with certain of IBM's personal computer products, IBM is not obligated to purchase these products and is free to purchase microphone and earphone products and technologies from our competitors. Our failure to maintain sales of Andrea Anti-Noise Products and Andrea DSP Microphone and Software Products to IBM would have a material adverse effect on our business, results of operations and financial condition.

IF WE FAIL TO MAINTAIN SALES OF AIRCRAFT COMMUNICATION PRODUCTS TO THE U.S. GOVERNMENT, WE WOULD EXPERIENCE A MATERIAL ADVERSE EFFECT ON OUR BUSINESS, RESULTS OF OPERATIONS AND FINANCIAL CONDITION.

We are substantially dependent on product sales to the U.S. Government. During the 2001 Second Quarter, the U.S. Government accounted for 27% of our net sales. The U.S. Government is not obligated to continue to purchase these products and is free to purchase similar products from our competitors. Our failure to maintain sales of Aircraft Communication Products to the U.S. Government would have a material adverse effect on our business, results of operations and financial condition.

SHORTAGES OF, OR INTERRUPTIONS IN, THE SUPPLY OF MORE SPECIALIZED COMPONENTS FOR ALL OF OUR PRODUCTS COULD HAVE A MATERIAL ADVERSE EFFECT ON OUR SALES.

We conduct assembly operations at our facilities in New York and Israel and through subcontractors using purchased components. Some specialized components for our products, such as microphones, digital signal processing boards and mechanical switches, as well as other discrete components, are available from a limited number of suppliers and subject to long lead times. We may not be able to continue to obtain sufficient supplies of these more specialized components, particularly if our sales increase substantially or market demand for these components otherwise increases.

IF OUR SUBCONTRACTOR FAILS TO MEET OUR PRODUCTION AND SHIPMENT SCHEDULES, OUR BUSINESS, RESULTS OF OPERATIONS AND FINANCIAL CONDITION WOULD BE MATERIALLY AND ADVERSELY AFFECTED.

We conduct assembly operations at our facilities in New York and Israel and through subcontracting. During initial production runs of Andrea Anti-Noise and Andrea DSP Microphone products, we perform assembly operations at our New York facility from purchased components. As sales of any particular product increase, assembly operations are primarily transferred to a subcontractor in

Asia.

OUR ABILITY TO COMPETE MAY BE LIMITED BY OUR FAILURE TO ADEQUATELY PROTECT OUR INTELLECTUAL PROPERTY OR BY PATENTS GRANTED TO THIRD PARTIES.

We rely on a combination of patents, patent applications, trade secrets, copyrights, trademarks, nondisclosure agreements with our employees, licensees and potential licensees, limited access to and dissemination of our proprietary information, and other measures to protect our intellectual property and proprietary rights.





However, the steps that we have taken to protect our intellectual property may not prevent its misappropriation or circumvention. In addition, numerous patents have been granted to other parties in the fields of noise cancellation, noise reduction, computer voice recognition, digital signal processing and related subject matter. We expect that products in these fields will increasingly be subject to claims under these patents as the numbers of products and competitors in these fields grow and the functionality of products overlap. Claims of this type could have an adverse effect on our ability to manufacture and market our products or to develop new products and technologies, because the parties holding these patents may refuse to grant licenses or only grant licenses with onerous royalty requirements. Moreover, the laws of other countries do not protect our proprietary rights to our technologies to the same extent as the laws of the United States.

AN UNFAVORABLE RULING IN ANY CURRENT LITIGATION PROCEEDING OR FUTURE PROCEEDING MAY ADVERSELY AFFECT OUR BUSINESS, RESULTS OF OPERATIONS AND FINANCIAL CONDITION.

From time to time we are subject to litigation incidental to our business. For example, we are subject to the risk of adverse claims, interference proceedings before the U.S. Patent and Trademark Office, oppositions to patent applications outside the United States, and litigation alleging infringement of the proprietary rights of others. Litigation to establish the validity of patents, to assert infringement claims against others, and to defend against patent infringement claims can be expensive and time-consuming, even if the outcome is in our favor.

As more fully disclosed in "Item 3. Legal Proceedings" in our annual report on Form 10-K for the year ended December 31, 2000 incorporated herein by reference, on November 17, 1998 a complaint was filed against us in the U.S. District Court for the Eastern District of New York by NCT Group, Inc. and NCT Hearing Products, Inc., one of NCT's subsidiaries, requesting a declaration that two of our patents, which relate to active noise reduction technology applicable to aircraft passenger headphones, are invalid and unenforceable and that these patents are not being infringed by NCT's products. The complaint also seeks to enjoin us from engaging in certain alleged activities and seeks compensatory damages of not less than $5 million, punitive damages of not less than $50 million and plaintiffs' costs and attorneys' fees.

On December 30, 1998, we filed and served an answer to the NCT complaint, denying the allegations and asserting affirmative defenses and counterclaims. The counterclaims seek injunctive relief for patent infringement, trademark infringement, false designation of origin and unfair competition. We are also seeking exemplary and punitive damages, prejudgment interest on all damages, costs, reasonable attorneys' fees and expenses. During the second half of 1999, both NCT and Andrea submitted briefs to the court on whether to have an early hearing on the meaning of the claims in the two Andrea patents. This type of hearing is called a "Markman Hearing." We are unable to anticipate when the court will issue a decision on this question. We and NCT are proceeding with discovery, including document production and depositions. If this suit is ultimately resolved in favor of NCT, we could be materially adversely effected. We believe, however, that NCT's allegations are without merit and we intend to vigorously defend ourselves and to assert against NCT the claims described above.

As more fully disclosed in "Item 3. Legal Proceedings" in our annual report on Form 10-K for the year ended December 31, 2000 incorporated herein by reference, on March 11, 1999, we were notified about a claim filed with the New York State Environmental Protection and Spill Compensation Fund by the owners (Mark J. Mergler and Ann Mergler) of property adjoining our former Long Island City facility. This claim alleges property damages arising from petroleum migrating from our former facility and was purportedly detected in the basement of the claimants' property. In their claim to the fund, the claimants alleged that their property has been damaged and that they have incurred remedial costs. In the event the fund honors this claim in whole or in part, we may be liable to reimburse the fund. The New York State Department of Environmental Conservation has asserted a demand that we investigate and remediate the discharge of petroleum from a fuel oil storage tank at our former Long Island City facility, and determine whether the petroleum discharge has migrated to the claimants' adjoining property.

We engaged environmental consultants to investigate the discharge from the fuel oil storage tank and we are currently funding remediation work. We denied, however, the allegations that any petroleum discharge has



migrated to the claimant's property and objected to the claim made by the claimant to the fund. On September 2, 1999, a civil action related to this matter was commenced in the Nassau County Supreme Court by Mark J. Mergler and Ann Mergler. The plaintiffs allege that the fuel oil released from the heating system of our former facility has migrated beneath and onto the neighboring property causing in excess of $1,000,000 in direct and consequential damages. The plaintiffs' allegations against us include, negligence, nuisance and strict liability under the New York State Navigation Law. We have submitted an answer denying the allegations and all liability relating to the alleged property damage. This lawsuit is at an early stage and we are unable to evaluate the likelihood of an unfavorable outcome or estimate the amount or range of potential loss, if any.

CHANGES IN ECONOMIC AND POLITICAL CONDITIONS OUTSIDE THE UNITED STATES COULD ADVERSELY AFFECT OUR BUSINESS, RESULTS OF OPERATIONS AND FINANCIAL CONDITION.

We have been seeking to increase our sales to regions outside the United States, particularly in Europe and areas in the Americas and Asia. For the 2001 Second Quarter, sales to customers outside the United States accounted for approximately 22% of our net sales. International sales and operations are subject to a number of risks, including:

- trade restrictions in the form of license requirements;
- restrictions on exports and imports and other government controls;

- changes in tariffs and taxes;
- difficulties in staffing and managing international operations;
- problems in establishing and managing distributor relationships;
- general economic conditions; and
- political and economic instability or conflict, particularly current Middle Eastern hostilities which could impact our research and development operations in Israel.

To date, we have invoiced our international sales in U.S. dollars, and have not engaged in any foreign exchange or hedging transactions. We may not continue to be able to invoice all our sales in U.S. dollars and to avoid engaging in foreign exchange or hedging transactions. If we are required to invoice any material amount of international sales in non-U.S. currencies, fluctuations in the value of non-U.S. currencies relative to the U.S. dollar may adversely affect our business, results of operations and financial condition or require us to incur hedging costs to counter such fluctuations.

IF WE ARE UNABLE TO ATTRACT AND RETAIN THE NECESSARY MANAGERIAL, TECHNICAL AND OTHER PERSONNEL NECESSARY FOR OUR BUSINESS, THEN OUR BUSINESS, RESULTS OF OPERATIONS AND FINANCIAL CONDITION WILL BE HARMED.

Our performance is substantially dependent on the performance of our executive officers and key employees. The loss of the services of any of these executive officers or key employees could have a material adverse effect on our business, results of operations and financial condition. Our future success depends on our continuing ability to attract and retain additional highly qualified managers and technical personnel. Competition for qualified personnel is intense and we may not be able to attract, assimilate or retain qualified personnel in the future.



ANDREA ELECTRONICS

Our mission is to provide the emerging "voice interface" markets with state-of-the-art communications products. The idea underlying these markets is that natural language spoken by the human voice will become an important means by which to control many types of computing devices and other appliances and equipment that contain microprocessors. We are designing and marketing our products and technologies to be used for these "natural language, human/machine" interfaces with:

- desktop, laptop and hand-held computers and mobile personal computing devices;
- military and commercial aircraft systems;
- cellular and other wireless communication devices; and
- automotive communication systems.

We believe that end users of these applications and interfaces will require high quality microphone and earphone products that enhance voice transmission, particularly in noisy environments. To improve our product offering, we are utilizing digital signal processing technology. This technology converts voice signals to digital signals which can then be processed in microprocessors and similar electronic devices to reduce external interference and increase clarity. In order to further our efforts to develop digital signal processing technology, in May 1998, we acquired Lamar Signal Processing, Ltd., an Israeli corporation engaged in the development of noise cancellation microphones covering a wide range of audio and acoustic applications.

High quality audio communication technologies is also required for emerging applications for microphones located several feet from the person speaking, or far-field microphone technology. Applications in this area range include:

- continuous speech dictation to personal computer and personal data assistants;
- multiparty video teleconferencing and software that allows participants to see and jointly edit documents, spreadsheets and other information; and
- natural language-driven interfaces for automobiles, home and office automation.

We believe that an increasing number of these devices will be introduced during the next several years.

We outsource the assembly of most of our Andrea Anti-Noise products from purchased components, and we are currently assembling our Andrea DSDA microphone and software products from purchased components at our New York and Israeli facilities. We manufacture our Aircraft Communications products at our New York facility.

Our strategy is to

- maintain and extend our market position with our Aircraft Communications and Andrea Anti-Noise products;
- broaden our Andrea Anti-Noise product lines and Andrea DSDA microphone and software product lines through internal research and development and, from time to time, strategic acquisitions;
- design our products to satisfy specific end-user requirements identified by our collaborative partners; and



- outsource manufacturing of some of our products in order to achieve economies of scale.

An important element of our strategy for expanding the channels of distribution and broadening the base of users for our products is our collaborative arrangements with manufacturers of computing and communications equipment, software publishers, and distributors and retailers actively engaged in the various markets in which our products have application. Under some of these arrangements, we supply our products for sale by our collaborative partners. Under others, the collaborative partners supply us with software that we include with our products. In addition, we have been increasing our own direct marketing efforts.

The success of our strategy will depend on our ability to, among other things,

- increase sales,
- contain costs,
- manage growth,
- introduce additional Andrea Anti-Noise products and Andrea DSDA microphone and software products,
- maintain the competitiveness of our technologies through successful research and development, and
- achieve widespread adoption of our products and technologies.

## FORWARD LOOKING STATEMENTS

We make certain "forward-looking statements" within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, throughout this prospectus and in the documents we incorporate by reference into this prospectus. The words "anticipates," "believes," "estimates," "expects," "intends," "plans," "seeks," variations of such words, and similar expressions are intended to identify forward-looking statements. We have based these forward-looking statements on our current expectations, estimates and projections about our business and industry, our beliefs and certain assumptions made by our management. Investors are cautioned that matters subject to forward-looking statements involve risks and uncertainties including economic, competitive, governmental, technological and other factors which may affect our business and prospects.

These statements are not guarantees of future performance and are subject to certain risks, uncertainties and assumptions that are difficult to predict. Important factors which could cause our actual results to differ materially from the forward-looking statements in this prospectus include, but are not limited to, those identified in this



prospectus under "Risk Factors" and those described in Management's Discussion and Analysis of Financial Condition and Results of Operations in our Form 10-K for the fiscal year ended December 31, 2000, our Form 10-Q for the quarter ended March 31, 2001, our Form 10-Q for the quarter ended June 30, 2001 and in any other filings which are incorporated by reference in this prospectus.

You should read this prospectus and the documents that we incorporate by reference into this prospectus completely and with the understanding that our actual future results may be materially different from what we expect. Forward-looking statements in this prospectus speak only as of the date of this prospectus. We have ongoing disclosure obligations under the federal securities laws to file periodic quarterly and annual reports as well as current reports that cover events that are material to our business, results of operations and financial condition. These reports could contain information that reflect subsequent developments relating to forward-looking statements in this prospectus. All forward-looking statements attributable to us are expressly qualified by these cautionary statements.

## USE OF PROCEEDS

All of the shares of Common Stock offered hereby are being offered for the account of the selling stockholders. We will not receive any proceeds from the sale by the selling stockholders of the Common Stock made pursuant to this registration statement.

## SELLING STOCKHOLDERS

We are registering the shares in order to permit the selling stockholders to offer the shares of Common Stock for resale from time to time. The shares of Common Stock being offered by HFTP Investment L.L.C. are issuable upon conversion of the Series C convertible preferred stock. For additional information regarding the Series C convertible preferred stock, see "Description of Capital Stock -- Preferred Stock." None of the selling stockholders has had any material relationship with us in the past three years.

The following table sets forth as of August 31, 2001 the name of the selling stockholders, the number of shares of Common Stock owned beneficially by the selling stockholders, calculated in the manner described below, the number of shares which may be offered pursuant to this prospectus and the number of shares and percentage of class to be owned by each of the selling stockholders after this offering.

For HFTP Investment L.L.C., the second column lists the number of shares of Common Stock held, plus the number of shares of Common Stock, based on its ownership of Series C convertible preferred stock as well as Series B preferred stock and related warrants, that would have been issuable to the selling stockholder as of August 31, 2001 assuming conversion of all Series B and Series C convertible preferred stock and exercise of the warrants issued in connection with the Series B convertible preferred stock held by the selling stockholder on that date, without regard to any limitations on conversions or exercise. Because conversion of the Series B and Series C convertible preferred stock is based on a formula that may depend on the market price of our Common Stock, the numbers listed in the second column may fluctuate from time to time. The third column lists the shares of Common Stock being offered by this prospectus by the selling stockholders.

In accordance with the terms of the registration rights agreement with the holder of the Series C convertible preferred stock, this prospectus covers the resale of at least that number of shares of Common Stock equal to the product of 2.0 and the number of shares of Common Stock issuable upon conversion of the Series C convertible preferred stock, without regard to any limitations on conversions, determined as if the outstanding Series C convertible preferred stock was converted in full as of the date immediately preceding the filing of the registration statement of which this prospectus is a part. Because of adjustments at the reset dates, at maturity or upon dilutive issuances, the number of shares that will actually be issued upon conversion of the Series C convertible preferred stock may be more or less than the 10,890,411 shares being offered by this prospectus for the holder of the Series C convertible preferred stock.

The fourth column assumes the sale of all of the shares offered by the selling stockholders pursuant to this prospectus.

Under the certificate of amendment for the Series C convertible preferred stock, the Series C Holder is prohibited from converting its holdings of the Series C Convertible Preferred Stock or Series B Convertible Preferred Stock or from exercising the Warrants issued in connection witht the Series B Convertible Preferred Stock if after giving effect to such conversion or exercise it would beneficially own in excess of 4.99% or, over the sixty day period prior to the conversion, 9.99% of the outstanding shares of our Common Stock following such conversion. The number of shares in the second column and fourth column and the percentage in the fifth column for HFTP does not reflect this limitation.

The selling stockholders may sell all, some or none of its shares in this offering. See "Plan of Distribution."

The "Shares Beneficially Owned After the Offering" column assumes the sale of all shares offered. The "Percentage of Class" column is based on 15,503,866 shares of Common Stock outstanding as of September 7, 2001.

| Selling Stockholder | Shares Beneficially Owned Prior To The Offering(1) | Shares Offered By This Prospectus | Shares Beneficially Owned After The Offering | Percen of Clas |
|---|---|---|---|---|
| HFTP Investment L.L.C.(1) | 9,915,807 | 10,890,411 | 4,475,596 | 18.0 |
| Ventnor LLC (2) | 92,835 | 61,890 | 30,945 | * |
| Cherry Hill LLC (2) | 144,738 | 96,492 | 48,246 | * |
| Marla LLC (2) | 144,663 | 96,442 | 48,221 | * |
| Knighthawk Investment LLC (2) | 98,904 | 65,936 | 32,968 | * |

* Represents less than 1%.

(1) In addition to the 5,440,211 shares issuable as of August 31, 2001 upon conversion of the Series C preferred stock, includes up to 3,876,667 shares of Common Stock issuable upon conversion of the Series B convertible preferred stock and exercise of related warrants held of record by HFTP Investment LLC, without regard to any limitations on conversions or exercises. Promethean Asset Management, LLC, a New York limited liability company, serves as investment manager to HFTP Investment L.L.C. and may be deemed to share beneficial ownership of the shares beneficially owned by HFTP by reason of shared power to vote and to dispose of the shares beneficially owned by HFTP. Promethean disclaims beneficial ownership of the shares beneficially owned by HFTP. Mr. James F. O'Brien, Jr. indirectly controls Promethean. Mr. O'Brien disclaims beneficial ownership of the shares beneficially owned by Promethean and HFTP. HFTP is not a registered broker-dealer. HFTP, however, is under common control with, and therefore an affiliate of, Promethean Capital Group LLC which is a registered broker-dealer.

(2) The natural person having the ultimate voting power over the ordinary

shares is Fred Knoll.

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* Represents less than 1%.





## DESCRIPTION OF CAPITAL STOCK

As of September 7, 2001 our authorized capital stock totaled 75,000,000 shares, consisting of:

(1) 70,000,000 shares of Common Stock, par value $.50 per share, of which 15,503,866 shares were issued and outstanding; and

(2) 5,000,000 shares of preferred stock, par value $.01 per share, of which

(a) 25,000 shares were designated Series A junior participating preferred stock, none of which were issued and outstanding,

(b) 1,500 shares were designated as Series B convertible preferred stock, of which 283 shares were issued and outstanding,

(c) 1,000 shares were designated Series C preferred stock, of which 750 shares were issued and outstanding and

(d) 4,972,500 shares of preferred stock which have not been designated.

Of the 15,503,866 shares of Common Stock outstanding on September 7, 2001, this amount does not include 5,915,625 shares of Common Stock reserved for issuance upon exercise of options granted under our 1991 Performance Equity Plan and 1998 Stock Plan and 20,496,848 shares of common stock reserved for issuance upon conversion of the Series B and Series C convertible preferred stock and exercise of related warrants.

### COMMON STOCK

The holders of our Common Stock are entitled to one vote per share on all matters to be voted on by shareholders and are entitled to receive dividends when declared by our board of directors, at their discretion, from legally available funds. The holders of our Common Stock are not entitled to preemptive, subscription or conversion rights, and there are no redemption or sinking fund provisions applicable to our Common Stock.

Upon liquidation or dissolution, the holders of our Common Stock are entitled to receive all assets available for distribution to shareholders, subject to the preferential rights of the holders of Series B and Series C convertible preferred stock and any other series of preferred stock that may be then outstanding.

### PREFERRED STOCK

Shares of preferred stock are issuable in one or more series at the time or times and for the consideration as our board of directors may determine. All shares of each series of preferred stock shall be equal in rank and identical in all respects. Authority is expressly granted to our board of directors to fix from time to time, by resolution or resolutions providing for

- the establishment and/or issuance of any series of preferred stock,
- the designation of any series of preferred stock,
- the powers, preferences and rights of the shares of that series, and
- the qualifications, limitations or restrictions of the preferred stock.

We currently have designated three series of preferred stock. Each series of preferred stock is summarized below. While we have no present intention to issue shares of any additional series of preferred stock, any such





issuance could dilute the equity of the outstanding shares of Common Stock and could have the effect of making it more difficult for a third party to acquire a majority of our outstanding voting stock. In addition, any newly issued preferred stock may have other rights, including economic rights senior to the Common Stock, and, as a result, the issuance thereof could have a material adverse effect on the market value of the Common Stock.

SERIES A JUNIOR PARTICIPATING PREFERRED STOCK

Under our Shareholder Rights Plan, preferred stock purchase rights were distributed as a dividend at the rate of one right for each share of Common Stock outstanding as of the close of business on May 7, 1999. Each purchase right entitles the holder to purchase one-thousandth of a share of our Series A junior participating preferred stock, par value $0.01 per share, at an exercise price of $50. These purchase rights will not be exercisable unless a person or group acquires, or announces the intent to acquire, beneficial ownership of 20% or more of our Common Stock.

Each share of Series A junior participating preferred stock shall entitle the holder to 1,000 votes on all matters submitted to a vote of our stockholders.

Subject to the rights of the holders of any series of preferred stock ranking senior to the Series A junior participating preferred stock with respect to dividends, each holder of a share of Series A junior participating preferred stock, in preference to the holders of shares of Common Stock, will be entitled to a dividend equal to one thousand times any dividend declared per share of Common Stock.

Upon our liquidation or dissolution, holders of Series A junior participating preferred stock are entitled to:

(1) $1,000 per share, plus accrued and unpaid dividends and distributions, or an aggregate amount per share (subject to adjustment) equal to 1,000 times the aggregate amount to be distributed per share to holders of Common Stock, before we make

any distributions to the holders of stock ranking junior to the Series A junior participating preferred stock; or

pro rata distributions in proportion to the total amounts to which all holders of stock ranking in parity with the Series A junior participating preferred stock are entitled before we make any distributions to those other holders.

In the case of any consolidation, merger, combination or other transaction in which shares of Common Stock are exchanged, each share of Series A junior participating preferred stock shall be similarly exchanged into an amount per share equal to 1,000 times the aggregate amount of stock, securities, cash and/or any other property (payable in kind), as the case may be, into which each share of Common Stock is exchanged.

The Series A junior participating preferred stock ranks, with respect to the payment of dividends and the distribution of assets, junior to all series of any other class of preferred stock. Whenever dividends or distributions payable on the Series A junior participating preferred stock are in arrears, we cannot, until all accrued and unpaid dividends and distributions, whether or not declared, on the Series A junior participating preferred stock outstanding have been paid:

o declare or pay dividends, or make any other distributions, on any stock ranking junior to the Series A junior participating preferred stock;

o declare or pay dividends, or make any other distributions, on any stock ranking on a parity with the Series A junior participating preferred stock, except dividends paid ratably on the Series A junior participating preferred stock and all such parity stock on which dividends are payable or in arrears in proportion to the total amounts to which the holders of all such shares are then entitled;

o redeem or purchase or otherwise acquire any stock ranking junior to the Series A junior



participating preferred stock, provided that we may at any time redeem, purchase or otherwise acquire shares of any such junior stock in exchange for any of our stock ranking junior to the Series A junior participating preferred stock; or

o redeem or purchase or otherwise acquire any Series A junior participating preferred stock, or any shares of stock ranking on a parity with the Series A junior participating preferred stock, except in accordance with a purchase offer made in writing or by publication to all holders of such shares upon such terms as the board of directors shall determine in good faith will result in fair and equitable treatment among the respective series or classes.

The shares of Series A junior participating preferred stock are also subject to antidilution provisions which are triggered in the event of stock splits, recapitalizations, or other dilutive transactions. The Series A junior participating preferred stock is not redeemable.

SERIES B CONVERTIBLE PREFERRED STOCK AND WARRANT

BACKGROUND. On June 18, 1999, we issued 750 shares of the Series B Convertible Preferred Stock, $10,000 stated value per share, and a warrant to purchase, at an exercise price of $8.725 per share, 75,000 shares of Common Stock, for $7.5 million in a private placement to one investor (the "Investor"). At September 7, 2001, 283 shares of B Preferred Stock remain outstanding; 467 shares (including the applicable premium) of B Preferred Stock have been converted into a total of 1,950,723 shares of Common Stock.

GENERAL TERMS OF THE SERIES B CONVERTIBLE PREFERRED STOCK. The B Preferred Stock has no voting rights, other than as required by law and is not entitled to the payment of dividends. However, the holder is entitled to receive an additional amount in cash or shares of Common Stock, at our option, upon conversion of the B Preferred Stock. The additional amount is calculated based on an annual premium of 4% on the $10,000 per share stated value of the B Preferred Stock.

In the event of our liquidation or dissolution, the holder of the B Preferred Stock is entitled to receive in cash out of our assets an amount per share equal to $10,000 plus the additional amount described above. The holder of B Preferred Stock is entitled to these amounts in preference to the holders of our Common Stock and any other junior class of our capital stock.

CONVERSION. Each share of B Preferred Stock is convertible into shares of the Common Stock at the option of the holder, at our option under certain circumstances after June 18, 2002, and mandatorily on the maturity date for the B Preferred Stock, which, subject to a possible required extension, is June 18, 2004. The number of shares of Common Stock into which a share may be converted (the "conversion rate") is equal to $10,000 divided by the conversion price of the B Preferred Stock. The conversion price is variable and, at the time of conversion, will be equal to the average of the two lowest closing bid prices of the Common Stock during the 15 consecutive trading days immediately preceding conversion. However, the conversion price cannot exceed $8.775 per share. There is no minimum conversion price, but the number of shares that may be converted at any one time may be limited. For more information about limitations, see "--Limitations on Conversion."

We have reserved 9,606,437 shares of Common Stock for issuance upon conversion of shares of the B Preferred Stock (including to satisfy the additional amounts discussed above) and the exercise of the warrant. Depending on the conversion price, this amount may or may not be adequate to account for the total number of shares of Common Stock issuable upon such conversion.

The following table illustrates the varying amounts of shares of Common Stock issuable upon conversion of all 283 shares of Series B convertible preferred stock at the indicated conversion prices (without regard to any limitations on conversion) and assuming that the 4% additional amount is paid in cash:



| Assumed | Assumed Number of Shares | Number of Shares Outstanding after | Percentage of Outstanding Common |
|---|---|---|---|

| Conversion Price | Converted(1) | Assumed Conversion | Stock(2) |
|---|---|---|---|
| $0.50 | 5,660,000 | 21,163,886 | 27% |
| $1.50 | 1,886,667 | 17,390,553 | 11% |
| $2.50 | 1,132,000 | 16,635,886 | 7% |
| $3.50 | 808,571 | 16,312,457 | 5% |
| $4.50 | 628,889 | 16,132,775 | 4% |
| $5.50 | 514,545 | 16,018,431 | 3% |
| $6.50 | 435,385 | 15,939,271 | 3% |
| $7.50 | 377,333 | 15,881,219 | 2% |

(1) The Series B Holder is prohibited from converting its holdings of the Series B Convertible Preferred Stock if after giving effect to such conversion it would beneficially own in excess of 4.99% or, over the sixty day period prior to the conversion, 9.99% of the outstanding shares of our Common Stock following such conversion. The numbers in this column do not reflect these limitations.

(2) Based on 15,503,866 shares of Common Stock outstanding as of September 7, 2001.

REDEMPTION. The holder of the B Preferred Stock has the right to require Andrea to redeem all or a portion of its shares upon the announcement of a major transaction or the happening of a triggering event. Major transactions include a merger, consolidation, tender offer or sale of substantially all of Andrea's assets. Triggering events include a default under Andrea's registration obligations with respect to the Series B convertible preferred stock, the delisting of the Common Stock and a default with respect to Andrea's conversion obligations, among other things.

The redemption price upon the happening of these events would be equal to the greater of 120% of the liquidation value of the B Preferred Stock, and

- in the case of a major transaction, the product of the conversion rate in effect for the B Preferred Stock and the closing bid price on the date of the public announcement of the transaction;

- in the case of a triggering event, the product of the conversion rate in effect for the B Preferred Stock and the closing bid price immediately before the triggering event or on the date of the holder's redemption notice.

In addition, to the extent that Andrea is not able to issue the shares of Common Stock required to be issued upon the voluntary or mandatory conversion of the B Preferred Stock, Andrea could be required to redeem the shares of B Preferred Stock that cannot be converted into Common Stock.



The redemption price for the B Preferred Stock under these circumstances would be the product of the conversion rate in effect for the B Preferred Stock and the closing bid price for the Common Stock on the applicable conversion date. If Andrea does not timely pay the redemption price, such unpaid amount bears interest at the rate of 2% per month.

LIMITATIONS ON CONVERSION. The issuance of shares of Common Stock upon conversion of the B Preferred Stock is limited to an amount which, after giving effect to the conversion, would cause the holder to beneficially own in excess of 4.99%, or, together with other shares beneficially owned during the 60-day period prior to such conversion, beneficially own in excess of 9.99% of the outstanding shares of the Common Stock. This calculation excludes the number of shares of Common Stock which would be issuable upon:

- conversion of the remaining, nonconverted shares of B Preferred Stock beneficially owned by the holder and its affiliates;

- exercise or conversion of any of the unexercised or unconverted portion of any other of Andrea's securities (including, without limitation, any warrants or convertible preferred stock) subject to a limitation on conversion or exercise analogous to this limitation beneficially owned by the holder and its affiliates.

This limitation does not prevent the holder from reducing its beneficial ownership by sale or other transfer of Common Stock, and then acquiring additional shares of Common Stock, up to the beneficial ownership limits, by conversion of shares of B Preferred Stock.

GENERAL TERMS OF THE WARRANT. In connection with the sale of the B Preferred Stock, Andrea issued a warrant to purchase up to 75,000 shares of Common Stock, exercisable at the price of $8.775 per share. The warrant expires on June 18, 2004, subject to certain possible extensions. The right to exercise the warrant is also limited by the 4.99% and 9.99% beneficial ownership limitations described above with respect to the B Preferred Stock. The exercise price and number of shares that may be purchased upon exercise of the warrants are subject to adjustment upon the occurrence of certain dilution events (as defined in the warrant). Andrea intends to use the proceeds, if the warrants are exercised, for working capital and general corporate purposes.

SERIES C CONVERTIBLE PREFERRED STOCK

The following is a summary of the material terms of the Series C convertible preferred stock. The underlying documents for the Series C convertible preferred stock are a securities purchase agreement, registration rights agreement and a certificate of amendment, all filed as exhibits to our Form 8-K dated October 12, 2000.

BACKGROUND. On October 10, 2000, Andrea issued 750 shares of the C Preferred Stock, $10,000 stated value per share, for $7.5 million in a private placement to the Investor. Subject to various terms and conditions, the C Preferred Stock, among other things, is convertible into shares of Common Stock at the election of the holder and mandatorily at the maturity date of the C Preferred Stock. The C Preferred Stock has an initial maturity date of October 10, 2002 for those outstanding shares of C Preferred Stock which can be converted into shares of Common Stock on that date without exceeding various limitations on such conversion. In general, for the outstanding shares of C Preferred Stock in excess of those subject to the October 10, 2002 maturity date, the maturity date is extended until five trading days after such shares can be converted into Common Stock without violating the applicable limitations on conversion (or after a triggering event as discussed below under "--Triggering Events").

ADDITIONAL CLOSINGS. In addition to the issuance of 750 shares of C Preferred Stock on October 10, 2000 as described above, the holder of the C Preferred Stock has an option to purchase additional shares. During the period beginning on October 10, 2000, the initial closing date, and ending on April 11, 2002, the holder, on not more than two occasions, may purchase from Andrea up to an aggregate of 250 additional shares of the C Preferred Stock for up to an additional $2,500,000. The terms and conditions of these additional shares of C Preferred Stock would be identical to existing C Preferred Stock. The conditions to the additional closings include:





- o that our representations in the transaction documents are true and correct as of the date of the additional closing,
- o our Common Stock is listed with The American Stock Exchange,
- o we deliver all required certificates, opinions, and documents required under the securities purchase agreement, and
- o satisfaction of other terms and conditions, all as more fully set forth in the securities purchase agreement.

We are using the proceeds from the offering of the Series C convertible preferred stock, including the initial closing and any additional closing, for working capital and general corporate purposes, including the expansion of our sales and marketing capabilities for the commercialization of our anti-noise products and the expansion of our research and development activities.

GENERAL TERMS OF THE SERIES C CONVERTIBLE PREFERRED STOCK. The C Preferred Stock has no voting rights other than as required by law, and is not entitled to receive dividends. However, the holder of C Preferred Stock is entitled to receive an additional amount in cash or shares of Common Stock, at Andrea's option, upon conversion of the C Preferred Stock. The additional amount is calculated based on an annual premium of 5% on the $10,000 per share stated value of the C Preferred Stock.

In the event of Andrea's liquidation or dissolution, the holder of the C Preferred Stock is entitled to receive in cash out of Andrea's assets an amount per share of equal to $10,000 plus the additional amount described above. The holder of C Preferred Stock is entitled to receive these amounts in preference to the holders of Andrea's Common Stock and any other junior class of Andrea's capital stock.

CONVERSION. Each share of C Preferred Stock is convertible into shares of the Common Stock at the option of the holder, at the option of Andrea under certain circumstances after October 10, 2001, and mandatorily on the "maturity date" for the C Preferred Stock. The C Preferred Stock has an initial maturity date of October 10, 2002 for those outstanding shares of C Preferred Stock which can be converted into shares of Common Stock on that date without exceeding various limitations on such conversion. In general, for the outstanding shares of C Preferred Stock in excess of those subject to the October 10, 2002 maturity date, the maturity date is extended until five trading days after such shares can be converted into Common Stock without violating the applicable limitations on conversion (or after a triggering event as discussed below).

The number of shares of Common Stock into which a share of C Preferred Stock may be converted (the "conversion rate,") is equal to $10,000 divided by the conversion price of the C Preferred Stock. The conversion price was initially equal to $7.0565 per share for the first nine months or 110% of the average of the two lowest closing bid prices of the Common Stock during the five consecutive trading days immediately proceeding the issuance of October 10, 2000. The conversion price will be reset every six months thereafter to the lesser of the then existing conversion price or the average of the two lowest closing bid prices of the Common Stock during the five consecutive trading days immediately preceding the six-month reset dates or, for the period beginning on the day two years after the initial issuance and ending on the maturity of the Series C Preferred Stock, the least of: (i) the then existing conversion price, (ii) the average of the two lowest closing bid prices of the Common Stock during the 15 consecutive trading days immediately proceding such two year date, or (iii) the closing bid price on the day of conversion, subject in each case to certain adjustments. The current conversion price is $1.44. There is no minimum conversion price, but the number of shares that may be converted at any one time may be limited. For more information about limitations, see "--Limitations on Conversion."

Andrea has reserved 10,890,411 shares of Common Stock for issuance upon conversion of the shares of the C Preferred Stock (including to satisfy the additional amounts discussed above). Depending on the conversion





price, this amount may or may not be adequate to account for the total number of shares of Common Stock issuable upon such conversion.

The following table illustrates the varying amounts of shares of Common Stock that would be issuable upon conversion of all outstanding 750 shares of Series C convertible preferred stock at the indicated conversion prices (without regard to any limitations on conversion) and assuming that the 5% additional amount is paid in cash:

| Assumed Conversion Price | Assumed Number of Shares Converted(1) | Number of Shares Outstanding after Assumed Conversion | Percentage of Outstanding Common Stock(2) |
|---|---|---|---|
| $0.40 | 18,750,000 | 34,253,886 | 55% |
| $0.55 | 13,636,364 | 29,140,250 | 47% |
| $0.70 | 10,714,286 | 26,218,172 | 41% |
| $0.85 | 8,823,529 | 24,327,415 | 36% |
| $1.00 | 7,500,000 | 23,003,886 | 33% |
| $1.15 | 6,521,739 | 22,025,625 | 30% |
| $1.30 | 5,769,231 | 21,273,117 | 27% |
| $1.44 | 5,208,333 | 20,712,219 | 25% |

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(1) The Series C Holder is prohibited from converting its holdings of the Series C Convertible Preferred Stock if after giving effect to such conversion it would beneficially own in excess of 4.99% or, over the sixty day period prior to the conversion, 9.99% of the outstanding shares of our Common Stock following such conversion. The numbers in this column do not reflect these limitations.
(2) Based on 15,503,866 shares of Common Stock outstanding as of September 7, 2001.

REDEMPTION. The holder of the C Preferred Stock has the right to require Andrea to redeem all or a portion of its shares upon the announcement of a major transaction or the happening of a triggering event. For more information about triggering events, see "--Triggering Events." Major transactions include a merger, consolidation, tender offer or sale of substantially all Andrea's assets.

The redemption price upon the happening of these events would be equal to the greater of 120% of the liquidation value of the C Preferred Stock, and:

- in the case of a major transaction, the product of the conversion rate in effect for the C Preferred Stock and the closing bid price on the date of the public announcement of the transaction; or

- in the case of a triggering event, the product of the conversion rate in effect for the C Preferred Stock and the closing bid price immediately before the triggering event or on the date of the holder's redemption notice.





In addition, to the extent that Andrea is not able to issue the shares of Common Stock required to be issued upon the voluntary or mandatory conversion of the C Preferred Stock, Andrea could be required to redeem the shares of C Preferred Stock that cannot be converted into Common Stock.

The redemption price for the C Preferred Stock under these circumstances would be the product of the conversion rate in effect for the C Preferred Stock and the closing bid price for the Common Stock on the applicable conversion date. If Andrea does not timely pay the redemption price, such unpaid amount bears interest at the rate of 2% per month.

TRIGGERING EVENTS. A triggering event will occur upon:

- the lapse of the effectiveness of the registration statement for ten consecutive trading days or for an aggregate of fifteen trading days per year;

- the unavailability of the registration statement for the sale of all of the shares of Common Stock into which the Series C convertible preferred stock is convertible for a period of ten consecutive trading days or an aggregate of fifteen trading days per year;

- the delisting of our Common Stock by AMEX for five consecutive trading days or for an aggregate of ten trading days per year;

- the failure of us or our transfer agent to comply with the conversion obligations of the Series C convertible preferred stock within ten business days after a conversion notice is submitted;

- our inability to issue conversion shares due to limitations imposed by the requirements of AMEX;

- our failure to make any excluded redemption event daily payment (as defined in certificate of amendment); and

- the breach of our representations, warranties, covenants (that are not cured in fewer than ten days) or terms of the transaction documents which would have a material adverse effect (as defined in the certificate of amendment).

LIMITATIONS ON CONVERSION. The issuance of shares of Common Stock upon conversion of the C Preferred Stock is limited to that amount which, after giving effect to the conversion, would cause the holder to beneficially own in excess of 4.99% or, together with other shares beneficially owned during the 60-day period prior to such conversion, beneficially own in excess of 9.99% of the outstanding shares of the Common Stock. These calculations exclude the number of shares of Common Stock which would be issuable upon:

- conversion of the remaining, nonconverted shares of C Preferred Stock beneficially owned by the holder and its affiliates;

- conversion of any of the B Preferred Stock or exercise of the warrants issued in connection with the B Preferred Stock beneficially owned by the holder and its affiliates; and

- exercise or conversion of any of the unexercised or unconverted portion of any other of Andrea's securities (including, without limitation, any warrants or convertible preferred stock) subject to a limitation on conversion or exercise analogous to this limitation beneficially owned by the holder and its affiliates.

These limitations do not prevent the holder from reducing its beneficial ownership by sale or other transfer of Common Stock, and then acquiring additional shares of Common Stock, up to the beneficial ownership limits, by conversion of shares of C Preferred Stock.





CONVERSION AT OUR OPTION. As more fully set forth in the certificate of amendment, after one year we may require that the shares of Series C convertible preferred stock be submitted for conversion. We may only exercise this right if the last reported sale price (as reported by Bloomberg) for our Common Stock is greater than $17.64125, among other conditions.

REGISTRATION OF SHARES. We are obligated by a registration rights agreement to register the Common Stock issuable upon conversion of the Series C convertible preferred stock. We are required by this agreement to initially register with the Commission the resale of at least the number of shares of Common Stock equal to the product of

(a) 2.0 and

(b) the number of initial registrable securities (without regard to any limitation on conversion).

We are also required by the registration rights agreement to initially register with the Commission the resale of at least the number of shares of Common Stock equal to the product of

(a) 2.0 and

(b) the number of additional registrable securities (without regard to any limitation on conversion) as of the date immediately preceding the date the registration statement is initially filed.

We filed the registration statement with respect to the initial shares of Series C convertible preferred stock on December 7, 2000, no later than 60 days after the initial closing date, the initial filing deadline, and had the registration statement declared effective by the Commission on February 14, 2001, no later than 120 days after the initial closing, the initial effectiveness deadline. If the holder elects to purchase additional shares of Series C convertible preferred stock, we have agreed to use our best efforts to file the registration statement with respect to the additional shares of Series C convertible preferred stock as soon as possible but no later than 30 days after the additional closing date and have the registration statement declared effective by the Commission no later than 120 days after the additional closing.

If we are unable to have the registration statement filed or declared effective in the time required, we shall pay to each holder of registrable securities an amount in cash per registrable security held equal to the product of

(a) $10,000 multiplied by

(b) the sum of

(1) .01, if the registration statement is not filed by the initial filing deadline described above, plus

(2) .01, if the registration statement is not declared effective by the initial effectiveness deadline described above, plus

(3) the product of

(i) .0005 multiplied by

(ii) the sum of

(x) the number of days after the scheduled filing date that such registration statement is not filed with the Commission, plus





(y) the number of days after the scheduled effective date that the registration statement is not declared effective by the Commission, plus

(z) the number of days that sales cannot be made pursuant to the registration statement after the registration statement has been declared effective by the Commission (excluding days during any allowable grace period set forth in the registration rights agreement).

We have agreed to indemnify the holders of registrable securities against liabilities under the Securities Act in connection with the registration of the Common Stock issuable upon conversion of the Series C convertible preferred stock. To the extent any indemnification is prohibited or limited by law, we have agreed to make the maximum contribution with respect to any amounts for which we would otherwise be liable under the registration rights agreement to the fullest extent permitted by law. The holders will similarly indemnify us.

OTHER TERMS. The transaction documents relating to the Series C convertible preferred stock contain other representations, warranties, agreements and indemnification obligations of Andrea. The operative agreements

- contain a right of first refusal in favor of the investors which applies to certain of our private equity financings for one year after the initial closing,

- restrict our ability to redeem, pay any cash dividends and make certain distributions on our Common Stock,

- limit our ability to issue any senior preferred stock, and

- prohibit us from entering into certain related party transactions except as set forth in the securities purchase agreement.

The shares of Series C convertible preferred stock are also subject to antidilution provisions which are triggered in the event of certain stock splits, recapitalizations, or other dilutive transactions, as well as issuances of Common Stock at a price below the conversion price in effect, or the issuance of warrants, options, rights, or convertible securities which have an exercise price or conversion price less than the conversion price, other than for certain previously outstanding securities and certain "excluded securities" (as defined in the certificate of amendment). In the event that we issue securities in the future which have a conversion price or exercise price which varies with the market price and the terms of such variable price are more favorable than the conversion price in the Series C convertible preferred stock, the purchasers may elect to substitute the more favorable variable price when making conversions of the Series C convertible preferred stock.

PLACEMENT AGENT COMPENSATION. We and the purchaser each acknowledges that it has not engaged any placement agent in connection with the sale of the Series C convertible preferred stock.

USE OF PROCEEDS. The net proceeds of the Series C convertible preferred stock received by us have been and will continue to be used for working capital and general corporate purposes, including the expansion of our sales and marketing capabilities for the commercialization of our anti-noise products and the expansion of our research and development activities. We will not receive any of the proceeds from the sale of Common Stock by the selling stockholder.

INTERESTS OF CERTAIN PERSONS. None of the investors in the Series C convertible preferred stock transactions is a director, executive officer or five percent or greater shareholder of us or is our affiliate.



## STOCKHOLDER DILUTION

The conversion of the B Preferred Stock and the C Preferred Stock may result in substantial dilution to other shareholders of the Common Stock.

The following table illustrates the varying amounts of shares of Common

Stock that would be issuable upon conversion of all 283 outstanding shares of B Preferred Stock and all 750 outstanding shares of C Preferred Stock at the indicated conversion prices (without regard to any limitation on conversion), assuming that all additional amounts are paid cash.

| Assumed Conversion Price | Assumed Number of Shares Converted(1)(2)(3) | Number of Shares Outstanding after Assumed Conversion | Percentage of Outstanding Common Stock(4) |
|---|---|---|---|
| $0.50 | 20,660,000 | 36,163,886 | 57% |
| $1.00 | 10,330,000 | 25,833,886 | 40% |
| $1.44 | 7,173,611 | 22,677,497 | 32% |
| $2.50 | 6,340,333 | 21,844,219 | 29% |
| $3.50 | 6,016,905 | 21,520,791 | 28% |
| $4.50 | 5,837,222 | 21,341,108 | 27% |
| $5.50 | 5,722,879 | 21,226,765 | 27% |
| $6.50 | 5,643,718 | 21,147,604 | 27% |
| $7.50 | 5,585,667 | 21,089,553 | 26% |

(1) The calculation assumes that the conversion price of the Series B and Series C convertible preferred stock are the same at the assumed conversion prices of $.50, $1.00 and $1.44. This could only occur if the market price of Andrea's Common Stock declines, and at a future reset date, the conversion price of the Series C adjusts to the then prevailing market price (the current fixed conversion price of the Series C is $1.44, and such conversion price is fixed unless adjusted downward at a future reset date).
(2) The calculation assumes that for any conversion of the Series B convertible preferred stock when the prevailing market price is above $1.44, the Series C would still be converted at its maximum conversion price of $1.44.
(3) The Series B and Series C holder is prohibited from converting the Series C or Series B convertible preferred stock, or from exercising the warrants issued in connection with the Series B convertible preferred stock, if after giving effect to such conversion it would beneficially own in excess of 4.99% or, over the sixty day period prior to the conversion, 9.99% of the outstanding shares of our Common Stock following such conversion.
(4) Based on 15,503,866 shares of Common Stock outstanding as of September 7, 2001.

ADDITIONAL INFORMATION REGARDING THE TERMS OF THE SERIES B CONVERTIBLE PREFERRED STOCK AND WARRANTS AND THE SERIES C CONVERTIBLE PREFERRED STOCK

Copies of the relevant documents regarding the issuance of the B Preferred Stock and the C Preferred Stock were filed with the Securities and Exchange Commission as exhibits to Andrea's Reports on Form 8-K, dated June 22, 1999 and October 12, 2000, respectively. Shareholders desiring a more complete understanding of these securities are urged to refer to such disclosures and exhibits.

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Andrea will furnish to any shareholder upon receipt of a written or oral request, copies of these Reports on Form 8-K, including exhibits, without charge, to the Corporate Secretary, Andrea Electronics Corporation, 45 Melville Park Road, Melville, New York 11747 (631) 719-1800.

In connection with Andrea's issuance of the B Preferred Stock and the related warrant and the C Preferred Stock, Andrea filed registration statements on Form S-3 with the Securities and Exchange Commission on July 17, 1999, as amended September 13, 1999 and October 13, 1999, and on December 7, 2000, as amended January 16, 2001, January 31, 2001 and February 14, 2001, respectively. Those registration statements relate to the resale of the shares of Common Stock that are issuable upon conversion of the B Preferred Stock, and upon exercise of the warrants, and upon conversion of the C Preferred Stock.

## NEW YORK ANTI-TAKEOVER LAW

We are also subject to provisions of the New York Business Corporation Law which relate to certain business combinations with an "interested shareholder" and prohibit any person from making a takeover bid for a New York corporation unless certain prescribed disclosure requirements are satisfied.

Section 912 of the NYBCL provides, with certain exceptions, that a New York corporation may not engage in a "business combination," such as a merger, consolidation, recapitalization or disposition of stock, with any "interested shareholder" for a period of five years from the date that such persons first became an interested shareholder unless:

(a) the transaction resulting in a person becoming an interested shareholder, or the business combination, was approved by the board of directors of the corporation prior to that person becoming an interested shareholder,

(b) the business combination is approved by the holders of a majority of the outstanding voting stock not beneficially owned by such interested shareholder, or

(c) the business combination meets certain valuation requirements for the stock of the New York corporation.

An "interested shareholder" is defined as any person that

(x) is the beneficial owner of 20% or more of the outstanding voting stock of a New York corporation or

(y) is an affiliate or associate of the corporation that at any time during the prior five years was the beneficial owner, directly or indirectly, of 20% or more of the corporation's then outstanding voting stock.

The provisions of Section 912 of the NYBCL apply if and for so long as a New York corporation has a class of securities registered under Section 12 of the Exchange Act, at least 25% of its total employees are employed primarily within New York, or at least 250 employees are so employed and at least 10% of our voting stock is owned beneficially by residents of the State of New York. We expect to continue to meet one or more of these tests and, accordingly, to be subject to Section 912 of the NYBCL. Article 16 of the NYBCL provides that persons seeking to make takeover bids comply with certain registration and disclosure requirements.

## PLAN OF DISTRIBUTION

We are registering the shares of Common Stock to permit the resale of shares of Common Stock by the holder from time to time after the date of this prospectus. We will not receive any of the proceeds from the sale by the selling stockholder of the shares of Common Stock. We will bear all fees and expenses incident to our





obligation to register the shares of Common Stock.

The selling stockholders may sell all or a portion of the Common Stock beneficially owned by them and offered hereby from time to time directly or through one or more underwriters, broker-dealers or agents. If the Common Stock is sold through underwriters or broker-dealers, the selling stockholder will be responsible for underwriting discounts or commissions or agent's commissions. The Common Stock may be sold in one or more transactions at fixed prices, at prevailing market prices at the time of the sale, at varying prices determined at the time of sale, or at negotiated prices. These sales may be effected in transactions, which may involve crosses or block transactions,

- on any national securities exchange or quotation service on which the securities may be listed or quoted at the time of sale,
- in the over-the-counter market,
- in transactions otherwise than on these exchanges or systems or in the over-the-counter market,
- through the writing of options, whether such options are listed on an options exchange or otherwise, or
- through short sales.

If the selling stockholder effects such transactions by selling shares of Common Stock to or through underwriters, broker-dealers or agents, such underwriters, broker-dealers or agents may receive commissions in the form of discounts, concessions or commissions from the selling stockholder or commissions from purchasers of the shares of Common Stock for whom they may act as agent or to whom they may sell as principal (which discounts, concessions or commissions as to particular underwriters, brokers-dealers or agents may be in excess of those customary in the types of transactions involved). In connection with sales of the Common Stock or otherwise, the selling stockholder may enter into hedging transactions with broker-dealers, which may in turn engage in short sales of the Common Stock in the course of hedging in positions they assume. The selling stockholder may also sell shares of Common Stock short and deliver shares of Common Stock covered by this prospectus to close out short positions, provided that the short sale is made after the registration statement is declared effective and a copy of this prospectus is delivered in connection with the short sale. The selling stockholder may also loan or pledge shares of Common Stock to broker-dealers that in turn may sell such shares.

The selling stockholder may pledge or grant a security interest in some or all of the shares of Common Stock owned by them and, if they default in the performance of their secured obligations, the pledgees or secured parties may offer and sell the shares of Common Stock from time to time pursuant to the prospectus. The selling stockholder also may transfer and donate the shares of Common Stock in other circumstances in which case the transferees, donees, pledgees or other successors in interest will be the selling beneficial owners for purposes of the prospectus.

The selling stockholder and any broker-dealer participating in the distribution of the shares of Common Stock may be deemed to be "underwriters" within the meaning of the Securities Act, and any commissions paid, or any discounts or concessions allowed to any such broker-dealer may be deemed to be underwriting commissions or discounts under the Securities Act. At the time a particular offering of the shares of Common Stock is made, a prospectus supplement, if required, will be distributed which will set forth the aggregate amount of shares of Common Stock being offered and the terms of the offering, including the name or names of any broker-dealers or agents, any discounts, commissions and other terms constituting compensation from the selling stockholder and any discounts, commissions or concessions allowed or reallowed or paid to broker-dealers.

Under the securities laws of some states, the shares of Common Stock may be sold in such states only through registered or licensed brokers or dealers.





There can be no assurance that any selling stockholder will sell any or all of the shares of Common Stock registered pursuant to the shelf registration statement, of which this prospectus forms a part.

The selling stockholder and any other person participating in sales of shares pursuant to this prospectus will be subject to applicable provisions of the Exchange Act and the Exchange Act's rules and regulations, including, without limitation, Regulation M of the Exchange Act, which may limit the timing of purchases and sales of any of the shares of Common Stock by the selling stockholder and any other participating person. Regulation M may also restrict the ability of any person engaged in a distribution of the shares of Common Stock to engage in market-making activities with respect to the shares of Common Stock. All of the foregoing may affect the marketability of the shares of Common Stock and the ability of any person or entity to engage in market-making activities with respect to the shares of Common Stock.

We will pay all expenses of the registration of the shares of Common Stock pursuant to the registration rights agreement estimated to be $45,000 in total, including, without limitation, Commission filing fees and expenses of compliance with state securities or "blue sky" laws; provided, however, that the selling stockholder will pay all underwriting discounts and selling commissions, if any.

In connection with sales made pursuant to this prospectus, we will indemnify the selling stockholder against liabilities, including some liabilities under the Securities Act, in accordance with the registration rights agreement or the selling stockholder will be entitled to contribution. We will be indemnified by the selling stockholder against civil liabilities, including liabilities under the Securities Act that may arise from any written information furnished to us by the selling stockholder for use in this prospectus or we will be entitled to contribution.

Once sold under the shelf registration statement, of which this prospectus forms a part, the shares of Common Stock will be freely tradable in the hands of persons other than our affiliates.

HFTP, the selling stockholder, has advised us that it purchased the Series C convertible preferred stock in the ordinary course of its business and, at the time HFTP purchased the Series C convertible preferred stock, it was not a party to any agreement or other understanding to distribute the securities, directly or indirectly.

## LEGAL MATTERS

Legal matters with respect to our Common Stock being offered hereby have been passed upon for us by our counsel, Muldoon Murphy & Faucette LLP, Washington, D.C.

## EXPERTS

The consolidated financial statements and schedules of Andrea incorporated in this prospectus and registration statement by reference to our annual report on Form 10-K have been audited by Arthur Andersen LLP, independent public accountants, as indicated in their reports with respect thereto, and are incorporated by reference in reliance upon the authority of said firm as experts in accounting and auditing.

## WHERE YOU CAN FIND MORE INFORMATION

We file annual, quarterly and periodic reports, proxy statements and other information with the Securities and Exchange Commission using the Commission's EDGAR system. You may inspect these documents and copy information from them at the Commission's public reference facilities at 450 Fifth Street, N.W., Washington, D.C. 20549 or at the regional offices of the Commission at Citicorp Center, 500 West Madison Street, Suite 1400, Chicago, Illinois 60661 and Seven World Trade Center, Suite 1300, New York, New York 10048. Copies of such





material can be obtained at prescribed rates from the Public Reference Section of the Commission at 450 Fifth Street, N.W., Washington, D.C. 20549. The Commission maintains a Web site that contains reports, proxy and information statements and other information regarding registrants that file electronically with the Commission. The address of such site is http://www.sec.gov.

We have filed a registration statement with the Commission relating to the offering of the Common Stock. The registration statement contains information which is not included in this prospectus. You may inspect or copy the registration statement at the Commission's public reference facilities or its web site.

We furnish our stockholders with annual reports containing audited financial statements and with such other periodic reports as we from time to time deem appropriate or as may be required by law.

## INCORPORATION OF CERTAIN INFORMATION BY REFERENCE

We have filed the following documents with the Commission. We are incorporating these documents in this prospectus, and they are a part of this prospectus.

(1) Our annual report on Form 10-K for the fiscal year ended December 31, 2000;

(2) Our quarterly reports on Form 10-Q for the quarters ended March 31, 2001 and June 30, 2001;

(3) Our current report on Form 8-K dated June 6, 2001;

(4) Our current report on Form 8-K dated March 1, 2001; and

(5) The description of our Common Stock, par value $.50 per share, contained in

(a) our registration statement filed under the Exchange Act of 1934, as amended, No. 1-4324, as declared effective on February 28, 1967,

(b) Article Third of our Restated Certificate of Incorporation filed as Exhibit 3.1 to our current report on Form 8-K dated November 30, 1998 as amended by our certificate of Amendment dated June 10, 1999 filed as Exhibit 3.1 to our current report on Form 8-K dated June 18, 1999 and as subsequently amended by our Certificate of Amendment dated October 5, 2000 filed as Exhibit 3.1 to our Current Report on Form 8-K dated October 12, 2000 and

(c) any subsequent amendment(s) or report(s) filed for the purpose of updating such description.

We are also incorporating by reference in this prospectus all documents which we file pursuant to Section 13(a), 13(c), 14 or 15 of the Securities Exchange Act of 1934, as amended, after the date of this prospectus. Such documents are incorporated by reference in this prospectus and are a part of this prospectus from the date we file the documents with the Commission.

If we file with the Commission any document that contains information that is different from the information contained in this prospectus, you may rely only on the most recent information which we have filed with the Commission.

We will provide a copy of the documents referred to above without charge if you request the information from us. Requests for such copies should be directed to us at our principal executive offices at Andrea Electronics Corporation, 45 Melville Park Road, Melville, New York, 11747, attention: Secretary or (631) 719-1800.

You should only rely on the information incorporated by reference or provided in this prospectus or any supplement. We have not authorized any person to provide you with any different information. If anyone provides



you with different or inconsistent information you should not rely on it. The Common Stock is not being offered in any state where the offer is not permitted. You should not assume that the information in this prospectus or any supplement is accurate as of any date other than the date on the front of this prospectus.

The information in this prospectus may not contain all of the information that may be important to you. You should read the entire prospectus, as well as the documents incorporated by reference in the prospectus, before making an investment decision.

No dealer, salesman, or any other person has been authorized to give any information or to make any representations other than those contained in this prospectus in connection with the offering herein contained and, if given or made, such information or representations must not be relied upon as having been authorized by us or the selling stockholders. This prospectus does not constitute an offer to sell, or a solicitation of an offer to buy, the securities offered hereby in any jurisdiction to any person to whom it is unlawful to make an offer or solicitation.

Neither the delivery of this prospectus nor any sale made hereunder shall, under any circumstances, create an implication that there has been no change in our affairs since the date hereof or that any information contained herein is correct as to any of the time subsequent to its date. However, we have undertaken to amend the registration statement of which this prospectus is a part to reflect any facts or events arising after the effective date thereof which individually or in the aggregate represent a fundamental change in the information set forth in the registration statement. It is anticipated, however, that most updated information will be incorporated herein by reference to our reports filed under the securities exchange act of 1934. See "documents incorporated by reference."

All dealers effecting transactions in the Common Stock offered hereby, whether or not participating in this distribution, may be required to deliver a prospectus. This is in addition to the obligation of dealers to deliver a prospectus when acting as underwriters and with respect to their unsold allotments or subscriptions.

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11,211,171 SHARES

ANDREA ELECTRONICS CORPORATION

COMMON STOCK

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PROSPECTUS

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SEPTEMBER __, 2001

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PART II

INFORMATION NOT REQUIRED IN PROSPECTUS

ITEM 14. OTHER EXPENSES OF ISSUANCE AND DISTRIBUTION

| | | |
|---|---|---|
| Registration Fee - Securities and Exchange Commission | $ | 1,313 |
| American Stock Exchange Listing Fee* | | 17,500 |
| Legal Fees and Disbursements* | | 15,000 |
| Accounting Fees and Disbursements* | | 5,000 |
| Legal Fees and Expenses in Connection with Blue Sky Filings* | | 2,000 |
| Miscellaneous* | | 4,187 |
| Total | $ | 45,000 |

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*Estimated.



ITEM 15. INDEMNIFICATION OF DIRECTORS AND OFFICERS.

Section 722 of the Business Corporation Law of the State of New York empowers a New York corporation to indemnify any person made, or threatened to be made, a party to any action or proceeding (other than an action by or in the right of the corporation to procure a judgment in its favor), whether civil or criminal, including an action by or in the right of any other corporation of any type or kind, domestic or foreign, or any partnership, joint venture, trust, employee benefit plan or other enterprise, which any director or officer of the corporation served in any capacity at the request of the corporation, by reason of the fact that such person, such person's testator or such person's intestate is or was a director or officer of the corporation, or was serving at the request of the corporation as a director or officer of another corporation, partnership, joint vr-bottom:1px solid #000000;background-color:#cceeff;padding-left:2px;padding
TRUST CORPUS: End of period$349,237
$456,415
$349,237
$456,415

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

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CHESAPEAKE GRANITE WASH TRUST
NOTES TO FINANCIAL STATEMENTS
(Unaudited)

1. Organization of the Trust

Chesapeake Granite Wash Trust (the "Trust") is a statutory trust formed in June 2011 under the Delaware Statutory Trust Act pursuant to an initial trust agreement by and among Chesapeake Energy Corporation ("Chesapeake"), as Trustor, The Bank of New York Mellon Trust Company, N.A., as Trustee (the "Trustee"), and The Corporation Trust Company, as Delaware Trustee (the "Delaware Trustee").

The Trust was created to own royalty interests (the "Royalty Interests") for the benefit of Trust unitholders pursuant to a trust agreement dated as of June 29, 2011 and subsequently amended and restated as of November 16, 2011 by and among Chesapeake, Chesapeake Exploration, L.L.C., a wholly owned subsidiary of Chesapeake, the Trustee and the Delaware Trustee (the "Trust Agreement"). The Royalty Interests are derived from Chesapeake's interests in specified oil and natural gas properties located within an area of mutual interest (the "AMI") in the Colony Granite Wash play in Washita County in the Anadarko Basin of western Oklahoma (the "Underlying Properties"). Chesapeake conveyed the Royalty Interests to the Trust from (a) Chesapeake's interests in 69 existing horizontal wells (the "Producing Wells"), and (b) Chesapeake's interests in 118 horizontal development wells (the "Development Wells") that have since been, or that are to be, drilled on properties held by Chesapeake within the AMI. Pursuant to a development agreement with the Trust, Chesapeake is obligated to drill, cause to be drilled or participate as a non-operator in the drilling of the 118 Development Wells by June 30, 2016. Additionally, based on Chesapeake's assessment of the ability of a Development Well to produce in paying quantities, Chesapeake is obligated to either complete and tie into production or plug and abandon each Development Well. Chesapeake has retained an interest in each of the Producing Wells and Development Wells and currently operates 95% of the Producing Wells and the completed Development Wells and expects to operate approximately 88% of the remaining Development Wells.

The business and affairs of the Trust are managed by the Trustee. The Trust Agreement limits the Trust's business activities generally to owning the Royalty Interests and any activity reasonably related to such ownership, including activities required or permitted by the terms of the conveyances related to the Royalty Interests and derivative contracts between the Trust and its counterparty. The royalty interests in the Producing Wells entitle the Trust to receive 90% of the proceeds (exclusive of any production or development costs but after deducting certain post-production expenses and any applicable taxes) from the sales of oil, natural gas liquids ("NGL") and natural gas production attributable to Chesapeake's net revenue interest in the Producing Wells. The royalty interests in the Development Wells entitle the Trust to receive 50% of the proceeds (exclusive of any production or development costs but after deducting certain post-production expenses and any applicable taxes) from the sales of oil, NGL and natural gas production attributable to Chesapeake's net revenue interest in the Development Wells.

Through an initial public offering in November 2011, the Trust sold to the public 23,000,000 common units, representing beneficial interests in the Trust, for cash proceeds of approximately $409.7 million, net of offering costs. The Trust delivered the net proceeds of the initial public offering, along with 12,062,500 common units and 11,687,500 subordinated units, to certain wholly owned subsidiaries of Chesapeake in exchange for the conveyance of the Royalty Interests to the Trust. Upon completion of these transactions, there were 46,750,000 Trust units issued and outstanding, consisting of 35,062,500 common units and 11,687,500 subordinated units. The common units and subordinated units have identical rights and privileges, except with respect to their voting rights and rights to receive distributions as described below.

The subordinated units are entitled to receive pro rata distributions from the Trust each quarter if and to the extent there is sufficient cash to provide a cash distribution on the common units that is no less than 80% of the target distribution for the corresponding quarter (the "subordination threshold"). If there is not sufficient cash to fund such a distribution on all of the Trust units, the distribution to be made with respect to the subordinated units will be reduced or eliminated for such quarter in order to make a distribution, to the extent possible, of up to the subordination threshold amount on the common units. In exchange for agreeing to subordinate a portion of its Trust units, and in order to provide additional financial incentive to Chesapeake to satisfy its drilling obligation and perform operations on the Underlying Properties in an efficient and cost-effective manner, Chesapeake is entitled to receive incentive distributions equal to 50% of the amount by which the cash available for distribution on all of the Trust units in any quarter is 20% greater than the target distribution for such quarter (the “incentive threshold”). The remaining 50% of cash available for distribution in excess of the applicable incentive threshold will be paid to Trust unitholders, including Chesapeake, on a pro rata basis. At the end of the fourth full calendar quarter following Chesapeake’s satisfaction of its drilling obligation with respect to the Development Wells, the subordinated units will automatically convert into common units

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on a one-for-one basis and Chesapeake's right to receive incentive distributions will terminate. After such time, the common units will no longer have the protection of the subordination threshold, and all Trust unitholders will share on a pro rata basis in the Trust's distributions.

The distributable income for the production period from December 1, 2012 to February 28, 2013 and the production period from September 1, 2012 to November 30, 2012 was, in each case, below the subordination threshold. As a result, the distributions paid in the three months ended June 30, 2013 and the three months ended March 31, 2013 were $0.6900 per common unit and $0.3010 per subordinated unit and $0.6700 per common unit and $0.3772 per subordinated unit, respectively. All of the subordinated units are held by Chesapeake. See Risks and Uncertainties in Note 2 below.

The Trust will dissolve and begin to liquidate on June 30, 2031, or earlier upon certain events (the "Termination Date"), and will soon thereafter wind up its affairs and terminate. At the Termination Date, (a) 50% of the total Royalty Interests conveyed by Chesapeake will revert automatically to Chesapeake and (b) 50% of the total Royalty Interests conveyed by Chesapeake (the "Perpetual Royalties") will be retained by the Trust and thereafter sold. The net proceeds of the sale of the Perpetual Royalties, as well as any remaining Trust cash reserves, will be distributed to the unitholders on a pro rata basis. Chesapeake will have a right of first refusal to purchase the Perpetual Royalties retained by the Trust at the Termination Date.

2. Basis of Presentation and Significant Accounting Policies

Basis of Accounting. The accompanying Statement of Assets, Liabilities and Trust Corpus as of December 31, 2012, which has been derived from audited financial statements, and the unaudited interim financial statements of the Trust as of, or for the three and six months ended, June 30, 2013 and June 30, 2012, have been presented in accordance with the rules and regulations of the Securities and Exchange Commission ("SEC") and include all adjustments which are, in the opinion of the Trustee, necessary for a fair statement of the results for the interim periods presented. The accompanying unaudited interim financial statements should be read in conjunction with the December 31, 2012 audited financial statements and notes of the Trust included in the Trust's Annual Report on Form 10-K for the year ended December 31, 2012.

Financial statements of the Trust differ from financial statements prepared in accordance with accounting principles generally accepted in the United States of America ("GAAP") as the Trust records revenues when received and expenses when paid and may also establish certain cash reserves for contingencies which would not be accrued in financial statements prepared in accordance with GAAP. This non-GAAP comprehensive basis of accounting corresponds to the accounting principles permitted for royalty trusts by the SEC as specified by Staff Accounting Bulletin Topic 12:E, Financial Statements of Royalty Trusts.

Most accounting pronouncements apply to entities whose financial statements are prepared in accordance with GAAP, directing such entities to accrue or defer revenues and expenses in a period other than when such revenues were received or expenses were paid. Because the Trust's financial statements are prepared on the modified cash basis as described above, most accounting pronouncements are not applicable to the Trust's financial statements.

Use of Estimates. The preparation of financial statements requires the Trust to make estimates and assumptions that affect the reported amounts of assets, liabilities and Trust corpus during the reporting period. Significant estimates that impact the Trust's financial statements include estimates of proved oil and natural gas reserves, which are used to compute the Trust's amortization of the Investment in Royalty Interests (as defined in Investment in Royalty Interests below) and, as necessary, to evaluate potential impairments of Investment in Royalty Interests and of the fair value of derivatives. Actual results could differ from those estimates.

Risks and Uncertainties. The Trust's revenue and distributions are substantially dependent upon the prevailing and future prices for oil, NGL and natural gas, each of which depends on numerous factors beyond the Trust's control such as economic conditions, regulatory developments and competition from other energy sources. Oil, NGL and natural gas prices historically have been volatile, and may be subject to significant fluctuations in the future. The Trust's derivative contracts serve to mitigate the effect of this price volatility on a portion of the Trust's anticipated oil and NGL production through September 30, 2015. See Note 3 for the Trust's derivative contracts.

Low natural gas prices combined with stronger oil prices have resulted in an industry-wide increase in drilling activity in oil- and NGL-rich plays. The resulting increase in production volumes of NGL led to a significant decrease

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in the price of NGL in both absolute terms and on a relative basis compared to oil. The Trust’s exposure to low prices for NGL and reduced production volumes for the production periods from September 1, 2012 to May 31, 2013, in addition to higher than expected pressure depletion within the AMI described below, resulted in per unit income available for distribution below the applicable subordination threshold. Accordingly, the Trust paid a common unit distribution at the subordination threshold of $0.6900 and a subordinated unit distribution of $0.3010 on May 31, 2013, covering production from December 1, 2012 through February 28, 2013, and a common unit distribution at the subordination threshold of $0.6700 and a subordinated unit distribution of $0.3772 on March 1, 2013, covering production from September 1, 2012 through November 30, 2012 and, on August 8, 2013, the Trust announced that, on or about August 29, 2013, it will pay a common unit distribution at the subordination threshold of $0.6900 and a subordinated unit distribution of $0.1432, covering production from March 1, 2013 to May 31, 2013, to record unitholders as of August 19, 2013. Sustained low commodity prices and higher than expected pressure depletion have reduced and may continue to reduce the Trust’s revenues and distributable income available to unitholders, which may contribute to future distributions to common unitholders below the subordination threshold, and could lead to future impairments.

For the three months ended June 30, 2013 and March 31, 2013, the Trust recognized an $11.4 million and a $32.9 million impairment of the Royalty Interests, for each period, primarily due to higher than expected pressure depletion within certain areas of the AMI which has resulted in lower initial production rates and lower expected ultimate recovery in certain recent Development Wells. See Investment in Royalty Interests below for further discussion of the impairments. Chesapeake has informed the Trust that it is currently performing additional testing and scientific analysis of the Colony Granite Wash reservoir in an effort to potentially enhance the value of the remaining Development Wells by optimizing well spacing and Colony Granite Wash interval selections. Chesapeake has also advised that it believes it is prudent to reduce its operated rig count in the AMI from four rigs to two rigs beginning in mid-August 2013, which will allow more time to apply well performance analysis from well to well as Chesapeake's drilling program progresses at a slower pace. At this time, Chesapeake is unable to predict how long its operated rig count will remain at two rigs or the outcome of its additional testing and analysis, including any potential improvement in Development Well drilling performance or the potential effects on future distributions to common unitholders. If well performance does not improve, the Trust's revenues and distributable income available to unitholders will be reduced, which may contribute to future distributions to common unitholders below the subordination threshold, and decreased well performance or lower expected ultimate recovery may also lead to further impairments. In addition, the operated rig count reduction from four rigs to two rigs will decrease the rate at which royalty income from the remaining Development Wells becomes available to the Trust for distribution to unitholders, which, if combined with continued low NGL and natural gas prices and reduced well performance, will likely result in future distributions to common unitholders below the subordination threshold beginning in 2014. If a quarterly cash distribution in respect of the common units is lower than the applicable subordination threshold, the common units will not be entitled to receive any additional distributions nor will the units be entitled to arrearages in any future quarter.

Chesapeake’s ability to perform its obligations to the Trust will depend on its future results of operations, financial condition and liquidity, which in turn will depend upon the supply and demand for oil, NGL and natural gas, prevailing economic conditions and financial, business and other factors, many of which are beyond Chesapeake’s control.

If Chesapeake were to default on its obligation to drill the Development Wells, the Trust would be able to foreclose on a drilling support lien (the “Drilling Support Lien”) to the extent of Chesapeake’s remaining interests in the undeveloped portions of the AMI, file a lawsuit to collect monetary damages from Chesapeake and pursue other available legal remedies against Chesapeake. However, the Trust is not permitted to obtain specific performance from Chesapeake of its drilling obligation and the maximum amount the Trust can recover in a foreclosure or other action was limited to approximately $102.2 million as of June 30, 2013 and further reduced to $96.6 million as of August 2, 2013. The

maximum amount that may be recovered under the Drilling Support Lien will decrease as the remaining Development Wells are drilled and completed.
Delays and expenses associated with a foreclosure could reduce distributions to the Trust unitholders by reducing the amount of proceeds available for distribution and may result in the loss of acreage due to leasehold expirations. Any amounts actually recovered in a foreclosure action would be applied to completion of Chesapeake’s drilling obligation, would not result in any distribution to the Trust unitholders and may be insufficient to drill the number of wells needed for the Trust to realize the full value of the Royalty Interests in the Development Wells.

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In the event of a bankruptcy of Chesapeake or the wholly owned subsidiaries of Chesapeake that conveyed the Royalty Interests to the Trust, the Trust could lose the value of all of the Royalty Interests if a bankruptcy court were to hold that the Royalty Interests constitute an asset of the bankruptcy estate. Chesapeake could also be unable to provide support to the Trust through loans and performance of its management duties.

Cash. Cash equivalents include all highly-liquid instruments with maturities of three months or less at the time of acquisition. The Trustee maintains a minimum cash reserve of $1.0 million and may at the Trustee's discretion reserve funds for future expected administrative expenses.

Investment in Royalty Interests. The conveyance of the Royalty Interests to the Trust was accounted for as a transfer of properties between entities under common control and recorded at the historical cost of Chesapeake ("Investment in Royalty Interests"), which is based on an allocation of the historical net book value of Chesapeake's full cost pool according to the fair value of the Royalty Interests relative to the fair value of Chesapeake's proved reserves. The carrying value of the Trust's Investment in Royalty Interests will not necessarily be indicative of the fair value of such Royalty Interests. The Trust is not burdened by development costs of the Royalty Interests.

The Investment in Royalty Interests is amortized as a single cost center on a units-of-production basis over total proved reserves. Such amortization does not reduce distributable income, rather it is charged directly to Trust corpus. Revisions to estimated future units-of-production are treated on a prospective basis beginning on the date such revisions are known.

On a quarterly basis, the Trust evaluates the carrying value of the Investment in Royalty Interests under the full cost accounting method prescribed by the SEC. This quarterly review is referred to as a ceiling test. Under the ceiling test, the carrying value of the Investment in Royalty Interests may not exceed an amount equal to the sum of the present value (using a 10% discount rate) of the estimated future net revenues from proved reserves. For the three months ended June 30, 2013 and March 31, 2013, the carrying value of the Investment in Royalty Interests exceeded the estimated present value calculation of future net revenues from proved reserves, resulting in an $11.4 million and a $32.9 million impairment, for each period, in the carrying value of the Investment in Royalty Interests. The impairments were the result of reserve revisions attributable to current results being below expectations, primarily caused by higher than expected pressure depletion within certain areas of the AMI. This has resulted in lower initial production rates and lower expected ultimate recovery in certain recent Development Wells. The impairments resulted in non-cash charges to the Trust corpus and did not affect the Trust distributable income. See Risks and Uncertainties above for further discussion.

Derivatives. To mitigate a portion of the exposure to adverse market changes of oil prices and, to the extent oil production falls below the hedged oil volume, NGL prices, the Trust is party to derivative contracts with its hedge counterparty. See Note 3 for discussion of the derivative contracts currently outstanding.

The Trust records gains or losses from the derivative contracts when proceeds are received or payments are made, respectively. Additionally, changes in the fair value of the derivative contracts are accounted for as an adjustment to Trust corpus and the fair value carried on the statement of assets, liabilities and trust corpus. Cash distributions to unitholders will be increased or decreased by the effect of the Trust's derivative contracts.

Loan Commitment. Pursuant to the Trust Agreement, if at any time the Trust's cash on hand (including available cash reserves) is not sufficient to pay the Trust's ordinary course expenses as they become due, Chesapeake will loan funds to the Trust necessary to pay such expenses. Such loans will be recorded as a liability on the statement of assets, liabilities and Trust corpus until repaid. A loan neither increases nor decreases distributions to unitholders; however, no further distributions will be made to unitholders (except in respect of any previously determined quarterly cash distribution amount) until the loan is repaid. There were no loans outstanding as of June 30, 2013 or December 31, 2012.

Revenues and Expenses. Neither the Trust nor the Trustee is responsible for, or has any control over, any costs related to the drilling of the Development Wells or any other operating or capital costs of the Underlying Properties. The

Trust's revenues with respect to the Royalty Interests in the Underlying Properties are net of existing royalties and overriding royalties associated with Chesapeake's interests and are determined after deducting certain post-production expenses and any applicable taxes associated with the Royalty Interests. Post-production expenses generally consist of costs incurred to gather, store, compress, transport, process, treat, dehydrate and market the oil, NGL and natural

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gas produced. However, the Trust is not responsible for costs of marketing services provided by affiliates of Chesapeake. Cash distributions to unitholders will be reduced by the Trust's general and administrative expenses. See Derivative Contracts in Note 3.

3. Derivative Contracts

The Trust uses derivative instruments in an effort to manage its exposure to variability in cash flow from changes in oil prices and, to the extent oil production falls below hedged oil volume, NGL prices. On November 16, 2011, Chesapeake novated the derivative contracts described in the table below to the Trust pursuant to which the Trust became party to derivative contracts covering a portion of its expected production from October 1, 2011 through September 30, 2015. These derivative contracts consist of fixed-price oil swaps, in which the Trust receives a fixed price and pays a floating market price, based on New York Mercantile Exchange ("NYMEX") settlement prices, to the counterparty for the underlying commodity of the derivative. As a party to these contracts, the Trust receives payments directly from its counterparty or is required to pay any amounts owed directly to the counterparty. All swaps are net settled based on the difference between the fixed-price payment and the floating-price payment. Settlements are due on a quarterly basis, including the first two months of the calendar quarter just ended and the last month of the calendar quarter prior to that one. Any payment due to or from such counterparty will be made by the 40th day following the end of the calendar quarter in which such payments become due.

The Trust's obligations to the counterparty under the derivative contracts are secured by liens on proved reserves attributable to the Trust's interest in the Underlying Properties. The counterparty's obligations under the hedge facility must be secured by cash or short-term U.S. Treasury instruments to the extent that any mark-to-market amounts owed to the Trust exceed the defined thresholds. Mark-to-market amounts did not exceed the defined thresholds as of June 30, 2013.

As of June 30, 2013, the Trust had the following oil derivative contracts:

| | Fixed-Price Oil Swaps | | |
|---|---|---|---|
| Production Quarter | Volume (mbbl) | Weighted Avg. Price (per bbl) | Fair Value Asset/(Liability) ($ in thousands) |
| Q1 2013[(1)] | 61.3 | $87.54 | $(352) |
| Q2 2013[(2)] | 184.3 | $87.60 | (1,205) |
| Q3 2013 | 187.9 | $87.79 | (1,504) |
| Q4 2013 | 184.2 | $87.99 | (1,145) |
| Q1 2014 | 179.8 | $88.08 | (729) |
| Q2 2014 | 180.3 | $88.21 | (417) |
| Q3 2014 | 178.8 | $88.34 | (158) |
| Q4 2014 | 174.3 | $88.45 | 75 |
| Q1 2015 | 171.0 | $88.59 | 295 |
| Q2 2015 | 175.4 | $88.76 | 477 |
| Q3 2015 | 153.6 | $88.90 | 587 |
| Total | 1,830.9 | $88.23 | $(4,076) |

(1) Includes March 2013 production that was settled in August 2013.
(2) Includes April and May 2013 production that was settled in August 2013.

To the extent expected oil production falls below the hedged oil volume, the derivative contracts will also cover expected NGL production. Such estimated production of NGL is hedged with oil contracts using a conversion ratio of one barrel of NGL to 49.2% of a barrel of oil. In 2012 and continuing in 2013, NGL prices decreased relative to oil prices. To the extent oil and NGL prices are not correlated, the derivative contracts will not effectively mitigate the price risk of the Trust's NGL production.

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Additional Disclosures Regarding Derivative Contracts

In accordance with accounting guidance for derivatives and hedging, and because a legal right of set-off exists, the Trust has netted the value of its derivative contracts with the counterparty in the accompanying statement of assets, liabilities and trust corpus. Short-term derivative liability represents the estimated fair value of derivatives scheduled to settle in cash over the next twelve months based on market prices as of June 30, 2013. The Trust does not apply hedge accounting to any of its derivative contracts, and therefore, any changes in the fair value of the derivative contracts prior to settlement are accounted for as an adjustment to Trust corpus. Results of settled derivative contracts are reflected in distributable income in the period when paid. For the three months ended June 30, 2013 and June 30, 2012, the Trust settled derivative contracts that resulted in a payment to the counterparty of $1.0 million and $2.6 million, respectively. For the six months ended June 30, 2013 and June 30, 2012, the Trust settled derivative contracts that resulted in payments to the counterparty, in the aggregate, of $1.6 million and $3.4 million, respectively.

The following table presents the fair value and location of each classification of derivative contracts disclosed in the statements of assets, liabilities and trust corpus as of June 30, 2013 and December 31, 2012 on a gross basis without regard to same-counterparty netting:

| | Statement of Assets, Liabilities and Trust Corpus Location | Fair Value June 30, 2013 | December 31, 2012 |
|---|---|---|---|
| | | ($ in thousands) | |
| Asset Derivatives: | | | |
| Not designated as hedging instrument | | | |
| Commodity contracts | Short-term derivative asset | $— | $212 |
| Commodity contracts | Long-term derivative asset | 2,093 | 411 |
| Total | | $2,093 | $623 |
| Liability Derivatives: | | | |
| Not designated as hedging instrument | | | |
| Commodity contracts | Short-term derivative liability | $(4,762) | $(3,488) |
| Commodity contracts | Long-term derivative liability | (1,407) | (5,219) |
| Total | | (6,169) | (8,707) |
| Total derivatives instruments | | $(4,076) | $(8,084) |

All of the Trust's derivative positions are subject to netting arrangements which provide for offsetting of asset and liability positions, as well as related cash collateral if applicable. Such netting arrangements generally do not have restrictions. Under such netting arrangements, the Trust offsets the fair value of derivative instruments with cash collateral received or paid for those contracts executed with the same counterparty, which reduces the Trust's total assets and Trust corpus. As of June 30, 2013 and December 31, 2012, the Trust did not have any cash collateral balances for these derivatives.

The following tables present the netting offsets of derivative assets and liabilities as of June 30, 2013 and December 31, 2012.

| | June 30, 2013 | | | |
|---|---|---|---|---|
| | Derivative Assets | | Derivative Liabilities | |
| | Short-term | Long-Term | Short-term | Long-Term |
| | ($ in thousands) | | | |
| Commodity Contracts: | | | | |
| Gross amounts of recognized assets (liabilities) | $— | $2,093 | $(4,762) | $(1,407) |

| | | | | |
|---|---|---|---|---|
| Gross amounts offset in the statement of assets, liabilities and trust corpus | — | (1,407) | — | 1,407 |
| Total derivatives as reported | $— | $686 | $(4,762) | $— |

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| | December 31, 2012 | | | |
|---|---|---|---|---|
| | Derivative Assets | | Derivative Liabilities | |
| | Short-term | Long-Term | Short-term | Long-Term |
| | ($ in thousands) | | | |
| Commodity Contracts: | | | | |
| Gross amounts of recognized assets (liabilities) | $212 | $411 | $(3,488) | $(5,219) |
| Gross amounts offset in the statement of assets, liabilities and trust corpus | (212) | (411) | 212 | 411 |
| Total derivatives as reported | $— | $— | $(3,276) | $(4,808) |

4. Income Taxes

The Trust is a Delaware statutory trust that is treated as a partnership for U.S. federal income tax purposes. The Trust is not required to pay federal or state income taxes. Accordingly, no provision for federal or state income tax has been made.

Trust unitholders are treated as partners of the Trust for U.S. federal income tax purposes. The Trust Agreement contains tax provisions that generally allocate the Trust’s income, deductions and credits among the Trust unitholders in accordance with their percentage interests in the Trust. The Trust Agreement also sets forth the tax accounting principles to be applied by the Trust.

5. Related Party Transactions

Trustee Administrative Fee. Under the terms of the Trust Agreement, the Trust pays an annual administrative fee of $175,000 to the Trustee, paid in equal quarterly installments. The administrative fee may be adjusted for inflation by no more than 3% in any calendar year beginning in 2015.

Agreements with Chesapeake. In connection with the initial public offering and the conveyance of the Royalty Interests to the Trust, the Trust entered into an administrative service agreement, a development agreement and a registration rights agreement with Chesapeake.

Pursuant to the administrative services agreement, Chesapeake provides the Trust with certain accounting, tax preparation, bookkeeping and information services related to the Royalty Interests and the registration rights agreement. In return for the services provided by Chesapeake under the administrative services agreement, the Trust pays Chesapeake, in equal quarterly installments, an annual fee of $200,000, which will remain fixed for the life of the Trust. Chesapeake is also entitled to receive reimbursement for its actual out-of-pocket fees, costs and expenses incurred in connection with the provision of any of the services under the agreement.

Additionally, the administrative services agreement established Chesapeake as the Trust’s hedge manager, pursuant to which Chesapeake has the authority, on behalf of the Trust, to administer the Trust’s derivative contracts. As hedge manager, Chesapeake also has authority to terminate, restructure or otherwise modify all or any portion of the derivative contracts to the extent that Chesapeake reasonably determines, acting in good faith, that the volumes hedged under such contracts exceed, or are expected to exceed, the combined estimated production attributable to the Royalty Interests over the periods hedged. However, in fulfilling its role as hedge manager, Chesapeake does not act as a fiduciary for the Trust and has no affirmative duty to modify any of the Trust’s derivative contracts, except as required by the derivative contracts and the administrative services agreement. Moreover, the Trust will indemnify Chesapeake for any actions it takes in this regard.

The administrative services agreement will terminate upon the earliest to occur of (a) the date the Trust shall have dissolved and wound up its business and affairs in accordance with the Trust Agreement, (b) the date that all of the Royalty Interests have been terminated or are no longer held by the Trust, (c) with respect to services to be provided with respect to any Underlying Properties being transferred by Chesapeake, the date that either Chesapeake or the Trustee may designate by delivering 90-days prior written notice, provided that Chesapeake’s drilling obligation has been completed and the transferee of such Underlying Properties assumes responsibility to perform the services in place of Chesapeake or (d) a date mutually agreed by Chesapeake and the Trustee.

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The development agreement obligates Chesapeake to drill, cause to be drilled or participate as a non-operator in the drilling of the Development Wells on or prior to June 30, 2016. Additionally, based on Chesapeake's assessment of the ability of a Development Well to produce in paying quantities, Chesapeake is obligated to either complete and tie into production or plug and abandon each Development Well. Chesapeake has also agreed not to drill and complete, or permit any other person within its control to drill and complete, any well in the AMI other than the Development Wells until Chesapeake has met its obligation to drill the Development Wells.

In drilling the Development Wells, Chesapeake is required to act diligently and as a reasonably prudent oil and gas operator would act under the same or similar circumstances as if it were acting with respect to its own properties, disregarding the existence of the Royalty Interests as burdens affecting such properties (the "Reasonably Prudent Operator Standard"). Where Chesapeake does not operate the Underlying Properties, Chesapeake is required to use commercially reasonable efforts to exercise its contractual rights to cause the operators of such Underlying Properties to adhere to the Reasonably Prudent Operator Standard. Chesapeake expects that the drilling and completion techniques used for the Development Wells will be generally consistent with those used for the Producing Wells, the existing Development Wells and other Colony Granite Wash producing wells outside of the AMI.

Under the development agreement, Chesapeake will be credited for drilling one full Development Well if the perforated length of the well is equal to or greater than 3,500 feet and Chesapeake's net revenue interest in the well is equal to 52.0%. For wells with a perforated length that is less than 3,500 feet, and for wells in which Chesapeake has a net revenue interest greater than or less than 52.0%, Chesapeake receives proportionate credit.

A wholly owned subsidiary of Chesapeake has granted to the Trust the Drilling Support Lien covering Chesapeake's retained interest in the AMI (except its interest in the Producing Wells, Development Wells and any other wells not subject to the Royalty Interests) in order to secure the estimated amount of the drilling costs for the Trust's interests in the Development Wells. The maximum amount that may be obtained by the Trust pursuant to the Drilling Support Lien initially could not exceed $262.7 million. As Chesapeake fulfills its drilling obligation over time, the total amount that may be recovered is proportionately reduced and completed Development Wells are released from the lien. If Chesapeake does not fulfill its drilling obligation by June 30, 2016, the Trust may foreclose on any remaining interest in the AMI that is subject to the Drilling Support Lien. Any amounts actually recovered in a foreclosure action would be applied to the completion of Chesapeake's drilling obligation and would not result in any distribution to the Trust unitholders.

Chesapeake's drilling activity with respect to the Development Wells is consistent with its intent to meet the drilling obligation contemplated by the development agreement. As of August 2, 2013, Chesapeake had drilled and completed, or caused to be drilled or completed, a total of 68 wells in the AMI (approximately 74.6 Development Wells as calculated under the development agreement), reducing the amount that may be recovered under the Drilling Support Lien to approximately $96.6 million. See Risks and Uncertainties in Note 2 regarding Chesapeake's plan to reduce its operated rig count from four rigs to two rigs in connection with testing and analysis it is conducting related to future Development Well drilling.

The Trust also entered into a registration rights agreement for the benefit of Chesapeake and certain of its affiliates (each, a "holder"). Pursuant to the registration rights agreement, the Trust agreed to register the Trust units held by each such holder for resale under the Securities Act of 1933, as amended. In connection with the preparation and filing of any registration statement, Chesapeake will bear all costs and expenses incidental to any registration statement, excluding certain internal expenses of the Trust, which will be borne by the Trust, and any underwriting discounts and commissions, which will be borne by the seller of the Trust units.

Loan Commitment. Pursuant to the Trust Agreement, if at any time the Trust's cash on hand (including available cash reserves) is not sufficient to pay the Trust's ordinary course expenses as they become due, Chesapeake will loan funds to the Trust necessary to pay such expenses. Any funds loaned by Chesapeake pursuant to this commitment will be limited to the payment of current accounts payable or other obligations to trade creditors in connection with obtaining goods or services or the payment of other current liabilities arising in the ordinary course of the Trust's business, and may not be used to satisfy Trust indebtedness for borrowed money of the Trust. If Chesapeake loans funds pursuant to this commitment, unless Chesapeake agrees otherwise, no further distributions will be made to unitholders (except in respect of any previously determined quarterly cash distribution amount) until such loan is repaid. There were no loans outstanding as of June 30, 2013 or December 31, 2012.

CHESAPEAKE GRANITE WASH TRUST
NOTES TO FINANCIAL STATEMENTS - (Continued)
(Unaudited)

6. Fair Value Measurement

Certain financial instruments are reported at fair value on the statement of assets, liabilities and trust corpus. Under fair value measurement accounting guidance, fair value is defined as the amount that would be received from the sale of an asset or paid for the transfer of a liability in an orderly transaction between market participants, i.e., an exit price. To estimate an exit price, a three-level hierarchy is used. The fair value hierarchy prioritizes the inputs, which refer broadly to assumptions market participants would use in pricing an asset or a liability, into three levels. Level 1 inputs are unadjusted quoted prices in active markets for identical assets and liabilities and have the highest priority. Level 2 inputs are inputs other than quoted prices within Level 1 that are observable for the asset or liability, either directly or indirectly. Level 3 inputs are unobservable inputs for the financial asset or liability and have the lowest priority. The Trust uses a market valuation approach based on available inputs and the following methods and assumptions to measure the fair values of its assets and liabilities, which may or may not be observable in the market.

Derivatives. The fair value of our derivatives is based on third-party pricing models which utilize inputs that are either readily available in the public market, such as oil forward curves and discount rates, or can be corroborated from active markets or broker quotes. These values are then compared to the values given by our counterparty for reasonableness. Since commodity swaps do not include optionality and therefore have no unobservable inputs, they are classified as Level 2.

The following table provides fair value measurement information for financial assets (liabilities) measured at fair value on a recurring basis as of June 30, 2013:

| | Quoted Prices in Active Markets (Level 1) ($ in thousands) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) | Total Fair Value |
|---|---|---|---|---|
| Financial Assets (Liabilities): | | | | |
| Derivative assets | $— | $686 | $— | $686 |
| Derivative liabilities | — | (4,762) | — | (4,762) |
| Total | $— | $(4,076) | $— | $(4,076) |

The following table provides fair value measurement information for financial assets (liabilities) measured at fair value on a recurring basis as of December 31, 2012:

| | Quoted Prices in Active Markets (Level 1) ($ in thousands) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) | Total Fair Value |
|---|---|---|---|---|
| Financial Assets (Liabilities): | | | | |
| Derivative liabilities | $— | $(8,084) | $— | $(8,084) |
| Total | $— | $(8,084) | $— | $(8,084) |

Fair Value of Other Financial Instruments. The estimated fair value of financial instruments is made in accordance with accounting guidance for financial instruments. The carrying values of financial instruments comprising cash and cash equivalents approximate fair values due to the short-term maturities of these instruments.

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CHESAPEAKE GRANITE WASH TRUST
NOTES TO FINANCIAL STATEMENTS - (Continued)
(Unaudited)

7. Distributions to Unitholders

The Trust makes quarterly cash distributions of substantially all of its cash receipts, after deducting the Trust’s expenses, approximately 60 days following the completion of each quarter through (and including) the quarter ending June 30, 2031.

For the six months ended June 30, 2013 and June 30, 2012, the Trust declared and paid the following cash distributions:

| Production Period | Distribution Date | Cash Distribution per Common Unit | Cash Distribution per Subordinated Unit |
|---|---|---|---|
| December 2012 - February 2013 | May 31, 2013 | $0.6900 | $0.3010 |
| September 2012 - November 2012 | March 1, 2013 | $0.6700 | $0.3772 |
| December 2011 - February 2012 | May 31, 2012 | $0.6588 | $0.6588 |
| September 2011 - November 2011 | March 1, 2012 | $0.7277 | $0.7277 |

8. Subsequent Events

On August 8, 2013, the Trust declared a cash distribution of $0.6900 per common unit and $0.1432 per subordinated unit, consisting of proceeds attributable to production from March 1, 2013 to May 31, 2013, to record unitholders as of August 19, 2013. The distribution will be paid on August 29, 2013. The Trust's quarterly income available for distribution was $0.5533 per unit, which was $0.1367 below the subordination threshold. As a result, the distribution per common unit will be the subordination threshold of $0.6900 for the quarter. Distributable income attributable to production from March 1, 2013 to May 31, 2013 was calculated as follows (in thousands except for unit and per unit amounts):

| | |
|---|---|
| REVENUES: | |
| Royalty income (1) | $27,759 |
| Total Revenues | 27,759 |
| EXPENSES: | |
| Production taxes | 497 |
| Trust administrative expenses (2) | 342 |
| Derivative settlement loss | 1,053 |
| Total Expenses | 1,892 |
| Distributable income available to unitholders | $25,867 |
| Distributable income per common unit (35,062,500 units) | $0.6900 |
| Distributable income per subordinated unit (11,687,500 units) | $0.1432 |

(1) Net of certain post-production expenses.
(2) Includes cash reserves withheld.

Beginning in mid-August 2013, Chesapeake intends to reduce its operated rig count in the AMI from four rigs to two. See Risks and Uncertainties in Note 2 for further discussion.

ITEM 2. Trustee's Discussion and Analysis of Financial Condition and Results of Operations

Introduction

The following discussion and analysis is intended to help the reader understand the Trust's financial condition and results of operations. This discussion and analysis should be read in conjunction with the Trust's unaudited interim financial statements and the accompanying notes relating to the Trust and the Underlying Properties included in Item 1 of Part I of this Quarterly Report as well as the Trust's Annual Report on Form 10-K for the year ended December 31, 2012 (the "2012 Form 10-K"). Capitalized items in this Item 2 have the same meanings ascribed to them in Note 1 to the Trust's financial statements included in Item 1 of Part I of this Quarterly Report.

Overview

The Trust is a statutory trust formed in June 2011 under the Delaware Statutory Trust Act. The business and affairs of the Trust are managed by the Trustee and, as necessary, the Delaware Trustee. The Trust does not conduct any operations or activities other than owning the Royalty Interests and activities related to such ownership. The Trust's purpose is generally to own the Royalty Interests, to distribute to the Trust unitholders cash that the Trust receives in respect of the Royalty Interests and the derivative contracts (described in Note 3 to the financial statements contained in Item 1 of Part I of this Quarterly Report) and to perform certain administrative functions in respect of the Royalty Interests and the Trust units. The Trust derives all or substantially all of its income and cash flow from the Royalty Interests and the derivative contracts. The Trust is treated as a partnership for federal income tax purposes.

Concurrent with the Trust's initial public offering in November 2011, Chesapeake conveyed the Royalty Interests to the Trust effective July 1, 2011, which included interests in (a) 69 Producing Wells in the Colony Granite Wash play and (b) 118 Development Wells that have been or that are to be drilled in the Colony Granite Wash play on properties within the AMI. Chesapeake is obligated to drill, cause to be drilled or participate as a non-operator in the drilling of the Development Wells from drill sites in the AMI on or prior to June 30, 2016. Additionally, based on Chesapeake's assessment of the ability of a Development Well to produce in paying quantities, Chesapeake is obligated to either complete and tie into production or plug and abandon each Development Well. As of June 30, 2013, Chesapeake had drilled and completed 65 wells within the AMI (approximately 72.1 Development Wells as calculated under the development agreement). As of August 2, 2013, Chesapeake had drilled and completed, or caused to be drilled and completed, a total of 68 wells within the AMI (approximately 74.6 Development Wells as calculated under the development agreement).

The Trust is not responsible for any costs related to the drilling of the Development Wells or any other operating or capital costs of the Underlying Properties, and Chesapeake is not permitted to drill and complete any well in the Colony Granite Wash formation on acreage included within the AMI for its own account until it has satisfied its drilling obligation to the Trust.

The Royalty Interests entitle the Trust to receive 90% of the proceeds (after deducting certain post-production expenses and any applicable taxes) from the sales of production of oil, NGL and natural gas attributable to Chesapeake's net revenue interest in the Producing Wells and 50% of the proceeds (after deducting certain post-production expenses and any applicable taxes) from the sales of oil, NGL and natural gas production attributable to Chesapeake's net revenue interest in the Development Wells. Post-production expenses generally consist of costs incurred to gather, store, compress, transport, process, treat, dehydrate and market the oil, NGL and natural gas produced. However, the Trust is not responsible for costs of marketing services provided by Chesapeake or its affiliates.

On November 16, 2011, Chesapeake novated to the Trust, and the Trust became party to, derivative contracts covering a portion of the production attributable to the Royalty Interests from October 1, 2011 through September 30, 2015. The Trust's distributable income will include net settlements under these derivative contracts. The value of the derivative contracts as of June 30, 2013 was a net liability of $4.1 million.

The Trust is required to make quarterly cash distributions of substantially all of its cash receipts, after deducting the Trust's administrative expenses, on or about 60 days following the completion of each calendar quarter through (and including) the quarter ending June 30, 2031.The distribution made in the first quarter of 2013, consisting of proceeds attributable to production from September 1, 2012 through November 30, 2012, was made on March 1, 2013

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to record unitholders as of February 19, 2013. The distribution made in the second quarter of 2013, consisting of proceeds attributable to production from December 1, 2012 through February 28, 2013, was made on May 31, 2013 to record unitholders as of May 21, 2013.

The amount of Trust revenues and cash distributions to Trust unitholders will fluctuate from quarter to quarter depending on several factors, including:

- timing and amount of initial production and sales from the Development Wells;
- oil, NGL and natural gas prices received;
- volumes of oil, NGL and natural gas produced and sold;
- amounts received from, or paid under, derivative contracts;
- certain post-production expenses and any applicable taxes; and
- the Trust's expenses.

Subordination Threshold. In order to provide support for cash distributions on the common units, Chesapeake agreed to subordinate 11,687,500 of the Trust units retained following the initial public offering of common units, which constitute 25% of the outstanding Trust units. The subordinated units are entitled to receive pro rata distributions from the Trust each quarter if and to the extent there is sufficient cash to pay a cash distribution on the common units that is no less than 80% of the target distribution for the corresponding quarter. If there is not sufficient cash to fund such a distribution on all of the common units, the distribution to be made with respect to the subordinated units will be reduced or eliminated for such quarter in order to make a distribution, to the extent possible, of up to the subordination threshold amount on all the common units, including the common units held by Chesapeake.

Incentive Threshold. In exchange for agreeing to subordinate a portion of its Trust units, and in order to provide additional financial incentive to Chesapeake to satisfy its drilling obligation and perform operations on the Underlying Properties in an efficient and cost-effective manner, Chesapeake is entitled to receive incentive distributions equal to 50% of the amount by which the cash available for distribution on all of the Trust units in any quarter is 20% greater than the target distribution for such quarter. The remaining 50% of cash available for distribution in excess of the applicable incentive threshold will be paid to the Trust unitholders, including Chesapeake, on a pro rata basis.

At the end of the fourth full calendar quarter following Chesapeake's satisfaction of its drilling obligation with respect to the Development Wells, the subordinated units will automatically convert into common units on a one-for-one basis and Chesapeake's right to receive incentive distributions will terminate. With respect to distributions for quarters following the fourth full quarter after Chesapeake's satisfaction of its Development Well drilling obligation, the common units will no longer have the protection of the subordination threshold, and all Trust unitholders will share on a pro rata basis in the Trust's distributions. The period during which the subordinated units are outstanding is referred to as the subordination period.

The following table sets forth the subordination threshold and the incentive threshold for each calendar quarter through the second quarter of 2017, as established in the Trust Agreement:

| Period | Subordination Threshold (per unit) | Incentive Threshold |
|---|---|---|
| 2013: | | |
| First Quarter [(1)] | $0.69 | $1.04 |
| Second Quarter [(2)] | $0.69 | $1.04 |
| Third Quarter | $0.71 | $1.07 |
| Fourth Quarter | $0.69 | $1.04 |
| 2014: | | |
| First Quarter | $0.69 | $1.04 |
| Second Quarter | $0.68 | $1.02 |
| Third Quarter | $0.69 | $1.03 |
| Fourth Quarter | $0.66 | $0.99 |
| 2015: | | |
| First Quarter | $0.66 | $0.99 |
| Second Quarter | $0.68 | $1.02 |
| Third Quarter | $0.64 | $0.96 |
| Fourth Quarter | $0.56 | $0.84 |
| 2016: | | |
| First Quarter | $0.51 | $0.76 |
| Second Quarter | $0.47 | $0.70 |
| Third Quarter | $0.44 | $0.66 |
| Fourth Quarter | $0.41 | $0.62 |
| 2017: | | |
| First Quarter | $0.39 | $0.59 |
| Second Quarter | $0.37 | $0.56 |

(1) A distribution of $0.6900 per common unit and $0.3010 per subordinated unit was made on May 31, 2013 to unitholders of record as of May 21, 2013.

(2) A distribution of $0.6900 per common unit and $0.1432 per subordinated unit was declared on August 8, 2013 and will be paid on or about August 29, 2013 to unitholders of record as of August 19, 2013.

Results of Trust Operations

The quarterly payments to the Trust with respect to the Royalty Interests are based on the amount of proceeds actually received by Chesapeake during the preceding calendar quarter. Proceeds from production are typically received by Chesapeake one month after production. Due to the timing of the payment of production proceeds, quarterly distributions made by Chesapeake to the Trust will generally include royalties attributable to sales of oil, NGL and natural gas for three months, comprised of the first two months of the quarter just ended and the last month of the quarter prior to that one. Chesapeake is required to make the Royalty Interest payments to the Trust within 35 days of the end of each calendar quarter. As a result, in May 2013, the Trust received a payment on the Royalty Interests representing royalties attributable to proceeds from sales of oil, NGL and natural gas for December 1, 2012 through February 28, 2013. In March 2013, the Trust received a payment on the Royalty Interests representing royalties attributable to proceeds from sales of oil, NGL and natural gas for September 1, 2012 through November 30, 2012.

Low natural gas prices combined with stronger oil prices have resulted in an industry-wide increase in drilling activity in oil- and NGL-rich plays. The resulting increase in production volumes of NGL led to a significant decrease in the price of NGL in both absolute terms and on a relative basis compared to oil. The Trust’s exposure to low prices for NGL and reduced production volumes for the production periods from September 1, 2012 to May 31, 2013, in addition to higher than expected pressure depletion within the AMI described below, resulted in per unit income available for distribution below the applicable subordination threshold. Accordingly, the Trust paid a common unit distribution at the subordination threshold of $0.6900 and a subordinated unit distribution of $0.3010 on May 31, 2013, covering production from December 1, 2012 through February 28, 2013, and a common unit distribution at the subordination threshold of $0.6700 and a subordinated unit distribution of $0.3772 on March 1, 2013, covering production from September 1, 2012 through November 30, 2012 and, on August 8, 2013, the Trust announced that, on or about August 29, 2013, it will pay a common unit distribution at the subordination threshold of $0.6900 and a subordinated unit distribution of $0.1432, covering production from March 1, 2013 to May 31, 2013, to record unitholders as of August 19, 2013. Sustained low commodity prices and higher than expected pressure depletion have reduced and may continue to reduce the Trust's revenues and distributable income available to unitholders, which may contribute to future distributions to common unitholders below the subordination threshold, and could lead to future impairments.

For the three months ended June 30, 2013 and March 31, 2013, the Trust recognized an $11.4 million and a $32.9 million impairment of the Royalty Interests, for each period, primarily due to higher than expected pressure depletion within certain areas of the AMI which has resulted in lower initial production rates and lower expected ultimate recovery in certain recent Development Wells. See Risks and Uncertainties in Note 2 for further discussion.

Chesapeake has informed the Trust that it is currently performing additional testing and scientific analysis of the Colony Granite Wash reservoir in an effort to potentially enhance the value of the remaining Development Wells by optimizing well spacing and Colony Granite Wash interval selections. Chesapeake has also advised that it believes it is prudent to reduce its operated rig count in the AMI from four rigs to two rigs beginning in mid-August 2013, which will allow more time to apply well performance analysis from well to well as Chesapeake's drilling program progresses at a slower pace. At this time, Chesapeake is unable to predict how long its operated rig count will remain at two rigs or the outcome of its additional testing and analysis, including any potential improvement in Development Well drilling performance or the potential effects on future distributions to common unitholders. If well performance does not improve, the Trust's revenues and distributable income available to unitholders will be reduced, which may contribute to future distributions to common unitholders below the subordination threshold, and decreased well performance or lower expected ultimate recovery may also lead to further impairments. In addition, the operated rig count reduction from four rigs to two rigs will decrease the rate at which royalty income from the remaining Development Wells becomes available to the Trust for distribution to unitholders, which, if combined with continued low NGL and natural gas prices and reduced well performance, will likely result in future distributions to common unitholders below the subordination threshold beginning in 2014. If a quarterly cash distribution in respect of the common units is lower than the applicable subordination threshold, the common units will not be entitled to receive any additional distributions nor will the units be entitled to arrearages in any future quarter.

Trust Operations for the Three Months Ended June 30, 2013 as compared to June 30, 2012.

Distributable Income. The Trust's distributable income was $27.7 million for the three months ended June 30, 2013 compared to $30.8 million for the three months ended June 30, 2012, a decrease of $3.1 million. This decrease was primarily due to the decrease in the average realized prices received from sales of oil and NGL and lower than expected initial production rates from Development Wells completed in the production period from December 1, 2012 to February 28, 2013 ("current production quarter"). During the current production quarter, the average price received for oil was $88.08 per barrel ("bbl") compared to $97.03 per bbl for the production period from December 1, 2011 to February 29, 2012 ("prior production quarter"). NGL prices received were $32.67 per bbl for the current production quarter compared to $36.56 per bbl for the prior production quarter. Current production quarter oil sales volumes also decreased from the prior production quarter to 149 thousand barrels ("mbbls") from 182 mbbls due to higher than expected pressure depletion within certain areas of the AMI. These decreases were offset by an increase in the price received for natural gas to $2.28 per thousand cubic feet ("mcf") for the current production quarter from $1.90 per mcf for the prior production quarter.

On a per unit basis, cash distributions during the three months ended June 30, 2013 and attributable to the current production quarter were $0.6900 per common unit and $0.3010 per subordinated unit as compared to $0.6588 per common and subordinated unit for the three months ended June 30, 2012 and attributable to the prior production quarter. Distributable income for the three months ended June 30, 2013, and attributable to the current production quarter, and the three months ended June 30, 2012, and attributable to the prior production quarter, was calculated as follows:

| | Three Months Ended June 30, | |
|---|---|---|
| | 2013 | 2012 |
| | ($ in thousands, except per unit data) | |
| Revenues: | | |
| Royalty income[(1)] | $29,868 | $34,554 |
| Interest income | — | 1 |
| Total Revenues | $29,868 | $34,555 |
| Expenses: | | |
| Production taxes | $577 | $798 |
| Trust administrative expenses[(2)] | 573 | 389 |
| Derivative settlement loss | 1,007 | 2,567 |
| Total Expenses | 2,157 | 3,754 |
| Distributable income available to unitholders | $27,711 | $30,801 |
| Distributable income per common unit (35,062,500 units issued and outstanding) | $0.6900 | $0.6588 |
| Distributable income per subordinated unit (11,687,500 units issued and outstanding) | $0.3010 | $0.6588 |

(1) Net of certain post-production expenses.

(2) Includes cash reserves withheld.

Royalty Income. Royalty income to the Trust for the three months ended June 30, 2013, and attributable to the current production quarter, totaled $29.9 million based upon sales of production attributable to the Royalty Interests of 149 mbbls of oil, 312 mbbls of NGL and 2,886 million cubic feet ("mmcf") of natural gas. Total production for the current production quarter was 942 thousand barrels of oil equivalent (“mboe”). Average prices received for oil, NGL and natural gas production, including the impact of certain post-production expenses and excluding production taxes, during the current production quarter were $88.08 per bbl, $32.67 per bbl and $2.28 per mcf, respectively.

Royalty income to the Trust for the three months ended June 30, 2012, and attributable to the prior production quarter, totaled $34.5 million based upon sales of production attributable to the Royalty Interests of 182 mbbls of oil, 315 mbbls of NGL and 2,921 mmcf of natural gas. Total production for the prior production quarter was 984 mboe. Average prices received for oil, NGL and natural gas production, including the impact of certain post-production expenses and excluding production taxes, during the prior production quarter were $97.03 per bbl, $36.56 per bbl and $1.90 per mcf, respectively.

Production Taxes. Production taxes are calculated as a percentage of oil, NGL and natural gas revenues, net of any applicable tax credits. Production taxes for the three months ended June 30, 2013, and attributable to the current production quarter, totaled $0.6 million, or $0.61 per barrel of oil equivalent (“boe”) as compared to production taxes for the three months ended June 30, 2012 and attributable to the prior production quarter, which totaled $0.8 million, or $0.81 per boe. In both periods, production taxes were approximately 2% of royalty income.

Trust Administrative Expenses. Trust administrative expenses, including additional cash reserves, for the three months ended June 30, 2013 totaled $0.6 million as compared to $0.4 million for the three months ended June 30, 2012. Trust administrative expenses primarily consist of the administrative fees paid to the Trustees and Chesapeake and costs for accounting and legal services.

Derivative Settlement Loss. The Trust records gains or losses from the derivative contracts when proceeds are received or payments are made, respectively. Swaps covering the current production quarter were settled, during the three months ended June 30, 2013, with proceeds from royalty income for the current production quarter. Total losses during the three months ended June 30, 2013 were $1.0 million. Swaps covering the prior production quarter were settled, during the three months ended June 30, 2012, with proceeds from royalty income for the prior production quarter. Total losses during the three months ended June 30, 2012 were $2.6 million.

Development Wells. As of June 30, 2013, all of the Producing Wells were producing and approximately 72.1 Development Wells (as calculated under the development agreement) were completed and producing. The amount that could be recovered under the Drilling Support Lien as of June 30, 2013 was approximately $102.2 million. In addition, 2.5 Development Wells (as calculated under the development agreement) were drilled in the AMI and subsequently completed in July 2013. As of August 2, 2013, Chesapeake had drilled and completed, or caused to be drilled and completed, a total of 68 wells within the AMI (approximately 74.6 Development Wells as calculated under the development agreement) and the amount that could be recovered under the Drilling Support Lien was approximately $96.6 million.

Impairment of Royalty Interests. During the quarter ended June 30, 2013, the Trust recognized an $11.4 million impairment of the Royalty Interests. The impairment was the result of reserve revisions attributable to current production being below expectations, primarily as a result of higher than expected pressure depletion within certain areas of the AMI. This has resulted in lower initial production rates and lower expected ultimate recovery in certain recent development wells. The impairment resulted in a non-cash charge to the Trust corpus and did not affect the Trust's distributable income. See Risks and Uncertainties in Note 2 in Item I of Part I.

Trust Operations for the Six Months Ended June 30, 2013 as compared to June 30, 2012.

Distributable Income. The Trust's distributable income was $55.6 million for the six months ended June 30, 2013 compared to $64.8 million for the six months ended June 30, 2012, a decrease of $9.2 million. This decrease was primarily due to the decrease in the average realized prices received from sales of oil, NGL and natural gas and lower than expected initial production rates from Development Wells completed in the production period from September 1, 2012 to February 28, 2013 ("current production period"). During the current production period, the average price received for oil was $87.16 per bbl compared to $91.68 per bbl for the production period from September 1, 2011 to February 29, 2012 ("prior production period"). NGL prices received were $32.29 per bbl for the current production period compared to $39.72 per bbl for the prior production period. Natural gas prices were $2.10 per mcf for the current production period compared to $2.26 per mcf for the prior production period.

On a per unit basis, cash distributions during the six months ended June 30, 2013 and attributable to the current production period were $1.3600 per common unit and $0.6782 per subordinated unit as compared to $1.3865 per common and subordinated unit for the six months ended June 30, 2012 and attributable to the prior production period. Distributable income for the six months ended June 30, 2013, and attributable to the current production period, and the six months ended June 30, 2012, and attributable to prior production period, was calculated as follows:

| | Six Months Ended June 30, | |
|---|---|---|
| | 2013 | 2012 |
| | ($ in thousands, except per unit data) | |
| Revenues: | | |
| Royalty income(1) | $59,331 | $70,624 |
| Interest income | — | 2 |
| Total Revenues | $59,331 | $70,626 |
| Expenses: | | |
| Production taxes | $1,165 | $1,550 |
| Trust administrative expenses(2) | 939 | 865 |
| Derivative settlement loss | 1,616 | 3,391 |
| Total Expenses | 3,720 | 5,806 |
| Distributable income available to unitholders | $55,611 | $64,820 |
| Distributable income per common unit (35,062,500 units issued and outstanding) | $1.3600 | $1.3865 |
| Distributable income per subordinated unit (11,687,500 units issued and outstanding) | $0.6782 | $1.3865 |

(1) Net of certain post-production expenses.

(2) Includes cash reserves withheld.

Royalty Income. Royalty income to the Trust for the six months ended June 30, 2013, and attributable to the current production period, totaled $59.3 million based upon sales of production attributable to the Royalty Interests of 300 mbbls of oil, 641 mbbls of NGL and 5,946 mmcf of natural gas. Total production for the current production period was 1,932 mboe. Average prices received for oil, NGL and natural gas production, including the impact of certain post-production expenses and excluding production taxes, during the current production period were $87.16 per bbl, $32.29 per bbl and $2.10 per mcf, respectively.

Royalty income to the Trust for the six months ended June 30, 2012, and attributable the prior production period, totaled $70.6 million based upon sales of production attributable to the Royalty Interests of 359 mbbls of oil, 618 mbbls of NGL and 5,831 mmcf of natural gas. Total production for the prior production period was 1,949 mboe. Average prices received for oil, NGL and natural gas production, including the impact of certain post-production expenses and excluding production taxes, during the prior production period were $91.68 per bbl, $39.72 per bbl and $2.26 per mcf, respectively.

Production Taxes. Production taxes are calculated as a percentage of oil, NGL and natural gas revenues, net of any applicable tax credits. Production taxes for the six months ended June 30, 2013 and attributable to the current production period totaled $1.2 million, or $0.60 per boe as compared to production taxes for the six months ended June 30, 2012 and attributable to the prior production period, which totaled $1.6 million, or $0.80 per boe. In both periods, production taxes were approximately 2% of royalty income.

Trust Administrative Expenses. Trust administrative expenses, including additional cash reserves, for the six months ended June 30, 2013 and June 30, 2012, respectively, totaled $0.9 million for each period and are comparable. Trust administrative expenses primarily consist of the administrative fees paid to the Trustees and Chesapeake and costs for accounting and legal services.

Derivative Settlement Loss. The Trust records gains or losses from the derivative contracts when proceeds are received or payments are made, respectively. Swaps covering the current production period were settled, during the six months ended June 30, 2013, with proceeds from royalty income for the current production period. Total losses during the six months ended June 30, 2013 were $1.6 million. Swaps covering the prior production period were settled, during the six months ended June 30, 2012, with proceeds from royalty income for the prior production period. Total losses during the six months ended June 30, 2012 were $3.4 million.

Impairment of Royalty Interests. During the six months ended June 30, 2013, the Trust recognized a $44.3 million impairment of the Royalty Interests. The impairment was the result of reserve revisions attributable to current production being below expectations, primarily as a result of higher than expected pressure depletion within certain areas of the AMI. This has resulted in lower initial production rates and lower expected ultimate recovery in certain recent development wells. The impairment resulted in a non-cash charge to the Trust corpus and did not affect the Trust's distributable income. See Risks and Uncertainties in Note 2 in Item I of Part I.

Liquidity and Capital Resources

The Trust’s principal sources of liquidity and capital are cash flows generated from the Royalty Interests, the loan commitment as described below and, during periods in which oil prices fall below the fixed price received on derivative contracts, the derivative contracts. The Trust’s primary uses of cash are distributions to Trust unitholders, including, if applicable, incentive distributions to Chesapeake, payments of production taxes, payments of Trust administrative expenses, including any reserves established by the Trustee for future liabilities and repayment of loans, payments for derivative contract settlements and payments of expense reimbursements to Chesapeake for out-of-pocket expenses it incurs on behalf of the Trust. Administrative expenses include payments to the Trustee and the Delaware Trustee as well as a quarterly fee of $50,000 to Chesapeake pursuant to an administrative services agreement. Each quarter, the Trustee determines the amount of funds available for distribution. Available funds are the excess cash, if any, received by the Trust from the sales of oil, NGL and natural gas production attributable to the Royalty Interests during the quarter, over the Trust’s expenses for the quarter and any cash reserve for the payment of liabilities of the Trust, subject in all cases to the subordination and incentive provisions described previously.

The Trust is required to make quarterly cash distributions of substantially all of its cash receipts, after deducting the Trust’s administrative expenses, on or about 60 days following the completion of each calendar quarter through (and including) the quarter ending June 30, 2031. During the six month period ended June 30, 2013, two distributions were paid. The current quarter distribution of $0.6900 per common unit and $0.3010 per subordinated unit, consisting of proceeds attributable to production from December 1, 2012 through February 28, 2013, was made on May 31, 2013 to record unitholders as of May 21, 2013. The 2013 first quarter distribution of $0.6700 per common unit and $0.3772 per subordinated unit, consisting of proceeds attributable to production from September 1, 2012 through November 30, 2012, was made on March 1, 2013 to record unitholders as of February 19, 2013.

On August 8, 2013, the Trust declared a cash distribution of $0.6900 per common unit and $0.1432 per subordinated unit, consisting of proceeds attributable to production from March 1, 2013 to May 31, 2013, to record unitholders as of August 19, 2013. The distribution will be paid on August 29, 2013. The Trust's quarterly income available for distribution was $0.5533 per unit, which was $0.1367 below the subordination threshold. As a result, the distribution per common unit will be the subordination threshold of $0.6900 for the quarter. Distributable income attributable to production from March 1, 2013 to May 31, 2013 was calculated as follows (in thousands except for unit and per unit amounts):

| | |
|---|---|
| REVENUES: | |
| Royalty income (1) | $27,759 |
| Total Revenues | 27,759 |
| EXPENSES: | |
| Production taxes | 497 |
| Trust administrative expenses (2) | 342 |
| Derivative settlement loss | 1,053 |
| Total Expenses | 1,892 |
| Distributable income available to unitholders | $25,867 |
| | |
| Distributable income per common unit (35,062,500 units) | $0.6900 |
| Distributable income per subordinated unit (11,687,500 units) | $0.1432 |

(1) Net of certain post-production expenses.
(2) Includes cash reserves withheld.

The Trustee can authorize the Trust to borrow money to pay Trust expenses that exceed cash held by the Trust. The Trustee may authorize the Trust to borrow from the Trustee as a lender provided the terms of the loan are fair to the Trust unitholders. The Trustee may also deposit funds awaiting distribution in an account with itself, if the interest paid to the Trust at least equals amounts paid by the Trustee on similar deposits, and make other short-term investments with the funds distributed to the Trust. The Trustee may also hold funds awaiting distribution in a non-interest bearing account.

Pursuant to the Trust Agreement, if at any time the Trust's cash on hand (including cash reserves) is not sufficient to pay the Trust's ordinary course expenses as they become due, Chesapeake will loan funds to the Trust necessary to pay such expenses. Any funds loaned by Chesapeake pursuant to this commitment will be limited to the payment of current accounts payable or other obligations to trade creditors in connection with obtaining goods or services or the payment of other current liabilities arising in the ordinary course of the Trust's business, and may not be used to satisfy Trust indebtedness for borrowed money of the Trust. If Chesapeake loans funds pursuant to this commitment, unless Chesapeake agrees otherwise, no further distributions will be made to unitholders (except in respect of any previously determined quarterly cash distribution amount) until such loan is repaid. There were no loans outstanding as of June 30, 2013 or December 31, 2012.

The Trust is not responsible for any costs related to the drilling of the Development Wells and Chesapeake granted to the Trust the Drilling Support Lien in order to secure the estimated amount of the drilling costs for the Trust's interests in the Development Wells. As Chesapeake fulfills its drilling obligation over time, Development Wells that are completed or that are perforated for completion and then plugged and abandoned are released from the Drilling Support Lien and the total dollar amount that may be recovered by the Trust for Chesapeake's failure to fulfill its drilling obligation is proportionately reduced.

Off-Balance Sheet Arrangements
The Trust has no off-balance sheet arrangements. The Trust has not guaranteed the debt of any other party, nor does the Trust have any other arrangements or relationships with other entities that could potentially result in unconsolidated debt, losses or contingent obligations other than the derivative contracts disclosed in the section Derivative Contracts in Note 3 in Item I of Part I of this Quarterly Report.
Critical Accounting Policies and Estimates
Refer to Note 2 in Item I of Part I for a discussion of significant accounting policies and estimates that impact the Trust's financial statements. Critical accounting policies and estimates relating to the Trust are contained in Item 7 of the 2012 Form 10-K.
ITEM 3. Quantitative and Qualitative Disclosures about Market Risk
The discussion in this section provides information about derivative contracts between the Trust and the derivative counterparty effective October 1, 2011. The contracts underlying the derivative contracts cover a portion of the expected production attributable to the Royalty Interests from the Producing Wells and the Development Wells through September 30, 2015. The derivative contracts are settled in cash and do not require the actual delivery of oil or NGL at settlement. The contracts are settled based upon NYMEX prices. Under the derivative contracts, the Trust receives payments directly from the counterparty and pays any amounts owed to the counterparty. The Trust does not have the ability to enter into any additional oil, NGL or natural gas derivative contracts, except in limited circumstances involving the restructuring of the existing oil derivatives contracts.
As of June 30, 2013, the Trust had the following oil derivative contracts:

| | Fixed-Price Oil Swaps | | | |
|---|---|---|---|---|
| | | Weighted | Fair Value | |
| Production Quarter | Volume | Avg. Price | Asset/(Liability) | |
| | (mbbl) | (per bbl) | ($ in thousands) | |
| Q1 2013[(1)] | 61.3 | $87.54 | $(352 | ) |
| Q2 2013[(2)] | 184.3 | $87.60 | (1,205 | ) |
| Q3 2013 | 187.9 | $87.79 | (1,504 | ) |
| Q4 2013 | 184.2 | $87.99 | (1,145 | ) |
| Q1 2014 | 179.8 | $88.08 | (729 | ) |
| Q2 2014 | 180.3 | $88.21 | (417 | ) |
| Q3 2014 | 178.8 | $88.34 | (158 | ) |
| Q4 2014 | 174.3 | $88.45 | 75 | |
| Q1 2015 | 171.0 | $88.59 | 295 | |
| Q2 2015 | 175.4 | $88.76 | 477 | |
| Q3 2015 | 153.6 | $88.90 | 587 | |
| Total | 1,830.9 | $88.23 | $(4,076 | ) |

(1) Includes March 2013 production that was settled in August 2013.
(2) Includes April 2013 and May 2013 production that was settled in August 2013.

To the extent expected oil production falls below the hedged oil volume, the derivative contracts will also cover expected NGL production. Such estimated production of NGL is hedged with oil contracts using a conversion ratio of one barrel of NGL to 49.2% of a barrel of oil. In 2012 and continuing in 2013, NGL prices have decreased relative to oil prices. To the extent oil and NGL prices are not correlated, the derivative contracts will not effectively mitigate the price risk of the Trust’s NGL production.

The Trust's obligations to the counterparty under the derivative contracts are secured by liens on proved reserves attributable to the Trust's interest in the Underlying Properties. The value of the derivative contracts as of June 30, 2013 was a net liability of $4.1 million.

Oil, NGL and Natural Gas Price Risk. The Trust's primary asset and source of income is the Royalty Interests, which generally entitle the Trust to receive a portion of the net proceeds from the sales of oil, NGL and natural gas from the Underlying Properties. The Trust is significantly exposed to fluctuations in the prices received for oil, NGL and natural gas produced and sold. The derivative contracts described above are designed to mitigate a portion of the variability of the prices received for the Trust's share of production. The use of crude oil derivatives to partially mitigate the price risk of NGL production, to the extent oil production falls below the hedged oil volume, is subject to basis risk to the extent oil and NGL prices are not highly correlated.

Credit Risk. A portion of the Trust's liquidity is concentrated in the derivative contracts described above. The use of oil derivative contracts exposes the Trust to credit risk from the counterparty, which has an investment grade credit rating.

Credit Risk Associated With Chesapeake. Chesapeake's ability to perform its obligations to the Trust will depend on its future results of operations, financial condition and liquidity, which in turn will depend upon the supply and demand for oil, NGL and natural gas, prevailing economic conditions and financial, business and other factors, many of which are beyond Chesapeake's control.

If Chesapeake were to default on its obligation to drill the Development Wells, the Trust would be able to foreclose on the Drilling Support Lien to the extent of Chesapeake's remaining interests in the undeveloped portions of the AMI, file a lawsuit to collect money damages from Chesapeake and pursue other available legal remedies against Chesapeake. However, the Trust is not permitted to obtain specific performance from Chesapeake of its drilling obligation and the maximum amount the Trust can recover in a foreclosure or other action was limited to approximately $96.6 million as of August 2, 2013 and will decease as the remaining Development Wells are drilled and completed.

Delays and expenses associated with a foreclosure could reduce distributions to the Trust unitholders by reducing the amount of proceeds available for distribution and may result in the loss of acreage due to leasehold expirations. Any amounts actually recovered in a foreclosure action would be applied to completion of Chesapeake's drilling obligation, would not result in any distribution to the Trust unitholders and may be insufficient to drill the number of wells needed for the Trust to realize the full value of the Royalty Interests in the Development Wells.

In the event of a bankruptcy of Chesapeake or the wholly owned subsidiaries of Chesapeake that conveyed the Royalty Interests to the Trust, the Trust could lose the value of all of the Royalty Interests if a bankruptcy court were to hold that the Royalty Interests constitute an asset of the bankruptcy estate. Chesapeake could also be unable to provide support to the Trust through loans and performance of its management duties.

ITEM 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures. The Trustee maintains disclosure controls and procedures as defined in Rule 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the "Exchange

Act"), designed to ensure that information required to be disclosed by the Trust in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms. Disclosure controls and procedures include controls and procedures designed to ensure that information required to be disclosed by the Trust is accumulated and communicated by Chesapeake to The Bank of New York Mellon Trust Company, N.A., as Trustee of the Trust, and its employees who participate in the preparation of the Trust's periodic reports as appropriate to allow timely decisions regarding required disclosures. As of the end of the period covered by this Quarterly Report, the Trustee carried out an evaluation of the Trustee's disclosure controls and procedures. Michael J. Ulrich, as Trust Officer of the Trustee, has concluded that the disclosure controls and procedures of the Trust are effective.

Due to the nature of the Trust as a passive entity and in light of the contractual arrangements pursuant to which the Trust was created, including the provisions of (i) the Trust Agreement, (ii) the administrative services agreement, (iii) the development agreement and (iv) the conveyances granting the Royalty Interests, the Trustee's disclosure controls and procedures related to the Trust necessarily rely on (a) information provided by Chesapeake, including information relating to results of operations, the status of drilling of the Development Wells, the costs and revenues attributable to the Trust's interests under the conveyance and other operating and historical data, plans for future operating and capital expenditures, reserve information, information relating to projected production, and other information relating to the status and results of operations of the underlying properties and the Royalty Interests, and (b) conclusions and reports regarding reserves by the Trust's independent reserve engineers. Other than reviewing the financial and other information provided to the Trust by Chesapeake, the Trustee has not made an independent or direct verification of this financial or other information.

Changes in Internal Control over Financial Reporting. During the quarter ended June 30, 2013, there has been no change in the Trustee's internal control over financial reporting that has materially affected, or is reasonably likely to materially affect, the Trustee's internal control over financial reporting related to the Trust. The Trustee notes for purposes of clarification that it has no authority over, and makes no statement concerning, the internal control over financial reporting of Chesapeake.

PART II. OTHER INFORMATION

ITEM 1A. Risk Factors

Risk factors relating to the Trust are contained in Part 1, Item 1A of the 2012 Form 10-K. There have not been any material changes from the risk factors previously disclosed in the 2012 Form 10-K.

ITEM 6. Exhibits

The following exhibits are filed or furnished as a part of this report:

| | | Incorporated by Reference | | | | | |
|---|---|---|---|---|---|---|---|
| Exhibit Number | Exhibit Description | Form | SEC File Number | Exhibit | Filing Date | Filed Herewith | Furnished Herewith |
| 3.1 | Certificate of Trust of Chesapeake Granite Wash Trust. | S-1 | 333-175395 | 3.1 | 7/7/2011 | | |
| 3.2 | Amended and Restated Trust Agreement, dated as of November 16, 2011, by and among Chesapeake Energy Corporation, Chesapeake Exploration, L.L.C., The Bank of New York Mellon Trust Company, N.A., as Trustee, Trustee and The Corporation Trust Company, as Delaware Trustee. | 8-K | 001-35343 | 3.1 | 11/21/2011 | | |
| 31.1 | Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 – Trustee’s Vice President. | | | | | X | |
| 32.1 | Certification pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 – Trustee’s Vice President | | | | | | X |

SIGNATURES

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

Date: August 8, 2013

CHESAPEAKE GRANITE WASH TRUST

| | |
|---|---|
| By: | THE BANK OF NEW YORK MELLON TRUST COMPANY, N.A, Trustee |
| By: | /s/ Michael J. Ulrich |
| | Michael J. Ulrich |
| | Vice President |

The registrant, Chesapeake Granite Wash Trust, has no principal executive officer, principal financial officer, board of directors or persons performing similar functions. Accordingly, no additional signatures are available, and none have been provided. In signing the report above, the Trustee does not imply that it has performed any such function or that such function exists pursuant to the terms of the Trust Agreement under which it serves.

EXHIBIT INDEX

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