

CAPITAL ONE FINANCIAL CORP

Form 424B2

March 08, 2017

[Table of Contents](#)

**Filed Pursuant to Rule 424(b)(2)**  
**Registration No. 333-203125**

**CALCULATION OF REGISTRATION FEE**

<b>Title of each class of securities offered</b>	<b>Maximum aggregate</b>	<b>Amount of</b>
	<b>offering price</b>	<b>registration fee</b>
3.050% Senior Notes due 2022	\$850,000,000	\$98,515 <sup>(1)</sup>
Floating Rate Senior Notes due 2022	\$400,000,000	\$46,360 <sup>(1)</sup>
3.750% Senior Notes due 2027	\$750,000,000	\$86,925 <sup>(1)</sup>
Total	\$2,000,000,000	\$231,800 <sup>(1)</sup>

(1) The total filing fee of \$231,800 is calculated in accordance with Rule 457(r) of the Securities Act of 1933.

**Table of Contents**

**PROSPECTUS SUPPLEMENT**

**(To prospectus dated March 31, 2015)**

**Capital One Financial Corporation**

**\$850,000,000 3.050% Senior Notes Due 2022**

**\$400,000,000 Floating Rate Senior Notes Due 2022**

**\$750,000,000 3.750% Senior Notes Due 2027**

We will pay interest on the 3.050% senior notes due 2022 (the 2022 fixed rate notes ) semi-annually in arrears on March 9 and September 9 of each year. We will make the first interest payment on the 2022 fixed rate notes on September 9, 2017. The 2022 fixed rate notes will mature on March 9, 2022.

We will pay interest on the floating rate senior notes due 2022 (the floating rate notes ) quarterly in arrears on March 9, June 9, September 9 and December 9 of each year, at a rate equal to the then applicable U.S. dollar LIBOR rate plus 0.950% quarterly in arrears. We will make the first interest payment on the floating rate notes on June 9, 2017. The floating rate notes will mature on March 9, 2022.

We will pay interest on the 3.750% senior notes due 2027 (the 2027 fixed rate notes and, together with the 2022 fixed rate notes and the floating rate notes, the notes ) semi-annually in arrears on March 9 and September 9 of each year. We will make the first interest payment on the 2027 fixed rate notes on September 9, 2017. The 2027 fixed rate notes will mature on March 9, 2027.

We have the option to redeem the 2022 fixed rate notes at a redemption price equal to 100% of the principal amount of the notes to be redeemed, plus accrued and unpaid interest thereon to the redemption date, in whole or in part at any time after February 9, 2022 (which is the date that is one month prior to the maturity date of the notes). See Description of the Notes Optional Redemption.

We have the option to redeem the floating rate notes at a redemption price equal to 100% of the principal amount of the notes to be redeemed, plus accrued and unpaid interest thereon to the redemption date, in whole or in part at any time after February 9, 2022 (which is the date that is one month prior to the maturity date of the notes). See Description of the Notes Optional Redemption.

We have the option to redeem the 2027 fixed rate notes at a redemption price equal to 100% of the principal amount of the notes to be redeemed, plus accrued and unpaid interest thereon to the redemption date, in whole or in part at any time after February 9, 2027 (which is the date that is one month prior to the maturity date of the notes). See Description of the Notes Optional Redemption.

The notes will be our unsecured obligations and will rank equally with all of our existing and future unsecured and unsubordinated indebtedness that may be outstanding from time to time.

We will issue the notes in minimum denominations of \$2,000 and integral multiples of \$1,000 in excess thereof. There is no sinking fund for the notes. The notes are a new issue of securities with no established trading market. The notes will not be listed on any securities exchange.

Investing in the notes involves risks. See **Risk Factors** beginning on page S-7 of this prospectus supplement.

Neither the Securities and Exchange Commission (the **SEC**) nor any state securities commission has approved or disapproved of these securities or determined if this prospectus supplement or the accompanying prospectus is truthful or complete. Any representation to the contrary is a criminal offense.

The notes are not savings accounts, deposits or other obligations of a bank and are not insured or guaranteed by the Federal Deposit Insurance Corporation (the **FDIC**) or any other governmental agency or instrumentality.

	<b>Price to Public</b>	<b>Underwriting Discounts and Commissions</b>	<b>Proceeds to Capital One (Before Expenses)</b>
Per 2022 Fixed Rate Note	99.936% <sup>(1)</sup>	0.350%	99.586%
2022 Fixed Rate Notes			
Total	\$ 849,456,000	\$ 2,975,000	\$ 846,481,000
Per Floating Rate Note	100.000% <sup>(1)</sup>	0.350%	99.650%
Floating Rate Notes Total	\$ 400,000,000	\$ 1,400,000	\$ 398,600,000
Per 2027 Fixed Rate Note	99.694% <sup>(1)</sup>	0.450%	99.244%
2027 Fixed Rate Notes			
Total	\$ 747,705,000	\$ 3,375,000	\$ 744,330,000
<b>Total</b>	<b>\$ 1,997,161,000</b>	<b>\$ 7,750,000</b>	<b>\$ 1,989,411,000</b>

(1) Plus accrued interest, if any, from March 9, 2017.

The underwriters expect to deliver the notes in book-entry form only through the facilities of The Depository Trust Company and its participants, including Euroclear System and Clearstream Banking, S.A., on or about March 9, 2017. Because our affiliate, Capital One Securities, Inc., is participating in the sale of the notes, the offering is being conducted in compliance with Financial Industry Regulatory Authority ( **FINRA** ) Rule 5121, as administered by FINRA.

### ***Joint Book-Running Managers***

<b>BofA Merrill Lynch</b>	<b>Credit Suisse</b>	<b>J.P. Morgan Co-Managers</b>	<b>Morgan Stanley</b>	<b>Capital One Securities</b>
<b>Citigroup</b>	<b>Academy Securities</b>		<b>Mischler Financial Group, Inc.</b>	

**The date of this prospectus supplement is March 6, 2017**

**Table of Contents****TABLE OF CONTENTS**

<b>Prospectus Supplement</b>	<b>Page</b>
<u>About This Prospectus Supplement</u>	S-1
<u>Forward-Looking Statements</u>	S-2
<u>Summary</u>	S-4
<u>Risk Factors</u>	S-7
<u>Use of Proceeds</u>	S-9
<u>Description of the Notes</u>	S-10
<u>Material United States Federal Income Tax Consequences</u>	S-15
<u>Certain ERISA Considerations</u>	S-20
<u>Underwriting</u>	S-22
<u>Validity of the Notes</u>	S-27
<u>Experts</u>	S-27
<u>Where You Can Find More Information</u>	S-27

<b>Prospectus</b>	<b>Page</b>
<u>About This Prospectus</u>	1
<u>Forward-Looking Statements</u>	1
<u>Where You Can Find More Information</u>	3
<u>Ratio of Earnings to Fixed Charges and Ratio of Earnings to Combined Fixed Charges and Preferred Stock</u>	
<u>Dividends</u>	4
<u>Use of Proceeds</u>	5
<u>Description of Debt Securities</u>	6
<u>Description of Preferred Stock</u>	17
<u>Description of Common Stock</u>	19
<u>Description of Other Securities</u>	23
<u>Resale by Selling Securityholders</u>	24
<u>Book-Entry Procedures and Settlement</u>	25
<u>Certain Legal Matters</u>	28
<u>Experts</u>	28

**You should rely only on the information contained in or incorporated by reference in this prospectus supplement and the accompanying prospectus. We have not, and the underwriters have not, authorized any other person to provide you with different information. If anyone provides you with different or inconsistent information, you should not rely on it. We are not, and the underwriters are not, making an offer to sell the notes in any jurisdiction where the offer or sale is not permitted. You should assume that the information appearing in this prospectus supplement (including any related free writing prospectus prepared by us or on our behalf, if any), the accompanying prospectus and the documents incorporated by reference herein and therein, is accurate only as of their respective dates. Our business, financial condition, results of operations and prospects may have changed since those dates.**

**Table of Contents**

**ABOUT THIS PROSPECTUS SUPPLEMENT**

We provide information to you about the notes in two separate documents: (1) this prospectus supplement (including any related free writing prospectus prepared by us or on our behalf, if any), which describes the specific terms of the notes and also adds to and updates information contained in the accompanying prospectus and the documents incorporated by reference in that prospectus, and (2) the accompanying prospectus, which provides general information about securities we may offer from time to time, including securities other than the notes that are being offered by this prospectus supplement. If information in this prospectus supplement or any related free writing prospectus, if any, is inconsistent with the accompanying prospectus, you should rely on this prospectus supplement and such related free writing prospectus, if any.

It is important for you to read and consider all of the information contained in this prospectus supplement and any related free writing prospectus, if any, and the accompanying prospectus in making your investment decision. You also should read and consider the information in the documents we have referred you to in the section entitled **Where You Can Find More Information** beginning on page S-27 of this prospectus supplement and page 3 of the accompanying prospectus.

We include cross-references in this prospectus supplement and the accompanying prospectus to captions in these materials where you can find additional related discussions. The table of contents in this prospectus supplement provides the pages on which these captions are located.

Unless the context requires otherwise, references to **Capital One**, **issuer**, **we**, **our**, or **us** in this prospectus supplement refer to Capital One Financial Corporation, a Delaware corporation.

**Table of Contents**

**FORWARD-LOOKING STATEMENTS**

This prospectus supplement, the accompanying prospectus and the documents incorporated by reference herein and therein contain forward-looking statements. Statements that are not historical facts, including statements about our beliefs and expectations, are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended (the Securities Act), and Section 21E of the Securities Exchange Act of 1934, as amended (the

Exchange Act). Forward-looking statements include, among other things, information relating to our strategies, goals, outlook or other non-historical matters; projections, revenues, income, returns, expenses, capital measures, accruals for claims in litigation and for other claims against us; earnings per share or other financial measures for us; future financial and operating results; our plans, objectives, expectations and intentions; and the assumptions that underlie these matters. Forward-looking statements also include statements using words such as expect, anticipate, hope, intend, plan, believe, estimate, will or similar expressions. We have based these forward-looking statements on our current plans, estimates and projections, and you should not unduly rely on them. To the extent that any of the information in this prospectus supplement, the accompanying prospectus and the documents incorporated by reference herein and therein is forward-looking, it is intended to fit within the safe harbor for forward-looking information provided by the Private Securities Litigation Reform Act of 1995.

Numerous factors could cause our actual results to differ materially from those described in such forward-looking statements, including, among other things:

general economic and business conditions in the U.S., the U.K., Canada or our local markets, including conditions affecting employment levels, interest rates, collateral values, consumer income, credit worthiness and confidence, spending and savings that may affect consumer bankruptcies, defaults, charge-offs and deposit activity;

an increase or decrease in credit losses, including increases due to a worsening of general economic conditions in the credit environment, and the impact of inaccurate estimates or inadequate reserves;

financial, legal, regulatory, tax or accounting changes or actions, including the impact of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act) and the regulations promulgated thereunder, and other regulatory reforms and regulations governing bank capital and liquidity standards, including Basel-related initiatives and potential changes to financial accounting and reporting standards;

developments, changes or actions relating to any litigation, governmental investigation or regulatory enforcement action or matter involving us;

the inability to sustain revenue and earnings growth;

increases or decreases in interest rates;

our ability to access the capital markets at attractive rates and terms to capitalize and fund our operations and future growth;

the success of our marketing efforts in attracting and retaining customers;

increases or decreases in our aggregate loan balances or the number of customers and the growth rate and composition thereof, including increases or decreases resulting from factors such as shifting product mix, amount of actual marketing expenses we incur and attrition of loan balances;

the level of future repurchase or indemnification requests we may receive, the actual future performance of mortgage loans relating to such requests, the success rates of claimants against us, any developments in litigation and the actual recoveries we may make on any collateral relating to claims against us;

the amount and rate of deposit growth;

S-2



**Table of Contents**

changes in the reputation of, or expectations regarding, the financial services industry or us with respect to practices, products or financial condition;

changes in retail distribution strategies and channels, including in the behavior and expectations of our customers;

any significant disruption in our operations or in the technology platforms on which we rely, including security failures or breaches of our systems or those of our customers, partners, service providers or other third parties;

our ability to maintain a compliance and technology infrastructure suitable for the nature of our business;

our ability to develop digital technology that addresses the needs of our customers, including the challenges relating to rapid significant technological changes;

the effectiveness of our risk management strategies;

our ability to control costs, including the amount of, and rate of growth in, our expenses as our business develops or changes or as it expands into new market areas;

our ability to execute on our strategic and operational plans;

the extensive use of models in our business, including those to aggregate and assess various risk exposures and estimate certain financial values;

any significant disruption of, or loss of public confidence in, the internet affecting the ability of our customers to access their accounts and conduct banking transactions;

our ability to recruit and retain talented and experienced personnel;

changes in the labor and employment markets;

fraud or misconduct by our customers, employees, business partners or third parties;

competition from providers of products and services that compete with our businesses;

increased competition for rewards customers resulting in higher rewards expense, or impairing our ability to attract and retain credit card customers;

merchants increasing focus on the fees charged by credit card networks; and

other risk factors listed from time to time in reports that we file with the SEC.

You should carefully consider the factors referred to above in evaluating these forward-looking statements.

When considering these forward-looking statements, you should keep in mind these risks, uncertainties and other cautionary statements made in this prospectus supplement, the accompanying prospectus and in the documents incorporated by reference. See the factors set forth under the Risk Factors section beginning on page S-7 of this prospectus supplement and in any other documents incorporated or deemed to be incorporated by reference therein or herein, including our Annual Report on Form 10-K for the year ended December 31, 2016, as such discussion may be amended or updated in other reports filed by us with the SEC, for additional information that you should consider carefully in evaluating these forward-looking statements.

**Forward-looking statements are not guarantees of future performance. They involve risks, uncertainties and assumptions, including the risk factors referred to above. Our future performance and actual results may differ materially from those expressed in forward-looking statements. Many of the factors that will determine these results and values are beyond our ability to control or predict. Any forward-looking statements made by us or on our behalf speak only as of the date they are made or as of the date indicated, and we do not undertake any obligation to update forward-looking statements as a result of new information, future events or otherwise.**

**Table of Contents**

**SUMMARY**

*The following summary highlights selected information from this prospectus supplement and the accompanying prospectus about the notes and this offering. This description is not complete and does not contain all of the information that you should consider before investing in the notes. You should read this prospectus supplement and the accompanying prospectus, including the documents we incorporate by reference, carefully to understand fully the terms of the notes as well as other considerations that are important to you in making a decision about whether to invest in the notes. You should pay special attention to the **Risk Factors** section beginning on page S-7 of this prospectus supplement and the **Risk Factors** section in our Annual Report on Form 10-K for the year ended December 31, 2016, as such discussion may be amended or updated in other reports filed by us with the SEC, to determine whether an investment in the notes is appropriate for you. This prospectus supplement includes forward-looking statements that involve risks and uncertainties. For a more complete understanding of the notes, you should read the section entitled **Description of the Notes** beginning on page S-10 of this prospectus supplement as well as the section entitled **Description of Debt Securities** beginning on page 6 of the accompanying prospectus. To the extent the information in this prospectus supplement is inconsistent with the information in the accompanying prospectus, you should rely on the information contained in this prospectus supplement.*

**Capital One**

Capital One Financial Corporation, a Delaware corporation established in 1994 and headquartered in McLean, Virginia, is a diversified financial services holding company with banking and non-banking subsidiaries. Capital One Financial Corporation and its subsidiaries offer a broad array of financial products and services to consumers, small businesses and commercial clients through branches, the internet and other distribution channels. As of December 31, 2016, our principal subsidiaries included Capital One Bank (USA), National Association ( **COBNA** ), which offers credit and debit card products, other lending products and deposit products; and Capital One, National Association ( **CONA** ), which offers a broad spectrum of banking products and financial services to consumers, small businesses and commercial clients. For more information on Capital One, see the documents incorporated by reference into this prospectus supplement and the accompanying prospectus. Our principal executive office is located at 1680 Capital One Drive, McLean, Virginia 22102 (telephone number (703) 720-1000).

**Table of Contents**

**The Offering**

<b>Issuer</b>	Capital One Financial Corporation
<b>Securities Offered</b>	<p>\$850,000,000 aggregate principal amount of 3.050% senior notes due 2022.</p> <p>\$400,000,000 aggregate principal amount of floating rate senior notes due 2022.</p> <p>\$750,000,000 aggregate principal amount of 3.750% senior notes due 2027.</p>
<b>Maturity Date</b>	<p>The 2022 fixed rate notes will mature on March 9, 2022.</p> <p>The floating rate notes will mature on March 9, 2022.</p> <p>The 2027 fixed rate notes will mature on March 9, 2027.</p>
<b>Interest Payment Dates</b>	<p>The 2022 fixed rate notes will bear interest at the rate of 3.050% per year from the original issuance date. We will pay interest on the notes semi-annually in arrears on each March 9 and September 9. We will make the first interest payment on September 9, 2017.</p> <p>The floating rate notes will bear interest from the original issuance date at a rate equal to the then applicable U.S. dollar LIBOR rate plus 0.950%. The rate of interest on the floating rate notes will be reset quarterly. We will pay interest on the floating rate notes quarterly in arrears on each March 9, June 9, September 9 and December 9. We will make the first interest payment on June 9, 2017.</p> <p>The 2027 fixed rate notes will bear interest at the rate of 3.750% per year from the original issuance date. We will pay interest on the notes semi-annually in arrears on each March 9 and September 9. We will make the first interest payment on September 9, 2017.</p>

**Use of Proceeds**

We intend to use the net proceeds from the sale of the notes for general corporate purposes in the ordinary course of our business. General corporate purposes may include repayment of debt, redemptions and repurchases of shares of our common stock and of our other securities, acquisitions, additions to working capital, capital expenditures and investments in our subsidiaries. See **Use of Proceeds** in this prospectus supplement.

**Optional Redemption**

We have the option to redeem the 2022 fixed rate notes at a redemption price equal to 100% of the principal amount of the 2022 fixed rate notes to be redeemed, plus accrued and unpaid interest thereon to the redemption date, in whole or in part at any time after February 9, 2022 (which is the date that is one month prior to the maturity date of the 2022 fixed rate notes).

S-5

**Table of Contents**

We have the option to redeem the floating rate notes at a redemption price equal to 100% of the principal amount of the floating rate notes to be redeemed, plus accrued and unpaid interest thereon to the redemption date, in whole or in part at any time after February 9, 2022 (which is the date that is one month prior to the maturity date of the floating rate notes).

We have the option to redeem the 2027 fixed rate notes at a redemption price equal to 100% of the principal amount of the 2027 fixed rate notes to be redeemed, plus accrued and unpaid interest thereon to the redemption date, in whole or in part at any time after February 9, 2027 (which is the date that is one month prior to the maturity date of the 2027 fixed rate notes).

See Description of the Notes Optional Redemption.

**Ranking**

The notes are our direct, unsecured and unsubordinated obligations and rank equal in priority with all of our existing and future unsecured and unsubordinated indebtedness and senior in right of payment to all of our existing and future subordinated indebtedness.

**Listing**

The notes will not be listed on any securities exchange.

**Conflicts of Interest**

One of the underwriters, Capital One Securities, Inc., is our affiliate. The distribution arrangements for this offering comply with the requirements of FINRA Rule 5121 regarding a FINRA member firm's participation in the distribution of securities of an affiliate. In accordance with Rule 5121, no FINRA member that has a conflict of interest under Rule 5121 may make sales in this offering to any discretionary account without the prior approval of the customer. Capital One Securities, Inc. may use this prospectus supplement and the accompanying prospectus in connection with offers and sales of the notes in the secondary market. Capital One Securities, Inc. may act as principal or agent in those transactions. Secondary market sales will be made at prices related to market prices at the time of sale. Capital One Securities, Inc. is not primarily responsible for managing this offering.



**Table of Contents**

**RISK FACTORS**

*Investing in the notes involves risks, including the risks described below that are specific to the notes and those that could affect us and our business. You should not purchase notes unless you understand these investment risks. Please be aware that other risks may prove to be important in the future. New risks may emerge at any time, and we cannot predict such risks or estimate the extent to which they may affect our financial performance. Before purchasing any notes, you should consider carefully the risks and other information in this prospectus supplement and the accompanying prospectus and carefully read the risks described in the documents incorporated by reference in this prospectus supplement and the accompanying prospectus, including the discussion under the Risk Factors section in our Annual Report on Form 10-K for the year ended December 31, 2016, as such discussion may be amended or updated in other reports filed by us with the SEC.*

***The notes are our obligations and not obligations of our subsidiaries and will be effectively subordinated to the claims of our subsidiaries' creditors.***

The notes are exclusively our obligations and not those of our subsidiaries. We are a holding company and, accordingly, substantially all of our operations are conducted through our subsidiaries. As a result, our cash flow and our ability to service our debt, including the notes, depend upon the earnings of our subsidiaries. In addition, we depend on the distribution of earnings, loans or other payments by our subsidiaries to us.

Our subsidiaries are separate and distinct legal entities. Our subsidiaries have no obligation to pay any amounts due on the notes or to provide us with funds to pay our obligations, whether by dividends, distributions, loans or other payments. In addition, any payment of dividends, distributions, loans or advances by our subsidiaries to us would be subject to regulatory or contractual restrictions. Payments to us by our subsidiaries also will be contingent upon those subsidiaries' earnings and business considerations.

Our right to receive any assets of any of our subsidiaries upon their liquidation or reorganization, and, therefore, the right of the holders of the notes to participate in those assets, will be effectively subordinated to the claims of those subsidiaries' creditors, including senior and subordinated debtholders and general trade creditors. In the event of any such distribution of assets of our bank subsidiaries, the claims of depositors and other general or subordinated creditors would be entitled to priority over the claims of holders of the notes. In addition, even if we were a creditor of any of our subsidiaries, our rights as a creditor would be subordinate to any security interest in the assets of those subsidiaries and any indebtedness of those subsidiaries senior to that held by us.

***The notes will not be guaranteed by the FDIC or any other governmental agency.***

The notes are not bank deposits and are not insured by the FDIC or any other governmental agency, nor are they obligations of, or guaranteed by, a bank. The notes will be obligations of Capital One Financial Corporation only and will not be guaranteed by any of our subsidiaries, including COBNA or CONA, our principal banking subsidiaries.

***The indenture governing the notes does not contain any limitations on our ability to incur additional indebtedness, sell or otherwise dispose of assets, pay dividends or repurchase our capital stock.***

Neither we nor any of our subsidiaries is restricted from incurring additional indebtedness or other liabilities, including additional senior indebtedness, under the indenture governing the terms of the notes. If we incur additional indebtedness or liabilities, our ability to pay our obligations on the notes could be adversely affected. We expect that we will from time to time incur additional indebtedness and other liabilities. In addition, we are not restricted under the indenture governing the notes from paying dividends or issuing or repurchasing our securities.



In addition, there are no financial covenants in the indenture. You are not protected under the indenture in the event of a highly leveraged transaction, reorganization, default under our existing indebtedness, restructuring,

S-7

## **Table of Contents**

merger or similar transaction that may adversely affect you, except to the extent set forth under Description of Debt Securities Covenants and Consolidation, Merger and Sale of Assets in the accompanying prospectus would apply to the transaction.

### ***Government regulation may affect the priority of the notes in the case of a bankruptcy or liquidation.***

The Dodd-Frank Act created a new resolution regime known as the orderly liquidation authority. Under the orderly liquidation authority, the FDIC may be appointed as receiver for an entity, including a bank holding company, for purposes of liquidating the entity if the Secretary of the Treasury, following a process set out in the Dodd-Frank Act, determines that the entity is in default or danger of default and that the entity's failure and its resolution under otherwise applicable law would have serious adverse effects on the financial stability of the United States.

If the FDIC is appointed as receiver under the orderly liquidation authority, then the Dodd-Frank Act, rather than applicable insolvency laws, would determine the powers of the receiver, and the rights and obligations of creditors and other parties who have dealt with the institution. There are substantial differences in the rights of creditors under the orderly liquidation authority compared to those under the U.S. Bankruptcy Code, including the power of the FDIC to disregard the strict priority of creditor claims in some circumstances, the use of an administrative claims procedure to determine creditors' claims (as opposed to the judicial procedure utilized in bankruptcy proceedings) and the power of the FDIC to transfer claims to a bridge entity. As a consequence of the power of the FDIC under the orderly liquidation authority, the holders of the notes may be fully subordinated to interests held by the U.S. government and others in the event that we enter into a receivership, insolvency, liquidation or similar proceeding. Although the FDIC has issued regulations to implement the orderly liquidation authority, not all aspects of how the FDIC might exercise this authority are known and additional rulemakings are likely. Further, it is uncertain how the FDIC might exercise its discretion under the orderly liquidation authority in a particular case.

**Table of Contents**

**USE OF PROCEEDS**

We estimate that the net proceeds from this offering, after deducting the underwriting discounts and commissions and offering expenses payable by us, will be approximately \$1.987 billion. We intend to use the net proceeds from the sale of the notes for general corporate purposes in the ordinary course of our business. General corporate purposes may include repayment of debt, redemptions and repurchases of shares of our common stock and of our other securities, acquisitions, additions to working capital, capital expenditures and investments in our subsidiaries.

S-9

**Table of Contents**

**DESCRIPTION OF THE NOTES**

*The following is a description of the particular terms of the notes offered pursuant to this prospectus supplement. This description supplements and, to the extent inconsistent, modifies the description of the general terms and provisions of senior debt securities set forth in the accompanying prospectus under Description of Debt Securities. To the extent the description in this prospectus supplement is inconsistent with the description contained in the accompanying prospectus, you should rely on the description in this prospectus supplement. The following description is qualified in its entirety by reference to the provisions of the senior indenture dated as of November 1, 1996, between us and The Bank of New York Mellon Trust Company, N.A., formerly known as The Bank of New York Trust Company, N.A. (as successor to Harris Trust and Savings Bank), as indenture trustee, which we refer to as the senior indenture. A copy of the senior indenture is filed as an exhibit to the registration statement of which this prospectus supplement and the accompanying prospectus are a part. Capitalized terms not defined in this section have the meanings assigned to such terms in the accompanying prospectus or in the senior indenture.*

**General**

The 2022 fixed rate notes, the floating rate notes and the 2027 fixed rate notes offered hereby constitute separate series of senior debt securities described in the accompanying prospectus to be issued under the senior indenture. The notes will be our direct, unsecured obligations.

The 2022 fixed rate notes are initially offered in the principal amount of \$850,000,000, the floating rate notes are initially offered in the principal amount of \$400,000,000 and the 2027 fixed rate notes are initially offered in the principal amount of \$750,000,000. We may, without the consent of existing holders, increase the principal amount of any series of notes by issuing more notes in the future, on the same terms and conditions (other than any differences in the issue date, the price to the public and the first interest payment date) and with the same CUSIP number (if appropriate), as the notes being offered by this prospectus supplement. We do not plan to inform existing holders if we reopen a series of notes to issue and sell additional notes in the future.

**Payments**

*2022 Fixed Rate Notes*

The 2022 fixed rate notes will mature on March 9, 2022. The notes will bear interest from March 9, 2017 at the annual rate of 3.050%. We will pay interest on the notes semi-annually in arrears on each March 9 and September 9. We will make the first interest payment on September 9, 2017.

*Floating Rate Notes*

The floating rate notes will mature on March 9, 2022. The floating rate notes will bear interest from March 9, 2017 to, but excluding, June 9, 2017 at a rate per annum equal to the initial interest rate and thereafter at an interest rate that will be reset as described below to a rate per annum equal to LIBOR (as defined below) plus 0.950% per annum. The initial interest rate will be equal to LIBOR plus 0.950% per annum as determined by the calculation agent as described below. We will pay interest on the floating rate notes quarterly in arrears on each March 9, June 9, September 9 and December 9. We will make the first interest payment on June 9, 2017.

The rate of interest on the floating rate notes will be reset quarterly (the interest reset period and the first day of each interest reset period will be an interest reset date). The interest reset dates will be March 9, June 9, September 9 and December 9 of each year; provided that the interest rate in effect from March 9, 2017 to but excluding the first interest

reset date will be the initial interest rate. If any interest reset date falls on a day that is not a business day, the interest reset date will be postponed to the next day that is a business day.

S-10

## **Table of Contents**

The calculation agent for the floating rate notes will be The Bank of New York Mellon Trust Company, N.A., which we refer to as the calculation agent. Upon the request of the holder of any floating rate note, the calculation agent will provide the interest rate then in effect and, if determined, the interest rate that will become effective on the next interest reset date.

The calculation agent will determine the initial interest rate for the floating rate notes on the second London banking day preceding the issue date and the interest rate for each succeeding interest reset period by reference to LIBOR on the second London banking day preceding the applicable interest reset date, each of which we refer to as an interest determination date.

London banking day means any day on which dealings in deposits in U.S. dollars are transacted in the London interbank market.

The interest rate for the floating rate notes will be based on the London interbank offered rate, which we refer to as LIBOR, and will be determined by the calculation agent as follows:

(i) As of an interest determination date, LIBOR will be equal to the offered rate for deposits in U.S. dollars having an index maturity of three months, in amounts of at least \$1,000,000, as such rate appears on Reuters Page LIBOR01 at approximately 11:00 a.m., London time, on such interest determination date. If on an interest determination date, such rate does not appear on the Reuters Page LIBOR01 as of 11:00 a.m., London time, or if the Reuters Page LIBOR01 is not available on such date, the calculation agent will obtain such rate from Bloomberg L.P.'s page BBAM (or any successor page).

(ii) If no rate appears on Reuters Page LIBOR01 or Bloomberg L.P.'s page BBAM (or any successor page), then the calculation agent will request the principal London offices of each of four major reference banks in the London interbank market, as selected by the calculation agent after consultation with us, to provide the calculation agent with its offered quotation for deposits in U.S. dollars for a period of three months, commencing on the related interest reset date, to prime banks in the London interbank market at approximately 11:00 a.m., London time, on that interest determination date and in a principal amount that is representative of a single transaction in U.S. dollars in that market at that time. If at least two quotations are provided, LIBOR determined on that interest determination date will be the arithmetic mean of those quotations. If fewer than two quotations are provided, LIBOR will be determined for the related interest reset date as the arithmetic mean of the rates quoted at approximately 11:00 a.m., New York time, on that interest reset date, by three major banks in New York, New York, as selected by the calculation agent after consultation with us, for loans in U.S. dollars to leading European banks, for a period of three months, commencing on the related interest reset date, and in a principal amount that is representative of a single transaction in U.S. dollars in that market at that time. If the banks so selected by the calculation agent are not quoting as set forth above, LIBOR for that interest determination date will remain LIBOR for the immediately preceding interest reset period, or, if there was no preceding interest reset period, the rate of interest payable will be the initial interest rate.

Accrued interest on any floating rate note will be calculated by multiplying the principal amount of the note by an accrued interest factor. The accrued interest factor will be computed by adding the interest factors calculated for each day in the period for which interest is being paid. The interest factor for each day is computed by dividing the interest rate applicable to that day by 360. The interest rate in effect on any interest reset date will be the applicable rate as reset on that date. The interest rate applicable to any other day is the interest rate from the immediately preceding interest reset date, or if none, the initial interest rate. All percentages used in or resulting from any calculation of the rate of interest on a floating rate note will be rounded, if necessary, to the nearest one hundred-thousandth of a percentage point (with .000005% rounded up to .00001%), and all U.S. dollar amounts used in or resulting from these calculations will be rounded to the nearest cent (with one-half cent rounded upward).

S-11

## **Table of Contents**

### *2027 Fixed Rate Notes*

The 2027 fixed rate notes will mature on March 9, 2027. The notes will bear interest from March 9, 2017 at the annual rate of 3.750%. We will pay interest on the notes semi-annually in arrears on each March 9 and September 9. We will make the first interest payment on September 9, 2017.

### *General*

We will pay interest to the person in whose name the note is registered at the close of business on the fifteenth calendar day (whether or not a business day) immediately preceding the relevant interest payment date, except that we will pay interest payable at the maturity date of the notes to the person or persons to whom principal is payable.

Interest on the 2022 fixed rate notes and the 2027 fixed rate notes will be paid on the basis of a 360-day year comprised of twelve 30-day months. If any date on which interest is payable on the 2022 fixed rate notes or the 2027 fixed rate notes is not a business day, the payment of the interest payable on that date will be made on the next day that is a business day, without any interest or other payment in respect of the delay, with the same force and effect as if made on the scheduled payment date. If the maturity date of the 2022 fixed rate notes or the 2027 fixed rate notes would fall on a day that is not a business day, the payment of interest and principal will be made on the next succeeding business day, and no interest will accrue after such maturity date.

Interest on the floating rate notes will be paid on the basis of a 360-day year and the actual number of days elapsed. If any date on which interest is payable on the notes is not a business day, the payment of the interest payable on that date will be postponed to the next succeeding business day, except that if that business day falls in the next succeeding calendar month, the interest payment date will be the immediately preceding business day, and interest will accrue to but excluding the date interest is paid. If the maturity date of the floating rate notes would fall on a day that is not a business day, the payment of interest and principal will be made on the next succeeding business day, and no interest will accrue after such maturity date.

The notes will not have the benefit of a sinking fund that is, we will not deposit money on a regular basis into any separate custodial account to repay the notes.

### **Optional Redemption**

The notes are not subject to repayment at the option of the holders at any time prior to maturity.

On or after February 9, 2022 (which is the date that is one month prior to the maturity date of the 2022 fixed rate notes), the 2022 fixed rate notes will be redeemable upon not less than 15 nor more than 45 days prior notice given to the holders of the 2022 fixed rate notes to be redeemed, at a redemption price equal to 100% of the principal amount of the 2022 fixed rate notes to be redeemed plus accrued and unpaid interest to the date of redemption.

On or after February 9, 2022 (which is the date that is one month prior to the maturity date of the floating rate notes), the floating rate notes will be redeemable upon not less than 15 nor more than 45 days prior notice given to the holders of the floating rate notes to be redeemed, at a redemption price equal to 100% of the principal amount of the floating rate notes to be redeemed plus accrued and unpaid interest to the date of redemption.

On or after February 9, 2027 (which is the date that is one month prior to the maturity date of the 2027 fixed rate notes), the 2027 fixed rate notes will be redeemable upon not less than 15 nor more than 45 days prior notice given to the holders of the 2027 fixed rate notes to be redeemed, at a redemption price equal to 100% of the principal amount



of the 2027 fixed rate notes to be redeemed plus accrued and unpaid interest to the date of redemption.

S-12

## **Table of Contents**

If money sufficient to pay the redemption price of and accrued interest on any series of notes (or portions thereof) to be redeemed on the applicable redemption date is deposited with the Trustee or paying agent on or before the applicable redemption date and certain other conditions are satisfied, then on and after such redemption date, interest will cease to accrue on such series of notes (or such portion thereof) called for redemption and such series of notes will cease to be outstanding. If any redemption date is not a business day, we will pay the redemption price on the next business day without any interest or other payment due to the delay.

If fewer than all of a series of notes are to be redeemed, the depository will select the notes of such series for redemption on a pro rata basis, by lot or by such other method in accordance with the depository's procedures. No notes of \$1,000 or less will be redeemed in part.

## **Denominations**

The notes will be issued in minimum denominations of \$2,000 and in integral multiples of \$1,000 in excess thereof.

## **Ranking**

Payments of the principal and interest on the notes will rank equally with all of Capital One's other unsecured and unsubordinated debt. Capital One's senior indebtedness ranks *pari passu* with the notes. The notes will be our exclusive obligations and not those of our subsidiaries. Since we are a holding company and substantially all of our operations are conducted through subsidiaries, our cash flow and consequently our ability to service debt, including the notes, depend upon the earnings of our subsidiaries and the distribution of those earnings to us or upon other payments of funds by those subsidiaries to us. The subsidiaries are separate and distinct legal entities and have no obligation, contingent or otherwise, to pay any amounts due on the notes or to provide us with funds for payments on the notes, whether by dividends, distributions, loans or other payments. In addition, the payment of dividends and distributions and the making of loans and advances to us by our subsidiaries may be subject to regulatory, statutory or contractual restrictions, are contingent upon the earnings of those subsidiaries, and are subject to various business considerations.

Any right we have to receive assets of any of our subsidiaries upon their liquidation or reorganization and the resulting right of the holders of notes to participate in those assets effectively will be subordinated to the claims of that subsidiary's creditors, including trade creditors, except to the extent that we are recognized as a creditor of the subsidiary, in which case our claims would be subordinated to any security interests in the assets of the subsidiary and any indebtedness of the subsidiary senior to the debt held by us.

The senior indenture does not limit the amount of additional senior indebtedness that we or any of our subsidiaries may incur. We may, without the consent of the holders of the notes, create and issue additional debt securities under the senior indenture ranking equally with the notes.

As of December 31, 2016, Capital One Financial Corporation had approximately \$5.4 billion in senior unsecured indebtedness outstanding. As of December 31, 2016, our consolidated banking subsidiaries, CONA and COBNA, had approximately \$9.6 billion and \$5.5 billion in senior and subordinated indebtedness outstanding, respectively.

## **Events of Default**

Events of default under the senior indenture with respect to the notes of a series are:

(1) failure to pay interest on the notes of such series when due and continuance of that default for 30 days;

(2) failure to pay the principal of the notes of such series when due and payable;

S-13

## **Table of Contents**

(3) failure to perform or the breach of any covenant or warranty in the senior indenture or the notes of such series (other than a covenant or warranty included solely for the benefit of a series of debt securities other than the notes of such series) that continues for 60 days after we are given written notice by the indenture trustee or we and the indenture trustee are given written notice by the holders of at least 25% in principal amount of the outstanding notes of such series;

(4) any event of default under any mortgage, indenture or other instrument securing or evidencing any indebtedness of us or any significant subsidiary for money borrowed, resulting in such indebtedness in principal amount exceeding \$10,000,000 becoming or being declared due and payable prior to the date on which it would otherwise become due and payable, if the acceleration is not rescinded or annulled within 30 days after written notice; or

(5) certain events of bankruptcy, insolvency or reorganization of us or any of our significant subsidiaries.

## **Defeasance and Discharges**

The defeasance provisions of the senior indenture described under **Description of Debt Securities** **Legal Defeasance and Covenant Defeasance** in the accompanying prospectus will apply to the notes.

## **Same-Day Settlement and Payment**

Settlement by purchasers of the notes will be made in immediately available funds. All payments by us to the depository of principal and interest will be made in immediately available funds. So long as any notes are represented by global securities registered in the name of the depository or its nominee, those notes will trade in the depository's Same-Day Funds Settlement System which requires secondary market trading in those notes to settle in immediately available funds. No assurance can be given as to the effect, if any, of this requirement to settle in immediately available funds on trading activity in notes.

## **Global Securities; Book-Entry Issue**

We expect that the notes will be issued in the form of global securities held by The Depository Trust Company and its participants, including Euroclear System and Clearstream Banking, S.A., as described under **Book-Entry Procedures and Settlement** in the accompanying prospectus.

## **Trustee**

The Bank of New York Mellon Trust Company, N.A., formerly known as The Bank of New York Trust Company, N.A. (as successor to Harris Trust and Savings Bank) is the indenture trustee with respect to the notes. The indenture trustee is one of a number of banks with which we and our subsidiaries maintain banking and trust relationships in the ordinary course of business.

**Table of Contents**

**MATERIAL UNITED STATES FEDERAL INCOME TAX CONSEQUENCES**

This section summarizes the material U.S. federal income tax considerations relating to the purchase, ownership, and disposition of the notes. This summary does not provide a complete analysis of all potential tax considerations. The information provided below is based on the Internal Revenue Code of 1986, as amended (referred to herein as the

Code ), Treasury regulations issued under the Code, judicial authority and administrative rulings and practice, all as of the date of this prospectus supplement and all of which are subject to change, possibly on a retroactive basis. As a result, the tax considerations of purchasing, owning or disposing of the notes could differ from those described below. This summary deals only with beneficial owners who purchase the notes on original issuance at the first price at which a substantial portion of the notes is sold for cash (other than to bond houses, brokers or similar persons or organizations acting in the capacity of underwriters, placement agents or wholesalers) and who hold the notes as capital assets within the meaning of Section 1221 of the Code. This summary does not deal with persons in special tax situations, such as financial institutions, insurance companies, S corporations, regulated investment companies, real estate investment trusts, tax exempt investors, dealers in securities and currencies, traders in securities that elect to use a mark-to-market method of accounting for their securities, controlled foreign corporations, corporations that accumulate earnings to avoid U.S. federal income tax, U.S. expatriates, persons holding notes as a position in a straddle, hedge, conversion transaction, or other integrated transaction for U.S. federal income tax purposes, investors in pass-through entities, or U.S. holders (as defined below) whose functional currency is not the U.S. dollar. Further, this discussion does not address the consequences under U.S. alternative minimum tax rules, U.S. federal estate or gift tax laws, the tax laws of any U.S. state or locality, any non-U.S. tax laws, or any tax laws other than income tax laws. We will not seek a ruling from the Internal Revenue Service (the IRS ) with respect to any of the matters discussed herein and there can be no assurance that the IRS will not challenge one or more of the tax consequences described herein.

As used herein, the term U.S. Person means:

an individual that is a citizen or resident of the United States, for U.S. federal income tax purposes;

a corporation (or any other entity treated as a corporation for U.S. federal income tax purposes) created or organized in or under the laws of the United States, any state or the District of Columbia;

an estate whose income is includible in gross income for U.S. federal income tax purposes regardless of its source; or

a trust, if (i) a court within the United States is able to exercise primary supervision over the administration of the trust and one or more U.S. persons have the authority to control all substantial decisions of the trust or (ii) it has a valid election in effect under applicable Treasury regulations to be treated as a U.S. person.

As used herein, a U.S. holder is a beneficial owner of notes that is, for U.S. federal income tax purposes, a U.S. Person. As used herein, the term non-U.S. holder means a beneficial owner, other than a partnership (or entity treated as a partnership for U.S. federal income tax purposes), of notes that is not a U.S. holder.

If a partnership, including for this purpose any entity treated as a partnership for U.S. federal income tax purposes, is a beneficial owner of notes, the treatment of a partner in the partnership generally will depend upon the status of the

partner and upon the activities of the partnership. A holder of notes that is a partnership and partners in such a partnership should consult their independent tax advisors about the U.S. federal income tax consequences of holding and disposing of notes.

**Investors should consult their tax advisor concerning the tax consequences of the ownership and disposition of the notes, including the tax consequences under the laws of any foreign, state, local or other taxing jurisdictions and the possible effects on investors of changes in U.S. federal or other tax laws.**

S-15

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**Table of Contents**

**U.S. holders**

***Interest***

It is anticipated, and this discussion assumes, that the notes will be issued without original issue discount for U.S. federal income tax purposes. In such case, interest on a note will be includable by a U.S. holder as interest income at the time it accrues or is received in accordance with such holder's method of accounting for U.S. federal income tax purposes and will be ordinary income.

***Sale, Exchange, Redemption, Retirement or Other Taxable Disposition of the Notes***

Upon a sale, exchange, redemption, retirement or other taxable disposition of a note, a U.S. holder will generally recognize gain or loss equal to the difference between (i) the amount realized on the disposition (other than amounts attributable to accrued but unpaid interest, which will be taxed as interest income as discussed above to the extent not previously included in income) and (ii) the U.S. holder's tax basis in the note. A U.S. holder's tax basis in a note generally will equal the cost of the note. A U.S. holder's gain or loss will generally constitute capital gain or loss and will be long-term capital gain or loss if the U.S. holder has held such note for longer than one year. The deductibility of capital losses is subject to certain limitations. Net long-term capital gain recognized by a non-corporate U.S. holder is generally taxed at preferential rates.

***Medicare Tax***

U.S. holders who are individuals, estates or certain trusts are required to pay an additional 3.8% Medicare tax on the lesser of (1) the U.S. person's net investment income for the relevant taxable year and (2) the excess of the U.S. person's modified gross income for the taxable year over a certain threshold (which in the case of individuals will be between \$125,000 and \$250,000 depending on the individual's circumstances). Net investment income will generally include interest income and net gains from the disposition of the notes, unless such interest income or net gains are derived in the ordinary course of the conduct of a trade or business (other than a trade or business that consists of certain passive or trading activities). A U.S. holder that is an individual, estate or trust should consult its tax advisor regarding the applicability of the Medicare tax to its income and gains in respect of its investment in the notes.

***Backup Withholding and Information Reporting***

In general, a U.S. holder of a note will be subject to backup withholding at the applicable tax rate with respect to payments of interest or the gross proceeds from dispositions of notes, unless the holder (i) is an entity that is exempt from backup withholding (generally including tax-exempt organizations and certain qualified nominees) and, when required, provides appropriate documentation to that effect, (ii) provides us or our paying agent with the holder's social security number or other taxpayer identification number ( "TIN" ), certifies that the TIN provided is correct and that the holder has not been notified by the IRS that it is subject to backup withholding due to underreporting of interest or dividends, and otherwise complies with applicable requirements of the backup withholding rules. In addition, such payments to U.S. holders that are not exempt entities will generally be subject to information reporting requirements. A U.S. holder who does not provide us or our paying agent with the correct TIN may be subject to penalties imposed by the IRS. The amount of any backup withholding from a payment to a U.S. holder will be allowed as a credit against such holder's U.S. federal income tax liability and may entitle such holder to a refund, provided that the required information is timely furnished to the IRS.





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**Table of Contents**

**Non-U.S. holders**

***Interest***

Subject to the discussions of backup withholding and the Foreign Account Tax Compliance Act ( FATCA ) below, interest income of a non-U.S. holder will qualify for the portfolio interest exemption and therefore not be subject to U.S. federal income tax or withholding, provided that:

the interest paid on the note is not income that is effectively connected with a United States trade or business carried on by the non-U.S. holder ( ECI ) (and, if required by an applicable income tax treaty, is not attributable to a U.S. permanent establishment);

the non-U.S. holder does not actually or constructively (pursuant to the rules of Section 871(h)(3)(C) of the Code) own 10% or more of the total combined voting power of all classes of our stock that are entitled to vote;

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Employee stock options excluded from the computation of diluted  
per share amounts:

Shares for which exercise price exceeds average market price of common stock

630

910

Average exercise price per share that exceeds average market  
price of common stock \$33.40 \$30.41

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**Cautionary statement for purposes of the Safe Harbor provisions of the Private Securities Litigation Reform Act of 1995:** Apria's business is subject to a number of risks which are partly or entirely beyond the company's control. The company has described certain of those risks in its Annual Report on Form 10-K for the fiscal year ended December 31, 2004, as filed with the Securities and Exchange Commission on March 16, 2005. This report may be used for purposes of the Private Securities Litigation Reform Act of 1995 as a readily available document containing meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those projected in any forward-looking statements the company may make from time to time. Key factors that may have an impact on Apria include the following:

trends and developments affecting the collectibility of accounts receivable;  
government legislative and budget developments that could continue to affect reimbursement levels;  
the ongoing government investigation regarding patients covered by Medicare and other federal programs;  
the effectiveness of the Apria's operating systems and controls;  
healthcare reform and the effect of federal and state healthcare regulations;  
pricing pressures from large payors;  
the successful implementation of the company's acquisition strategy and integration of acquired businesses; and  
other factors described in Apria's filings with the Securities and Exchange Commission.

In addition, the military and national security activities in which the United States is currently engaged, have and could continue to have significant impacts on the economy and government spending priorities. The effects of any further such developments, including the ongoing

occupation in Iraq, pose significant risks and uncertainties to Apria's business. Deficit spending by the government as the result of adverse developments in the economy and the continuing costs of military and national security activities have increased pressure to reduce government expenditures for other purposes, including government-funded programs such as Medicare and Medicaid.

## ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Apria operates in the home healthcare segment of the healthcare industry and provides services in the home respiratory therapy, home infusion therapy and home medical equipment areas. In all three lines, Apria provides patients with a variety of clinical services and related products and supplies, most of which are prescribed by a physician as part of a care plan. Apria provides these services to patients in the home throughout the United States through approximately 480 branch locations.

**Critical Accounting Policies.** Apria's management considers the accounting policies that govern revenue recognition and the determination of the net realizable value of accounts receivable to be the most critical in relation to the company's consolidated financial statements. These policies require management's most complex and subjective judgments. Additionally, the accounting policies related to goodwill, long-lived assets and income taxes require significant judgment. These policies are presented in detail in Apria's Annual Report on Form 10-K for the fiscal year ended December 31, 2004 Management's Discussion and Analysis of Financial Condition and Results of Operations.

### Results of Operations

**Net Revenues.** Net revenues were \$371.9 million in the first quarter of 2005, compared to \$350.9 million for the corresponding period in 2004, representing an increase of 6.0%. Revenues for 2004 for respiratory medications were reduced by \$3.6 million due to Medicare reimbursement reductions that went into effect January 1, 2004. Additional Medicare pricing reductions became effective January 1, 2005 for respiratory medications and certain equipment items, which further eroded revenue growth. Expected Medicare reimbursement reductions on oxygen and oxygen equipment were delayed until April 8, 2005, when the revised 2005 fee schedule was implemented. Management estimates the impact of the 2005 Medicare reimbursement reductions to be approximately \$4.5 million for the quarter ended March 31, 2005. Apria has also experienced a decline in revenues as a result of the transition out of the Gentiva CareCentrix (Gentiva) contract, which management chose not to renew for 2004. The related reduction to revenues is estimated at \$10.4 million for the first three months of 2005 as compared to the first three months of 2004. Further, the company is experiencing increased pricing pressure from its managed care customers as these organizations seek to lower costs by obtaining more favorable pricing from providers such as Apria. Managed care organizations are also evaluating alternative delivery models for certain products and services, which include those provided by Apria. This may cause Apria to provide reduced levels of certain products and services in the future, resulting in a corresponding reduction in revenue.

The growth in revenues, after consideration of the Medicare and Gentiva revenue reductions, was due to volume increases from contracted and traditional sources and the acquisition of complementary businesses. Apria's acquisition strategy generally results in the rapid integration of acquired businesses into existing operating locations. This rapid integration limits Apria's ability to separately track the amount of revenue generated by an acquired business. Therefore, estimating the net revenue contribution from acquisitions requires certain assumptions. Based on its analysis, Apria estimates that approximately \$22.0 million of the net revenue growth between the three-month periods in 2004 and 2005 was derived from acquisitions.

The following table sets forth a summary of net revenues by service line:

(dollars in thousands)	Three Months Ended March 31,			
	2005		2004	
	\$	%	\$	%
Respiratory therapy	\$257,488	69.2%	\$242,386	69.1%
Infusion therapy	61,703	16.6%	58,688	16.7%
Home medical equipment/other	52,672	14.2%	49,807	14.2%
Total net revenues	\$371,863	100.0%	\$350,881	100.0%

**Respiratory Therapy.** Respiratory therapy revenues are derived primarily from the provision of oxygen systems, home ventilators, sleep apnea equipment, nebulizers, respiratory medications and related services. Net revenues in the respiratory therapy service line increased 6.2% in the first quarter of 2005 as compared to the corresponding period in 2004. This growth was primarily driven by volume increases and acquisitions of respiratory therapy businesses. The Medicare reimbursement reduction for respiratory medications caused a decline of 1.5% in

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the revenue growth rate for the three-month period ended March 31, 2005. The growth in this service line was also reduced by the exit from the Gentiva contract in 2004, representing approximately 3.5% of prior year first quarter respiratory revenues.

**Infusion Therapy.** The infusion therapy service line involves the administration of a drug or nutrient directly into the body intravenously through a needle or catheter. Infusion therapy services also include administering enteral nutrients directly into the gastrointestinal tract through a feeding tube. Infusion therapy revenues increased 5.1% in the first quarter of 2005. Enteral nutrition, which makes up approximately 44% of the revenue in the infusion service line, increased by 7.6% in the first three months of 2005 when compared to the corresponding period in 2004.

**Home Medical Equipment/Other.** Home medical equipment/other revenues are derived from the provision of equipment to assist patients with ambulation, safety and general care in and around the home. Home medical equipment/other revenues increased 5.8% in the first quarter of 2005 versus the first quarter of 2004. Diabetic supplies, historically a very small percentage of the home medical equipment line, grew significantly in the first quarter of 2005 when compared to the first quarter of 2004. This growth is directly attributable to the March 2004 acquisition of a company that entered the diabetic supply market just prior to being acquired by Apria. Excluding the growth in diabetic supplies, home medical equipment/other revenue was flat for the three months ended March 31, 2005, when compared to the same period in 2004. Medicare reimbursement reductions implemented in 2005 that impact this line of business represent 1.6% of home medical equipment/other revenues for the first quarter ended March 31, 2004.

**Revenue Recognition and Certain Concentrations.** Revenues are recognized on the date services and related products are provided to patients and are recorded at amounts estimated to be received under reimbursement arrangements with third-party payors, including private insurers, prepaid health plans, Medicare and Medicaid. Due to the nature of the industry and the reimbursement environment in which Apria operates, certain estimates are required to record net revenues and accounts receivable at their net realizable values. Inherent in these estimates is the risk that they will have to be revised or updated as additional information becomes available, which could have an impact on the consolidated financial statements.

In 2005, approximately 38% of Apria's revenues are being reimbursed under arrangements with Medicare and Medicaid. No other third-party payor represents more than 9% of the company's revenues. The majority of the company's revenues are derived from fees charged for patient care under fee-for-service arrangements. Revenues derived from capitation arrangements represent less than 10% of total net revenues for all periods presented.

**Medicare Reimbursement.** In December 2003, the Medicare Prescription Drug, Improvement and Modernization Act of 2003, which is herein referred to as the Medicare Modernization Act, became law. The Medicare Modernization Act includes a number of provisions that affect Medicare Part B reimbursement policies for items and services provided by Apria, the most significant of which are:

**Reimbursement reductions for five durable medical equipment categories, including oxygen** Reimbursement for most of these categories is based on the median price paid for such items on behalf of beneficiaries of federal employee health benefit plans, or FEHBP. The new fee schedules went into effect January 1, 2005. However, the reimbursement reduction for oxygen was delayed until the Office of the Inspector General, or OIG, provided the Centers for Medicare and Medicaid Services, or CMS, with the additional data required to establish pricing. On March 30, 2005, the OIG issued a report containing the final 2005 Medicare fee schedule for oxygen and oxygen equipment. The revised pricing was to be implemented as soon as possible and no later than April 8, 2005. Any 2005 claims for oxygen and oxygen equipment that had been submitted prior to the implementation of the new fee schedule were paid based on 2004 pricing schedules and will not be retroactively adjusted. Further, a freeze on annual payment increases for durable medical equipment has been instituted from 2004 through 2008.

**Reimbursement reduction for inhalation drugs** The previous reimbursement rate of 95% of the average wholesale price was reduced to 80% of the average wholesale price, effective January 1, 2004. Beginning in January 2005, reimbursement for these drugs was further reduced through a shift to the manufacturer-reported average sales price, as defined by the Medicare Modernization Act, plus 6%, plus a separate dispensing fee per patient episode. The dispensing fees for 2005 have been established at \$57.00 for a 30-day supply of medications and \$80.00 for a 90-day supply.

**Establishment of a competitive bidding program** Such a program would require that suppliers wishing to provide certain items to beneficiaries submit bids to Medicare. The program, for as yet unspecified durable medical equipment items and services, is to be transitioned into (i) 10 of the largest metropolitan statistical areas in 2007; (ii) 80 of the largest metropolitan statistical areas in 2009; and (iii) additional areas after 2009. The legislation contains special provisions for rural areas.

**Reimbursement for home infusion therapy under Medicare Part D** Currently, a limited number of infusion therapies, supplies and equipment are covered by Medicare Part B. The Medicare Modernization Act provides expanded coverage for home infusion drugs. The industry is currently working with CMS to further define the coverage and payment policies that will govern the administration of this benefit, which takes effect in 2006.

**Incentives for expansion of Medicare Part C** The Medicare Modernization Act includes financial incentives for managed care plans to expand their provision of Medicare Advantage plans in 2006 in a stated effort to attract more Medicare beneficiaries to managed care models. The company maintains contracts to provide respiratory, infusion and medical equipment and related services to a significant number of managed care plans nationwide, and believes that the Medicare Advantage expansion represents a growth opportunity starting in 2006.

Apria's management estimates that the revision to inhalation drug reimbursement in 2004 resulted in a revenue reduction of approximately \$15.0 million from 2003 levels. Management further estimates that 2005 net revenues will be reduced from 2004 levels by approximately \$40.0 million as a result of the lower Medicare pricing implemented in 2005. The impact of the competitive bidding program scheduled to commence in 2007 cannot be estimated at this time.

The Balanced Budget Act of 1997 contained several provisions that lowered Apria's Medicare reimbursement levels. Subsequent legislation the Medicare Balanced Budget Refinement Act of 1999 and the Medicare, Medicaid and SCHIP Benefits Improvement and Protection Act of 2000 mitigated some of the effects of the original legislation. The Medicare Modernization Act also addressed some of the issues pending from the earlier legislation. However, still pending from the 1997 Legislation is the streamlined authority granted to the Secretary of the U.S. Department of Health and Human Services, or HHS, to increase or reduce the reimbursement for home medical equipment, including oxygen, by up to 15% each year under an inherent reasonableness authority. In December 2002, CMS issued an interim final rule that establishes a process by which such adjustments may be made. The rule applies to all Medicare Part B services except those paid under a physician fee schedule, a prospective payment system, or a competitive bidding program. As of this date, neither CMS nor the durable medical equipment regional carriers have used the expedited authority.

**Medicaid Reimbursement.** Since 2001, some states have adopted alternative pricing methodologies for certain drugs and biologicals under the Medicaid program. In at least 22 states, these changes have reduced the level of reimbursement received by Apria without a corresponding offset or increase to compensate for the service costs incurred. In several of those states, Apria has elected to stop accepting new Medicaid patient referrals for the affected drugs. Apria is continuing to provide services to patients already on service, and for those who receive other Medicaid-covered respiratory, home medical equipment or infusion therapies, if the reimbursement levels for those services remain adequate. Further, some states are considering other reductions in Medicaid reimbursement as they work through their respective state's budget process. Apria management cannot predict the outcome of such budget negotiations and whether other states will consider reductions as well.

***Gross Profit.*** Gross margins were 70.6% and 71.8% for the first quarters of 2005 and 2004, respectively. The decline is primarily due to the Medicare reimbursement reductions and the effects of the non-renewal of the Gentiva contract in 2004. Further eroding the gross margin is a manufacturer's price increase for a particular respiratory drug, effected concurrently with higher government reimbursement for that drug in 2005. This price increase is estimated to have a \$1.2 million negative impact on Apria's gross margin for the three-month period ended March 31, 2005.

***Provision for Doubtful Accounts.*** The provision for doubtful accounts results from management's estimate of the net realizable value of accounts receivable after considering actual write-offs of specific receivables. The provision was 3.9% of net revenues for the first quarter of 2005 and 3.8% for the same period last year. The provision is generally higher in the first quarter than it is for the rest of the year due to delays in cash collections resulting from insurance plan deductible requirements and payor changes as new enrollment periods commence. Also impacting the provision requirements in the first quarter of 2005 are higher co-pay amounts and delays caused by the Medicare reimbursement changes. See Liquidity and Capital Resources Accounts Receivable.

***Selling, Distribution and Administrative.*** Selling, distribution and administrative expenses are comprised of expenses incurred in support of operations and those associated with administrative functions. Expenses incurred by the operating locations include salaries and other expenses in the following functional areas: selling, distribution, clinical, intake, reimbursement, warehousing and repair. Many of these operating costs are variable with revenue growth patterns. Certain expenses, such as facility lease and fuel costs, are very sensitive to market-driven price fluctuations. Administrative expenses include overhead costs incurred by the operating locations and corporate support functions. These expenses do not vary as closely with revenue growth as do the operating costs. Selling, distribution and administrative expenses, expressed as percentages of net revenues, were 55.3% in the first quarter of 2005, up from 53.4% in the first quarter of 2004. The percentage increase between the quarters is primarily attributable to the lower revenues resulting from Medicare pricing changes without a corresponding reduction in the company's actual cost of providing those products and services. Outsourced collection fees and higher fuel prices also factored into the increase. Advertising costs related to the company's diabetic supply business are also higher in the first quarter of 2005 as compared to the first quarter of 2004 because this business was not acquired until late in the first quarter of 2004. Other incremental costs include severance charges related to the departure of two executives and a reduction in workforce at the Corporate office. Management has implemented several new productivity initiatives aimed at reducing costs to mitigate the effects of the 2005 Medicare reimbursement reductions.

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***Amortization of Intangible Assets.*** For the quarter ended March 31, 2005, amortization expense was \$1.6 million. This compares to \$1.3 million for the same period last year. The increase is due to ongoing acquisition activity and the valuation of certain customer relationships acquired in business combinations. See Liquidity and Capital Resources Business Combinations.

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**Interest Expense.** Interest expense was \$4.8 million for the first quarter of 2005, down from \$5.0 million in the first quarter of 2004. The decrease is due to lower debt levels and reduced interest rates on debt that was refinanced in the fourth quarter of 2004. See Liquidity and Capital Resources Long-term Debt.

**Income Taxes.** Income taxes for the three months ended March 31, 2005 have been provided at a lower effective rate than is expected to be applicable for the entire year. The lower rate is primarily due to a decrease in the valuation allowance account of \$2.6 million and the corresponding reduction of the tax provision for the quarter ended March 31, 2005. This resulted from state net operating loss carryforwards that became realizable based on a change in estimate of expected future earnings. Income taxes for the three-month period ended March 31, 2004 were provided at the effective tax rate expected to be applicable for that year.

At March 31, 2005, the company had various apportioned state net operating loss carryforwards which resulted in a deferred tax asset of \$10.0 million, net of federal tax benefit.

The company believes it has adequately provided for income tax issues not yet resolved with federal, state and local tax authorities. At March 31, 2005, \$18.6 million, net of tax benefit, was accrued for such tax matters and is included in income taxes payable. Although not probable, the most adverse resolution of these federal, state and local tax issues could result in additional charges to earnings in future periods in addition to the \$18.6 million accrued as of March 31, 2005. Based upon a consideration of all relevant facts and circumstances, the company does not believe the ultimate resolution of tax issues for all open tax periods will have a materially adverse effect upon its results of operations or financial condition.

Apria utilized \$5.0 million of federal net operating loss carryforwards in 2004. The remaining \$7.1 million of federal net operating loss carryforwards expired unused on December 31, 2004.

### Liquidity and Capital Resources

Apria's principal source of liquidity is its operating cash flow, which is supplemented by a \$500.0 million revolving credit facility. Apria's ability to generate operating cash flows in excess of its operating needs has afforded it the ability, among other things, to pursue its acquisition strategy and fund patient service equipment expenditures to support revenue growth. Management believes that its operating cash flow and revolving credit line will continue to be sufficient to fund its operations and growth strategies. However, sustaining current cash flow levels is dependent on many factors, some of which are not within Apria's control, such as government reimbursement levels and the financial health of its payors.

**Cash Flow.** Cash provided by operating activities was \$51.6 million in the first three months of 2005 compared with \$65.7 million in the corresponding period in 2004. The decrease in operating cash flow between the two periods can be attributed to several factors, including the Medicare reimbursement changes and the exit from the Gentiva contract which negatively impacted net income for the first quarter of 2005. Also reducing operating cash flow was a higher increase in accounts receivable during the first quarter of 2005 as compared to the same period in 2004, resulting from acquisition activity, higher co-pay amounts, and delays in cash collections due to the Medicare pricing changes.

Cash used in investing activities decreased to \$63.1 million for the first three months of 2005 compared to \$67.0 million during the same period last year. The decrease is primarily attributable to lower expenditures for acquisitions in 2005. Expenditures for patient service equipment increased slightly in the first quarter of 2005 when compared to the corresponding period in 2004.

Cash used in financing activities was \$261,000 during the first three months of 2005 compared to \$54.0 million for the first three months of 2004. Cash used in 2004 primarily relates to the \$50.0 million repurchase of the company's common stock.

**Contractual Cash Obligations.** The following table summarizes Apria's long-term cash payment obligations to which the company is contractually bound. The years presented below represent 12-month rolling periods ending March 31.

(dollars in millions)	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6+	Totals
Revolving loan	\$ -	\$ -	\$ -	\$ -	\$ 225	\$ -	\$ 225
Convertible senior notes	-	-	-	-	-	250	250
Capital lease obligations	2	1	-	-	-	-	3
Other long-term debt	1	-	-	-	-	-	1
Operating leases	63	49	33	19	11	17	192
Deferred acquisition payments	8	-	-	-	-	-	8

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<i>(dollars in millions)</i>	<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>	<u>Year 4</u>	<u>Year 5</u>	<u>Year 6+</u>	<u>Totals</u>
Total contractual cash obligations	\$ 74	\$ 50	\$ 33	\$ 19	\$ 236	\$ 267	\$ 679

The holders of the convertible senior notes will first have the option to require Apria to repurchase all or a portion of their notes in September 2008.

**Accounts Receivable.** Accounts receivable before allowance for doubtful accounts increased to \$283.3 million at March 31, 2005 from \$264.4 million at December 31, 2004, which is primarily due to delays in cash collections in the first quarter resulting from insurance plan deductible requirements and payor changes as new enrollment periods commence. Also impacting accounts receivable balances are higher co-payments, delays caused by Medicare pricing changes and acquisition activity. Days sales outstanding, which are calculated as of each period end by dividing accounts receivable, less allowance for doubtful accounts, by the 90-day rolling average of net revenues, were 57 at March 31, 2005, 53 at March 31, 2004 and 52 at December 31, 2004. The increase in days sales outstanding at the end of the first quarter of 2005 is directly attributable to the same delays in cash collections that are causing temporary increases in accounts receivable balances. Days sales outstanding is also negatively impacted by the 2005 Medicare reimbursement reductions, which reduces the 90-day rolling average net revenue from previous levels.

Accounts aged in excess of 180 days of total receivables for certain payor categories, and in total, are as follows:

<i>(dollars in thousands)</i>	<u>March 31, 2005</u>	<u>December 31, 2004</u>
Medicare	16.4%	18.7%
Medicaid	25.7%	25.2%
Self pay	34.4%	33.0%
Managed care/other	19.8%	21.2%
	<u>20.6%</u>	<u>21.3%</u>

**Evaluation of Net Realizable Value.** Management performs various analyses to evaluate accounts receivable balances to ensure that recorded amounts reflect estimated net realizable value. Management applies specific percentages to the accounts receivable aging to estimate the amount that will ultimately be uncollectible and therefore should be reserved. The percentages are increased as the accounts age. Accounts aged in excess of 360 days are reserved at 100%. Management establishes and monitors these percentages through analyses of historical realization data, accounts receivable aging trends, other operating trends, the extent of contracted business and business combinations. Also considered are relevant business conditions, such as governmental and managed care payor claims processing procedures and system changes. If indicated by such analyses, management may periodically adjust the uncollectible estimate and corresponding percentages. Further, focused reviews of certain large and/or problematic payors are performed to determine if their respective reserve levels are appropriate.

**Unbilled Receivables.** Included in accounts receivable are earned but unbilled receivables of \$38.2 million and \$36.3 million at March 31, 2005 and at December 31, 2004, respectively. Delays, ranging from one day up to several weeks, between the date of service and billing can occur due to delays in obtaining certain required payor-specific documentation from internal and external sources. Earned but unbilled receivables are aged from date of service and are considered in Apria's analysis of historical performance and collectibility. The higher unbilled amount at March 31, 2005 is largely due to acquisitions effected during the first quarter of 2005.

**Inventories and Patient Service Equipment.** Inventories consist primarily of pharmaceuticals and disposable products used in conjunction with patient service equipment. Patient service equipment consists of respiratory and home medical equipment that is provided to in-home patients for the course of their care plan, normally on a rental basis and subsequently returned to Apria for redistribution after cleaning and maintenance is performed.

The branch locations serve as the primary point from which inventories and patient service equipment are delivered to the patient. The branches are supplied with inventory and equipment from the regional warehouses, which coordinate purchasing with the corporate office. The regions are also responsible for repairs and scheduled maintenance of patient service equipment, which adds to the frequent movement of equipment between the region and branch locations. Further, the majority of Apria's patient service equipment is located in patients' homes. While the utilization varies widely between equipment types, on the average, approximately 80% of the equipment is on rent at any given time. Inherent in this asset flow is the fact that losses will occur. Management has successfully instituted a number of controls over the company's inventories and patient service equipment to minimize such losses. Depending on the product type, the company performs physical inventories on an annual or quarterly basis and adjusts the related balances accordingly. Inventory and patient service equipment losses for the three months ended March 31, 2005 and 2004 were \$466,000 and \$387,000, respectively. There can be no assurance that Apria will be able to maintain its

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current level of control over inventories and patient service equipment. Continued revenue growth is directly dependent on the company's ability to fund its equipment and inventory requirements. The increases in both accounts between December 31, 2004 and March 31, 2005 reflect purchases to support increased business levels and the addition of patient items recorded in conjunction with acquisitions that closed in 2005.

**Long-Term Debt. Revolving Credit Facility.** At March 31, 2005, borrowings under Apria's revolving credit facility were \$224.8 million; outstanding letters of credit totaled \$3.8 million; and credit available under the revolving facility was \$271.4 million. The company continues to be in compliance with all of the financial covenants required by the credit agreement.

**Convertible Senior Notes.** At March 31, 2005, the fair value of the \$250.0 million in convertible senior notes was \$275.1 million, as determined by reference to quoted market prices.

**Hedging Activities.** Apria is exposed to interest rate fluctuations on its underlying variable rate long-term debt. Apria's policy for managing interest rate risk is to evaluate and monitor all available relevant information, including but not limited to, the structure of its interest-bearing assets and liabilities, historical interest rate trends and interest rate forecasts published by major financial institutions. The tools Apria may utilize to moderate its exposure to fluctuations in the relevant interest rate indices include, but are not limited to: (i) strategic determination of repricing periods and related principal amounts, and (ii) derivative financial instruments such as interest rate swap agreements, caps or collars. Apria does not use derivative financial instruments for trading or other speculative purposes.

At March 31, 2005, Apria had two interest rate swap agreements in effect to fix its LIBOR-based variable rate debt. The terms of such agreements are as follows: a three-year agreement with a notional amount of \$25.0 million and a fixed rate of 3.04%, expiring December 2005; and a four-year agreement with a notional amount of \$25.0 million and a fixed rate of 3.42%, expiring December 2006.

The swap agreements are being accounted for as cash flow hedges under SFAS No. 133, Accounting for Derivative and Hedging Activities. Accordingly, the difference between the interest received and interest paid is reflected as an adjustment to interest expense. For the first quarter of 2005, Apria paid a net settlement amount of \$84,000. Unrealized gains and losses on the fair value of the swap agreements are reflected, net of taxes, in other comprehensive income. At March 31, 2005, the aggregate fair value of the swap agreements was an asset of \$327,000. While no assurances can be made, Apria does not anticipate losses due to counterparty nonperformance as its counterparties to the various swap agreements are nationally recognized financial institutions with strong credit ratings.

During the second quarter of 2005, Apria entered into two new interest rate swap agreements. The forward-starting agreements, each with a notional amount of \$25.0 million, become effective January 2006. Both agreements are for a three-year term with fixed rates of 4.44% and 4.38%, respectively.

**Business Combinations.** Pursuant to one of its primary growth strategies, Apria periodically acquires complementary businesses in specific geographic markets. The results of operations of the acquired companies are included in the accompanying condensed consolidated income statements from the dates of acquisition. Covenants not to compete are being amortized over the life of the respective agreements. Tradenames and customer lists are being amortized over the period of their expected benefit.

The aggregate consideration for acquisitions that closed during the first three months of 2005 was \$28.1 million. Pending receipt of additional valuation information, the preliminary allocation of this amount includes \$19.7 million to goodwill, \$2.6 million to other intangible assets and \$2.3 million to patient service equipment.

Cash paid for acquisitions, which includes amounts deferred from prior year acquisitions, totaled \$28.9 million and \$34.6 million in the first three months of 2005 and 2004, respectively.

The success of Apria's acquisition strategy is directly dependent on Apria's ability to maintain and/or generate sufficient liquidity to fund such acquisitions and on the company's ability to successfully integrate the acquired operations.

**HIPAA.** The Health Insurance Portability and Accountability Act of 1996, or HIPAA, is comprised of a number of components. Pursuant to the administrative simplification section of HIPAA, HHS has issued multiple regulations, each with its own compliance date. Regulation under HIPAA that may have a material effect on Apria govern the following:

privacy of individually identifiable health information - compliance date: April 14, 2003 - Apria was materially compliant by this date;

standard electronic transaction and code sets - compliance date: October 16, 2003 - Apria was materially compliant by this date;

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electronic security of individually identifiable health information - compliance date: April 20, 2005 - Apria was materially compliant by this date;

standards for unique national health identifier for healthcare providers for use in connection with standard transactions compliance date: May 23, 2007 Apria expects to be materially compliant with these regulations by the compliance date; and

the first installment of an interim enforcement rule, when issued in full, will address both substantive and procedural requirements for the imposition of civil monetary penalties.

Apria faces potential criminal or civil sanctions if it does not comply with existing or new laws and regulations related to patient health information, use of standard transaction and code sets and use of standard identifiers. New health information standards, whether implemented pursuant to HIPAA or otherwise, could have a significant effect on the manner in which Apria handles healthcare related data and communicates with payors.

**Federal Investigation.** As previously reported, since mid-1998 Apria has been the subject of an investigation conducted by the U.S. Attorney's office in Los Angeles and the U.S. Department of Health and Human Services. The investigation concerns the documentation supporting Apria's billing for services provided to patients whose healthcare costs are paid by Medicare and other federal programs. Apria is cooperating with the government and has responded to various document requests and subpoenas.

The investigation relates to two civil *qui tam* lawsuits against Apria filed under seal on behalf of the government. In 2004 the government provided Apria with redacted copies of the complaints in these lawsuits for the first time. On the copies provided to Apria, the names of the plaintiffs, the courts and the dates instituted were blacked out. In general, both complaints allege that for an unspecified period of time commencing in 1995 Apria knowingly engaged in various schemes to defraud the government by submitting false claims for payment and by manipulating and falsifying documentation in support of such claims. The complaints do not quantify the alleged damages sought and do not identify any of the particular individuals, patient accounts or Apria facilities alleged to be involved in any improper billing. To date, the U.S. Attorney's office has not informed Apria of any decision to intervene in the *qui tam* actions; however, it could reach a decision with respect to intervention at any time.

Apria has acknowledged that there may be errors and omissions in supporting documentation affecting a portion of its billings. However, it believes that most of the alleged documentation errors and omissions should not give rise to any liability. Accordingly, Apria believes that most of the assertions made by the government and the *qui tam* plaintiffs are legally and factually incorrect and that Apria is in a position to assert numerous meritorious defenses.

During the past several years, Apria and representatives of the government have been analyzing and discussing the documentation underlying Apria's billings to the federal government for services provided by Apria from mid-1995 through 1998 to a sample of 300 patients selected by the government. Government representatives and counsel for the plaintiffs asserted in 2001 that, by a process of extrapolation from the patient files in the sample to all of Apria's government billings during the sample period, Apria could have a very significant liability to the government under the False Claims Act. Differences between Apria and the government have been reduced on a number of issues as a result of the analysis and discussions referred to above. Consequently, while Apria's potential liability could still be very material, Apria believes that the amount the government is now seeking is significantly less than asserted in 2001.

Apria and government representatives are continuing to explore whether it will be possible to resolve this matter on a basis that would be considered fair and reasonable by all parties. Notwithstanding the progress made to date in reducing the differences between Apria and the government, there remain significant disagreements as to the number and the legal implications of billing documentation deficiencies in the 300-patient sample. Accordingly, Apria cannot provide any assurances as to the outcome of its discussions with the government, or as to the outcome of the *qui tam* litigation in the absence of a settlement. Management cannot estimate the possible loss or range of loss that may result from these proceedings and, therefore, has not recorded any related accruals.

If a judge, jury or administrative agency were to determine that false claims were submitted to federal healthcare programs or that there were significant overpayments by the government, Apria could face civil and administrative claims for refunds, sanctions and penalties for amounts that would be highly material to its business, results of operations and financial condition, including the exclusion of Apria from participation in federal healthcare programs.

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### Off-Balance Sheet Arrangements

Apria is not a party to off-balance sheet arrangements as defined by the Securities and Exchange Commission. However, from time to time the company enters into certain types of contracts that contingently require the company to indemnify parties against third-party claims. The contracts primarily relate to: (i) certain asset purchase agreements, under which the company may provide customary indemnification to the seller of the business being acquired; (ii) certain real estate leases, under which the company may be required to indemnify property owners for



environmental and other liabilities, and other claims arising from the company's use of the applicable premises; and (iii) certain agreements with the company's officers, directors and employees, under which the company may be required to indemnify such persons for liabilities arising out of their employment relationship.

The terms of such obligations vary by contract and in most instances a specific or maximum dollar amount is not explicitly stated therein. Generally, amounts under these contracts cannot be reasonably estimated until a specific claim is asserted. Consequently, no liabilities have been recorded for these obligations on the company's balance sheets for any of the periods presented.

### **ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

Apria is exposed to interest rate fluctuations on its underlying variable rate long-term debt. Apria utilizes interest rate swap agreements to moderate such exposure. Apria does not use derivative financial instruments for trading or other speculative purposes.

At March 31, 2005, Apria's revolving credit facility borrowings totaled \$224.8 million. The bank credit agreement governing the term loans provides interest rate options based on the following indices: Federal Funds Rate, Prime Rate or the London Interbank Offered Rate (LIBOR). All such interest rate options are subject to the application of an interest margin as specified in the bank credit agreement. At March 31, 2005, all of Apria's outstanding revolving debt was tied to LIBOR.

At March 31, 2005, Apria had a three-year interest rate swap agreement with a notional amount of \$25.0 million and a fixed rate of 3.04% and a four-year interest rate swap agreement with a notional amount of \$25.0 million and a fixed rate of 3.42%. Both rates are before application of the interest margin.

Based on the revolving debt outstanding and the swap agreements in place at March 31, 2005, a 100 basis point change in the applicable interest rates would increase or decrease Apria's annual cash flow and pretax earnings by approximately \$1.7 million. See Management's Discussion and Analysis of Financial Condition and Results of Operations—Long-term Debt—Hedging Activities.

### **ITEM 4. CONTROLS AND PROCEDURES**

As of the end of the period covered by this report, the company carried out an evaluation, under the supervision and with the participation of the company's management, including the company's principal executive officer and principal financial officer, of the effectiveness of the design and operation of the company's disclosure controls and procedures. Based upon that evaluation, the principal executive officer and principal financial officer concluded that the company's disclosure controls and procedures are effective in timely alerting them to material information relating to the company that is required to be included in the company's periodic Securities and Exchange Commission filings.

During the period covered by this report, there have been no changes to the company's internal control over financial reporting or in other factors that have materially affected, or are reasonably likely to materially affect, the company's internal control over financial reporting.

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## **PART II OTHER INFORMATION**

### **ITEM 1. LEGAL PROCEEDINGS**

As previously reported, since mid-1998 Apria has been the subject of an investigation conducted by the U.S. Attorney's office in Los Angeles and the U.S. Department of Health and Human Services. The investigation concerns the documentation supporting Apria's billing for services provided to patients whose healthcare costs are paid by Medicare and other federal programs. Apria is cooperating with the government and has responded to various document requests and subpoenas.

The investigation relates to two civil *qui tam* lawsuits against Apria filed under seal on behalf of the government. In 2004 the government provided Apria with redacted copies of the complaints in these lawsuits for the first time. On the copies provided to Apria, the names of the plaintiffs, the courts and the dates instituted were blacked out. In general, both complaints allege that for an unspecified period of time commencing in 1995 Apria knowingly engaged in various schemes to defraud the government by submitting false claims for payment and by manipulating and falsifying documentation in support of such claims. The complaints do not quantify the alleged damages sought and do not identify any of the particular individuals, patient accounts or Apria facilities alleged to be involved in any improper billing. To date, the U.S. Attorney's office has not informed Apria of any decision to intervene in the *qui tam* actions; however, it could reach a decision with respect to intervention at any time.

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Apria has acknowledged that there may be errors and omissions in supporting documentation affecting a portion of its billings. However, it believes that most of the alleged documentation errors and omissions should not give rise to any liability. Accordingly, Apria believes that most of the assertions made by the government and the *qui tam* plaintiffs are legally and factually incorrect and that Apria is in a position to assert numerous meritorious defenses.

During the past several years, Apria and representatives of the government have been analyzing and discussing the documentation underlying Apria's billings to the federal government for services provided by Apria from mid-1995 through 1998 to a sample of 300 patients selected by the government. Government representatives and counsel for the plaintiffs asserted in 2001 that, by a process of extrapolation from the patient files in the sample to all of Apria's government billings during the sample period, Apria could have a very significant liability to the government under the False Claims Act. Differences between Apria and the government have been reduced on a number of issues as a result of the analysis and discussions referred to above. Consequently, while Apria's potential liability could still be very material, Apria believes that the amount the government is now seeking is significantly less than asserted in 2001.

Apria and government representatives are continuing to explore whether it will be possible to resolve this matter on a basis that would be considered fair and reasonable by all parties. Notwithstanding the progress made to date in reducing the differences between Apria and the government, there remain significant disagreements as to the number and the legal implications of billing documentation deficiencies in the 300-patient sample. Accordingly, Apria cannot provide any assurances as to the outcome of its discussions with the government, or as to the outcome of the *qui tam* litigation in the absence of a settlement. Management cannot estimate the possible loss or range of loss that may result from these proceedings and, therefore, has not recorded any related accruals.

If a judge, jury or administrative agency were to determine that false claims were submitted to federal healthcare programs or that there were significant overpayments by the government, Apria could face civil and administrative claims for refunds, sanctions and penalties for amounts that would be highly material to its business, results of operations and financial condition, including the exclusion of Apria from participation in federal healthcare programs.

Apria is also engaged in the defense of certain claims and lawsuits arising out of the ordinary course and conduct of its business, the outcomes of which are not determinable at this time. Apria has insurance policies covering such potential losses where such coverage is cost effective. In the opinion of management, any liability that might be incurred by Apria upon the resolution of these claims and lawsuits will not, in the aggregate, have a material adverse effect on Apria's results of operations or financial condition.

### ITEM 6. EXHIBITS

<u>Exhibit Number</u>	<u>Reference</u>
31.1	Certification of Chief Executive Officer pursuant to Securities Exchange Act Rule 13a-14(a).
31.2	Certification of Chief Financial Officer pursuant to Securities Exchange Act Rule 13a-14(a).
32.1	Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350.
32.2	Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350.

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### 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.

APRIA HEALTHCARE GROUP INC.  
Registrant

May 10, 2005

/s/ AMIN I. KHALIFA  
Amin I. Khalifa

Executive Vice President and Chief Financial Officer  
(Principal Financial Officer)