

Fortress Investment Group LLC  
Form 10-Q  
August 12, 2008  
Table of Contents

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**  
**Washington, D.C. 20549**  
**FORM 10-Q**

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**  
For the quarterly period ended June 30, 2008

or

.. **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**  
For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number: 001-33294

**Fortress Investment Group LLC**

(Exact name of registrant as specified in its charter)

**Delaware**  
(State or other jurisdiction of incorporation

**20-5837959**  
(I.R.S. Employer Identification No.)

or organization)

**1345 Avenue of the Americas, New York, NY**  
(Address of principal executive offices)

**10105**  
(Zip Code)

**(212) 798-6100**

(Registrant's telephone number, including area code)

## Edgar Filing: Fortress Investment Group LLC - Form 10-Q

(Former name, former address and former fiscal year, if changed since last report)

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer  Accelerated filer  Non-accelerated filer  (Do not check if a smaller reporting company)

Smaller reporting company

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the last practicable date.

Class A Shares: 94,609,525 outstanding as of August 8, 2008.

Class B Shares: 312,071,550 outstanding as of August 8, 2008.

**Table of Contents**

**FORTRESS INVESTMENT GROUP LLC**

**FORM 10-Q**

**INDEX**

	<b>PAGE</b>
<b>PART I. FINANCIAL INFORMATION</b>	
Item 1. Financial Statements	
<u>Consolidated Balance Sheets as of June 30, 2008 (unaudited) and December 31, 2007</u>	1
The following statements are presented on a combined basis prior to the date of Fortress's reorganization (Note 1) on January 17, 2007 and consolidated thereafter:	
<u>Statements of Operations (unaudited) for the three and six months ended June 30, 2008 and 2007</u>	2
<u>Statement of Shareholders' Equity (unaudited) for the six months ended June 30, 2008</u>	3
<u>Statements of Cash Flows (unaudited) for the six months ended June 30, 2008 and 2007</u>	4
<u>Notes to Consolidated and Combined Financial Statements (unaudited)</u>	5
Item 2. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	36
Item 3. <u>Quantitative and Qualitative Disclosures About Market Risk</u>	62
Item 4. <u>Controls and Procedures</u>	65
<b>PART II. OTHER INFORMATION</b>	
Item 1. <u>Legal Proceedings</u>	65
Item 1A. <u>Risk Factors</u>	66
Item 2. <u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	90
Item 3. <u>Defaults upon Senior Securities</u>	90
Item 4. <u>Submission of Matters to a Vote of Security Holders</u>	90
Item 5. <u>Other Information</u>	90
Item 6. <u>Exhibits</u>	91
<u>SIGNATURES</u>	92

## **Table of Contents**

### **DEFINED TERMS**

As used in this Quarterly Report on Form 10-Q, unless the context otherwise requires:

Management Fee Paying Assets Under Management, or AUM, refers to the management fee paying assets we manage, including, as applicable, capital we have the right to call from our investors pursuant to their capital commitments to various funds. Our AUM equals the sum of:

- (i) the capital commitments or invested capital (or NAV, if lower) of our private equity funds, depending on which measure management fees are being calculated upon at a given point in time, which in connection with funds raised after March 2006 includes the mark-to-market value of public securities held within the funds;
- (ii) the contributed capital of our publicly traded alternative investment vehicles, which we refer to as our Castles ;
- (iii) the net asset value, or NAV, of our hedge funds; and
- (iv) the NAV of our managed accounts, to the extent management fees are charged.

For each of the above, the amounts exclude assets under management for which we charge either no or nominal fees, generally related to our principal investments in funds as well as investments in funds by our principals, directors and employees.

Our calculation of AUM may differ from the calculations of other asset managers and, as a result, this measure may not be comparable to similar measures presented by other asset managers. Our definition of AUM is not based on any definition of assets under management contained in our operating agreement or in any of our Fortress Fund management agreements.

Fortress, we, us, our, and the company refer, (i) following the consummation of the reorganization and the Nomura transaction on January 17, 2007, collectively, to Fortress Investment Group LLC and its subsidiaries, including the Fortress Operating Group and all of its subsidiaries, and, (ii) prior to the consummation of the reorganization and the Nomura transaction on January 17, 2007, to the Fortress Operating Group and all of its subsidiaries, in each case not including funds that, prior to March 31, 2007, were consolidated funds, except with respect to our historical financial statements and discussion thereof unless otherwise specified. Effective March 31, 2007, all of our previously consolidated funds were deconsolidated. The financial statements contained herein represent consolidated financial statements of Fortress Investment Group LLC subsequent to the reorganization and combined financial statements of Fortress Operating Group, considered the predecessor, prior to the reorganization. See Part I, Item 1, Financial Statements.

Fortress Funds and our funds refers to the private investment funds and alternative asset companies that are managed by the Fortress Operating Group.

Fortress Operating Group refers to the combined entities, which were wholly-owned by the principals prior to the Nomura transaction and in each of which Fortress Investment Group LLC acquired an indirect controlling interest upon completion of the Nomura transaction.

principals or Principals refers to Peter Briger, Wesley Edens, Robert Kauffman, Randal Nardone and Michael Novogratz, collectively, who prior to the completion of our initial public offering and the Nomura transaction directly owned 100% of the Fortress Operating Group units and following completion of our initial public offering and the Nomura transaction own a majority of the Fortress Operating Group units and all of the Class B shares, representing a majority of the total combined voting power of all of our outstanding Class A and Class B shares. The principals' ownership percentage is subject to change based on, among other things, equity offerings by Fortress and dispositions by the principals.

### **SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS**

Some of the statements under Part I, Item 2, Management's Discussion and Analysis of Financial Condition and Results of Operations, Part I, Item 3, Quantitative and Qualitative Disclosures About Market Risk, Part II, Item 1A, Risk Factors, and elsewhere in this Quarterly Report on

## Edgar Filing: Fortress Investment Group LLC - Form 10-Q

Form 10-Q may contain forward-looking statements which reflect our current views with respect to, among other things, future events and financial performance. Readers can identify these forward-looking statements by the use of forward-looking words such as outlook, believes, expects, potential, continues, may, will, should, seeks, approximately, predicts, intends, plans, estimates, anticipates those words or other comparable words. Any forward-looking statements contained in this report are based upon the historical performance of us and our subsidiaries and on our current plans, estimates and expectations. The inclusion of this forward-looking information should not be regarded as a representation by us or any other person that the future plans, estimates or expectations contemplated by us will be achieved. Such forward-looking statements are subject to various risks and uncertainties and assumptions relating to our operations, financial results, financial condition, business prospects, growth strategy and liquidity. If one or more of these or other risks or uncertainties materialize, or if our underlying assumptions prove to be incorrect, our actual results may vary materially from those indicated in these statements. These factors should not be construed as exhaustive and should be read in conjunction with the other cautionary statements that are included in this report. We do not undertake any obligation to publicly update or review any forward-looking statement, whether as a result of new information, future developments or otherwise.

**Table of Contents****PART I. FINANCIAL INFORMATION****ITEM 1. FINANCIAL STATEMENTS  
FORTRESS INVESTMENT GROUP LLC**

(PRIOR TO JANUARY 17, 2007, FORTRESS OPERATING GROUP NOTE 1)

**CONSOLIDATED BALANCE SHEETS**

(dollars in thousands, except share data)

	June 30, 2008 (Unaudited)	December 31, 2007
<b>Assets</b>		
Cash and cash equivalents	\$ 255,155	\$ 100,409
Due from affiliates	141,765	198,669
Investments		
Equity method investees	961,123	1,091,918
Options in affiliates	871	16,001
Deferred tax asset	512,237	511,204
Other assets	72,684	71,580
	\$ 1,943,835	\$ 1,989,781
<b>Liabilities and Shareholders' Equity</b>		
<b>Liabilities</b>		
Accrued compensation and benefits	\$ 126,040	\$ 269,324
Due to affiliates	464,709	455,734
Dividends payable	21,286	21,285
Deferred incentive income	164,144	173,561
Debt obligations payable	800,000	535,000
Other liabilities	40,239	36,729
	1,616,418	1,491,633
<b>Commitments and Contingencies</b>		
<b>Principals and Others' Interests in Equity of Consolidated Subsidiaries</b>	173,104	308,023
<b>Shareholders' Equity</b>		
Class A shares, no par value, 1,000,000,000 shares authorized, 94,604,806 and 94,597,646 shares issued and outstanding at June 30, 2008 and December 31, 2007, respectively		
Class B shares, no par value, 750,000,000 shares authorized, 312,071,550 shares issued and outstanding		
Paid-in capital	469,319	384,700
Retained earnings (accumulated deficit)	(315,564)	(193,200)
Accumulated other comprehensive income (loss)	558	(1,375)
	154,313	190,125
	\$ 1,943,835	\$ 1,989,781

See notes to consolidated and combined financial statements



**Table of Contents****FORTRESS INVESTMENT GROUP LLC**

(PRIOR TO JANUARY 17, 2007, FORTRESS OPERATING GROUP NOTE 1)

**CONSOLIDATED AND COMBINED STATEMENTS OF OPERATIONS (Unaudited)**

(dollars in thousands, except share data)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2008	2007	2008	2007
<b>Revenues</b>				
Management fees from affiliates	\$ 149,605	\$ 118,678	\$ 293,662	\$ 161,965
Incentive income from affiliates	18,300	132,961	55,444	177,189
Other revenues (affiliate portion disclosed in Note 6)	20,191	16,480	39,870	36,265
Interest and dividend income - investment company holdings				
Interest income				243,713
Interest income from controlled affiliate investments				4,707
Dividend income				7,436
Dividend income from controlled affiliate investments				53,174
	188,096	268,119	388,976	684,449
<b>Expenses</b>				
Interest expense				132,620
Investment company holdings				18,731
Other	9,888	6,711	20,224	18,731
Compensation and benefits	137,460	187,783	264,479	405,300
Principals agreement compensation	237,367	242,659	474,734	380,933
General, administrative and other	19,746	23,603	36,316	62,908
Depreciation and amortization	2,436	2,184	4,872	4,193
	406,897	462,940	800,625	1,004,685
<b>Other Income (Loss)</b>				
Gains (losses) from investments				
Investment company holdings				86,264
Net realized gains (losses)				715,024
Net realized gains (losses) from controlled affiliate investments				(19,928)
Net unrealized gains (losses)				(1,428,837)
Net unrealized gains (losses) from controlled affiliate investments				
Other investments				
Net realized gains (losses)	61	(1,735)	1,674	54
Net realized gains (losses) from affiliate investments	(92)	9,452	155	145,493
Net unrealized gains (losses)		(396)		(677)
Net unrealized gains (losses) from affiliate investments	(6,584)	(36,338)	(36,401)	(167,166)
Earnings (losses) from equity method investees	(26,500)	7,231	(75,629)	7,427
	(33,115)	(21,786)	(110,201)	(662,346)
<b>Income (Loss) Before Deferred Incentive Income, Principals and Others Interests in Income of Consolidated Subsidiaries and Income Taxes</b>				
	(251,916)	(216,607)	(521,850)	(982,582)
Deferred incentive income				307,034



## Edgar Filing: Fortress Investment Group LLC - Form 10-Q

Principals and others interests in (income) loss of consolidated subsidiaries	194,411	166,485	402,680	702,016
<b>Income (Loss) Before Income Taxes</b>	(57,505)	(50,122)	(119,170)	26,468
Income tax benefit (expense)	1,949	(5,009)	(5,303)	(19,456)
<b>Net Income (Loss)</b>	\$ (55,556)	\$ (55,131)	\$ (124,473)	\$ 7,012
<b>Dividends declared per Class A share</b>	\$ 0.2250	\$ 0.2250	\$ 0.4500	\$ 0.3924

	<b>January 1 through January 16</b>
<u>Earnings Per Unit - Fortress Operating Group</u>	
Net income per Fortress Operating Group unit	\$ 0.36
<u>Weighted average number of Fortress Operating Group units outstanding</u>	367,143,000

	<b>January 17 through June 30</b>
<u>Earnings Per Class A share - Fortress Investment Group</u>	
Net income (loss) per Class A share, basic	\$ (0.62) \$ (0.59) \$ (1.36) \$ (1.43)
Net income (loss) per Class A share, diluted	\$ (0.67) \$ (0.66) \$ (1.37) \$ (1.43)
<u>Weighted average number of Class A shares outstanding, basic</u>	94,913,677 94,894,636 94,904,157 89,226,434
<u>Weighted average number of Class A shares outstanding, diluted</u>	406,985,227 406,966,186 406,975,707 89,226,434

See notes to consolidated and combined financial statements

**Table of Contents****FORTRESS INVESTMENT GROUP LLC**

(PRIOR TO JANUARY 17, 2007, FORTRESS OPERATING GROUP NOTE 1)

**CONSOLIDATED AND COMBINED STATEMENT OF SHAREHOLDERS EQUITY (Unaudited)**

FOR THE SIX MONTHS ENDED JUNE 30, 2008

(dollars in thousands)

	Class A Shares	Class B Shares	Paid-In Capital	Retained Earnings (Accumulated Deficit)	Accumulated Other Comprehensive Income (Loss)	Total Shareholders Equity
<b>Shareholders Equity - December 31, 2007</b>	94,597,646	312,071,550	\$ 384,700	\$ (193,200)	\$ (1,375)	\$ 190,125
Director restricted share grant	7,160		164			164
Dividends declared			(42,572)			(42,572)
Capital increase related to equity-based compensation			129,286			129,286
Dividend and distribution equivalents accrued in connection with equity-based compensation (net of tax)			(2,259)			(2,259)
Cumulative effect adjustment - adoption of SFAS 159 (Note 3)				2,109	1,212	3,321
Comprehensive income (loss) (net of tax)						
Net income (loss)				(124,473)		(124,473)
Foreign currency translation					95	95
Comprehensive income (loss) from equity method investees					274	274
Allocation to Principals and others interests in equity of consolidated subsidiaries					352	352
Total comprehensive income (loss)						(123,752)
<b>Shareholders Equity - June 30, 2008</b>	94,604,806	312,071,550	\$ 469,319	\$ (315,564)	\$ 558	\$ 154,313

See notes to consolidated and combined financial statements

**Table of Contents****FORTRESS INVESTMENT GROUP LLC**

(PRIOR TO JANUARY 17, 2007, FORTRESS OPERATING GROUP NOTE 1)

**CONSOLIDATED AND COMBINED STATEMENT OF CASH FLOWS (Unaudited)**

(dollars in thousands)

	<b>Six Months Ended June 30,</b>	
	<b>2008</b>	<b>2007</b>
<b>Cash Flows From Operating Activities</b>		
Net income (loss)	\$ (124,473)	\$ 7,012
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities		
Depreciation and amortization	4,872	4,193
Other amortization and accretion	1,420	1,275
(Earnings) losses from equity method investees	75,629	(7,427)
Distributions of earnings from equity method investees	2,792	4,211
(Gains) losses from investments	34,572	669,773
Deferred incentive income	(35,494)	(311,174)
Principals and others interests in income (loss) of consolidated subsidiaries	(402,680)	(702,016)
Deferred tax (benefit) expense	(3,434)	2,484
Options received from affiliates		(2,006)
Assignments of options to employees		1,717
Equity-based compensation	556,131	445,233
Cash flows due to changes in		
Cash held at consolidated subsidiaries and restricted cash		(166,199)
Due from affiliates	14,841	186,215
Receivables from brokers and counterparties and other assets	902	(9,106)
Accrued compensation and benefits	(124,550)	72,733
Due to affiliates	(1,066)	(8,380)
Deferred incentive income	26,077	
Due to brokers and counterparties and other liabilities	7,634	65,592
Investment company holdings		
Purchases of investments		(5,105,865)
Proceeds from sale of investments		3,398,739
Net cash provided by (used in) operating activities	33,173	(1,452,996)
<b>Cash Flows From Investing Activities</b>		
Proceeds from sale of other loan and security investments		317
Contributions to equity method investees	(82,343)	(58,004)
Distributions of capital from equity method investees	182,072	39,906
Proceeds from sale of equity method investments		29,071
Cash received on settlement of derivatives		132
Purchase of fixed assets	(3,906)	(7,136)
Proceeds from disposal of fixed assets	53	
Net cash provided by (used in) investing activities	95,876	4,286
<b>Cash Flows From Financing Activities</b>		
Borrowings under debt obligations	450,000	1,924,070
Repayments of debt obligations	(185,000)	(2,010,025)
Payment of deferred financing costs	(5,060)	(6,656)
Issuance of Class A shares to Nomura		888,000

## Edgar Filing: Fortress Investment Group LLC - Form 10-Q

Issuance of Class A shares in initial public offering		729,435
Costs related to initial public offering		(76,766)
Dividends and dividend equivalents paid	(52,821)	(16,542)
Fortress Operating Group capital distributions to Principals		(219,112)
Purchase of Fortress Operating Group units from Principals		(888,000)
Principals and others interests in equity of consolidated subsidiaries - contributions	145	3,193,618
Principals and others interests in equity of consolidated subsidiaries - distributions	(181,567)	(1,808,987)
Net cash provided by (used in) financing activities	25,697	1,709,035
<b>Net Increase (Decrease) in Cash and Cash Equivalents</b>	<b>154,746</b>	<b>260,325</b>
<b>Cash and Cash Equivalents, Beginning of Period</b>	<b>100,409</b>	<b>61,120</b>
<b>Cash and Cash Equivalents, End of Period</b>	<b>\$ 255,155</b>	<b>\$ 321,445</b>
<b>Supplemental Disclosure of Cash Flow Information</b>		
Cash paid during the period for interest (excluding interest paid by master funds while such funds were consolidated of \$85.1 million in 2007)	\$ 16,790	\$ 63,944
Cash paid during the period for income taxes	\$ 5,637	\$ 28,407
<b>Supplemental Schedule of Non-cash Investing and Financing Activities</b>		
Employee compensation invested directly in subsidiaries	\$ 24,716	\$ 15,072
Investments of receivable amounts into Fortress Funds	\$ 43,355	\$ 36,747
Dividends, dividend equivalents and Fortress Operating Group unit distributions declared but not yet paid	\$ 103,776	\$ 47,272
Fortress Operating Group pre-IPO distributions of investments to Principals	\$	\$ 196,764
Fortress Operating Group pre-IPO distributions of investments to employees	\$	\$ 23,238
See Note 1 regarding the non-cash deconsolidation transaction in 2007		
See notes to consolidated and combined financial statements		

**Table of Contents**

**FORTRESS INVESTMENT GROUP LLC**

(PRIOR TO JANUARY 17, 2007, FORTRESS OPERATING GROUP NOTE 1)

**NOTES TO CONSOLIDATED AND COMBINED FINANCIAL STATEMENTS (Unaudited)**

JUNE 30, 2008

(dollars in tables in thousands, except share data)

**1. ORGANIZATION AND BASIS OF PRESENTATION**

Fortress Investment Group LLC (the Registrant, or, together with its subsidiaries, Fortress ) is a global alternative asset management firm whose predecessor was founded in 1998. Its primary business is to sponsor the formation of, and provide investment management services for, various investment funds and companies (the Fortress Funds ). Fortress generally makes principal investments in these funds.

Fortress has three primary sources of income from the Fortress Funds: management fees, incentive income, and investment income on its principal investments in the funds. The Fortress Funds fall into the following business segments in which Fortress operates:

- 1) Private equity funds:
  - a) Funds which invest in debt and equity securities of public or privately held entities; and
  - b) Publicly traded alternative investment vehicles that Fortress refers to as the Castles, which are companies that invest in operating real estate and real estate related loans and securities (debt and equity).
- 2) Hedge funds:
  - a) Liquid hedge funds, which invest in the global fixed income, commodities, currency and equity markets, and their related derivatives; and
  - b) Hybrid hedge funds, which invest in undervalued, distressed and other less liquid investments, as well as investment funds managed by external managers.
- 3) Principal investments in the above described funds.

The accompanying consolidated and combined financial statements include the following:

subsequent to Fortress's reorganization and the inception of operations of Fortress Investment Group LLC on January 17, 2007, the accounts of Fortress Investment Group LLC and its consolidated subsidiaries, and

## Edgar Filing: Fortress Investment Group LLC - Form 10-Q

prior to such reorganization and the inception of operations of Fortress Investment Group LLC, the accounts of eight affiliated entities under common control and management ( Fortress Operating Group or the predecessor ) and their respective consolidated subsidiaries. Each of the eight entities was owned either directly or indirectly by its members, Peter Briger, Wesley Edens, Robert Kauffman, Randal Nardone, and Michael Novogratz (the Principals ).

### ***Reorganization of Fortress Operating Group***

Fortress Investment Group LLC was formed on November 6, 2006 for the purpose of becoming the general partner of Fortress Operating Group, completing the Nomura Transaction (described below), and effecting a public offering of shares and related transactions (the Transactions ) in order to carry on the business of its predecessor, Fortress Operating Group, as a publicly traded entity. The Registrant is a limited liability company and its members are not responsible for any of its liabilities beyond the equity they have invested. Fortress s formation documents allow for an indefinite life.

### ***Nomura Transaction***

In December 2006, the Principals entered into a securities purchase agreement with Nomura Investment Managers U.S.A., Inc., or Nomura (whose ultimate parent is Nomura Holdings, Inc., a Japanese corporation). On January 17, 2007, Nomura completed the transaction by purchasing 55,071,450 Class A shares of the Registrant for \$888 million and the Registrant, in turn, purchased 55,071,450 Fortress Operating Group units, which then represented 15% of Fortress Operating Group s economic interests, from the Principals for \$888 million.

### ***Initial Public Offering ( IPO )***

On February 8, 2007, the Registrant completed an initial public offering of 39,428,900 of its Class A shares for net proceeds of approximately \$652.7 million.

### ***Consolidation and Deconsolidation of Fortress Funds***

Certain of the Fortress Funds were consolidated into Fortress prior to the Transactions, notwithstanding the fact that Fortress has only a minority economic interest in these funds. Consequently, Fortress s financial statements reflected the assets, liabilities, revenues, expenses and cash flows of the consolidated Fortress Funds on a gross basis through the date of their deconsolidation, as described below. The majority ownership interests in these funds, which are not owned by Fortress, were reflected as Principals and others interests in equity of consolidated subsidiaries in the accompanying financial statements during periods in which such funds were consolidated. The management fees and incentive income earned by Fortress from the consolidated

**Table of Contents****FORTRESS INVESTMENT GROUP LLC**

(PRIOR TO JANUARY 17, 2007, FORTRESS OPERATING GROUP NOTE 1)

**NOTES TO CONSOLIDATED AND COMBINED FINANCIAL STATEMENTS (Unaudited)**

JUNE 30, 2008

(dollars in tables in thousands, except share data)

Fortress Funds were eliminated in consolidation; however, Fortress's allocated share of the net income from these funds was increased by the amount of these eliminated fees. Accordingly, the consolidation of these Fortress Funds had no net effect on Fortress's earnings from the Fortress Funds.

Following the IPO, each Fortress subsidiary that acts as a general partner of a consolidated Fortress Fund granted rights, effective March 31, 2007, to the investors in the fund to provide that a simple majority of the fund's unrelated investors are able to liquidate the fund, without cause, in accordance with certain procedures, or to otherwise have the ability to exert control over the fund. The granting of these rights has led to the deconsolidation of the Fortress Funds from Fortress's financial statements as of March 31, 2007. The deconsolidation of the Fortress Funds has had significant effects on many of the items within these financial statements but has had no net effect on net income or equity. Since the deconsolidation did not occur until March 31, 2007, the statement of operations and the statement of cash flows for the six months ended June 30, 2007 are presented with these funds on a consolidated basis for the period prior to the deconsolidation. The unaudited pro forma effects of the deconsolidation on these financial statements are described in Note 12.

The accompanying consolidated and combined financial statements and related notes of Fortress have been prepared in accordance with accounting principles generally accepted in the United States for interim financial reporting and the instructions to Form 10-Q and Rule 10-01 of Regulation S-X. Accordingly, certain information and footnote disclosures normally included in financial statements prepared under U.S. generally accepted accounting principles have been condensed or omitted. In the opinion of management, all adjustments considered necessary for a fair presentation of Fortress's financial position, results of operations and cash flows have been included and are of a normal and recurring nature. The operating results presented for interim periods are not necessarily indicative of the results that may be expected for any other interim period or for the entire year. These financial statements should be read in conjunction with Fortress's consolidated and combined financial statements for the year ended December 31, 2007 and notes thereto included in Fortress's annual report on Form 10-K filed with the Securities and Exchange Commission. Capitalized terms used herein, and not otherwise defined, are defined in Fortress's consolidated and combined financial statements for the year ended December 31, 2007.

Certain prior period amounts have been reclassified to conform to the current period's presentation.

**2. MANAGEMENT AGREEMENTS AND FORTRESS FUNDS*****Management Fees, Incentive Income and Related Profit Sharing Expense***

Fortress recognized management fees and incentive income as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2008	2007	2008	2007(A)
Private Equity Funds				
Management fees	\$ 42,588	\$ 35,630	\$ 84,405	\$ 62,294
Incentive income	3,535	5,502	38,175	211,942
Castles				
Management fees	13,136	11,966	26,073	22,995
Management fees- options		1,195		2,006
Incentive income		14,217	12	17,905
Hedge Funds				

## Edgar Filing: Fortress Investment Group LLC - Form 10-Q

Liquid Hedge Funds				
Management fees	57,542	38,204	110,189	68,062
Incentive income	14,346	112,512	16,838	158,199
Hybrid Hedge Funds				
Management fees	36,339	31,683	72,995	59,680
Incentive income	419	730	419	825
Total				
Management fees	\$ 149,605	\$ 118,678	\$ 293,662	\$ 215,037
Incentive income	\$ 18,300	\$ 132,961	\$ 55,444	\$ 388,871

(A) Presented on a pro forma basis (Note 12), as adjusted for the deconsolidation of the Fortress Funds as if it has occurred on January 1, 2007.



**Table of Contents****FORTRESS INVESTMENT GROUP LLC**

(PRIOR TO JANUARY 17, 2007, FORTRESS OPERATING GROUP NOTE 1)

**NOTES TO CONSOLIDATED AND COMBINED FINANCIAL STATEMENTS (Unaudited)**

JUNE 30, 2008

(dollars in tables in thousands, except share data)

**Incentive Income Subject to Annual Performance Criteria**

Incentive income from certain Fortress Funds is earned based on achieving annual performance criteria. Accordingly, this incentive income is recorded as revenue at year end (in the fourth quarter of each year) and has not been recognized for these funds during the six months ended June 30, 2008 and 2007. If the amount of incentive income contingent on achieving annual performance criteria was not contingent on the results of the subsequent quarters, \$0.0 million and \$83.4 million of additional incentive income from affiliates would have been recognized during the six months ended June 30, 2008 and 2007, respectively. Incentive income based on achieving annual performance criteria that has not yet been recognized is included as undistributed deferred incentive income in the table below.

Deferred incentive income from the Fortress Funds, subject to contingent repayment, was comprised of the following, on an inception to date basis:

	<b>June 30, 2008</b>	<b>December 31, 2007</b>
Distributed - gross	\$ 470,798	\$ 444,721
Less: Recognized (A)	(306,654)	(271,160)
Distributed - unrecognized	\$ 164,144	\$ 173,561
Undistributed, net (B)	63,858	384,520
<b>Total</b>	<b>\$ 228,002</b>	<b>\$ 558,081</b>

(A) All related contingencies have been resolved.

(B) On a deconsolidated basis, subsequent to March 31, 2007, undistributed incentive income is no longer recorded and is not reflected on the balance sheet. At June 30, 2008, the undistributed incentive income is comprised of \$147.4 million of gross undistributed incentive income, net of \$83.5 million of previously distributed incentive income that would be returned by Fortress to the related funds if such funds were liquidated on June 30, 2008 at their net asset values.

From inception to June 30, 2008, Fortress has recognized and paid compensation expense under its employee profit sharing arrangements in connection with the \$470.8 million of distributed incentive income. If the \$63.9 million of undistributed incentive income were realized, Fortress would recognize and pay an additional \$28.5 million of compensation expense.

The change in deferred incentive income is summarized as follows:

Distributed	Undistributed	Total
-------------	---------------	-------

## Edgar Filing: Fortress Investment Group LLC - Form 10-Q

Deferred incentive income as of December 31, 2007	\$ 173,561	\$ 384,520	\$ 558,081
Share of income (loss) of Fortress Funds	26,077	(320,662)	(294,585)
Recognition of previously deferred incentive income	(35,494)		(35,494)
Deferred incentive income as of June 30, 2008	\$ 164,144	\$ 63,858	\$ 228,002

Recognized profit sharing compensation expense is summarized as follows (see Note 7 regarding Fortress's compensation expense):

	<b>Three Months Ended June 30,</b>		<b>Six Months Ended June 30,</b>	
	<b>2008</b>	<b>2007</b>	<b>2008</b>	<b>2007</b>
Private equity funds	\$ 1,146	\$ 20,692	\$ 2,544	\$ 92,445
Castles	1,175	4,518	2,341	6,874
Liquid hedge funds	16,119	58,499	33,117	87,446
Hybrid hedge funds	1,651	18,728	3,706	38,246
<b>Total</b>	<b>\$ 20,091</b>	<b>\$ 102,437</b>	<b>\$ 41,708</b>	<b>\$ 225,011</b>

**Table of Contents****FORTRESS INVESTMENT GROUP LLC**

(PRIOR TO JANUARY 17, 2007, FORTRESS OPERATING GROUP NOTE 1)

**NOTES TO CONSOLIDATED AND COMBINED FINANCIAL STATEMENTS (Unaudited)**

JUNE 30, 2008

(dollars in tables in thousands, except share data)

**Principals and Others Interests in Consolidated Subsidiaries**

This balance sheet caption was comprised of the following:

	June 30, 2008	December 31, 2007
Principals Fortress Operating Group units	\$ 120,278	\$ 232,826
Employee interests in majority owned and controlled fund advisor and general partner entities	52,650	75,062
Other	176	135
Total	\$ 173,104	\$ 308,023

This statement of operations caption was comprised of shares of consolidated net income related to the following, on a pre-tax basis:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2008 Actual	2007 Actual	2008 Actual	2007 Actual
Principals Fortress Operating Group units	\$ (194,714)	\$ (169,759)	\$ (403,590)	\$ (247,401)
Employee interests in majority owned and controlled fund advisor and general partner entities	303	3,158	442	6,000
Third party investors in Fortress Funds				(460,615)
Other		116	468	
Total	\$ (194,411)	\$ (166,485)	\$ (402,680)	\$ (702,016)

**Private Equity Funds**

In 2008, Fortress made an additional \$100 million commitment to Fund V. Fortress's affiliates, including employees and the Principals, made additional commitments to this fund of \$67.3 million at the same time.

During the six months ended June 30, 2008, Fortress formed new private equity funds which had capital commitments as follows:

Fortress's commitments	\$ 24,327
Fortress's affiliates' commitments	24,950
Third party investors' commitments	2,431,575
Total capital commitments	\$ 2,480,852

*Liquid Hedge Funds and Hybrid Hedge Funds*

During the six months ended June 30, 2008, Fortress formed new hedge funds with net asset values as follows:

	<b>June 30, 2008 NAV</b>	
	<b>Liquid</b>	<b>Hybrid</b>
Fortress (A)	\$ 15,719	\$
Fortress's affiliates	503,408	
Third party investors	1,206,976	
 Total NAV	 \$ 1,726,103	 \$

(A) Includes a second quarter incentive income allocation of \$14.6 million.

**Table of Contents****FORTRESS INVESTMENT GROUP LLC**

(PRIOR TO JANUARY 17, 2007, FORTRESS OPERATING GROUP NOTE 1)

**NOTES TO CONSOLIDATED AND COMBINED FINANCIAL STATEMENTS (Unaudited)**

JUNE 30, 2008

(dollars in tables in thousands, except share data)

**3. INVESTMENTS IN EQUITY METHOD INVESTEES AND OTHER EQUITY INVESTMENTS**

Fortress elected to record its investments in and options from Newcastle and Eurocastle at fair value pursuant to SFAS 159 ( The Fair Value Option For Financial Assets and Financial Liabilities ) beginning January 1, 2008. Fortress made this election to simplify its accounting for these publicly traded equity securities (and related options), which were previously recorded based on the equity method of accounting. As a result, Fortress recorded an aggregate increase to the carrying amounts of these assets of \$22.9 million, which was recorded as a cumulative effect adjustment to retained earnings (\$2.1 million) and also impacted the Principals' interests in the equity of consolidated subsidiaries (Fortress Operating Group) (\$17.6 million), deferred tax assets (\$1.9 million), and accumulated other comprehensive income (\$1.2 million). Fortress accounts for dividends received from these investments as dividend income, a component of Other Revenues.

***Investments in Equity Method Investees***

Fortress holds investments in certain unconsolidated Fortress Funds which are recorded based on the equity method of accounting. Upon the deconsolidation of the consolidated Fortress Funds on March 31, 2007 (Note 1), these funds also became equity method investees. Fortress's maximum exposure to loss with respect to these entities is generally equal to its investment plus its basis in any options received from such entities as described below. In addition, unconsolidated affiliates also hold an ownership interests in certain of these entities. Summary financial information related to these investments is as follows:

	Fortress's Investment		Fortress's Equity in Net Income (Loss)			
	June 30, 2008	December 31, 2007	Three Months Ended June 30, 2008	Three Months Ended June 30, 2007	Six Months Ended June 30, 2008	Six Months Ended June 30, 2007
Private equity funds, excluding NIH (A)	\$ 634,879	\$ 623,830	\$ (27,968)	\$ (8,024)	\$ (68,297)	\$ (8,024)
NIH	4,540	5,770	(178)	(843)	881	(1,024)
Newcastle (B)	7,190	3,184	N/A	460	N/A	1,189
Eurocastle (B)	9,690	11,799	N/A	309	N/A	(89)
<b>Total private equity</b>	<b>656,299</b>	<b>644,583</b>	<b>(28,146)</b>	<b>(8,098)</b>	<b>(67,416)</b>	<b>(7,948)</b>
Liquid hedge funds (A)	42,101	73,748	(412)	3,993	551	3,993
Hybrid hedge funds (A)	260,148	371,310	2,048	11,335	(8,775)	11,335
Other	2,575	2,277	10	1	11	47
	<b>\$ 961,123</b>	<b>\$ 1,091,918</b>	<b>\$ (26,500)</b>	<b>\$ 7,231</b>	<b>\$ (75,629)</b>	<b>\$ 7,427</b>

(A) These entities were consolidated prior to March 31, 2007.

(B) Fortress elected to record these investments at fair value pursuant to SFAS 159 beginning on January 1, 2008. A summary of the changes in Fortress's investments in equity method investees is as follows:

Edgar Filing: Fortress Investment Group LLC - Form 10-Q

Six Months Ended June 30, 2008

	Private Equity Funds		Castles (A)		Liquid	Hybrid	Other	Total
	NIH	Other	Newcastle	Eurocastle	Hedge Funds	Hedge Funds		
Investment, beginning	\$ 5,770	\$ 623,830	\$ 3,184	\$ 11,799	\$ 73,748	\$ 371,310	\$ 2,277	\$ 1,091,918
Earnings from equity method investees	881	(68,297)	N/A	N/A	551	(8,775)	11	(75,629)
Other comprehensive income from equity method investees	(9)	3,322	N/A	N/A				3,313
Contributions to equity method investees		80,751	N/A	N/A	44,395	262	290	125,698
Distributions of earnings from equity method investees	(2,102)	(180)	N/A	N/A	(580)		(3)	(2,865)
Distributions of capital from equity method investees		(3,410)	N/A	N/A	(76,013)	(102,649)		(182,072)
Total distributions from equity method investees	(2,102)	(3,590)	N/A	N/A	(76,593)	(102,649)	(3)	(184,937)
Sale of investments		(1,137)						(1,137)
Mark to fair value - January 1, 2008 (B)	N/A	N/A	10,110	12,762	N/A	N/A	N/A	22,872
Mark to fair value - during period (C)	N/A	N/A	(6,104)	(16,872)	N/A	N/A	N/A	(22,976)
Translation adjustment				2,001				2,001
Investment, ending	\$ 4,540	\$ 634,879	\$ 7,190	\$ 9,690	\$ 42,101	\$ 260,148	\$ 2,575	\$ 961,123
Ending balance of undistributed earnings	\$ 1,430	\$	N/A	N/A	\$ 86	\$ 8,004	\$ 8	\$ 9,528

(A) Fortress elected to record the investments at fair value pursuant to SFAS 159 beginning on January 1, 2008.

(B) Recorded as a cumulative effect adjustment to Retained Earnings.

(C) Recorded to Other Investments Net Unrealized Gains (Losses) from Affiliate Investments.



Edgar Filing: Fortress Investment Group LLC - Form 10-Q

	<i>Newcastle Investment Corp.</i>		<i>Eurocastle Investment Ltd.</i>	
	<b>June 30, 2008</b>	<b>December 31, 2007</b>	<b>June 30, 2008</b>	<b>December 31, 2007</b>
Assets	\$ 6,216,307	\$ 8,037,770	\$ 10,875,509	\$ 10,713,687
Liabilities	(6,120,564)	(7,590,145)	(9,177,658)	(8,865,921)
Minority interest			(8)	(8)
Equity	\$ 95,743	\$ 447,625	\$ 1,697,843	\$ 1,847,758
Ownership, basic (A)	1.9%	1.9%	1.6%	1.6%
Ownership, diluted (A) (B)	4.7%	4.7%	9.8%	9.8%
Ownership by Fortress and affiliates, diluted (B)	15.3%	15.5%	29.9%	29.3%
Market value of shares owned (A) (C)	\$ 7,190	\$ 13,293	\$ 9,690	\$ 24,561
	<b>Six Months Ended June 30, 2008</b>	<b>June 30, 2007</b>	<b>Six Months Ended June 30, 2008</b>	<b>June 30, 2007</b>
Revenues and gains (losses) on investments	\$ 248,589	\$ 374,016	\$ 405,837	\$ 346,862
Expenses	(183,802)	(300,693)	(445,576)	(408,234)
Other income (loss)	(181,020)		37,808	51,564
Discontinued operations	(8,951)	(19)		
Preferred dividends	(6,751)	(5,890)		
Net Income (Loss)	\$ (131,935)	\$ 67,414	\$ (1,931)	\$ (9,808)
Fortress's equity in net income (loss)	N/A	\$ 1,189	N/A	\$ (89)

(A) Excludes ownership interests held by other Fortress Funds, the Principals, employees and other affiliates.

(B) Fully diluted ownership represents the percentage of outstanding common shares assuming that all options are exercised. Currently, all of the options are out of the money (that is, their strike price is below the current market price per share).

(C) Based on the closing price of the related shares and, if applicable, the foreign currency exchange rate on the last day of trading in the applicable period.





Edgar Filing: Fortress Investment Group LLC - Form 10-Q

\$ 871 \$ 16,001

**Investments in Variable Interest Entities**

As part of the deconsolidation of the consolidated Fortress Funds (Note 1), Fortress caused reconsideration events to occur in each of the variable interest entities in which it was deemed to be the primary beneficiary. As a result of these reconsideration events, Fortress is no longer considered the primary beneficiary of, and therefore does not consolidate, any of the variable interest entities in which it holds an interest. No reconsideration events occurred during the six months ended June 30, 2008 which caused a change in Fortress's accounting.

The following table presents information as of June 30, 2008 regarding entities formed during the six months ended June 30, 2008 that were determined to be VIEs in which Fortress holds a variable interest:

Business Segment	Fortress is not Primary Beneficiary		Notes
	Gross Assets	Fortress Investment (B)	
Private Equity Funds	\$ 1,107,144	\$ 404	(A)
Liquid Hedge Funds	\$ 313,977	\$ 95	

(A) Fortress's investment includes \$0.2 million of management fees receivable from the Private Equity Funds.

(B) Represents Fortress's maximum exposure to loss with respect to these entities.

**Fair Value of Financial Instruments**

The following table presents information regarding Fortress's financial instruments which are recorded at fair value:

	June 30, 2008 Fair Value	Valuation Method
Assets - Carried at Fair Value		
Newcastle and Eurocastle common shares	\$ 16,880	Level 1 - Quoted prices in active markets for identical assets
Newcastle and Eurocastle options	\$ 871	Level 2 - Lattice-based option valuation models using significant observable inputs

**Table of Contents****FORTRESS INVESTMENT GROUP LLC**

(PRIOR TO JANUARY 17, 2007, FORTRESS OPERATING GROUP NOTE 1)

**NOTES TO CONSOLIDATED AND COMBINED FINANCIAL STATEMENTS (Unaudited)**

JUNE 30, 2008

(dollars in tables in thousands, except share data)

**4. DEBT OBLIGATIONS**

Debt Obligation	Month Issued	Face Amount and Carrying Value		Contractual Interest Rate	Final Stated Maturity	June 30, 2008	
		June 30, 2008	December 31, 2007			Weighted Average Funding Cost (A)	Weighted Average Maturity (Years)
Credit agreement (B)							
Revolving debt (C)	May 2007	\$	\$ 185,000	LIBOR + 0.85% (D)	May 2012	0.00%	N/A
Term loan	May 2007	350,000	350,000	LIBOR + 0.85%	May 2012	3.66%	3.86
Delayed term loan	May 2007	450,000		LIBOR + 0.85%	May 2012	3.78%	1.67
<b>Total</b>		<b>\$ 800,000</b>	<b>\$ 535,000</b>			<b>3.73%</b>	<b>2.63</b>

(A) The weighted average funding cost is calculated based on the contractual interest rate (utilizing the most recently reset LIBOR rate) plus the amortization of deferred financing costs. The most recently reset LIBOR rate was 2.48%.

(B) Collateralized by substantially all of Fortress Operating Group's assets as well as Fortress Operating Group's rights to fees from the Fortress Funds and its equity interests therein.

(C) Approximately \$189 million was undrawn and available under the revolving debt facility as of June 30, 2008, including a \$25 million letter of credit subfacility of which \$11 million was utilized.

(D) Subject to unused commitment fees of 0.25% per annum.

In connection with the repayment of a portion of a prior term loan, \$2.0 million of deferred loan costs were written off to interest expense in February 2007. In May 2007, Fortress entered into a new credit agreement to refinance its existing credit agreement, reduce the amount of interest and other fees payable under its credit facilities, and increase the amount of funds available for investments.

On April 17, 2008, Fortress entered into an amendment to its credit agreement. The amendment, among other things, (i) permits Fortress to issue an unlimited amount of subordinated indebtedness with specified terms so long as 40% of the net proceeds are used to repay amounts outstanding under the credit agreement, (ii) increased the applicable rate on Eurodollar loans and letters of credit by 20 basis points (making the current rate LIBOR plus 0.85%) and the undrawn commitment fee by 5 basis points (making the current fee 0.25%), (iii) added an amortization schedule requiring Fortress to repay \$100 million of amounts outstanding under the agreement each year during the next three years (with the first payment due on January 15, 2009), (iv) modified the financial covenants by (a) replacing the EBITDA-based financial covenant with a Consolidated Leverage Ratio covenant, (b) increasing the minimum amount of management fee earning assets by \$3 billion to \$21.5 billion (which minimum amount increases annually by \$500 million) and (c) eliminating the annual \$50 million increase in required minimum investment assets, and (v) revised various definitions and clarified terms with respect to swap providers who are lenders under the agreement. In connection with this amendment, Fortress incurred \$4.9 million of deferred loan costs which were recorded in Other Assets. In addition, on

## Edgar Filing: Fortress Investment Group LLC - Form 10-Q

May 29, 2008, Fortress entered into an amendment to its credit agreement to change from a co-borrower structure to a single borrower structure.

Fortress was in compliance with all of its debt covenants as of June 30, 2008.

**Table of Contents****FORTRESS INVESTMENT GROUP LLC**

(PRIOR TO JANUARY 17, 2007, FORTRESS OPERATING GROUP NOTE 1)

**NOTES TO CONSOLIDATED AND COMBINED FINANCIAL STATEMENTS (Unaudited)**

JUNE 30, 2008

(dollars in tables in thousands, except share data)

**5. INCOME TAXES AND TAX RELATED PAYMENTS**

The provision for income taxes consists of the following:

	<b>Three Months Ended June 30,</b>		<b>Six Months Ended June 30,</b>	
	<b>2008</b>	<b>2007</b>	<b>2008</b>	<b>2007</b>
<u>Current</u>				
Federal income tax	\$ (660)	\$ (1,160)	\$ 1,994	\$ 5,055
Foreign income tax	562	360	1,199	1,066
State and local income tax	1,862	5,722	5,544	10,106
	1,764	4,922	8,737	16,227
<u>Deferred</u>				
Federal income tax expense (benefit)	(1,311)	5,060	(20)	11,068
Foreign income tax expense (benefit)	22	(219)	180	(733)
State and local income tax expense (benefit)	(2,424)	(4,754)	(3,594)	(7,106)
	(3,713)	87	(3,434)	3,229
<b>Total</b>	<b>\$ (1,949)</b>	<b>\$ 5,009</b>	<b>\$ 5,303</b>	<b>\$ 19,456</b>

The tax effects of temporary differences have resulted in deferred income tax assets and liabilities as follows:

	<b>June 30, 2008</b>	<b>December 31, 2007</b>
Deferred tax assets	\$ 512,237	\$ 511,204
Deferred tax liabilities (A)	\$ 778	\$ 891

**(A) Included in Other Liabilities**

For the six months ended June 30, 2008, an estimated annual negative effective tax rate of (4.45%) was used to compute the tax provision. Fortress incurred a loss before income taxes for financial reporting purposes, after deducting the compensation expense arising from the Principals' forfeiture agreement. However, this compensation expense is not deductible for income tax purposes. Also, a portion of Fortress' income is not subject to U.S. federal income tax, but is allocated directly to Fortress' shareholders. For the six months ended June 30, 2008, a deferred income tax provision of \$0.3 million was debited to other comprehensive income, primarily related to the equity method investees. A current income tax benefit of \$2.1 million was credited to additional paid in capital, related to (i) dividend equivalent payments on RSUs, and (ii) distributions to Fortress Operating Group restricted partnership unit holders (Note 7), which are currently deductible for income tax purposes.

***Tax Receivable Agreement***

Although the tax receivable agreement payments are calculated based on annual tax savings, for the six months ended June 30, 2008, the payments which would have been made pursuant to the tax receivable agreement, if such period was calculated by itself, were estimated to be \$8.4 million.

**Table of Contents****FORTRESS INVESTMENT GROUP LLC**

(PRIOR TO JANUARY 17, 2007, FORTRESS OPERATING GROUP NOTE 1)

**NOTES TO CONSOLIDATED AND COMBINED FINANCIAL STATEMENTS (Unaudited)**

JUNE 30, 2008

(dollars in tables in thousands, except share data)

**6. RELATED PARTY TRANSACTIONS**

Due from affiliates was comprised of the following:

June 30, 2008	Private Equity Funds	Castles	Liquid Hedge Funds	Hybrid Hedge Funds	Other	Total
Management fees and incentive income	\$ 6,194	\$ 10,595	\$ 14,911	\$ 1,857	\$	\$ 33,557
Expense reimbursements	3,657	4,419	5,542	3,784		17,402
Dividends and distributions		345				345
Other (A)	89,639			151	671	90,461
<b>Total</b>	<b>\$ 99,490</b>	<b>\$ 15,359</b>	<b>\$ 20,453</b>	<b>\$ 5,792</b>	<b>\$ 671</b>	<b>\$ 141,765</b>

December 31, 2007	Private Equity Funds	Castles	Liquid Hedge Funds	Hybrid Hedge Funds	Other	Total
Management fees and incentive income	\$ 1,733	\$ 45,004	\$ 40,751	\$ 98,197	\$	\$ 185,685
Expense reimbursements	1,307	2,051	3,074	3,487		9,919
Dividends and distributions		739				739
Other				1	2,325	2,326
<b>Total</b>	<b>\$ 3,040</b>	<b>\$ 47,794</b>	<b>\$ 43,825</b>	<b>\$ 101,685</b>	<b>\$ 2,325</b>	<b>\$ 198,669</b>

Due to affiliates was comprised of the following:

	June 30, 2008	December 31, 2007
<b>Principals</b>		
- Tax receivable agreement - Note 5	\$ 393,266	\$ 393,265
- Distributions payable on Fortress Operating Group units	70,216	60,176
Other	1,227	2,293
	<b>\$ 464,709</b>	<b>\$ 455,734</b>

(A) Includes an \$85 million loan to a newly formed fund. The loan was made to finance a fund investment prior to the fund's related capital call, was outstanding less than two weeks, and bore interest at 7.0%.

For the six months ended June 30, 2008 and 2007, Other Revenues included approximately \$31.2 million and \$20.5 million, respectively, of revenues from affiliates, primarily expense reimbursements. Dividend income from affiliates of approximately \$1.0 million was recorded during the six months ended June 30, 2008.

## Edgar Filing: Fortress Investment Group LLC - Form 10-Q

Fortress has entered into cost sharing arrangements with the Fortress Funds, including subleases of certain of its office space. Expenses borne by the Fortress Funds under these agreements are generally paid directly by those entities (i.e. they are generally not paid by Fortress and reimbursed). For the six months ended June 30, 2008 and 2007, these expenses, mainly related to subscriptions to market data services, approximated \$9.4 million and \$10.8 million, respectively.



**Table of Contents****FORTRESS INVESTMENT GROUP LLC**

(PRIOR TO JANUARY 17, 2007, FORTRESS OPERATING GROUP NOTE 1)

**NOTES TO CONSOLIDATED AND COMBINED FINANCIAL STATEMENTS (Unaudited)**

JUNE 30, 2008

(dollars in tables in thousands, except share data)

**7. EQUITY-BASED COMPENSATION**

The following tables present information regarding equity-based compensation during the six months ended June 30, 2008.

	Employees		RSUs		Restricted Shares Issued to Directors		RPU Employees	
	Number	Value (A)	Number	Value (A)	Number	Value (A)	Number	Value (A)
Outstanding as of December 31, 2007	43,215,535	\$ 16.74	9,318,968	\$ 15.22	97,296	\$ 18.50		\$
Issued	2,063,600	10.79	283,457	10.39	7,159	13.15	31,000,000	13.75
Forfeited	(1,603,015)	17.65	(345,069)	14.54				
Outstanding as of June 30, 2008 (B)	43,676,120	\$ 16.43	9,257,356	\$ 15.10	104,455	\$ 18.13	31,000,000	\$ 13.75

	Three Months Ended June 30,		Six Months Ended June 30,	
	2008	2007	2008	2007
Expense incurred (B)				
Employee RSUs	\$ 27,337	\$ 24,533	\$ 53,909	\$ 54,015
Non-Employee RSUs	5,421	4,664	5,411	8,478
Restricted Shares	150	149	299	233
LTIP	1,715	(251)	3,429	1,574
RPU	18,349		18,349	
Total equity-based compensation expense	\$ 52,972	\$ 29,095	\$ 81,397	\$ 64,300

(A) Represents the weighted average grant date estimated fair value per share or unit. The weighted average estimated fair value per unit as of June 30, 2008 for RSU awards granted to non-employees was \$9.45.

(B) In future periods, Fortress will recognize compensation expense on its non-vested equity based awards of \$1,027.7 million, with a weighted average recognition period of 4.6 years.

In April 2008, Fortress granted 31 million Fortress Operating Group ( FOG ) restricted partnership units ( RPUs ) to a senior employee. In connection with the grant of these interests, the employee receives partnership distribution equivalent payments on such units with economic effect as from January 1, 2008. The interests will vest into full capital interests in FOG units in three equal portions on the first business day of 2011, 2012 and 2013, respectively, subject to continued employment with Fortress. In connection with this grant, Fortress has reduced the employee's profit sharing interests in various Fortress Funds.

When Fortress records equity-based compensation expense, including that related to the Principals Agreement, it records a corresponding increase in capital. Of the total increase in capital during the six months ended June 30, 2008 from equity-based compensation arrangements of \$556.1 million, \$129.3 million increased Fortress's paid-in capital, as reflected in the Statement of Shareholders' Equity, and \$426.8 million

## Edgar Filing: Fortress Investment Group LLC - Form 10-Q

increased Principals' interests in equity of consolidated subsidiaries, corresponding to the Principals' interest in the equity-based compensation expense.

Fortress's total compensation and benefits expense, excluding Principals Agreement compensation, is comprised of the following:

	<b>Three Months Ended June 30,</b>		<b>Six Months Ended June 30,</b>	
	<b>2008</b>	<b>2007</b>	<b>2008</b>	<b>2007</b>
Equity-based compensation, per above	\$ 52,972	\$ 29,095	\$ 81,397	\$ 64,300
Profit-sharing expense, per Note 2	20,091	102,437	41,708	225,011
Discretionary bonuses	29,599	29,778	74,056	53,059
Other payroll, taxes and benefits	34,798	26,473	67,318	62,930
	<b>\$ 137,460</b>	<b>\$ 187,783</b>	<b>\$ 264,479</b>	<b>\$ 405,300</b>

**Table of Contents****FORTRESS INVESTMENT GROUP LLC**

(PRIOR TO JANUARY 17, 2007, FORTRESS OPERATING GROUP NOTE 1)

**NOTES TO CONSOLIDATED AND COMBINED FINANCIAL STATEMENTS (Unaudited)**

JUNE 30, 2008

(dollars in tables in thousands, except share data)

**8. EARNINGS PER SHARE AND DISTRIBUTIONS**

As a result of Fortress's reorganization in January 2007 (Note 1), Fortress has calculated its earnings per share for two different periods within the six months ended June 30, 2007. For the first period, prior to the reorganization on January 17, 2007, the calculation is based on the income and outstanding units of Fortress Operating Group, which were owned by the Principals, as if such units had been outstanding from the beginning of the period. For the second period, subsequent to the reorganization and commencement of operations of the Registrant, the calculation is based on the consolidated income of Fortress from January 17, 2007 through June 30, 2007 and the Class A shares outstanding for such period.

The computations of net income per Fortress Operating Group unit are set forth below:

	<b>January 1 through January 16, 2007</b>	
	<b>Basic</b>	<b>Diluted</b>
<b>Weighted average units outstanding</b>		
Fortress Operating Group units outstanding	367,143,000	367,143,000
<b>Total weighted average units outstanding</b>	<b>367,143,000</b>	<b>367,143,000</b>
<b>Net income per unit is calculated as follows:</b>		
Net income	\$ 133,397	\$ 133,397
Dilution in earnings of certain equity method investees		
<b>Net income available to Fortress Operating Group unitholders</b>	<b>\$ 133,397</b>	<b>\$ 133,397</b>
Weighted average units outstanding	367,143,000	367,143,000
<b>Net income per unit</b>	<b>\$ 0.36</b>	<b>\$ 0.36</b>

The computations of basic and diluted net income (loss) per Class A share are set forth below:

	<b>Three Months Ended June 30, 2007</b>		<b>January 17 through June 30, 2007</b>	
	<b>Basic</b>	<b>Diluted</b>	<b>Basic</b>	<b>Diluted</b>
<b>Weighted average shares outstanding</b>				
Class A shares outstanding	94,500,350	94,500,350	89,004,200	89,004,200
Fully vested restricted Class A share units with dividend equivalent rights	394,286	394,286	222,234	222,234
Fortress Operating Group units exchangeable into Fortress Investment Group LLC Class A shares (1)		312,071,550		
Class A restricted shares and Class A restricted share units granted to employees and directors (eligible for dividend and dividend equivalent payments) (2)				

## Edgar Filing: Fortress Investment Group LLC - Form 10-Q

Class A restricted share units granted to employees (not eligible for dividend and dividend equivalent payments) (3)

Total weighted average shares outstanding	94,894,636	406,966,186	89,226,434	89,226,434
<b>Basic and diluted net income (loss) per Class A share</b>				
Net income (loss)	\$ (55,131)	\$ (55,131)	\$ (126,385)	\$ (126,385)
Dividend equivalents declared on non-vested restricted Class A share units	(1,048)	(1,048)	(1,617)	(1,617)
<b>Dilution in earnings of certain equity method investees</b>				
Add back Principals and others interests in loss of Fortress Operating Group, net of assumed corporate income tax at enacted rates, attributable to Fortress Operating Group units exchangeable into Fortress Investment Group LLC Class A shares (1)		(212,759)		
Net income (loss) available to Class A shareholders	\$ (56,179)	\$ (268,938)	\$ (128,002)	\$ (128,002)
Weighted average shares outstanding	94,894,636	406,966,186	89,226,434	89,226,434
Basic and diluted net income (loss) per Class A share	\$ (0.59)	\$ (0.66)	\$ (1.43)	\$ (1.43)

**Table of Contents****FORTRESS INVESTMENT GROUP LLC**

(PRIOR TO JANUARY 17, 2007, FORTRESS OPERATING GROUP NOTE 1)

**NOTES TO CONSOLIDATED AND COMBINED FINANCIAL STATEMENTS (Unaudited)**

JUNE 30, 2008

(dollars in tables in thousands, except share data)

	Three Months Ended June 30, 2008		Six Months Ended June 30, 2008	
	Basic	Diluted	Basic	Diluted
<b>Weighted average shares outstanding</b>				
Class A shares outstanding	94,500,351	94,500,351	94,500,351	94,500,351
Fully vested restricted Class A share units with dividend equivalent rights	394,286	394,286	394,286	394,286
Fully vested restricted Class A shares	19,040	19,040	9,520	9,520
Fortress Operating Group units exchangeable into Fortress Investment Group LLC Class A shares (1)		312,071,550		312,071,550
Class A restricted shares and Class A restricted share units granted to employees and directors (eligible for dividend and dividend equivalent payments) (2)				
Class A restricted share units granted to employees (not eligible for dividend and dividend equivalent payments) (3)				
Total weighted average shares outstanding	94,913,677	406,985,227	94,904,157	406,975,707
<b>Basic and diluted net income (loss) per Class A share</b>				
Net income (loss)	\$ (55,556)	\$ (55,556)	\$ (124,473)	\$ (124,473)
Dilution in earnings due to RPU's treated as a participating security of Fortress Operating Group (4)	(2,040)	(2,040)	(1,987)	(1,987)
Dividend equivalents declared on non-vested restricted Class A shares and restricted Class A share units	(1,159)	(1,159)	(2,276)	(2,276)
Add back Principals and others interests in loss of Fortress Operating Group, net of assumed corporate income taxes at enacted rates, attributable to Fortress Operating Group units exchangeable into Fortress Investment Group LLC Class A shares (1)		(214,667)		(429,829)
Net income (loss) available to Class A shareholders	\$ (58,755)	\$ (273,422)	\$ (128,736)	\$ (558,565)
Weighted average shares outstanding	94,913,677	406,985,227	94,904,157	406,975,707
Basic and diluted net income (loss) per Class A share	\$ (0.62)	\$ (0.67)	\$ (1.36)	\$ (1.37)

- (1) The Fortress Operating Group units not held by Fortress (that is, those held by the Principals) are exchangeable into Class A shares on a one-to-one basis. These units are not included in the computation of basic earnings per share. These units enter into the computation of diluted net income (loss) per Class A share when the effect is dilutive using the if-converted method.

## Edgar Filing: Fortress Investment Group LLC - Form 10-Q

- (2) Restricted Class A shares granted to directors and certain restricted Class A share units granted to employees are eligible to receive dividend or dividend equivalent payments when dividends are declared and paid on our Class A shares and therefore participate fully in the results of our operations from the date they are granted. They are included in the computation of both basic and diluted earnings per Class A share using the two-class method for participating securities, except during periods of net losses.
- (3) Certain restricted Class A share units granted to employees are not entitled to dividend or dividend equivalent payments until they are vested and are therefore non-participating securities. These units are not included in the computation of basic earnings per share. They are included in the computation of diluted earnings per share when the effect is dilutive using the treasury stock method. As a result of the net loss incurred for the period, the effect of the units on the calculation is anti-dilutive for the periods. The weighted average restricted Class A share units which are not entitled to receive dividend or dividend equivalent payments outstanding were:

<b>Period</b>	<b>Share Units</b>
Three months ended:	
June 30, 2008	27,641,251
June 30, 2007	25,705,670
Six months ended June 30, 2008	27,729,198
Period from January 17, 2007 to June 30, 2007	21,993,462

- (4) Fortress Operating Group RPU's are eligible to receive partnership distribution equivalent payments when distributions are declared and paid on Fortress Operating Group units. The RPU's represent a participating security of Fortress Operating Group and the resulting dilution in Fortress Operating Group earnings available to Fortress is reflected in the computation of both basic and diluted earnings per Class A share using the method prescribed for securities issued by a subsidiary.

The Class B shares have no net income (loss) per share as they do not participate in Fortress's earnings (losses) or distributions. The Class B shares have no dividend or liquidation rights. Each Class B share, along with one Fortress Operating Group unit, can be exchanged for one Class A share, subject to certain limitations. The Class B shares have voting rights on a pari passu basis with the Class A shares. The number of Class B shares outstanding did not change subsequent to the IPO.

**Table of Contents****FORTRESS INVESTMENT GROUP LLC**

(PRIOR TO JANUARY 17, 2007, FORTRESS OPERATING GROUP NOTE 1)

**NOTES TO CONSOLIDATED AND COMBINED FINANCIAL STATEMENTS (Unaudited)**

JUNE 30, 2008

(dollars in tables in thousands, except share data)

Fortress's dividend paying shares and units were as follows:

	Weighted Average			
	Three Months Ended June 30,		Six Months Ended June 30,	
	2008	2007	2008	2007
Class A shares	94,500,351	94,500,350	94,500,351	81,136,426
Restricted Class A share units (A)	394,286	394,286	394,286	202,589
Restricted Class A shares	104,219	97,296	100,757	76,331
Restricted Class A share units	23,652,206	23,730,308	23,708,849	18,753,486
Fortress Operating Group units	312,071,550	312,071,550	312,071,550	316,939,744
Fortress Operating Group RPU's	25,208,791		12,604,396	
<b>Total</b>	<b>455,931,403</b>	<b>430,793,790</b>	<b>443,380,189</b>	<b>417,108,576</b>

	As of June 30, 2008	As of December 31, 2007
Class A shares	94,500,351	94,500,350
Restricted Class A share units (A)	394,286	394,286
Restricted Class A shares	104,455	97,296
Restricted Class A share units	24,171,891	23,906,779
Fortress Operating Group units	312,071,550	312,071,550
Fortress Operating Group RPU's	31,000,000	
<b>Total</b>	<b>462,242,533</b>	<b>430,970,261</b>

(A) Represents fully vested restricted Class A share units which are entitled to dividend equivalent payments.

Dividends and distributions during the six months ended June 30, 2008 are summarized as follows:

	Declared in Prior Year, Paid Current Year	Declared and Paid	Current Year Declared but not yet Paid	Total
Dividends on Class A Shares	\$ 21,285	\$ 21,286	\$ 21,286	\$ 42,572
Dividend equivalents on restricted Class A share units (A)	5,428	5,387	5,527	10,914
Distributions to Fortress Operating Group unit holders (Principals)	60,176	73,246	70,216	143,462
Distributions to Fortress Operating Group RPU holders (Note 7)			6,975	6,975
<b>Total distributions</b>	<b>\$ 86,889</b>	<b>\$ 99,919</b>	<b>\$ 104,004</b>	<b>\$ 203,923</b>

- (A) A portion of these dividend equivalents, related to RSUs expected to be forfeited, is included as compensation expense in the consolidated statement of operations and is therefore considered an operating cash flow.



**Table of Contents****FORTRESS INVESTMENT GROUP LLC**

(PRIOR TO JANUARY 17, 2007, FORTRESS OPERATING GROUP NOTE 1)

**NOTES TO CONSOLIDATED AND COMBINED FINANCIAL STATEMENTS (Unaudited)**

JUNE 30, 2008

(dollars in tables in thousands, except share data)

**9. COMMITMENTS AND CONTINGENCIES**

Other than as described below, Fortress's commitments and contingencies remain materially unchanged from December 31, 2007.

**Private Equity Fund Capital Commitments** Fortress has remaining capital commitments to certain of the Fortress Funds which aggregated \$183.3 million as of June 30, 2008. These commitments can be drawn by the funds on demand.

**Minimum Future Rentals** Fortress is a lessee under operating leases for office space located in New York, Atlanta, Charlotte, Chicago, Dallas, Frankfurt, Geneva, Hong Kong, London, Los Angeles, Munich, New Canaan, Rome, San Diego, San Francisco, Shanghai, Sydney, Tokyo, and Toronto.

Minimum future rent payments under these leases is as follows:

July 1 to December 31, 2008	\$ 9,124
2009	18,930
2010	15,087
2011	12,141
2012	10,508
2013	9,791
Thereafter	31,021
<b>Total</b>	<b>\$ 106,602</b>

Rent expense recognized on a straight-line basis during the six months ended June 30, 2008 and 2007 was \$9.3 million and \$7.4 million, respectively, and during the three months ended June 30, 2008 and 2007 was \$4.5 million and \$3.8 million, respectively, and was included in General, Administrative and Other Expense.

**Litigation** Fortress is, from time to time, a defendant in legal actions from transactions conducted in the ordinary course of business. Management, after consultation with legal counsel, believes the ultimate liability arising from such actions that existed as of June 30, 2008, if any, will not materially affect Fortress's results of operations, liquidity or financial position.

On September 15, 2005, a lawsuit captioned David T. Atkins et al. v. Apollo Real Estate Advisors, L.P. et al. was brought on behalf of current and former limited partners in certain investing partnerships related to the sale of certain facilities to Ventas Realty Limited Partnership ( Ventas ) against a number of defendants, including one of the Portfolio Companies and a subsidiary of Fortress ( FIG ). FIG was the investment manager of consolidated Fortress Funds that were controlling shareholders of the Portfolio Company during the relevant time periods. The suit alleges that the defendants improperly obtained certain rights with respect to such facilities from the investing partnerships. The plaintiffs have asked for damages in excess of \$100 million on each of nine counts, as to which FIG is a defendant on seven counts, including treble damages with respect to certain counts. On April 18, 2006, Fortress filed a motion to dismiss the claims with prejudice. On April 30, 2008, the court entered a memorandum and order granting the motion and dismissing the plaintiff's complaint in its entirety. The plaintiffs were granted a period of 30 days from April 30, 2008 in which to file an amended complaint, after which the parties entered into a preliminary settlement, which will be paid in its entirety by Brookdale.

## Edgar Filing: Fortress Investment Group LLC - Form 10-Q

In addition, in the ordinary course of business, the Fortress Funds are and can be both the defendant and the plaintiff in numerous actions with respect to bankruptcy, insolvency and other types of proceedings. Such lawsuits may involve claims that adversely affect the value of certain financial instruments owned by the Fortress Funds. Although the ultimate outcome of actions cannot be ascertained with certainty, Fortress believes that the resolution of any such actions will not have a material adverse effect on its financial condition, liquidity or results of operations.

---

**Table of Contents**

**FORTRESS INVESTMENT GROUP LLC**

(PRIOR TO JANUARY 17, 2007, FORTRESS OPERATING GROUP NOTE 1)

**NOTES TO CONSOLIDATED AND COMBINED FINANCIAL STATEMENTS (Unaudited)**

JUNE 30, 2008

(dollars in tables in thousands, except share data)

**10. SEGMENT REPORTING**

Fortress conducts its management and investment business through the following five primary segments: (i) private equity funds, (ii) Castles, (iii) liquid hedge funds, (iv) hybrid hedge funds, and (v) principal investments in these funds as well as cash that is available to be invested. These segments are differentiated based on their varying investment strategies. Due to the increased significance of the principal investments segment, it has been disaggregated from the other segments in this period and for all periods presented.

Distributable earnings for the existing Fortress businesses is equal to net income adjusted as follows:

Incentive Income

- (i) a. for Fortress Funds which are private equity funds, adding (a) incentive income paid (or declared as a distribution) to Fortress, less an applicable reserve for potential future clawbacks if the likelihood of a clawback is deemed greater than remote (net of the reversal of any prior such reserves that are no longer deemed necessary), minus (b) incentive income recorded in accordance with GAAP,
- b. for other Fortress Funds, at interim periods, adding (a) incentive income on an accrual basis as if the incentive income from these funds were payable on a quarterly basis, minus (b) incentive income recorded in accordance with GAAP,

Other Income

- (ii) with respect to income from certain principal investments and certain other interests that cannot be readily transferred or redeemed:
  - a. for equity method investments in the Castles (prior to 2008) and private equity funds as well as indirect equity method investments in hedge fund special investment accounts (which generally have investment profiles similar to private equity funds), treating these investments as cost basis investments by adding (a) realizations of income, primarily dividends, from these funds, minus (b) impairment with respect to these funds, if necessary, minus (c) equity method earnings (or losses) recorded in accordance with GAAP,
  - b. subtracting gains (or adding losses) on stock options held in the Castles,
  - c. subtracting unrealized gains (or adding unrealized losses) from consolidated private equity funds,
  - d.

## Edgar Filing: Fortress Investment Group LLC - Form 10-Q

subtracting unrealized gains (or adding unrealized losses) from the Castles subsequent to the election of the fair value option under SFAS 159,

- Expenses
- (iii) adding (a) proceeds from the sale of shares received pursuant to the exercise of stock options in certain of the Castles, in excess of their strike price, minus (b) management fee income recorded in accordance with GAAP in connection with the receipt of these options,
  - (iv) adding or subtracting, as necessary, the employee profit sharing in incentive income described in (i) above to match the timing of the expense with the revenue,
  - (v) adding back equity-based compensation expense (including Castle options assigned to employees, RSUs and RPU's (including the portion of related dividend and distribution equivalents recorded as compensation expense), restricted shares and the LTIP),
  - (vi) adding back compensation expense recorded in connection with the forfeiture arrangements entered into among the principals,
  - (vii) adding the income (or subtracting the loss) allocable to the interests in consolidated subsidiaries attributable to Fortress Operating Group units, and
  - (viii) adding back income tax expense and any expense recorded in connection with the tax receivable agreement (Note 5).
- Total segment assets are equal to total GAAP assets adjusted for:
- (i) the difference between the GAAP carrying amount of equity method investments and their carrying amount for segment reporting purposes, which is generally fair value for publicly traded investments and cost for nonpublic investments,
  - (ii) employee portions of investments, which are reported gross for GAAP purposes (as assets offset by Principals and others' interests in equity of consolidated subsidiaries) but net for segment reporting purposes, and
  - (iii) the difference between the GAAP carrying amount for options owned in certain of the Castles and their carrying amount for segment reporting purposes, which is intrinsic value.

Summary financial data on Fortress's segments is presented on the following pages, together with a reconciliation to revenues, assets and net income for Fortress as a whole. Fortress's investments in, and earnings from, its equity method investees by segment are presented in Note 3.

**Table of Contents****FORTRESS INVESTMENT GROUP LLC**

(PRIOR TO JANUARY 17, 2007, FORTRESS OPERATING GROUP NOTE 1)

**NOTES TO CONSOLIDATED AND COMBINED FINANCIAL STATEMENTS (Unaudited)**

JUNE 30, 2008

(dollars in tables in thousands, except share data)

	Private Equity Funds	Castles	Liquid Hedge Funds	Hybrid Hedge Funds	Principal Investments	Unallocated	Fortress Subtotal
<b>June 30, 2008 and the Six Months Then Ended</b>							
Segment revenues							
Management fees	\$ 84,330	\$ 27,655	\$ 110,325	\$ 73,455	\$	\$	\$ 295,765
Incentive income	28,741	12	17,040	872			46,665
Segment revenues - total	\$ 113,071	\$ 27,667	\$ 127,365	\$ 74,327	\$	\$	\$ 342,430
Pre-tax distributable earnings	\$ 81,886	\$ 8,204	\$ 45,426	\$ 11,279	\$ (30,656)	\$ 7	\$ 116,146
Total segment assets	\$ 10,023	\$ 16,741	\$ 20,452	\$ 5,474	\$ 1,351,895	\$ 588,506	\$ 1,993,091

(A)

	Fortress Subtotal	Reconciliation to GAAP	Fortress Consolidated
Revenues	\$ 342,430	\$ 46,546	\$ 388,976
Pre-tax distributable earnings / net income	\$ 116,146	\$ (240,619)	\$ (124,473)
Total assets	\$ 1,993,091	\$ (49,256)	\$ 1,943,835

(A) Unallocated assets include deferred tax assets of \$512.2 million.

**Table of Contents****FORTRESS INVESTMENT GROUP LLC**

(PRIOR TO JANUARY 17, 2007, FORTRESS OPERATING GROUP NOTE 1)

**NOTES TO CONSOLIDATED AND COMBINED FINANCIAL STATEMENTS (Unaudited)**

JUNE 30, 2008

(dollars in tables in thousands, except share data)

**June 30, 2008 and the Six Months Then Ended****Reconciling items between segment measures and GAAP measures:****Adjustments from segment revenues to GAAP revenues**

Adjust management fees*	\$ 325
Adjust incentive income	9,434
Adjust income from the receipt of options	
Other revenues*	36,787
Total adjustments	\$ 46,546

\* Segment revenues do not include GAAP other revenues; GAAP other revenues are included elsewhere in the calculation of distributable earnings.

**Adjustments from pre-tax distributable earnings to GAAP net income**

Adjust incentive income		
Incentive income received from private equity funds, subject to contingent repayment	\$ (26,077)	
Incentive income accrued from private equity funds, no longer subject to contingent repayment	35,494	
Incentive income received from private equity funds, not subject to contingent repayment	17	
Incentive income received from hedge funds, subject to annual performance achievement		
Reserve for clawback		9,434
Adjust other income		
Distributions of earnings from equity method investees**	(367)	
Earnings (losses) from equity method investees**	(67,483)	
Gains (losses) on options in equity method investees	(15,426)	
Unrealized gains (losses) on Castles	(20,975)	
Impairment of investments	9,507	
Adjust income from the receipt of options		(94,744)
Adjust employee compensation		
Adjust employee equity-based compensation expense (including Castle options assigned)	(88,507)	
Adjust employee portion of incentive income from private equity funds, accrued prior to the realization of incentive income	9,648	
Adjust employee portion of incentive income from one private equity fund, not subject to contingent repayment	(4)	
		(78,863)
Adjust Principals equity-based compensation expense		(474,734)
Adjust Principals interests related to Fortress Operating Group units		403,591
Adjust income taxes		(5,303)

## Edgar Filing: Fortress Investment Group LLC - Form 10-Q

Total adjustments	\$ (240,619)
-------------------	--------------

\*\* This adjustment relates to all of the Castles, private equity Fortress Funds and hedge fund special investment accounts in which Fortress has an investment.

<u>Adjustments from total segment assets to GAAP assets</u>	
Adjust equity investments from fair value	\$
Adjust equity investments from cost	(92,966)
Adjust investments gross of employee portion	42,839
Adjust option investments to intrinsic value	871
Total adjustments	\$ (49,256)

**Table of Contents****FORTRESS INVESTMENT GROUP LLC**

(PRIOR TO JANUARY 17, 2007, FORTRESS OPERATING GROUP NOTE 1)

**NOTES TO CONSOLIDATED AND COMBINED FINANCIAL STATEMENTS (Unaudited)**

JUNE 30, 2008

(dollars in tables in thousands, except share data)

	Private Equity Funds	Castles	Liquid Hedge Funds	Hybrid Hedge Funds	Principal Investments	Unallocated	Fortress Subtotal
<b>Three Months Ended June 30, 2008</b>							
Segment revenues							
Management fees	\$ 42,550	\$ 13,961	\$ 57,606	\$ 36,611	\$	\$	\$ 150,728
Incentive income			14,345	447			14,792
Segment revenues - total	\$ 42,550	\$ 13,961	\$ 71,951	\$ 37,058	\$	\$	\$ 165,520
Pre-tax distributable earnings	\$ 31,942	\$ 3,928	\$ 30,695	\$ 9,231	\$ (17,326)	\$ (31)	\$ 58,439

	Fortress Subtotal	Reconciliation to GAAP	Fortress Consolidated
Revenues	\$ 165,520	\$ 22,576	\$ 188,096
Pre-tax distributable earnings / net income	\$ 58,439	\$ (113,995)	\$ (55,556)



**Table of Contents****FORTRESS INVESTMENT GROUP LLC**

(PRIOR TO JANUARY 17, 2007, FORTRESS OPERATING GROUP NOTE 1)

**NOTES TO CONSOLIDATED AND COMBINED FINANCIAL STATEMENTS (Unaudited)**

JUNE 30, 2008

(dollars in tables in thousands, except share data)

**Three Months Ended June 30, 2008****Reconciling items between segment measures and GAAP measures:****Adjustments from segment revenues to GAAP revenues**

Adjust management fees*	\$ 162
Adjust incentive income	3,535
Adjust income from the receipt of options	
Other revenues*	18,879
Total adjustments	\$ 22,576

\* Segment revenues do not include GAAP other revenues; GAAP other revenues are included elsewhere in the calculation of distributable earnings.

**Adjustments from pre-tax distributable earnings to GAAP net income**

Adjust incentive income	
Incentive income received from private equity funds, subject to contingent repayment	\$
Incentive income accrued from private equity funds, no longer subject to contingent repayment	3,535
Incentive income received from private equity funds, not subject to contingent repayment	
Incentive income received from hedge funds, subject to annual performance achievement	
Reserve for clawback	
	3,535
Adjust other income	
Distributions of earnings from equity method investees**	(2)
Earnings (losses) from equity method investees**	(26,841)
Gains (losses) on options in equity method investees	(2,933)
Unrealized gains (losses) on Castles	(3,651)
Impairment of investments	9,507
Adjust income from the receipt of options	
	(23,920)
Adjust employee compensation	
Adjust employee equity-based compensation expense (including Castle options assigned)	(52,906)
Adjust employee portion of incentive income from private equity funds, accrued prior to the realization of incentive income	
Adjust employee portion of incentive income from one private equity fund, not subject to contingent repayment	
	(52,906)
Adjust Principals equity-based compensation expense	(237,367)
Adjust Principals interests related to Fortress Operating Group units	194,714
Adjust income taxes	1,949

Edgar Filing: Fortress Investment Group LLC - Form 10-Q

Total adjustments	\$ (113,995)
-------------------	--------------

\*\* This adjustment relates to all of the Castles, private equity Fortress Funds and hedge fund special investment accounts in which Fortress has an investment.

**Table of Contents****FORTRESS INVESTMENT GROUP LLC**

(PRIOR TO JANUARY 17, 2007, FORTRESS OPERATING GROUP NOTE 1)

**NOTES TO CONSOLIDATED AND COMBINED FINANCIAL STATEMENTS (Unaudited)**

JUNE 30, 2008

(dollars in tables in thousands, except share data)

	Private Equity Funds	Castles	Liquid Hedge Funds	Hybrid Hedge Funds	Principal Investments	Unallocated	Fortress Unconsolidated Subtotal
<b>Six Months Ended June 30, 2007</b>							
Segment revenues							
Management fees	\$ 62,616	\$ 22,746	\$ 69,341	\$ 60,720	\$	\$	\$ 215,423
Incentive income	190,298	17,905	158,199	84,369			450,771
Segment revenues - total	\$ 252,914	\$ 40,651	\$ 227,540	\$ 145,089	\$	\$	\$ 666,194
Pre-tax distributable earnings	\$ 166,843	\$ 18,938	\$ 105,387	\$ 49,314	\$ 29,641	\$ (7,286)	\$ 362,837

	Fortress Unconsolidated Subtotal	Consolidation of Fortress Funds	Eliminations	Reconciliation to GAAP	Fortress Consolidated
Revenues	\$ 666,194	\$ 317,114	\$ (269,607)	\$ (29,252)	\$ 684,449
Pre-tax distributable earnings / net income	\$ 362,837	\$ (326,375)	\$ 326,375	\$ (355,825)	\$ 7,012

**Table of Contents****FORTRESS INVESTMENT GROUP LLC**

(PRIOR TO JANUARY 17, 2007, FORTRESS OPERATING GROUP NOTE 1)

**NOTES TO CONSOLIDATED AND COMBINED FINANCIAL STATEMENTS (Unaudited)**

JUNE 30, 2008

(dollars in tables in thousands, except share data)

**Six Months Then Ended June 30, 2007****Reconciling items between segment measures and GAAP measures:****Adjustments from segment revenues to GAAP revenues**

Adjust management fees*	\$ 325
Adjust incentive income	(61,793)
Adjust income from the receipt of options	2,006
Other revenues*	30,210
Total adjustments	\$ (29,252)

\* Segment revenues do not include GAAP other revenues; GAAP other revenues are included elsewhere in the calculation of distributable earnings.

**Adjustments from pre-tax distributable earnings to GAAP net income**

Adjust incentive income	
Incentive income received from private equity funds, subject to contingent repayment	\$ (138,822)
Incentive income accrued from private equity funds, no longer subject to contingent repayment	211,942
Incentive income received from private equity funds, not subject to contingent repayment	(51,476)
Incentive income received from hedge funds, subject to annual performance achievement	(83,437)
Reserve for clawback	
	(61,793)
Adjust other income	
Distributions of earnings from equity method investees**	(12,326)
Earnings (losses) from equity method investees**	(19,248)
Gains (losses) on options in equity method investees, treated as derivatives	(24,456)
Adjust income from the receipt of options	2,006
	(54,024)
Adjust employee compensation	
Adjust employee equity-based compensation expense (including Castle options assigned)	(67,363)
Adjust employee portion of incentive income from private equity funds, accrued prior to the realization of incentive income	(19,657)
	(87,020)
Adjust Principals equity-based compensation expense	(380,933)
Adjust Principals interests related to Fortress Operating Group units	247,401
Adjust income taxes	(19,456)
Total adjustments	\$ (355,825)

## Edgar Filing: Fortress Investment Group LLC - Form 10-Q

\*\* This adjustment relates to all of the Castles, private equity Fortress Funds and hedge fund special investment accounts in which Fortress has an investment. On an unconsolidated basis, each of these funds is accounted for under the equity method.

**Table of Contents****FORTRESS INVESTMENT GROUP LLC**

(PRIOR TO JANUARY 17, 2007, FORTRESS OPERATING GROUP NOTE 1)

**NOTES TO CONSOLIDATED AND COMBINED FINANCIAL STATEMENTS (Unaudited)**

JUNE 30, 2008

(dollars in tables in thousands, except share data)

	Private Equity Funds	Castles	Liquid Hedge Funds	Hybrid Hedge Funds	Principal Investments	Unallocated	Fortress Unconsolidated Subtotal
<b>Three Months Ended June 30, 2007</b>							
Segment revenues							
Management fees	\$ 35,852	\$ 11,841	\$ 38,400	\$ 31,707	\$	\$	\$ 117,800
Incentive income		14,217	112,920	38,264			165,401
Segment revenues - total	\$ 35,852	\$ 26,058	\$ 151,320	\$ 69,971	\$	\$	\$ 283,201
Pre-tax distributable earnings	\$ 28,070	\$ 13,883	\$ 74,871	\$ 17,534	\$ 13,650	\$ (4,752)	\$ 143,256

	Fortress Unconsolidated Subtotal	Reconciliation to GAAP	Fortress Consolidated
Revenues	\$ 283,201	\$ (15,082)	\$ 268,119
Pre-tax distributable earnings / net income	\$ 143,256	\$ (198,387)	\$ (55,131)

**Table of Contents****FORTRESS INVESTMENT GROUP LLC**

(PRIOR TO JANUARY 17, 2007, FORTRESS OPERATING GROUP NOTE 1)

**NOTES TO CONSOLIDATED AND COMBINED FINANCIAL STATEMENTS (Unaudited)**

JUNE 30, 2008

(dollars in tables in thousands, except share data)

**Three Months Ended June 30, 2007****Reconciling items between segment measures and GAAP measures:****Adjustments from segment revenues to GAAP revenues**

Adjust management fees*	\$ 325
Adjust incentive income	(32,376)
Adjust income from the receipt of options	1,195
Other revenues*	15,774
Total adjustments	\$ (15,082)

\*Segment revenues do not include GAAP other revenues; GAAP other revenues are included elsewhere in the calculation of distributable earnings

**Adjustments from pre-tax distributable earnings to GAAP net income**

Adjust incentive income	
Incentive income received from private equity funds, subject to contingent repayment	\$
Incentive income accrued from private equity funds, no longer subject to contingent repayment	5,502
Incentive income received from private equity funds, not subject to contingent repayment	
Incentive income received from hedge funds, subject to annual performance achievement	(37,878)
Reserve for clawback	
	(32,376)
Adjust other income	
Distributions of earnings from equity method investees**	(2,433)
Earnings (losses) from equity method investees**	(8,098)
Gains (losses) on options in equity method investees, treated as derivatives	(29,606)
Adjust income from the receipt of options	1,195
	(38,942)
Adjust employee compensation	
Adjust employee equity-based compensation expense (including Castle options assigned)	(28,934)
Adjust employee portion of incentive income from private equity funds, accrued prior to the realization of incentive income	(19,657)
Adjust employee portion of incentive income from one private equity fund, not subject to contingent repayment	(569)
	(49,160)
Adjust Principals equity-based compensation expense	(242,659)
Adjust Principals interests related to Fortress Operating Group units	169,759
Adjust income taxes	(5,009)
Total adjustments	\$ (198,387)

\*\* This adjustment relates to all of the Castles, private equity Fortress Funds and hedge fund special investment accounts in which Fortress has an investment. On an unconsolidated basis, each of these funds is accounted for under the equity method.



**Table of Contents****FORTRESS INVESTMENT GROUP LLC**

(PRIOR TO JANUARY 17, 2007, FORTRESS OPERATING GROUP NOTE 1)

**NOTES TO CONSOLIDATED AND COMBINED FINANCIAL STATEMENTS (Unaudited)**

JUNE 30, 2008

(dollars in tables in thousands, except share data)

Fortress's depreciation expense by segment was as follows:

	Private Equity Funds	Castles	Liquid Hedge Funds	Hybrid Hedge Funds	Unallocated	Total
<u>Six Months Ended June 30,</u>						
2008	\$ 546	\$ 374	\$ 1,495	\$ 1,486	\$ 971	\$ 4,872
2007	\$ 482	\$ 426	\$ 1,211	\$ 1,229	\$ 845	\$ 4,193
<u>Three Months Ended June 30,</u>						
2008	\$ 287	\$ 182	\$ 767	\$ 714	\$ 486	\$ 2,436
2007	\$ 243	\$ 212	\$ 631	\$ 653	\$ 445	\$ 2,184

**11. SUBSEQUENT EVENTS**

In July 2008, three of the Principals invested an aggregate of \$14.4 million in preferred equity interests of a subsidiary of one of the private equity Fortress Funds. The preferred equity does not pay a dividend.

**12. PRO FORMA FINANCIAL INFORMATION**

The unaudited pro forma financial information presented below was derived from the application of pro forma adjustments to the combined and consolidated financial statements of Fortress, as applicable, to give effect to the deconsolidation of the consolidated Fortress Funds. The deconsolidation transaction occurred effective March 31, 2007 as described in Note 1. The unaudited pro forma statement of operations and statement of cash flows information for the six months ended June 30, 2007 have been prepared as if this transaction had occurred on January 1, 2007.

**Table of Contents****FORTRESS INVESTMENT GROUP LLC**

(PRIOR TO JANUARY 17, 2007, FORTRESS OPERATING GROUP NOTE 1)

**NOTES TO CONSOLIDATED AND COMBINED FINANCIAL STATEMENTS (Unaudited)**

JUNE 30, 2008

(dollars in tables in thousands, except share data)

The unaudited pro forma effects of the deconsolidation of the Fortress Funds on the statement of operations information are as follows:

	Six Months Ended June 30, 2007		
	Consolidated	Deconsolidation Adjustments	Pro Forma Deconsolidated
<b>Revenues</b>			
Management fees from affiliates	\$ 161,965	\$ 53,072	\$ 215,037
Incentive income from affiliates	177,189	211,682	388,871
Other revenues	36,265	(3,232)	33,033
Interest and dividend income - investment company holdings	309,030	(309,030)	
	684,449	(47,508)	636,941
<b>Expenses</b>			
Interest expense			
Investment company holdings	132,620	(132,620)	
Other	18,731		18,731
Compensation and benefits	405,300	(9,805)	395,495
Principals agreement compensation	380,933		380,933
General, administrative and other	62,908	(22,024)	40,884
Depreciation and amortization	4,193		4,193
	1,004,685	(164,449)	840,236
<b>Other income</b>			
Gains (losses) from investments			
Investment company holdings	(647,477)	647,477	
Other investments			
Net realized gains	54		54
Net realized gains from affiliate investments	145,493		145,493
Net unrealized gains (losses)	(677)		(677)
Net unrealized gains (losses) from affiliate investments	(167,166)		(167,166)
Earnings from equity method investees	7,427	3,231	10,658
	(662,346)	650,708	(11,638)
<b>Income (loss) before Deferred Incentive Income, Principals and Others</b>			
<b>Interests in Income of Consolidated Subsidiaries and Income Taxes</b>	(982,582)	767,649	(214,933)
Deferred incentive income	307,034	(307,034)	
Principals and others interests in loss (income) of consolidated subsidiaries	702,016	(460,615)	241,401
<b>Income Before Income Taxes</b>	26,468		26,468
Income tax expense	(19,456)		(19,456)

Edgar Filing: Fortress Investment Group LLC - Form 10-Q

**Net Income** \$ 7,012 \$ 7,012

Total comprehensive income for this period was calculated as follows:

Comprehensive income	
Net income	\$ 7,012
Foreign currency translation	97
Net unrealized (loss) on derivatives designated as cash flow hedges	(8)
Comprehensive income (loss) from equity method investees	(2,652)
Allocation to Principals and others interests un equity of consolidated subsidiaries	463
<b>Total comprehensive income</b>	<b>\$ 4,912</b>

**Table of Contents****FORTRESS INVESTMENT GROUP LLC**

(PRIOR TO JANUARY 17, 2007, FORTRESS OPERATING GROUP NOTE 1)

**NOTES TO CONSOLIDATED AND COMBINED FINANCIAL STATEMENTS (Unaudited)**

JUNE 30, 2008

(dollars in tables in thousands, except share data)

The unaudited pro forma effects of the deconsolidation of the Fortress Funds on the statement of cash flows information are as follows:

	Six Months Ended June 30, 2007		
	Consolidated	Deconsolidation Adjustments	Pro Forma Deconsolidation
<b>Cash Flows From Operating Activities</b>			
Net income	\$ 7,012	\$	7,012
Adjustments to reconcile net income to net cash provided by (used in) operating activities			
Depreciation and amortization	4,193		4,193
Other amortization and accretion	1,275	(483)	792
Earnings from equity method investees	(7,427)	(3,231)	(10,658)
Distributions of earnings from equity method investees	4,211	3,231	7,442
(Gains) losses from investments	669,773	(647,477)	22,296
Recognition of deferred incentive income		(156,326)	(156,326)
Deferred incentive income	(311,174)	307,034	(4,140)
Principals and others interests in income of consolidated subsidiaries	(702,016)	460,615	(241,401)
Deferred tax expense	2,484		2,484
Options received from affiliates	(2,006)		(2,006)
Assignments of options to employees	1,717		1,717
Equity-based compensation	445,233		445,233
Cash flows due to changes in			
Cash held at consolidated subsidiaries and restricted cash	(166,199)	166,199	
Due from affiliates	186,215	65,445	251,660
Receivables from brokers and counterparties and other assets	(9,106)	32,131	23,025
Accrued compensation and benefits	72,733	(144)	72,589
Due to affiliates	(8,380)	8,594	214
Deferred incentive income		142,041	142,041
Due to brokers and counterparties and other liabilities	65,592	(87,935)	(22,343)
Investment company holdings			
Purchases of investments	(5,105,865)	5,105,865	
Proceeds from sale of investments	3,398,739	(3,398,739)	
Net cash provided by (used in) operating activities	(1,452,996)	1,996,820	543,824
<b>Cash Flows From Investing Activities</b>			
Proceeds from sale of other loan and security investments	317		317
Contributions to equity method investees	(58,004)	(148,812)	(206,816)
Distributions of capital from equity method investments	39,906	22,685	62,591
Proceeds from sale of equity method investees	29,071		29,071
Cash received on settlement of derivatives	132		132
Purchase of fixed assets	(7,136)	125	(7,011)
Net cash used in investing activities	4,286	(126,002)	(121,716)

Edgar Filing: Fortress Investment Group LLC - Form 10-Q

**Cash Flows From Financing Activities**

Borrowings under debt obligations	1,924,070	(1,564,070)	360,000
Repayments of debt obligations	(2,010,025)	1,312,872	(697,153)
Payment of deferred financing costs	(6,656)	660	(5,996)
Issuance of Class A shares to Nomura	888,000		888,000
Issuance of Class A shares in initial public offering	729,435		729,435
Costs related to initial public offering	(76,766)		(76,766)
Dividends paid	(16,542)		(16,542)
Fortress Operating Group capital distributions to Principals	(219,112)		(219,112)
Purchase of Fortress Operating Group units from Principals	(888,000)		(888,000)
Principals and others interests in equity of consolidated subsidiaries - contributions	3,193,618	(3,183,682)	9,936
Principals and others interests in equity of consolidated subsidiaries - distributions	(1,808,987)	1,563,402	(245,585)
Net cash provided by (used in) financing activities	1,709,035	(1,870,818)	(161,783)
<b>Net Increase in Cash and Cash Equivalents</b>	<b>260,325</b>		<b>260,325</b>
<b>Cash and Cash Equivalents, Beginning of Period</b>	<b>61,120</b>		<b>61,120</b>
<b>Cash and Cash Equivalents, End of Period</b>	<b>\$ 321,445</b>	<b>\$</b>	<b>\$ 321,445</b>

**Table of Contents**

**FORTRESS INVESTMENT GROUP LLC**

(PRIOR TO JANUARY 17, 2007, FORTRESS OPERATING GROUP NOTE 1)

**NOTES TO CONSOLIDATED AND COMBINED FINANCIAL STATEMENTS (Unaudited)**

JUNE 30, 2008

(dollars in tables in thousands, except share data)

**NOTE 13 CONSOLIDATING FINANCIAL INFORMATION**

The consolidating financial information presents the balance sheet, statement of operations and statement of cash flows for Fortress Operating Group (on a combined basis) and Fortress Investment Group LLC (including its consolidated subsidiaries other than those within Fortress Operating Group) on a deconsolidated basis, as well as the related eliminating entries for intercompany balances and transactions, which sum to Fortress Investment Group's consolidated financial statements as of, and for the six months ended, June 30, 2008.

Fortress Operating Group includes all of Fortress's operating and investing entities. The upper tier Fortress Operating Group entities are the obligors on Fortress's credit agreement (Note 4). Segregating the financial results of this group of entities provides a more transparent view of the capital deployed in Fortress's businesses and the relevant ratios for borrowing entities.

**Table of Contents****FORTRESS INVESTMENT GROUP LLC**

(PRIOR TO JANUARY 17, 2007, FORTRESS OPERATING GROUP NOTE 1)

**NOTES TO CONSOLIDATED AND COMBINED FINANCIAL STATEMENTS (Unaudited)**

JUNE 30, 2008

(dollars in tables in thousands, except share data)

The consolidating balance sheet information is as follows:

	As of June 30, 2008			
	Fortress Operating Group Combined	Fortress Investment Group LLC Consolidated (A)	Intercompany Eliminations	Fortress Investment Group LLC Consolidated
<b>Assets</b>				
Cash and cash equivalents	\$ 234,628	\$ 20,527	\$	\$ 255,155
Due from affiliates	141,765	1,615	(1,615)	141,765
Investments				
Equity method investees	961,123	42,438	(42,438)	961,123
Options in affiliates	871			871
Deferred tax asset	7,247	504,990		512,237
Other assets	67,495	5,189		72,684
	\$ 1,413,129	\$ 574,759	\$ (44,053)	\$ 1,943,835
<b>Liabilities and Shareholders Equity</b>				
<b>Liabilities</b>				
Accrued compensation and benefits	\$ 126,040	\$	\$	\$ 126,040
Due to affiliates	71,443	393,266		464,709
Dividends payable	1,615	21,286	(1,615)	21,286
Deferred incentive income	164,144			164,144
Debt obligations payable	800,000			800,000
Other liabilities	40,239			40,239
	1,203,481	414,552	(1,615)	1,616,418
<b>Commitments and Contingencies</b>				
<b>Principals and Others Interests in Equity of Consolidated Subsidiaries</b>				
	52,826	5,894	114,384	173,104
<b>Shareholders Equity</b>				
Paid-in capital	1,083,788	469,319	(1,083,788)	469,319
Retained earnings (accumulated deficit)	(930,746)	(315,564)	930,746	(315,564)
Accumulated other comprehensive income (loss)	3,780	558	(3,780)	558
	156,822	154,313	(156,822)	154,313
	\$ 1,413,129	\$ 574,759	\$ (44,053)	\$ 1,943,835

(A) Other than Fortress Operating Group.





**Table of Contents****FORTRESS INVESTMENT GROUP LLC**

(PRIOR TO JANUARY 17, 2007, FORTRESS OPERATING GROUP NOTE 1)

**NOTES TO CONSOLIDATED AND COMBINED FINANCIAL STATEMENTS (Unaudited)**

JUNE 30, 2008

(dollars in tables in thousands, except share data)

The consolidating statement of operations information is as follows:

	Six Months Ended June 30, 2008			
	Fortress Operating Group Consolidated	Fortress Investment Group LLC Consolidated (A)	Intercompany Eliminations	Fortress Investment Group LLC Consolidated
<b>Revenues</b>				
Management fees from affiliates	\$ 293,662	\$	\$	\$ 293,662
Incentive income from affiliates	55,444			55,444
Other revenues	39,829	41		39,870
	388,935	41		388,976
<b>Expenses</b>				
Interest expense	20,224			20,224
Compensation and benefits	264,479			264,479
Principals agreement compensation	474,734			474,734
General, administrative and other	36,462		(146)	36,316
Depreciation and amortization	4,872			4,872
	800,771		(146)	800,625
<b>Other Income (Loss)</b>				
Gains (losses) from investments				
Net realized gains (losses)	1,674			1,674
Net realized gains (losses) from affiliate investments	155			155
Net unrealized gains (losses)				
Net unrealized gains (losses) from affiliate investees	(36,401)			(36,401)
Earnings (losses) from equity method investees	(75,629)	(122,182)	122,182	(75,629)
	(110,201)	(122,182)	122,182	(110,201)
<b>Income (Loss) Before Principals and Others Interests in Income of Consolidated Subsidiaries and Income Taxes</b>				
	(522,037)	(122,141)	122,328	(521,850)
Principals and others interests in (income) loss of consolidated subsidiaries	(910)		403,590	402,680
<b>Income Before Income Taxes</b>				
	(522,947)	(122,141)	525,918	(119,170)
Income tax benefit (expense)	(2,971)	(2,332)		(5,303)
<b>Net Income (Loss)</b>				
	\$ (525,918)	\$ (124,473)	\$ 525,918	\$ (124,473)

(A) Other than Fortress Operating Group.

**Table of Contents****FORTRESS INVESTMENT GROUP LLC**

(PRIOR TO JANUARY 17, 2007, FORTRESS OPERATING GROUP NOTE 1)

**NOTES TO CONSOLIDATED AND COMBINED FINANCIAL STATEMENTS (Unaudited)**

JUNE 30, 2008

(dollars in tables in thousands, except share data)

The consolidating statement of cash flows information is as follows:

	Fortress Operating Group Consolidated	Six Months Ended June 30, 2008 Fortress Investment Group LLC Consolidated (A)	Intercompany Eliminations	Fortress Investment Group LLC Consolidated
<b>Cash Flows From Operating Activities</b>				
Net income (loss)	\$ (525,918)	\$ (124,474)	\$ 525,919	\$ (124,473)
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities				
Depreciation and amortization	4,872			4,872
Other amortization and accretion	1,420			1,420
(Earnings) losses from equity method investees	75,629	122,183	(122,183)	75,629
Distributions of earnings from equity method investees	2,792			2,792
(Gains) losses from investments	34,572			34,572
Deferred incentive income, net	(35,494)			(35,494)
Principals and others interests in income (loss) of consolidated subsidiaries	910		(403,590)	(402,680)
Deferred tax (benefit) expense	(2,440)	(994)		(3,434)
Equity-based compensation	556,131			556,131
Cash flows due to changes in				
Due from affiliates	14,841			14,841
Other assets	(1,639)	2,541		902
Accrued compensation and benefits	(124,550)			(124,550)
Due to affiliates	(1,066)			(1,066)
Deferred incentive income	26,077			26,077
Other liabilities	7,184	596	(146)	7,634
Net cash provided by (used in) operating activities	33,321	(148)		33,173
<b>Cash Flows From Investing Activities</b>				
Contributions to equity method investees	(82,343)			(82,343)
Distributions of capital from equity method investees	182,072	60,115	(60,115)	182,072
Purchase of fixed assets	(3,906)			(3,906)
Proceeds from disposal of fixed assets	53			53
Net cash provided by (used in) investing activities	95,876	60,115	(60,115)	95,876
<b>Cash Flows From Financing Activities</b>				
Borrowings under debt obligations	450,000			450,000
Repayments of debt obligations	(185,000)			(185,000)
Payment of deferred financing costs	(5,060)			(5,060)
Dividends and dividend equivalents paid	(203,788)	(42,570)	193,537	(52,821)

## Edgar Filing: Fortress Investment Group LLC - Form 10-Q

Principals and others interests in consolidated subsidiaries - distributions	145			145
Principals and others interests in consolidated subsidiaries - contributions	(48,145)		(133,422)	(181,567)
Net cash provided by (used in) financing activities	8,152	(42,570)	60,115	25,697
<b>Net Increase (Decrease) in Cash and Cash Equivalents</b>	<b>137,349</b>	<b>17,397</b>		<b>154,746</b>
<b>Cash and Cash Equivalents, Beginning of Period</b>	<b>97,279</b>	<b>3,130</b>		<b>100,409</b>
<b>Cash and Cash Equivalents, End of Period</b>	<b>\$ 234,628</b>	<b>\$ 20,527</b>	<b>\$</b>	<b>\$ 255,155</b>

(A) Other than Fortress Operating Group.

---

## **Table of Contents**

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

(tables in thousands except as otherwise indicated and per share data)

*The following discussion should be read in conjunction with Fortress Investment Group's consolidated and combined financial statements and the related notes (referred to as consolidated financial statements or historical consolidated financial statements) included within this Quarterly Report on Form 10-Q. This discussion contains forward-looking statements that are subject to known and unknown risks and uncertainties. Actual results and the timing of events may differ significantly from those expressed or implied in such forward-looking statements due to a number of factors, including those included in Part II, Item 1A, Risk Factors and elsewhere in this Quarterly Report on Form 10-Q.*

*During the first quarter of 2007, we consummated a number of significant transactions, including the Nomura transaction, the formation transactions, our initial public offering, and the deconsolidation of a number of Fortress Funds. The deconsolidation of the Fortress Funds has had significant effects on many of the items within our financial statements but had no net effect on net income or equity. Since the deconsolidation did not occur until March 31, 2007, the statement of operations and the statement of cash flows for the six months ended June 30, 2007 are presented including these funds on a consolidated basis for the period prior to deconsolidation. The pro forma effects of the deconsolidation on these financial statements are described in Note 12 to Part I, Item 1, Financial Statements Pro Forma Financial Information.*

#### **General**

##### *Our Business*

Fortress is a leading global alternative asset manager with approximately \$35.1 billion in AUM as of June 30, 2008. We raise, invest and manage private equity funds and hedge funds. We earn management fees based on the size of our funds, incentive income based on the performance of our funds, and investment income from our principal investments in those funds. We invest capital in each of our businesses.

As of June 30, 2008, we managed alternative assets in two core businesses:

**Private Equity Funds** a business that manages approximately \$17.0 billion of AUM comprised of two business segments: (i) funds that primarily make significant, control-oriented investments in North America and Western Europe, with a focus on acquiring and building asset-based businesses with significant cash flows. We also manage a family of long dated value funds focused on investing in undervalued assets with limited current cash flows and long investment horizons; and (ii) publicly traded alternative investment vehicles, which we refer to as Castles, that invest primarily in real estate and real estate related debt investments.

**Hedge Funds** a business that manages approximately \$18.1 billion of AUM comprised of two business segments; (i) hybrid hedge funds which make highly diversified investments globally in assets, opportunistic lending situations and securities through the capital structure with a value orientation, as well as investment funds managed by external managers; and (ii) liquid hedge funds which invest globally in fixed income, currency, equity and commodity markets and related derivatives to capitalize on imbalances in the financial markets.

In addition, we treat our principal investments in these funds as a distinct business segment.

##### *Managing Business Performance*

We conduct our management and investment business through the following five primary segments: (i) private equity funds, (ii) Castles (iii) liquid hedge funds, (iv) hybrid hedge funds, and (v) principal investments in those funds as well as cash that is available to be invested. These segments are differentiated based on the varying investment strategies of the funds we manage in each segment.

The amounts not allocated to a segment consist primarily of certain general and administrative expenses. Where applicable, portions of the general and administrative expenses have been allocated between the segments.

Management makes operating decisions and assesses performance with regard to each of our primary segments based on financial data that is presented without the consolidation of any Fortress Funds. Accordingly, segment data for these segments is reflected on an unconsolidated basis, even for periods prior to the deconsolidation. Management also assesses our segments on a Fortress Operating Group and pre-tax basis, and therefore adds back the interests in consolidated subsidiaries related to Fortress Operating Group units (held by the principals) and income tax expense.

## Edgar Filing: Fortress Investment Group LLC - Form 10-Q

Management assesses the net performance of each segment based on its distributable earnings. Distributable earnings is not a measure of cash generated by operations which is available for distribution. Rather distributable earnings is a supplemental measure of the value created during any period which management uses in its determination of its periodic distributions to its dividend paying share and unit holders. Distributable earnings should not be considered as an alternative to cash flow in accordance with GAAP or as a measure of our liquidity, and is not necessarily indicative of cash available to fund cash needs (including dividends and distributions).

## **Table of Contents**

We believe that the presentation of distributable earnings enhances a reader's understanding of the economic operating performance of our segments. For a more detailed discussion of distributable earnings and how it reconciles to our GAAP net income (loss), see Results of Operations Segments Analysis below.

### **Market Considerations**

Our revenues consist primarily of (i) management fees which are based on the size of our funds, (ii) incentive income which is based on the performance of our funds and (iii) investment income from our investments in those funds. Our ability to grow our revenues depends on our ability to attract new capital and investors, both at Fortress and within our funds, which in turn depends on our ability to successfully invest our capital and our funds' capital. The primary market factors that impact this are:

The strength of the alternative investment management industry, including the amount of capital invested and withdrawn from alternative investments. Our share of this capital is dependent on the strength of our performance relative to the performance of our competitors. The capital we attract is a driver of our AUM, as are our returns, which in turn drive the fees we earn.

The strength and liquidity of the U.S. and relevant global equity markets generally, and the IPO market specifically, which affect our ability to increase the value of our equity positions in our private equity portfolio companies.

The strength and liquidity of the U.S. and relevant global debt markets. Our funds make investments in debt instruments, which are assisted by a strong and liquid debt market. In addition, our funds borrow money to make acquisitions. Our funds utilize leverage in order to increase investment returns, which ultimately drive the performance of our funds. Furthermore, we utilize debt to finance our investments in our funds and for working capital purposes.

Volatility within the markets. Volatility within the debt and equity markets, as well as within the commodity market to a limited extent, increases opportunities for investments within each of our segments, and directly impacts the performance of our liquid hedge funds.

Other than in our liquid hedge funds, we benefit from stable interest rate and foreign currency exchange rate markets. The direction of the impact of changes in interest rates or foreign currency exchange rates on our liquid hedge funds is dependent on their expectations and the related direction of their investments at such time; therefore, historical trends in these markets are not necessarily indicative of future performance in these funds.

Furthermore, we are impacted by trends in investment behavior:

We have identified areas within other economies where we believe opportunities have been favorable for investment, such as Germany and the United Kingdom. Partially as a result of the globalization of our operations and the internationalization of our investments, we continue to identify what we believe to be attractive investment opportunities in new markets, most recently including Asia.

Institutions, high net worth individuals and other investors (including sovereign wealth funds) are increasing their allocations of capital to the alternative investment sector. As a leader in this sector based on the size, diversity and historical performance of our funds, we have been and continue to be able to attract a significant amount of new capital, at least in part as a result of this trend.

Allocations of capital to the alternative investment sector are also dependent, in part, on the strength of the economy and the returns available from other investments relative to returns from alternative investments. This, in turn, is also dependent on the interest rate

## Edgar Filing: Fortress Investment Group LLC - Form 10-Q

and credit spread markets; as interest rates rise and/or spreads widen, returns available on other investments would tend to increase, which could slow capital flow to the alternative investment sector. Credit spreads represent the yield demanded on financial instruments by the market in comparison to a benchmark rate, such as the relevant U.S. treasury rate or LIBOR.

While short-term disruptions in the markets, with respect to equity prices, interest rates, credit spreads or other market factors, including market liquidity, may adversely affect our existing positions, we believe such disruptions generally present significant new opportunities for investment, particularly in distressed asset classes. Our ability to take advantage of these opportunities will depend on our ability to access debt and equity capital, both at Fortress and within the Fortress Funds. No assurance can be given that future trends will not be disadvantageous to us, particularly if current challenging conditions, as discussed below, persist or intensify.

Over the past year, disruption in the U.S. and other credit markets has adversely affected the availability of credit and the financial markets in general. In addition, U.S., European and other equity markets have become less favorable for IPOs and other issuances. This disruption has negatively impacted the markets in which we operate in a number of ways:

We have benefited in recent years from relatively tight interest rate spreads, which have allowed us and the funds we manage to obtain financing for investments at attractive rates. Over the past several months, interest rate



---

**Table of Contents**

spreads have widened significantly. This widening will typically increase our costs when financing our investments using debt, which in turn reduces the net return we can earn on those investments. Furthermore, wider spreads reduce the value of investments currently owned by our funds, including investments in our hedge funds. A reduction in the value of our hedge funds' investments directly impacts our management fees and incentive income from such funds.

Moreover, there currently is less debt and equity capital available in the market relative to the levels available in recent years, which, coupled with recent additional margin collateral requirements imposed by lenders on some types of investments, debt and derivatives, has increased the importance of maintaining sufficient liquidity without relying upon additional infusions of capital from the debt and equity markets. Based on cash balances, committed financing and short-term operating cash flows, in the judgment of management we and the funds we manage have sufficient liquidity in the current market environment. However, maintaining this liquidity rather than investing such funds, and the reduced availability of attractive financing, has reduced our returns.

Many market participants have become increasingly uncertain about the health of a number of investment banks and other financial institutions, the most notable example being the recent events involving the solvency of Bear Stearns. Certain of these institutions serve as key counterparties for a tremendous number of derivatives and other financial instruments held by Fortress and our funds. This uncertainty has intensified the ongoing disruption in the global financial markets. A failure by a large financial institution would have a meaningfully negative impact on the financial markets in which we operate.

There has been a reduction in market trading activity. This reduction has made the valuation of investments more difficult and, in our opinion, has resulted in relatively conservative valuations by third party brokers and pricing agents.

The per share market prices of the investments held by our private equity funds in public companies have decreased substantially. This, in turn, has contributed to a significant decrease in our public company surplus. A decrease in this surplus hinders our ability to realize gains within these funds and therefore our ability to earn incentive income. Furthermore, the disruptions in the debt and equity markets have made exit strategies for private investments more difficult to execute as potential buyers have difficulty obtaining attractive financing and the demand for IPOs has been greatly reduced.

As a result of the above factors, our first half 2008 distributable earnings, as defined in - Segment Analysis - below, is lower than the amount of dividends we have paid in respect of such period. The decision to pay a dividend, as well as the amount of any dividends paid, is subject to change at the discretion of our board of directors based upon a number of factors, including actual and projected distributable earnings. In addition, our share of the NAV of certain fund investments, including certain investments on which we have received incentive returns, has declined below their related carrying amounts for distributable earnings purposes. While we expect returns on these investments, in the aggregate, to ultimately exceed their carrying amount, if they were liquidated at their current NAV (although we have no present intention of doing so), the result would be an impairment of approximately \$172 million. Furthermore, the current ratio of our distributable earnings to our AUM is lower than it has been historically due to a decrease in incentive income generated.

We do not currently know the full extent to which this disruption will affect us or the markets in which we operate. If the disruption continues, or results in a permanent, fundamental change in the credit markets, we and the funds we manage may experience further tightening of liquidity, reduced earnings and cash flow, impairment charges, increased margin requirements, as well as challenges in maintaining our reputation, raising additional capital, obtaining investment financing and making investments on attractive terms, and may need to make corresponding fundamental changes in our investment practices. However, to date we have been able to continue raising capital for our funds, both through new and existing funds, which serves both to increase our AUM and our management fee income and to give us a significant amount of capital available to be invested at a time when we believe attractive returns in distressed and other asset classes are available.

**Table of Contents****Results of Operations**

The following is a discussion of our results of operations as reported under GAAP. For a detailed discussion of distributable earnings and revenues from each of our segments, see Segment Analysis below.

Effective March 31, 2007, we deconsolidated our Fortress Funds and, subsequent to this transaction, our results of operations are presented on a deconsolidated basis. To provide better insight and understanding of our results of operations based on our current structure, and a better comparative basis, the following table compares results of operations for the six months ended June 30, 2008 to our pro forma results of operations for the six months ended June 30, 2007 on a deconsolidated basis. On a GAAP basis, excluding pro forma adjustments, we had broad decreases across all of our financial statement line items for the six months ended June 30, 2008 compared to the six months ended June 30, 2007 as a result of the deconsolidation.

	Six Months Ended June 30, 2008	Six Months Ended June 30, 2007			Variance
		Consolidated	Deconsolidation Adjustments	Pro Forma Deconsolidated	
<b>Revenues</b>					
Management fees from affiliates	\$ 293,662	\$ 161,965	\$ 53,072	\$ 215,037	\$ 78,625
Incentive income from affiliates	55,444	177,189	211,682	388,871	(333,427)
Other revenues	39,870	36,265	(3,232)	33,033	6,837
Interest and dividend income - investment company holdings		309,030	(309,030)		
	388,976	684,449	(47,508)	636,941	(247,965)
<b>Expenses</b>					
Interest expense	20,224	151,351	(132,620)	18,731	1,493
Compensation and benefits	264,479	405,300	(9,805)	395,495	(131,016)
Principals agreement compensation	474,734	380,933		380,933	93,801
General, administrative and other expense (including depreciation and amortization)	41,188	67,101	(22,024)	45,077	(3,889)
	800,625	1,004,685	(164,449)	840,236	(39,611)
<b>Other Income (Loss)</b>					
Net gains (losses) - investment company holdings		(647,477)	647,477		
Net gains (losses) - other investments	(34,572)	(22,296)		(22,296)	(12,276)
Earnings (losses) from equity method investees	(75,629)	7,427	3,231	10,658	(86,287)
	(110,201)	(662,346)	650,708	(11,638)	(98,563)
<b>Income (Loss) Before</b>					
<b>Deferred Incentive Income, Principals and Others</b>					
<b>Interests in Income of Consolidated Subsidiaries and Income Taxes</b>					
	(521,850)	(982,582)	767,649	(214,933)	(306,917)
Deferred incentive income		307,034	(307,034)		
Principals and others interests in loss (income) of consolidated subsidiaries	402,680	702,016	(460,615)	241,401	161,279
<b>Income (Loss) Before Income Taxes</b>	(119,170)	26,468		26,468	(145,638)
Income tax benefit (expense)	(5,303)	(19,456)		(19,456)	14,153
<b>Net Income (Loss)</b>	\$ (124,473)	\$ 7,012	\$	\$ 7,012	\$ (131,485)



**Table of Contents**

	Three Months Ended June 30, 2008	Three Months Ended June 30, 2007	Variance
<b>Revenues</b>			
Management fees from affiliates	\$ 149,605	\$ 118,678	\$ 30,927
Incentive income from affiliates	18,300	132,961	(114,661)
Other revenues	20,191	16,480	3,711
Interest and dividend income - investment company holdings			
	188,096	268,119	(80,023)
<b>Expenses</b>			
Interest expense	9,888	6,711	3,177
Compensation and benefits	137,460	187,783	(50,323)
Principals agreement compensation	237,367	242,659	(5,292)
General, administrative and other expense (including depreciation and amortization)	22,182	25,787	(3,605)
	406,897	462,940	(56,043)
<b>Other Income (Loss)</b>			
Net gains (losses) - investment company holdings			
Net gains (losses) - other investments	(6,615)	(29,017)	22,402
Earnings (losses) from equity method investees	(26,500)	7,231	(33,731)
	(33,115)	(21,786)	(11,329)
<b>Income (Loss) Before</b>			
<b>Deferred Incentive Income, Principals and Others Interests in Income of Consolidated Subsidiaries and Income Taxes</b>	(251,916)	(216,607)	(35,309)
Deferred incentive income			
Principals and others interests in loss (income) of consolidated subsidiaries	194,411	166,485	27,926
<b>Income (Loss) Before Income Taxes</b>	(57,505)	(50,122)	(7,383)
Income tax benefit (expense)	1,949	(5,009)	6,958
<b>Net Income (Loss)</b>	\$ (55,556)	\$ (55,131)	\$ (425)

*Factors Affecting Our Business*

During the periods discussed herein, the following are significant factors which have affected our business and materially impacted our results of operations:

changes in our AUM;

level of performance of our funds;

growth of our fund management and investment platform and our compensation structure to sustain that growth; and

the income tax expense as a result of our reorganization which occurred in 2007.

Fee Paying Assets Under Management

## Edgar Filing: Fortress Investment Group LLC - Form 10-Q

We measure AUM by reference to the fee paying assets we manage, including the capital we have the right to call from our investors due to their capital commitments. As a result of raising new funds with sizeable capital commitments for our private equity funds, raising capital for our Castles, and increases in the NAVs of our hedge funds from new investor capital and their retained profits, our AUM has increased significantly over the periods discussed.

### *Average Fee Paying AUM*

Average fee paying AUM represents the reference amounts upon which our management fees are based. The reference amounts for management fee purposes are: (i) capital commitments or invested capital (or NAV, if lower) for the private equity funds, which in connection with funds raised after March 2006 includes the mark-to-market value on public securities held within the fund, (ii) contributed capital for the Castles, or (iii) the NAV for hedge funds.

### *Management Fees*

Significant growth of our average AUM has had a positive effect on our revenues. As the AUM in our funds grew, so did the management fees we earned. Depending on the timing of capital contributions in a given period, the full economic benefits of an increase in AUM may not be recognized until the following period.

### Performance of Our Funds

#### *Incentive Income*

Incentive income is calculated as a percentage of profits earned by the Fortress Funds. Incentive income that is not subject to contingent repayment is recorded as earned, as incentive income from affiliates. Incentive income received from funds that continues to be subject to contingent repayment is deferred and recorded as a deferred incentive income liability until the related contingency is resolved.

**Table of Contents**

The contingencies related to a portion of the incentive income we have received from certain private equity Fortress Funds have been resolved. As our private equity funds continue to mature, the amount of incentive income recognized could continue to increase, subject to the performance of the funds and the resolution of the contingencies.

**Fund Management and Investment Platform**

In order to accommodate the increasing demands of our funds' rapidly growing investment portfolios, we have expanded our investment platforms, which are comprised primarily of our people, financial and operating systems and supporting infrastructure. Expansion of our investment platform required increases in headcount, consisting of newly hired investment professionals and support staff, as well as leases and associated improvements to corporate offices to house the increasing number of employees, and related augmentation of systems and infrastructure. Our headcount increased from 707 employees as of June 30, 2007 to 880 employees as of June 30, 2008. This resulted in increases in our compensation, office related and other personnel related expenses. In addition, in conjunction with and subsequent to our initial public offering, we have implemented an equity-based compensation plan described in Note 7 to Part I, Item 1, Financial Statements - Equity-Based Compensation as a means to provide an additional financial incentive to retain our existing and future employees.

**Income Tax Expense**

Prior to January 17, 2007, we, as a partnership, generally had not been subject to U.S. federal income tax but certain of our subsidiaries had been subject to the New York City unincorporated business tax (UBT) on their U.S. earnings based on a statutory rate of 4%. One of our subsidiaries was subject to U.S. federal corporate income taxes. Certain of our subsidiaries are subject to income tax of the foreign countries in which they conduct business.

In connection with the Nomura transaction and the initial public offering (see Note 1 to Part I, Item 1, Financial Statements - Organization and Basis of Presentation), our operating entities were reorganized and a portion of our income is now subject to U.S. federal and state corporate income tax.

The amount of income taxes that we may be required to pay could increase significantly if legislation recently introduced in Congress is passed in its proposed form. During June 2007, legislation was introduced in the U.S. Senate, which would tax us and other publicly traded partnerships as corporations, and similar legislation was introduced in the House. The proposed Senate legislation would not apply to us for five years, but the House legislation does not include any corresponding exemption period. As of today, no action has been taken on either bill. In addition, legislation has also been introduced in the House, and passed by the House Ways and Means Committee, that would have the effect of taxing income recognized from carried interests as ordinary income thereby effectively causing such income to be treated as nonqualifying income under the publicly traded partnership rules, which would preclude us qualifying for treatment as a partnership for U.S. federal income tax purposes. If any of this legislation is enacted in its current or similar form, we would incur a material increase in our tax liability. For more information on the proposed legislation, see Part II, Item 1A, Risk Factors - Risks Related to Taxation - Legislation has been introduced that would, if enacted, preclude us from qualifying for treatment as a partnership for U.S. federal income tax purposes under the publicly traded partnership rules. Our structure also is subject to potential judicial or administrative change and differing interpretations, possibly on a retroactive basis.

**Revenues**

	Six Months Ended June 30,			Three Months Ended June 30,		
	2008	2007 (A)	Variance	2008	2007	Variance
Management fees from affiliates	\$ 293,662	\$ 215,037	\$ 78,625	\$ 149,605	\$ 118,678	\$ 30,927
Incentive income from affiliates	55,444	388,871	(333,427)	18,300	132,961	(114,661)
Other revenues	39,870	33,033	6,837	20,191	16,480	3,711
Total Revenues	\$ 388,976	\$ 636,941	\$(247,965)	\$ 188,096	\$ 268,119	\$(80,023)

(A) Pro Forma results of our operations on a deconsolidated basis.  
Six months ended June 30

## Edgar Filing: Fortress Investment Group LLC - Form 10-Q

For the six months ended June 30, 2008 compared with the six months ended June 30, 2007, total revenues decreased as a result of the following:

Management fees from affiliates increased by \$78.6 million primarily due to the net effect of increases in average AUM of \$3.6 billion, \$0.4 billion, \$3.0 billion and \$2.0 billion in our private equity funds, our Castles, our liquid hedge funds and our hybrid hedge funds, respectively. The combined increase to average AUM generated \$73.2 million of additional management fees.

**Table of Contents**

Incentive income from affiliates decreased by \$333.4 million as a result of \$38.2 million of incentive income recognized from our private equity funds for the six months ended June 30, 2008, as contingencies for repayment had been resolved in certain funds allowing income recognition, compared to \$211.9 million of incentive income recognized from our private equity funds for the six months ended June 30, 2007, which was no longer subject to contingencies. Furthermore, our liquid hedge funds and our Castles contributed additional decreases of \$141.8 million and \$17.9 million, respectively, in incentive income primarily due to lower returns.

Other revenues increased by \$6.8 million due to \$9.7 million of additional expense reimbursements from our funds, which are recorded gross on our statement of operations, and dividend income of \$1.0 million from our Castles (prior to the adoption of SFAS 159, dividend income was recorded as return of capital on investments), which were offset by a decrease in interest income of \$4.5 million.

*Three months ended June 30*

For the three months ended June 30, 2008 compared with the three months ended June 30, 2007, total revenues decreased as a result of the following:

Management fees from affiliates increased by \$30.9 million primarily due to the net effect of increases in average AUM of \$1.7 billion, \$0.3 billion, \$2.2 billion and \$1.5 billion in our private equity funds, our Castles, our liquid hedge funds and our hybrid hedge funds, respectively. The combined increase to average AUM drove \$28.4 million of additional management fees.

Incentive income from affiliates decreased by \$114.7 million as a result of \$3.5 million of incentive income recognized from our private equity funds for the three months ended June 30, 2008, as contingencies for repayment had been resolved in certain funds allowing income recognition, compared to \$5.5 million of incentive income recognized from our private equity funds for the three months ended June 30, 2007, which was no longer subject to contingencies. Furthermore, our liquid hedge funds and our Castles contributed additional decreases of \$98.6 million and \$14.2 million, respectively, in incentive income primarily due to lower returns.

Other revenues increased by \$3.7 million primarily due to \$5.7 million of additional expense reimbursements from our funds, which are recorded gross on our statement of operations, and dividend income of \$0.3 million from our Castles (prior to the adoption of SFAS 159, dividend income was recorded as return of capital on investments), which were offset by a decrease in interest income of \$2.6 million.

**Expenses**

	Six Months Ended June 30,			Three Months Ended June 30,		
	2008	2007 <sup>(A)</sup>	Variance	2008	2007	Variance
Interest expense	\$ 20,224	\$ 18,731	\$ 1,493	\$ 9,888	\$ 6,711	\$ 3,177
Compensation and benefits	264,479	395,495	(131,016)	137,460	187,783	(50,323)
Principals agreement compensation	474,734	380,933	93,801	237,367	242,659	(5,292)
General, administrative and other (including depreciation and amortization)	41,188	45,077	(3,889)	22,182	25,787	(3,605)
<b>Total Expenses</b>	<b>\$ 800,625</b>	<b>\$ 840,236</b>	<b>\$ (39,611)</b>	<b>\$ 406,897</b>	<b>\$ 462,940</b>	<b>\$ (56,043)</b>

(A) Pro Forma results of our operations on a deconsolidated basis.

*Six months ended June 30*

For the six months ended June 30, 2008 compared with the six months ended June 30, 2007, total expenses increased as a result of the following:

Interest expense increased by \$1.5 million primarily due to an increase of \$2.7 million in interest expense due to higher average borrowings in 2008 and an increase of \$0.6 million due to an increase in the amortization of financing costs associated with the amendment to our credit facility in May 2007, offset by a \$2.0 million write off of financing expenses related to the partial paydown of our credit facility during the six months ended June 30, 2007.



## Edgar Filing: Fortress Investment Group LLC - Form 10-Q

Compensation and benefits decreased by \$131.0 million primarily due to a decrease in profit sharing compensation of \$183.3 million, offset by an increase due to growth in our employee population of \$26.8 million, a \$7.0 million discretionary bonus declared during the first quarter of 2008 to one senior employee, and an increase in equity based compensation of \$18.3 million due to the 31 million FOG RPU's granted in April 2008 (see discussion below). Profit-sharing compensation decreased due largely to greater private equity realization events in the first six months of 2007 than in the first six months of 2008, and decreased profit from our liquid and hybrid hedge funds. Our average headcount for the six months ended June 30, 2008 grew 29 % compared to the six months ended June 30, 2007.

**Table of Contents**

Principals agreement compensation increased by \$93.8 million because there was not a full six months of amortization in 2007. In connection with the initial public offering in February 2007, the principals entered into an agreement among themselves, which provides that in the event a principal voluntarily terminates his employment with Fortress Operating Group for any reason prior to the fifth anniversary of the initial public offering, a portion of the equity interests held by that principal as of the completion of the initial public offering will be forfeited to the principals who remain employed by Fortress Operating Group. As a result of this service requirement, the fair value of Fortress Operating Group units subject to the risk of forfeiture of \$4,763.0 million is being charged to compensation expense on a straight-line basis over the five-year vesting period. When Fortress records this non-cash expense, it records a corresponding increase in capital.

General, administrative and other expenses decreased by \$3.9 million, primarily as a result of a decrease in professional fees and consulting fees of \$8.3 million relating to our transition to being a public company during 2007 offset by an increase of \$3.4 million in office and administrative costs to support a significantly larger workforce and increased infrastructure demands, and an increase in other general expenses related to being a public company of \$1.0 million.

*Three months ended June 30*

For the three months ended June 30, 2008 compared with the three months ended June 30, 2007, total expenses increased as a result of the following:

Interest expense increased by \$3.2 million primarily due to a \$2.9 million increase in interest expense related to higher average borrowings in 2008, and an increase of \$0.3 million due to an increase in the amortization of financing costs associated with the amendment to our credit facility in May 2007.

Compensation and benefits decreased by \$50.3 million primarily due to a decrease in profit sharing compensation of \$82.3 million, offset by an increase in equity based compensation of \$24.1 million, primarily due to 31 million FOG RPU's granted in April 2008 (see discussion below), and an increase due to growth in our employee population of \$5.9 million. Profit-sharing compensation decreased due largely to greater private equity realization events in the second quarter of 2007 than in the second quarter of 2008, and decreased profit from our liquid and hybrid hedge funds. Our average headcount for the three months ended June 30, 2008 grew 25% compared to the three months ended June 30, 2007.

Principals agreement compensation is being amortized over the term of the agreement.

General, administrative and other expenses decreased by \$3.6 million, primarily as a result of a decrease in professional fees and consulting fees of \$5.0 million relating to our transition to being a public company during 2007 offset by an increase of \$0.4 million in office and administrative costs to support a significantly larger workforce and increased infrastructure demands, and a \$1.0 million increase in other general expenses related to being a public company.

*Future Compensation Expense*

In future periods, we will further recognize non-cash compensation expense on our non-vested equity-based awards of \$1,027.7 million with a weighted average recognition period of 4.6 years.

In April 2008, we granted 31 million Fortress Operating Group ( FOG ) restricted partnership units ( RPU's ) to a senior employee. In connection with the grant of these interests, the employee receives partnership distribution equivalent payments on such units with economic effect as from January 1, 2008. The interests will vest into full capital interests in FOG units in three equal portions on the first business day of 2011, 2012 and 2013, respectively, subject to continued employment with Fortress. In connection with this grant, we have reduced the employee's profit sharing interests in various Fortress Funds.

**Other Income (Loss)**

	Six Months Ended June 30,			Three Months Ended June 30,		
	2008	2007 <sup>(A)</sup>	Variance	2008	2007	Variance
Gains (losses) - other investments	\$ (34,572)	\$ (22,296)	\$ (12,276)	\$ (6,615)	\$ (29,017)	\$ 22,402
Earnings (losses) from equity method investees	(75,629)	10,658	(86,287)	(26,500)	7,231	(33,731)

## Edgar Filing: Fortress Investment Group LLC - Form 10-Q

Total Other Income (Loss)	\$ (110,201)	\$ (11,638)	\$ (98,563)	\$ (33,115)	\$ (21,786)	\$ (11,329)
---------------------------	--------------	-------------	-------------	-------------	-------------	-------------

(A) Pro Forma results of our operations on a deconsolidated basis.

---

**Table of Contents**

*Six months ended June 30*

For the six months ended June 30, 2008 compared with the six months ended June 30, 2007, total other income (loss) decreased as a result of the following:

Gains (losses) other investments decreased by \$12.3 million primarily due to the net effect of:

recognition of an unrealized loss of \$21.0 million for the six months ended June 30, 2008 attributable to a decline in the market value of our investments in the Castles. Our investments in the Castles are held at fair value as of January 1, 2008 pursuant to the provisions of SFAS 159; and

recognition of an unrealized loss of \$15.5 million for the six months ended June 30, 2008 on our options in our Castles as a result of a decline in the relative performance of the underlying stock price, as compared to the recognition of an unrealized loss of \$24.7 million for the six months ended June 30, 2007.

Earnings (losses) from equity method investees decreased by \$86.3 million primarily due to the net effect of (i) the recognition of a \$75.6 million net loss from equity method investees in 2008 as a result of a \$77.1 million loss attributable to investments in our private equity funds and hybrid hedge funds offset by our share of income from investments in our liquid hedge funds and other investments of \$1.5 million compared to (ii) the recognition of \$10.7 million in earnings on our equity method investments for the six months ended June 30, 2007. The overall decrease was primarily a result of diminished returns within the funds.

*Three months ended June 30*

For the three months ended June 30, 2008 compared with the three months ended June 30, 2007, total other income (loss) decreased as a result of the following:

Gains (losses) other investments increased by \$22.4 million primarily due to the net effect of:

recognition of an unrealized loss of \$3.7 million for the three months ended June 30, 2008 attributable to a decline in the market value of our investments in the Castles. Our investments in the Castles are held at fair value as of January 1, 2008 pursuant to the provisions of SFAS 159; and

recognition of an unrealized loss of \$2.7 million for the three months ended June 30, 2008 on our options in our Castles as a result of a decline in the relative performance of the underlying stock price, as compared to the recognition of an unrealized loss of \$29.8 million for the three months ended June 30, 2007.

Earnings (losses) from equity method investees decreased by \$33.7 million primarily due to the net effect of (i) the recognition of a \$26.5 million net loss from equity method investees in 2008 as a result of a \$28.6 million loss attributable to investments in our private equity funds and liquid hedge funds offset by our share of income from investments in our hybrid hedge funds and other investments of \$2.1 million compared to (ii) the recognition of \$7.2 million in earnings on our equity method investments for the three months ended June 30, 2007. The overall decrease was primarily a result of diminished returns within the funds.

**Income Tax Benefit (Expense)**

For the six and three months ended June 30, 2008, Fortress recognized income tax expense (benefit) of \$5.3 and (\$1.9 million), respectively. For the six and three months ended June 30, 2007, Fortress recognized income tax expense (benefit) of \$19.5 million and \$5.0 million, respectively. The primary reasons for the decrease in income tax expense for the six and three months ended June 30, 2008 compared to the six and three months ended June 30, 2007 are (i) a decrease in pre-tax book income; and (ii) a change in the mix of business segments producing income, which may be subject to tax at different rates.



## **Table of Contents**

### **Segment Analysis**

Fortress conducts its management and investment business through the following five primary segments: (i) private equity funds, (ii) Castles, (iii) liquid hedge funds, (iv) hybrid hedge funds, and (v) principal investments in these funds as well as cash that is available to be invested. These segments are differentiated based on their varying investment strategies. Due to the increased significance of the principal investments segment, it has been disaggregated from the other segments in this period and for all periods presented.

Discussed below are our results of operations for each of our reportable segments. They represent the separate segment information available and utilized by our management committee, which consists of our principals, and which functions as our chief operating decision maker to assess performance and to allocate resources. Management evaluates the performance of each segment based on its distributable earnings.

As segment revenues reflected in our distributable earnings are presented on an unconsolidated basis, management fee and incentive income are reflected on a gross basis prior to elimination as required in consolidation. As a result of this presentation, management fees and incentive income are greater than those reflected on a consolidated GAAP basis for periods prior to the deconsolidation on March 31, 2007. Other items within distributable earnings are less than the related amounts on a GAAP basis for these periods, as they do not include the effects of consolidating the Fortress Funds.

As mentioned above, results of operations for each of our segments are reflected on an unconsolidated basis, even for periods prior to the deconsolidation. Management also assesses our segments on a Fortress Operating Group and pre-tax basis, and therefore adds back the non-controlling interests in consolidated subsidiaries related to Fortress Operating Group units (held by the principals) and income tax expense.

Distributable earnings is GAAP net income adjusted for the following items:

- i. adding a measure of incentive income which is subject to contingent repayment but for which collectability is reasonably assured because management believes the likelihood of clawback is remote;
- ii. modifying the timing of recognition of compensation expense related to employee profit sharing in incentive income to match the timing of the recognition of the related revenue, which is not matched under GAAP;
- iii. recording income from equity method investees only to the extent it has been realized. While equity method income is a meaningful measure of the operating performance of equity method investees, it is not a measure of currently recognizable income for us as we are holding the interests in our funds for long-term investment purposes. Since any difference between our share of their GAAP income and the distributions we receive is unlikely to be realized until a liquidation transaction occurs, adjusting this income to delay recognition of our equity in undistributed earnings until it is realized is consistent with the principles of distributable earnings;
- iv. only recording income from options received once they are exercised and the underlying shares sold, since the timing and amount of economic gain which may be realized from options held in equity method investees is highly uncertain and the GAAP valuation of such options is not a reliable measure of sustainable earnings; and
- v. adding back our equity-based compensation because it does not require settlement by the future transfer or use of assets and therefore does not impact our analysis of earnings which will be available for potential distributions.

Distributable earnings for our existing businesses is equal to net income adjusted as follows:

Incentive Income

## Edgar Filing: Fortress Investment Group LLC - Form 10-Q

- (i) a. for Fortress Funds which are private equity funds, adding (a) incentive income paid (or declared as a distribution) to us, less an applicable reserve for potential future clawbacks if the likelihood of a clawback is deemed greater than remote (net of the reversal of any prior such reserves that are no longer deemed necessary), minus (b) incentive income recorded in accordance with GAAP,
- b. for other Fortress Funds, at interim periods, adding (a) incentive income on an accrual basis as if the incentive income from these funds were payable on a quarterly basis, minus (b) incentive income recorded in accordance with GAAP,

### Other Income

- (ii) with respect to income from certain principal investments and certain other interests that cannot be readily transferred or redeemed:
  - a. for equity method investments in the Castles (prior to 2008) and private equity funds as well as indirect equity method investments in hedge fund special investment accounts (which generally have investment profiles similar to private equity funds), treating these investments as cost basis investments by adding (a) realizations of income, primarily dividends, from these funds, minus (b) impairment with respect to these funds, if necessary, minus (c) equity method earnings (or losses) recorded in accordance with GAAP,

**Table of Contents**

- b. subtracting gains (or adding losses) on stock options held in the Castles,
  - c. subtracting unrealized gains (or adding unrealized losses) from our consolidated private equity funds,
  - d. subtracting unrealized gains (or adding unrealized losses) from the Castles subsequent to the election of the fair value option under SFAS 159,
- (iii) adding (a) proceeds from the sale of shares received pursuant to the exercise of stock options in certain of the Castles, in excess of their strike price, minus (b) management fee income recorded in accordance with GAAP in connection with our receipt of these options,

Expenses

- (iv) adding or subtracting, as necessary, the employee profit sharing in (i) above to match the timing of the expense with the revenue,
- (v) adding back equity-based compensation expense (including Castle options assigned to employees, RSUs and RPU's (including the portion of related dividend and distribution equivalents recorded as compensation expense), restricted shares and the LTIP),
- (vi) adding back compensation expense recorded in connection with the forfeiture arrangements entered into among the principals,
- (vii) adding the income (or subtracting the loss) allocable to the principals' interests attributable to Fortress Operating Group units, and
- (viii) adding back income tax expense and any expense recorded in connection with the tax receivable agreement.

**Private Equity Funds**

	Six Months Ended June 30,			Three Months Ended June 30,		
	2008	2007	Variance	2008	2007	Variance
Management Fees	\$ 84,330	\$ 62,616	\$ 21,714	\$ 42,550	\$ 35,852	\$ 6,698
Incentive Income	28,741	190,298	(161,557)			
Segment revenues - total	\$ 113,071	\$ 252,914	\$ (139,843)	\$ 42,550	\$ 35,852	\$ 6,698
Pre-tax distributable earnings	\$ 81,886	\$ 166,843	\$ (84,957)	\$ 31,942	\$ 28,070	\$ 3,872

*Six months ended June 30*

Pre-tax distributable earnings decreased by \$85.0 million mainly due to:



## Edgar Filing: Fortress Investment Group LLC - Form 10-Q

a \$21.7 million increase in management fees. Management fees increased mainly due to (i) \$26.6 million of management fees generated by the creation of new private equity funds, most notably Fund V, Fund V Coinvestment, Florida Coinvestment Fund and Mortgage Opportunities Fund, and (ii) an increase in AUM from Holiday Investment Fund ( FHIF ), which resulted in an increase in management fees of \$2.2 million. These increases to management fees were partially offset by a decrease of \$2.2 million in management fees collected from Fortress Residential Investment Deutschland ( FRID ) as a result of distributions to investors (which reduces AUM) during 2007, a decrease of \$2.4 million from Fund III as a result of the NAV of a portfolio company declining below its invested capital, and a decrease of \$3.1 million from Fund IV, as a consequence of the creation of Fund V in May 2007 (which caused the management fees from Fund IV to be based on invested capital rather than capital commitments);

a \$100.7 million net decrease in incentive income. Incentive income decreased by \$161.6 million partially offset by a corresponding decrease in the employee s share of incentive income of \$60.9 million reflected as profit sharing compensation expense. The decrease of \$161.6 million in incentive income was primarily attributable to a decline in the returns of our private equity funds of \$164.2 million, offset by an increase of \$2.7 million in incentive income due to higher FFO in excess of certain performance hurdles generated by NIH; and

a \$5.2 million increase in operating expenses mainly driven by an increase in headcount.

**Table of Contents***Three months ended June 30*

Pre-tax distributable earnings increased by \$3.9 million mainly due to:

a \$6.7 million increase in management fees. Management fees increased mainly due to (i) \$9.7 million of management fees generated by the creation of new private equity funds, most notably Fund V, Fund V Coinvestment, Florida Coinvestment Fund and Mortgage Opportunities Fund, offset by (ii) a decrease of \$1.1 million in management fees collected from Fortress Residential Investment Deutschland ( FRID ) as a result of distributions to investors (which reduces AUM) during 2007, a decrease of \$1.2 million from Fund III as a result of the NAV of a portfolio company declining below its invested capital, and a decrease of \$1.5 million from Fund IV, as a consequence of the creation of Fund V in May 2007 (which caused the management fees from Fund IV to be based on invested capital rather than capital commitments);

a \$2.6 million increase in operating expenses mainly driven by an increase in headcount.

Publicly Traded Alternative Investment Vehicles ( Castles )

	Six Months Ended June 30,			Three Months Ended June 30,		
	2008	2007	Variance	2008	2007	Variance
Management Fees	\$ 27,655	\$ 22,746	\$ 4,909	\$ 13,961	\$ 11,841	\$ 2,120
Incentive Income	12	17,905	(17,893)		14,217	(14,217)
Segment revenues - total	\$ 27,667	\$ 40,651	\$ (12,984)	\$ 13,961	\$ 26,058	\$ (12,097)
Pre-tax distributable earnings	\$ 8,204	\$ 18,938	\$ (10,734)	\$ 3,928	\$ 13,883	\$ (9,955)

*Six months ended June 30*

Pre-tax distributable earnings decreased by \$10.7 million primarily due to:

a \$4.9 million net increase in management fees. Management fees primarily increased due to (i) \$2.6 million as a result of the growth of average AUM, and (ii) \$2.3 million as a result of changes in foreign currency exchange rates;

a \$13.2 million net decrease in incentive income. Incentive income decreased by \$17.9 million which was offset by a decrease in the employees' share of incentive income of \$4.7 million reflected as profit sharing compensation expense. The decrease of \$17.9 million was primarily due to the recognition of incentive income generated by Newcastle and Eurocastle as a result of FFO exceeding certain performance hurdles for the six months ended June 30, 2007. For the six months ended June 30, 2008, Newcastle's and Eurocastle's FFO did not exceed these performance hurdles so no incentive income was generated; and

a \$2.4 million net increase in operating expenses primarily due to increases in general and administrative and other expenses.

*Three months ended June 30*

Pre-tax distributable earnings decreased by \$10.0 million primarily due to:

## Edgar Filing: Fortress Investment Group LLC - Form 10-Q

a \$2.1 million net increase in management fees. Management fees primarily increased due to (i) \$1.0 million as a result of the growth of average AUM, and (ii) \$1.1 million as a result of changes in foreign currency exchange rates;

a \$10.8 million net decrease in incentive income. Incentive income decreased by \$14.2 million which was offset a decrease in the employees' share of incentive income of \$3.4 million reflected as profit sharing compensation expense. The decrease of \$14.2 million was primarily due to the recognition of incentive income generated by Newcastle and Eurocastle as a result of FFO exceeding certain performance hurdles for the three months ended June 30, 2007. For the three months ended June 30, 2008, Newcastle's and Eurocastle's FFO did not exceed these performance hurdles so no incentive income was generated; and

a \$1.3 million net increase in operating expenses primarily due increases in general and administrative and other expenses.

**Table of Contents**Liquid Hedge Funds

	Six Months Ended June 30,			Three Months Ended June 30,		
	2008	2007	Variance	2008	2007	Variance
Management Fees	\$ 110,325	\$ 69,341	\$ 40,984	\$ 57,606	\$ 38,400	\$ 19,206
Incentive Income	17,040	158,199	(141,159)	14,345	112,920	(98,575)
Segment revenues - total	\$ 127,365	\$ 227,540	\$ (100,175)	\$ 71,951	\$ 151,320	\$ (79,369)
Pre-tax distributable earnings	\$ 45,426	\$ 105,387	\$ (59,961)	\$ 30,695	\$ 74,871	\$ (44,176)

*Six months ended June 30*

Pre-tax distributable earnings decreased by \$60.0 million mainly due to:

a \$42.1 million net increase in management fees. Management fees increased by \$41.0 million and the employees' share of management fees decreased by \$1.1 million (due to a reduction in the employees' percentage share of such fees). The \$41.0 million increase was primarily a result of the growth in average AUM, an increase in the average management fee percentage earned, and management fees generated by the formation of the new Commodities Fund, which generated \$26.5 million, \$9.7 million and \$6.0 million of additional management fees, respectively, partially offset by a decrease in non-affiliate management fees of \$1.2 million;

an \$87.9 million net decrease in incentive income. Incentive income decreased by \$141.2 million partially offset by a corresponding decrease in the employees' share of incentive income of \$53.3 million, reflected as profit sharing compensation expense. The \$141.2 million decrease in incentive income is primarily attributable to a decrease of \$158.2 million due to lower returns in our liquid hedge funds, offset by an increase in incentive income generated by special investments and the new Commodities Fund of \$2.0 million and \$15.0 million, respectively; and

a \$14.1 million increase in operating expenses mainly due to an increase in headcount.

*Three months ended June 30*

Pre-tax distributable earnings decreased by \$44.2 million mainly due to:

an \$18.9 million net increase in management fees. Management fees increased by \$19.2 million partially offset by a corresponding increase in the employees' share of management fees of \$0.3 million. The \$19.2 million increase was primarily a result of the growth in average AUM, an increase in the average management fee percentage earned, and management fees generated by the formation of the new Commodities Fund, which generated \$12.3 million, \$3.2 million and \$3.8 million of additional management fees, respectively, partially offset by a decrease in non-affiliate management fees of \$0.1 million;

a \$55.9 million net decrease in incentive income. Incentive income decreased by \$98.6 million partially offset by a corresponding decrease in the employees' share of incentive income of \$42.7 million, reflected as profit sharing compensation expense. The \$98.6 million decrease in incentive income is primarily attributable to a decrease of \$113.2 million due to lower returns in our liquid hedge funds, offset by an increase in incentive income generated by the new Commodities Fund of \$14.6 million; and

## Edgar Filing: Fortress Investment Group LLC - Form 10-Q

a \$7.2 million increase in operating expenses mainly due to an increase in headcount.

### Hybrid Hedge Funds

	Six Months Ended June 30,			Three Months Ended June 30,		
	2008	2007	Variance	2008	2007	Variance
Management Fees	\$ 73,455	\$ 60,720	\$ 12,735	\$ 36,611	\$ 31,707	\$ 4,904
Incentive Income	872	84,369	(83,497)	447	38,264	(37,817)
<b>Segment revenues - total</b>	<b>\$ 74,327</b>	<b>\$ 145,089</b>	<b>\$(70,762)</b>	<b>\$ 37,058</b>	<b>\$ 69,971</b>	<b>\$(32,913)</b>
Pre-tax distributable earnings	\$ 11,279	\$ 49,314	\$(38,035)	\$ 9,231	\$ 17,534	\$ (8,303)

### *Six months ended June 30*

Pre-tax distributable earnings decreased by \$38.0 million mainly due to:

an \$11.2 million net increase in management fees. Management fees increased by \$12.7 million partially offset by a corresponding increase in the employees' share of management fees of \$1.5 million. The \$12.7 million increase in management fees was mainly a result of growth in AUM, which drove a \$14.6 million increase, offset by a decrease of \$0.8 million due to a decrease in the average management fee percentage earned, and a \$1.1 million decrease in management fees from non-affiliate investments;

**Table of Contents**

a \$47.4 million net decrease in incentive income. Incentive income decreased by \$83.5 million and the employees' share of incentive income, reflected as profit sharing compensation expense, decreased by \$36.1 million. The \$83.5 million decrease in incentive income was mainly attributable to a decline in the return of our hybrid hedge funds, including special investments, which generated a decrease of \$95.9 million, partially offset by an increase of \$12.4 million due to the change in the average capital eligible for incentive income; and

a \$1.8 million increase in operating expenses primarily related to an increase in headcount.

*Three months ended June 30*

Pre-tax distributable earnings decreased by \$8.3 million mainly due to:

a \$4.0 million net increase in management fees. Management fees increased by \$4.9 million partially offset by a corresponding increase in the employees' share of management fees of \$0.9 million. The \$4.9 million increase in management fees was mainly a result of growth in AUM, which generated a \$5.3 million increase, offset by a decrease of \$0.3 million due to a decrease in the average management fee percentage earned, and a \$0.1 million decrease in management fees from non-affiliate investments;

a \$19.8 million net decrease in incentive income. Incentive income decreased by \$37.8 million and the employees' share of incentive income, reflected as profit sharing compensation expense, decreased by \$18.0 million. The \$37.8 million decrease in incentive income was mainly attributable to a decline in the return of our hybrid hedge funds, including special investments, which generated a decrease of \$41.7 million, partially offset by an increase of \$3.9 million due to the change in the average capital eligible for incentive income; and

a \$7.5 million decrease in operating expenses primarily related to a decrease in compensation expense.

**Principal Investments**

	Six Months Ended June 30,			Three Months Ended June 30,		
	2008	2007	Variance	2008	2007	Variance
Pre-tax distributable earnings (loss)	\$ (30,656)	\$ 29,641	\$ (60,297)	\$ (17,326)	\$ 13,650	\$ (30,976)

*Six months ended June 30*

Pre-tax distributable earnings decreased by \$60.3 million mainly due to:

Private Equity funds: a \$9.0 million decrease in net investment income primarily as a result of \$9.4 million of realized gains (representing our share) mainly from an investment in a residential housing company during 2007, as compared to \$0.4 million of realized gains in 2008;

Castles: a \$10.3 million decrease in net investment income primarily as a result of a \$9.5 million impairment on our shares held in Newcastle during 2008 and a decrease of \$2.3 million in the dividend income received on our shares held in Eurocastle and Newcastle, offset by a foreign currency hedge loss in the amount of \$0.7 million recognized during the six months ended June 30, 2007;

## Edgar Filing: Fortress Investment Group LLC - Form 10-Q

Liquid hedge funds: a \$6.9 million decrease in net investment income of which \$7.2 million is mainly attributable to lower returns in 2008 and the distribution of previously earned fees which had generated \$1.9 million of income for the six months ended June 30, 2007, partially offset by an increase of \$2.9 million due to the change in our average investment balance;

Hybrid hedge funds: a \$30.7 million decrease in net investment income. \$22.8 million of the decrease was due to lower returns and \$6.4 million of the decrease was due to the change in our average investment balance; and

Expenses: a \$3.4 million decrease in net investment income primarily due to a \$4.5 million decrease in interest income as a result of lower interest rates and lower average cash balances, and an increase of \$2.7 million in interest expense due to higher average borrowings. This was offset by a \$2.0 million write off of deferred financing expenses related to the partial paydown of our credit facility during the six months ended June 30, 2007, and gains of \$2.0 million related to foreign currency translation during the six months ended June 30, 2008.

*Three months ended June 30*

Pre-tax distributable earnings decreased by \$31.0 million mainly due to:

Private Equity funds: a \$0.4 million decrease in net investment income primarily as a result of realized gains from certain investments in 2007;

Castles: a \$10.4 million decrease in net investment income primarily as a result of a \$9.5 million impairment on our shares held in Newcastle during 2008 and a decrease of \$1.1 million in the dividend income received on our shares held in Eurocastle and Newcastle, offset by a foreign currency hedge loss in the amount of \$0.4 million recognized during the three months ended June 30, 2007;

**Table of Contents**

Liquid hedge funds: a \$4.6 million decrease in net investment income which is mainly attributable to a \$3.6 million decrease resulting from lower returns in 2008 and the distribution of previously earned fees which had generated \$1.0 million of income for the three months ended June 30, 2007;

Hybrid hedge funds: a \$9.9 million decrease in net investment income. \$5.1 million of the decrease was due to lower returns in 2008 and \$4.1 million of the decrease was due to the change in our average investment balance; and

Expenses: a \$5.7 million decrease in net investment income primarily due to a decrease of \$2.6 million in interest income as a result of lower interest rates and lower average cash balances, and an increase of \$2.9 million in interest expense as a result of higher average borrowings.

**Unallocated**

	Six Months Ended June 30,			Three Months Ended June 30,		
	2008	2007	Variance	2008	2007	Variance
Pre-tax distributable earnings (loss)	\$ 7	\$ (7,286)	\$ 7,293	\$ (31)	\$ (4,752)	\$ 4,721

*Six months ended June 30*

Pre-tax distributable earnings (loss) increased by \$7.3 million. The increase in earnings is due to a decrease in corporate expenses and professional fees that were incurred in 2007 in relation to the demands of being a new public company.

*Three months ended June 30*

Pre-tax distributable earnings (loss) increased by \$4.7 million. The increase in earnings is due to a decrease in corporate expenses and professional fees that were incurred in 2007 in relation to the demands of being a new public company.

**Sensitivity**

For an analysis of the sensitivity of segment revenues to changes in the estimated fair value of the Fortress Fund investments, see Part I, Item 3, Quantitative and Qualitative Disclosures About Market Risk.

**Liquidity and Capital Resources**

Liquidity is a measurement of our ability to meet potential cash requirements, including ongoing commitments to repay borrowings, fund and maintain investments, including our capital commitments to our funds, pay compensation, and satisfy our other general business needs including our obligation to pay U.S. federal income tax. In addition, we will require cash to meet our intended distribution policy. Our primary sources of funds for liquidity consist of cash flows provided by operating activities, primarily the management fees and incentive income paid to us from the Fortress Funds, borrowings under loans, and the issuance of debt and equity securities, as well as the investment returns on our principal investments in these funds.

The timing of receipt of cash flows from operating activities is in large part dependent on the timing of distributions from our private equity funds and redemptions from our hedge funds, which are subject to restrictions and to management's judgment regarding the optimal timing of the monetization of underlying investments. The timing of capital requirements to cover fund commitments is subject to management's judgment regarding the acquisition of new investments within the funds, as well as the liquidity requirements of the funds. The timing of capital requirements and the availability of liquidity from operating activities may not always coincide and we may make short-term, lower-yielding investments with excess liquidity or fund shortfalls with short-term debt or other sources of capital.

Our ability to execute our business strategy, particularly our ability to form new funds and increase our AUM, depends on our ability to raise additional investor capital within our funds. Decisions by counterparties to enter into transactions with us will depend upon a number of factors, such as our historical and projected financial performance and condition, compliance with the terms of our current credit arrangements, industry and market trends and performance, the availability of capital and our counterparties' policies and rates applicable thereto, the rates at which we



## Edgar Filing: Fortress Investment Group LLC - Form 10-Q

are willing to borrow, and the relative attractiveness of alternative investment or lending opportunities.

On February 8, 2007, we completed an initial public offering of 39,428,900 of our Class A shares. We contributed the net proceeds from the offering to Fortress Operating Group in exchange for 39,428,900 limited partnership units. We are a publicly traded partnership and have established a wholly owned corporate subsidiary ( FIG Corp. ). Accordingly, a substantial portion of our income earned by the corporate subsidiary is subject to U.S. federal income taxation and taxed at prevailing rates. The remainder of our income is allocated directly to our shareholders and is not subject to any corporate level of taxation.

**Table of Contents**

We expect that our cash on hand and our cash flows from operating activities and available financing will satisfy our liquidity needs with respect to current commitments relating to investments and with respect to our debt obligations over the next twelve months. We expect to meet our long-term liquidity requirements, including the repayment of our debt obligations and any new commitments or increases in our commitments, relating to principal investments, through the generation of operating income, additional borrowings and potential equity offerings.

As of June 30, 2008, our material cash commitments and contractual cash requirements were related to our distributions, capital commitments to our funds, lease obligations and debt obligations.

*Dividends / Distributions*

On June 25, 2008, we declared a second quarter cash dividend of \$0.225 per Class A share. The dividend was paid on July 11, 2008 to holders of record of our Class A shares on June 30, 2008. The aggregate amount of this dividend payment was \$21.3 million. In connection with this dividend, a distribution of \$70.2 million was declared from Fortress Operating Group to the principals, dividend equivalent payments of \$5.5 million were made to holders of restricted Class A share units, and a distribution equivalent payment of \$7.0 million was made to the holder of the Fortress Operating Group RPU.

On March 25, 2008, we declared a first quarter cash dividend of \$0.225 per Class A share. The dividend was paid on April 15, 2008 to holders of record of our Class A shares on March 31, 2008. The aggregate amount of this dividend payment was \$21.3 million. In connection with this dividend, a distribution of \$70.2 million was declared from Fortress Operating Group to the principals and dividend equivalent payments of \$5.4 million were made to holders of restricted Class A share units.

During the six months ended June 30, 2008, in addition to the distributions described above, Fortress Operating Group made distributions to the principals of \$3.0 million (all of which was distributed prior to the issuance of the RPUs) in connection with distributions made to FIG Corp. to pay Fortress's income taxes.

*Capital Commitments*

We determine whether to make capital commitments to our private equity funds in excess of the minimum required amounts based on a variety of factors, including estimates regarding our liquidity over the estimated time period during which commitments will have to be funded, estimates regarding the amounts of capital that may be appropriate for other funds which we are in the process of raising or are considering raising, and our general working capital requirements.

We generally fund our principal investments in the Fortress Funds with cash, either from working capital or borrowings, and not with carried interest. We do not hold any principal investments in the funds other than through the Fortress Operating Group entities. Our principals do not own any portion of the carried interest in any fund personally. Accordingly, their personal investments in the funds are funded directly with cash.

Our capital commitments to our funds with outstanding commitments as of June 30, 2008 consisted of the following:

	<b>Outstanding Commitment</b>
<b>Private Equity Funds</b>	
Fund I	\$ 12
Fund II	1,958
Fund III	2,249
Fund III Coinvestment	2
Fund IV	12,396
Fund IV Coinvestment	14
Fund V	89,824
Fund V Coinvestment	23
Fortress Residential Investment Deutschland	898
Holiday Investment Fund	11,446
Florida Coinvestment Fund	1,551
Long Dated Value Fund I	735
Long Dated Value Fund II	2,210

Edgar Filing: Fortress Investment Group LLC - Form 10-Q

Long Dated Value Fund III	477
Real Assets Fund	31,062
Karols Development Co	8,529
Credit Opportunities Fund	19,739
Drawbridge Assets Overflow Fund	201
Total	\$ 183,326

**Table of Contents***Lease Obligations*

Minimum future rental payments under our operating leases are as follows:

July 1, 2008 to December 31, 2008	\$ 9,124
2009	18,930
2010	15,087
2011	12,141
2012	10,508
2013	9,791
Thereafter	31,021
 Total	 \$ 106,602

*Debt Obligations*

As of June 30, 2008, our debt obligations consisted of the amount outstanding under our credit agreement, as described below.

In 2002, we borrowed \$2.9 million collateralized by our interest in an aircraft (the aircraft loan). This loan bore interest at LIBOR plus 2.25%. We had hedged our exposure to the risk of changes in market interest rates with respect to this loan by entering into an interest rate swap, which fixed the effective interest rate on this loan at approximately 6.80% through maturity. In June 2007, we repaid all amounts outstanding under the aircraft loan and terminated the related interest rate swap.

In June 2006, we entered into a \$750 million credit agreement (the 2006 Credit Agreement). Borrowings under the 2006 Credit Agreement bore interest at LIBOR plus 2.00%, with the agreement being subject to unused commitment fees of 0.375% per annum. The purpose of the 2006 Credit Agreement was to refinance a prior credit agreement, to make funds available for investments in the various existing and new Fortress Funds, and to make a one-time \$250 million distribution of capital to our principals.

As a result of our initial public offering, we became subject to a reduced unused commitment fee of 0.25% and a letter of credit fee of 1.50% and borrowings under the 2006 Credit Agreement accrued interest at a rate equal to (i) with respect to LIBOR loans, LIBOR plus 1.50% and (ii) with respect to base rate loans, the base rate, as defined in the credit agreement, plus 0.50%. \$250 million of the term loan and \$85 million of the revolving credit facility under the 2006 Credit Agreement were repaid with proceeds received from our initial public offering. In connection with the partial paydown of the existing credit facility, deferred loan costs of \$2.0 million were written off to interest expense in February 2007.

In May 2007, we entered into a new \$1 billion credit agreement (as amended, the 2007 Credit Agreement or our credit agreement) in order to refinance the 2006 Credit Agreement described above, reduce the amount of interest and other fees payable under our credit facilities and increase the amount of funds available for investments. The credit facilities available under the 2007 Credit Agreement include a \$200 million revolving credit facility (including a \$25 million letter of credit subfacility) and an \$800 million term loan facility. Borrowings and letters of credit issued under the 2007 Credit Agreement bore interest at a rate equal to (i) with respect to LIBOR loans, LIBOR plus 1.20%, or (ii) with respect to base rate loans, the base rate, as defined in the agreement, plus 0.20%. On February 1, 2008, the rate on LIBOR loans was reduced to LIBOR + 0.65% pursuant to the terms of the agreement. In addition, we were required to pay a commitment fee of 0.20% per annum on the unused portion of amounts available under our revolving credit facility. On April 17, 2008, we entered into an amendment to the 2007 Credit Agreement. The amendment, among other things, (i) permits us to issue an unlimited amount of subordinated indebtedness with specified terms so long as 40% of the net proceeds are used to repay amounts outstanding under the 2007 Credit Agreement, (ii) increased the applicable rate on Eurodollar loans and letters of credit by 20 basis points (making the current rate LIBOR plus 0.85%) and the undrawn commitment fee by 5 basis points (making the current fee 0.25%), (iii) added an amortization schedule requiring us to repay \$100 million of amounts outstanding under the agreement each year during the next three years (with the first payment due on January 15, 2009), (iv) modified the financial covenants by (a) replacing the EBITDA-based financial covenant with a Consolidated Leverage Ratio covenant, (b) increasing the minimum amount of management fee earning assets by \$3 billion to \$21.5 billion (which minimum amount increases annually by \$500 million) and (c) eliminating the annual \$50 million increase in required minimum investment assets, and (v) revised various definitions and clarified terms with respect to swap providers who are lenders under the agreement. In addition, on May 29, 2008, we entered into an amendment of our credit agreement to change from a co-borrower structure to a single borrower structure.



**Table of Contents**

The following table presents information regarding our debt obligations:

Debt Obligation	Face Amount and Carrying Value		Final Stated Maturity	June 30, 2008	
	June 30, 2008	December 31, 2007		Weighted Average Funding Cost <sup>(1)</sup>	Weighted Average Maturity (Years)
Credit Agreement <sup>(2)</sup>					
Revolving debt <sup>(3)</sup>	\$	\$ 185,000	May 2012	0.00%	N/A
Term loan	350,000	350,000	May 2012	3.66%	3.86
Delayed term loan	450,000		May 2012	3.78%	1.67
<b>Total</b>	<b>\$ 800,000</b>	<b>\$ 535,000</b>		<b>3.73%</b>	<b>2.63</b>

- (1) The weighted average funding cost is calculated based on the contractual interest rate (utilizing the most recently reset LIBOR rate) plus the amortization of deferred financing costs. The most recently reset LIBOR rate was 2.48%.
- (2) Collateralized by substantially all of Fortress Operating Group's assets as well as Fortress Operating Group's rights to fees from the Fortress Funds and its equity interests therein.
- (3) Approximately \$189 million was undrawn and available under the revolving debt facility as of June 30, 2008, including a \$25 million letter of credit subfacility of which \$11 million was utilized. As a result of the Nomura transaction and our initial public offering, FIG Asset Co. LLC lent excess proceeds of \$215 million to FIG Corp. pursuant to a demand note. Since then, FIG Corp. has repaid a portion of the demand note and, as of June 30, 2008, the outstanding balance was \$125.3 million. This intercompany debt is eliminated in consolidation.

*Covenants*

Fortress Operating Group is required to prepay the 2007 Credit Agreement upon the occurrence of certain events, including certain asset sales and other dispositions.

The 2007 Credit Agreement includes customary covenants. We were in compliance with all of these covenants as of June 30, 2008. Among other things, we are prohibited from incurring additional unsubordinated indebtedness or further encumbering our assets, subject to certain exceptions. In addition, Fortress Operating Group must not:

Permit AUM to be less than \$21.5 billion as of December 31, 2007, plus an additional \$500 million at the end of each subsequent fiscal year;

Permit the Consolidated Leverage Ratio, as defined in the 2007 Credit Agreement, to be greater than (i) for the fiscal quarters ending March 31, 2008, June 30, 2008, September 30, 2008, December 31, 2008 and March 31, 2009, 2.75 to 1.0, (ii) for the fiscal quarters ending June 30, 2009, September 30, 2009, December 31, 2009 and March 31, 2010, 2.50 to 1.0 and (iii) for each fiscal quarter thereafter, 2.25 to 1.0;

## Edgar Filing: Fortress Investment Group LLC - Form 10-Q

Permit the aggregate value of investments held, including certain cash, to be less than \$1.05 billion (the Required Investment Assets );

Permit the aggregate value of Fortress Fund Investments (generally defined in the 2007 Credit Agreement as the stock of Newcastle, Eurocastle and any other publicly traded company pledged as collateral (and any options in respect of such stock), and Fortress Operating Group's interest in the Fortress private equity funds and hedge funds and certain other investment funds) to be less than 40% of the Required Investment Assets;

Permit the aggregate value of the sum of (i) the Fortress Fund Investments plus (ii) certain investments in co-investment funds to be less than 60% of the Required Investment Assets (with no single co-investment fund investment exceeding \$75 million).

In addition, under the 2007 Credit Agreement, Fortress Operating Group is permitted to make (i) cash distributions in order for our shareholders to pay their taxes, and (ii) loans to its intermediate holding companies and cash distributions subject to the following restrictions: (a) no event of default exists immediately prior to, or subsequent to, the loan or distribution, as the case may be, and (b) the loan or distribution would not exceed cumulative free cash flow. Free cash flow, as defined in our 2007 Credit Agreement, is calculated on a cumulative basis as \$163 million plus EBITDA earned since March 31, 2007, minus interest paid, capital expenditures made, loans made (net of any repayments) and distributions made since March 31, 2007.

The events of default under the 2007 Credit Agreement are typical of such agreements and include payment defaults, failure to comply with credit agreement covenants, cross-defaults to material indebtedness, bankruptcy and insolvency, change of control, and adverse events (as defined in the 2007 Credit Agreement) with respect to our material funds.

This summary is qualified by reference to our 2007 Credit Agreement, a copy of which, including all amendments thereto, has been filed with the SEC.

---

## Table of Contents

### *Cash Flows*

Our historical consolidated statements of cash flows reflect the cash flows of Fortress Operating Group as well as those of our consolidated Fortress Funds (through their deconsolidation on March 31, 2007), which were all investment companies, for the six months ended June 30, 2007.

The consolidated Fortress Funds, on a gross basis, are much larger than Fortress Operating Group and therefore substantially all of the gross cash flows reflected in our statement of cash flows, through their deconsolidation on March 31, 2007, relate to their activities. The primary cash flow activities of Fortress Operating Group are: (i) generating cash flow from operations, (ii) making investments in Fortress Funds (these cash flows are eliminated in consolidation through March 31, 2007), (iii) meeting financing needs through our credit agreement, and (iv) distributing cash flow to equity holders. The primary cash flow activities of the Fortress Funds which were consolidated through March 31, 2007 were: (i) raising capital from their investors, which have historically been reflected as Principals and others interests in equity of consolidated subsidiaries in our financial statements, (ii) using this capital to make investments, (iii) financing certain investments with debt, (iv) generating cash flow from operations through the realization of investments, and (v) distributing cash flow to investors.

As described above in Results of Operations, our AUM has grown throughout the periods reflected in our financial statements included in this Quarterly Report on Form 10-Q. This growth is a result of the consolidated Fortress Funds raising and investing capital, and generating gains from investments, during these periods. Their cash flows are reflected in our statement of cash flows through their deconsolidation on March 31, 2007.

Our dividend policy has certain risks and limitations, particularly with respect to liquidity. Although we expect to pay dividends in accordance with our dividend policy, we may not pay the amount of dividends suggested by our policy, or at all, if, among other things, we do not have the cash necessary to pay the intended dividends, or if our board of directors determines it would be prudent to reduce or eliminate future dividend payments. To the extent we do not have cash on hand sufficient to pay dividends, we may borrow funds to pay dividends, but we are not obligated to do so. By paying cash dividends rather than investing that cash in our future growth, we risk slowing the pace of our growth, or not having a sufficient amount of cash to fund our operations or unanticipated capital expenditures, should the need arise.

Although we are not aware of any issue that would cause the IRS to challenge a tax basis increase, our principals will not reimburse the corporate taxpayers for any payments that have been previously made under the tax receivable agreement. As a result, in certain circumstances, payments could be made to our principals under the tax receivable agreement in excess of the corporate taxpayers cash tax savings. The corporate taxpayers ability to achieve benefits from any tax basis increase, and the payments to be made under this agreement, will depend upon a number of factors, including the timing and amount of our future income.

### Operating Activities

Our net cash flow provided by (used in) operating activities was \$33.2 million and (\$1,453.0) million during the six months ended June 30, 2008 and 2007, respectively. In addition to cash from Fortress s operations, these amounts included net purchases of investments by consolidated Fortress Funds (included in our statements of cash flows through their deconsolidation on March 31, 2007), which are investment companies, after proceeds from sales of investments, of (\$1,707.1) million which are reflected as operating activities pursuant to investment company accounting.

### Investing Activities

Our net cash flow provided by (used in) investing activities was \$95.9 million and \$4.3 million during the six months ended June 30, 2008 and 2007, respectively. Our investing activities primarily included: (i) contributions to equity method investees of (\$82.3) million and (\$58.0) million during the six months ended June 30, 2008 and 2007, respectively, (ii) distributions of capital from equity method investees of \$182.1 million and \$39.9 million during the six months ended June 30, 2008 and 2007, respectively, as well as proceeds from sale of equity method investments of \$29.1 million in 2007, and (iii) purchases of fixed assets, net of proceeds from the disposal of fixed assets of (\$3.9) million and (\$7.1) million during these periods, respectively.

### Financing Activities

On December 18, 2006, the principals entered into a securities purchase agreement with Nomura, pursuant to which Nomura acquired a then 15% indirect stake in Fortress Operating Group for \$888 million, all of the proceeds of which were paid to the principals. On January 17, 2007, Nomura completed the transaction by purchasing 55,071,450 Class A shares for \$888 million and we, in turn, purchased 55,071,450 Fortress Operating Group limited partnership units, which then represented 15% of Fortress Operating Group s economic interests, and the sole general



## Edgar Filing: Fortress Investment Group LLC - Form 10-Q

partner interest, from the principals for \$888 million.

In addition, on February 8, 2007, we completed an initial public offering of 39,428,900 of our Class A shares, for net proceeds of approximately \$652.7 million.

---

**Table of Contents**

Our net cash flow provided by financing activities was \$25.7 million and \$1,709.0 million during the six months ended June 30, 2008 and 2007, respectively. Our financing activities primarily included (i) contributions made by, net of distributions made to, the investors in our consolidated Fortress Funds (included in our statements of cash flows through their deconsolidation on March 31, 2007), historically reflected as others interests in consolidated subsidiaries, of \$1,620.3 million during 2007, (ii) distributions made to principals, including those classified within principals and others interests in consolidated subsidiaries, of (\$133.4) million and (\$340.0) million during these periods, respectively, (iii) distributions to employees related to their interests in consolidated subsidiaries of (\$48.1) million and (\$124.0) million during these periods, respectively, (iv) dividends to our shareholders, and (v) our net borrowing and repayment activity.

**Critical Accounting Policies***Consolidation*

Historically, we consolidated certain of the Fortress Funds as a result of owning a substantive, controlling general partner interest in these entities, or, for variable interest entities, by being their primary beneficiary. We had operational discretion and control of these funds combined with the limited partners' limited substantive rights to impact their ongoing governance and operating activities which resulted in their being consolidated by us; however, in no case were we the majority equity holder. In connection with the initial public offering, Fortress granted rights effective March 31, 2007 to the investors in the consolidated Fortress Funds to provide a simple majority of the unrelated limited partners with the ability to liquidate the funds without cause or to otherwise have the ability to exert control over the funds, resulting in the deconsolidation of these funds for financial reporting purposes.

The analysis as to whether to consolidate an entity is subject to a significant amount of judgment. Some of the criteria considered are the determination as to the degree of control over an entity by its various equity holders, the design of the entity, how closely related the entity is to each of its equity holders, the relation of the equity holders to each other and a determination of the primary beneficiary in entities in which we have a variable interest. These analyses involve estimates, probability weighting of subjectively determined cash flow scenarios, and other estimates based on the assumptions of management.

Fortress Operating Group's combined financial statements reflected the assets, liabilities, revenues, expenses and cash flows of the consolidated Fortress Funds on a gross basis through March 31, 2007. Our investors' interests in these funds, which are the majority ownership interests, have historically been reflected as others' interests in consolidated subsidiaries in these financial statements. The management fees and incentive income earned by Fortress from the consolidated Fortress Funds were eliminated in consolidation; however, our allocated share of the net income from these funds was increased by the amount of these eliminated fees. Accordingly, the consolidation of these Fortress Funds had no net effect on our net earnings from the Fortress Funds and the deconsolidation of the funds likewise had no net effect on Fortress's earnings. The deconsolidation has had the effect of restoring the presentation of management fees and incentive income from the Fortress Funds that had been eliminated in consolidation.

*Revenue Recognition on Incentive Income*

Incentive income is calculated as a percentage of the profits earned by the Fortress Funds subject to the achievement of performance criteria. Incentive income from certain of the private equity funds we manage is subject to contingent repayment (or clawback) and may be paid to us as particular investments made by the funds are realized. If, however, upon liquidation of a fund the aggregate amount paid to us as incentive income exceeds the amount actually due to us based upon the aggregate performance of the fund, the excess is required to be returned by us (i.e. clawed back) to that fund. We have elected to adopt the preferred method of recording incentive income subject to contingencies, Method 1 of Emerging Issues Task Force Topic D-96 Accounting for Management Fees Based on a Formula. Under this method, we do not recognize incentive income subject to contingent repayment until all of the related contingencies have been resolved. Deferred incentive income related to a particular private equity fund, each of which has a limited life, would be recognized upon the termination of a private equity fund, or when distributions from a fund exceed the point at which a clawback of a portion or all of the historic incentive income distributions could no longer occur. Recognition of incentive income allocated to us prior to that date is deferred and recorded as a deferred incentive income liability. For GAAP purposes, the determination of when incentive income is recognized as income is formulaic in nature, resulting directly from each fund's governing documents.

*Profit Sharing Arrangements*

Pursuant to employment arrangements, certain of Fortress's employees are granted profit sharing interests and are thereby entitled to a portion of the incentive income realized from certain Fortress Funds, which is payable upon a realization event within the respective funds. Accordingly, incentive income resulting from a realization event within a fund gives rise to the incurrence of a profit sharing obligation. Amounts payable under these profit sharing plans are recorded as compensation expense when they become probable and reasonably estimable.



---

## **Table of Contents**

For profit sharing plans related to hedge funds, where incentive income is received on a quarterly or annual basis, the related compensation expense is accrued during the period for which the related payment is made.

For profit sharing plans related to private equity funds, where incentive income is received as investments are realized but is subject to clawback (see Revenue Recognition on Incentive Income above), although Fortress defers the recognition of incentive income until all contingencies are resolved, accruing expense for employee profit sharing is based upon when it becomes probable and reasonably estimable that incentive income has been earned and therefore a profit sharing liability has been incurred. Based upon this policy, the recording of an accrual for profit sharing expense to employees generally precedes the recognition of the related incentive income revenue.

Our determination of the point at which it becomes probable and reasonably estimable that incentive income will be earned and therefore a corresponding profit sharing expense should be recorded is based upon a number of factors, the most significant of which is the level of realized gains generated by the underlying funds that may ultimately give rise to incentive income payments. Accordingly, profit sharing expense is generally recorded upon realization events within the underlying funds. A realization event has occurred when an investment within a fund generates proceeds in excess of its related invested capital, such as when an investment is sold at a gain. Changes in the judgments and estimates made in arriving at the appropriate amount of profit sharing expense accrual could materially impact net income.

For further information on amounts paid and payable in the future under our profit sharing arrangements, please see Note 2 to Part I, Item 1, Financial Statements Management Agreements and Fortress Funds.

### *Valuation of Investments*

As a result of the deconsolidation described above, our investments in the Fortress Funds are recorded based on the equity method of accounting subsequent to March 31, 2007. The Fortress Funds themselves apply specialized accounting principles specified by the AICPA Audit and Accounting Guide Investment Companies. As such, our results are based on the reported fair value of the funds as of the reporting date with our pro rata ownership interest (based on our principal investment) in the changes in each fund's NAV reflected in our results of operations. Fair value generally represents the amount at which an investment could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale. We are the manager of these funds and in certain cases participate in the valuation of underlying investments, many of which are illiquid and/or without a public market. The fair value of these investments is generally estimated based on either values provided by independent valuation agents, who use their own proprietary valuation models, or proprietary models developed by us, which include discounted cash flow analyses, public market comparables, and other techniques and may be based, at least in part, on independently sourced market parameters. The material estimates and assumptions used in these models include the timing and expected amount of cash flows, the appropriateness of discount rates used, and, in some cases, the ability to execute, timing of, and estimated proceeds from expected financings. The values arrived at may be adjusted if, when estimating the value, it is determined that a more accurate value can be obtained from recent trading activity or by incorporating other relevant information that may not have been reflected in pricing obtained from the models. Fair values obtained from external sources are rarely (less than 1% of our value estimates) adjusted in this manner. Significant judgment and estimation goes into the selection of an appropriate valuation methodology as well as the assumptions which drive these models, and the actual values realized with respect to investments could be materially different from values obtained based on the use of those estimates. The valuation methodologies applied impact the reported value of our investments in the Fortress Funds in our consolidated financial statements as of June 30, 2008.

### *Private Equity Funds*

Under the valuation policies and guidelines of our private equity funds, investments are categorized into two types of securities: those for which there is a market quotation and those for which there is no market quotation. Securities for which there is a market quotation are valued at their quoted market price. A discount may be applied to those securities with sale restrictions. Securities for which there is no market quotation are referred to as private securities and are valued at fair value. Our guidelines state that the fair values of private securities are generally based on the following methods:

1. Public market transactions of similar securities
2. Private market transactions of similar or identical securities

3. Analytical methods

Our private equity funds have never based a valuation of a private security upon public or private market transactions in a similar security. There have been no circumstances to date in which a security in a public market transaction, or a private market transaction of which we were aware, has been considered to be sufficiently similar to a private security owned by one of our private equity funds to be used as a measure of valuation for such private security investment.

Our private equity funds have used the price of private market transactions in identical securities as a valuation method for investments. In cases in which there has been a significant private transaction in a private security held by our private equity funds, the value of private equity fund investments in the private security are based upon the price of such recent private transaction in that security and no sensitivity analysis is used.

## **Table of Contents**

If the fair value of private security investments held by our private equity funds cannot be valued by reference to a public or private market transaction, then the primary analytical methods used to estimate the fair value of such private securities are the discounted cash flow method, by reference to performance statistics of similar public companies (for example, EBITDA multiples) or the use of third party valuations. Sensitivity analysis is applied to the estimated future cash flows using various factors depending on the investment, including assumed growth rates (in cash flows), capitalization rates (for determining terminal values) and appropriate discount rates based on the investment to determine a range of reasonable values. The valuation based on the inputs determined to be the most probable is used as the fair value of the investment.

### Liquid Hedge Funds

The majority of the investments in our liquid hedge funds are valued based on quoted market prices. Investments valued based on other observable market parameters in our liquid hedge funds are made up almost entirely of (i) interest rate swaps and swaptions, equity swaps and foreign exchange swaps which are valued by the independent fund administrator using models with significant observable market parameters, and (ii) funds managed by third parties for which we receive value information from the fund managers. The fair value of interest rate swaps and swaptions is calculated using the current market yield of the relevant interest rate durations and an appropriate discount rate to determine a present value. The fair value of equity swaps and foreign exchange swaps is calculated using the market price of the underlying stock or foreign exchange pair, plus the financing cost of carrying the transaction. The fair value of these investments is also confirmed independently with the counterparty to the transaction. Investments valued using methods, including internal models, with significant unobservable market parameters consist primarily of investments in other funds and certain illiquid securities.

### Hybrid Hedge Funds

In our hybrid hedge funds, investments are valued using quoted market prices, to the extent available. Independent valuation agents are used by our hybrid hedge funds to provide estimates of the fair value of investments, other than investments in other funds, for which quoted market prices are not available. For these investments, we understand that the independent valuation agents use some or all of the following methods and techniques to estimate the fair value of the relevant type of investments:

Private loans - The most common method used to value private loans is a discounted cash flow analysis. In this method, the estimated future payments to be made by the borrower under the loan agreement are discounted to the present using a discount rate appropriate to the risk level of the borrower and current market interest rates.

If it is likely that a borrower will not be able to repay a loan in full, the loan may be valued by estimating how much the borrower will be able to repay based on obtaining refinancing from a new lender. Under this method, the borrower's business must be examined in detail, and then compared to known loans in the market to estimate how much the borrower will likely be able to borrow, and therefore repay under the existing loan. If the amount likely to be able to be refinanced is less than the total payments due under the loan, the fair value of the loan will be reduced.

Another method used to value loans that may not be repaid in full is to value the total amount of assets of the borrower that might be sold to raise proceeds to repay the loan (and debt, if any, that has a higher claim against assets) if necessary. Under this method, all assets of the borrower must be analyzed and valued. If the total value is less than the total payments due under the loan (and debt, if any, that has a higher claim against assets), the fair value of the loan will be reduced.

Asset-backed securities and collateralized debt obligations for which there are no quoted market prices are valued using a discounted cash flow analysis based on the estimated cash flows to be generated by the relevant underlying assets and the appropriate interest rate based on the nature of the underlying assets.

Real estate is usually valued based on sales of comparable property. The value of real estate which is net leased is also influenced by the credit quality of major tenants, as their ability to make lease payments is relevant to the value of the property under lease.

Investments in other funds are valued primarily based on the net asset values provided by the fund managers of those funds.

Investments valued using methods, including internal models, with significant unobservable market parameters consist primarily of investments in other funds and certain illiquid investments.

**Table of Contents****Sensitivity**

Changes in the fair value of our funds' investments would impact our results of operations as described in Part II, Item 3, Quantitative and Qualitative Disclosures About Market Risk.

As discussed above, the determination of investment fair values involves management's judgments and estimates. The degree of judgment involved is dependent upon the availability of quoted market prices or observable market parameters. The following table summarizes the investments held by the Fortress Funds by valuation methodology as of June 30, 2008.

The categories displayed below correspond directly with the disclosures which are required under SFAS 157, described under Recent Accounting Pronouncements below. Note that negative percentages represent net short positions.

	Private Equity Funds	Liquid Hedge Funds	Hybrid Hedge Funds	Total Investment Company Holdings
<b>Basis for Determining Fair Value</b>				
1. Quoted market prices (A)	7%	(73%)	5%	(2%)
2. Other observable market parameters	9%	68%	5%	13%
3A. Third party pricing sources with significant unobservable market parameters (B)	10%	105%	85%	50%
3B. Internal models with significant unobservable market parameters	74%	0%	5%	39%
<b>Total</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>

(A) For liquid hedge funds, includes gross long positions of 124% and short positions of (197%).

(B) Primarily represents valuations based on third party pricing services, certain broker quotes, and third party fund managers. The result is skewed for the liquid hedge funds due to the offsetting net short positions in Level 1 and net long positions in Level 2.

As of June 30, 2008, \$11.2 billion of investments in our private equity funds, \$8.5 million of investments in our liquid hedge funds and \$0.7 billion of investments in our hybrid hedge funds are valued by internal models with significant unobservable market parameters. A 10% increase or decrease in the value of investments held by the Fortress Funds valued at level 3 (A or B) would have had the following effects on our results of operations on an unconsolidated basis for the six months ended June 30, 2008, consistent with the table above:

	Private Equity Funds	Liquid Hedge Funds	Hybrid Hedge Funds
Management fees, per annum on a prospective basis	\$2.1 million or (\$5.5 million) (A)	\$7.4 million	\$18.5 million
Incentive income	N/A (B)	\$0.0 million (\$0.2 million)	N/A (C)
Earnings from equity method investees	\$55.3 million	\$1.6 million	\$30.2 million

Note: This table excludes non-investment assets and liabilities of the funds, which are not classified in the fair value hierarchy. Such net assets may be material, particularly within the liquid hedge funds.

(A) Private equity fund management fees would be generally unchanged as, for investments in non-publicly traded securities, they are not based on the value of the funds, but rather on the amount of capital invested in the funds. However, if the NAV of a portfolio company of a private equity fund is reduced below its invested capital, there would be a reduction in management fees. As of June 30, 2008, \$5.4 billion

## Edgar Filing: Fortress Investment Group LLC - Form 10-Q

of private equity portfolio companies valued at level 3 (A or B) were carried at or below their invested capital and are in funds which are no longer in their commitment period. Management fees are generally calculated as of certain reset dates. The amounts disclosed show what the estimated effects would be to management fees over the next year assuming June 30, 2008 is the current reset date.

- (B) Private equity fund incentive income would be unchanged as it is not recognized until received and all contingencies are resolved. Furthermore, incentive income would be based on the actual price realized in a transaction, not based on a valuation.
- (C) Hybrid hedge fund incentive income would be unchanged as it is not recognized until all contingencies are resolved in the fourth quarter. Incentive income is generally not charged on amounts invested by hybrid hedge funds in funds managed by external managers.



---

## **Table of Contents**

### *Income Taxes*

Historically, we operated as a limited liability company which was not subject to U.S. federal income tax and had limited state income taxes. However, certain of our consolidated subsidiaries are subject to UBT on their trade and business activities conducted in New York City. The UBT rates vary significantly between the rate applicable to income from business activities and the rate applicable to income from investment activities. Allocation of income between business activities and investing activities is subject to detailed and complex rules applied to facts and circumstances that generally are not readily determinable at the date financial statements are prepared. Accordingly, estimates are made of income allocations in computing our effective tax rate that might be different from actual allocations determined when tax returns are prepared by investee companies and subsidiaries.

As a result of the completion of the transactions resulting from the initial public offering, and the reorganization of our businesses, FIG Corp. is subject to U.S. federal and state income tax on income allocated to it from Fortress Operating Group. FIG Corp.'s carrying value of Fortress Operating Group is higher for income tax purposes than for financial reporting purposes. The net deferred tax asset that has been recognized for this difference is limited to the tax benefit expected to be realized in the foreseeable future. This benefit was estimated based on a number of factors, with an important factor being the amount of unrealized gains in all of the net assets of Fortress Operating Group existing for tax purposes at the date of the reorganization that are expected to be realized for tax purposes in the foreseeable future. If our estimate of the unrealized gains at the date of our initial public offering that actually will be realized in the future increases or decreases, deferred income tax expense or benefit will be recognized.

For further information on our effective tax rate see Note 5 to our financial statements in Part I, Item 1, Financial Statements.

Our effective tax rate for GAAP reporting purposes may be subject to significant variation from period to period. In addition, legislation has been introduced in the United States, which, if enacted in its current or similar form, would cause us to incur a material increase in our tax liability. See Factors Affecting Our Business Income Tax Expense.

### *Equity-Based Compensation*

We currently have several categories of equity-based compensation which are described in Note 7 to Part I, Item 1, Financial Statements Equity-Based Compensation. The aggregate fair value of each of the RSU grants that are subject to service conditions is reduced by an estimated forfeiture factor (that is, the estimated amount of awards which will be forfeited prior to vesting). The estimated forfeiture factor is based upon historic turnover rates within our company adjusted for the expected effects of the grants on turnover and other factors in the judgment of management. The estimated forfeiture factor is updated at each reporting date. Since our IPO in February 2007, neither our actual forfeiture rate nor any other factors have caused us to change our forfeiture expectations or assumptions.

The volatility assumption used in valuing certain awards, as described below, was based on five-year historical stock price volatilities observed for a group of comparable companies, since we do not have sufficient historical share performance to use our own historical volatility, adjusted for management's judgment regarding our expected volatility. Since our IPO in February 2007, our actual volatility has exceeded the volatility assumption used. To the extent that this trend continues, and management's judgment concerning volatility is changed, we would adjust the volatility assumption used. The risk-free discount rate assumptions used in valuing certain awards were based on the applicable U.S. treasury rate of like term. The dividend yield assumptions used in valuing certain awards were based on our actual dividend rate at the time of the award; the dividend growth rate used with respect to one type of award was based on management's judgment and expectations.

The following elements of the accounting for equity-based compensation are subject to significant judgment and estimation:

the estimated forfeiture factor;

the discount related to RSUs which do not entitle the recipients to dividend equivalents prior to the delivery of Class A shares. This discount was based on the estimated present value of dividends to be paid during the service period, which in turn was based on an estimated initial dividend rate, an estimated dividend growth rate and a risk-free discount rate of like term;

## Edgar Filing: Fortress Investment Group LLC - Form 10-Q

the discount related to RSUs with no service conditions which are subject to the delayed delivery of Class A shares, which occurs in periods subsequent to the grant date. This discount was based on the estimated value of a put option on such shares over the delayed delivery period since essentially this would be the value of owning, and being able to trade, those shares during the delayed delivery period rather than having to wait for delivery. This estimated value was in turn derived from a binomial option pricing model based on the following assumptions: volatility, term, dividend rate and risk-free discount rate; and

the estimated fair value of the LTIP awards, which was estimated using a Monte Carlo simulation valuation model, with the following assumptions: volatility, term, dividend rate, and risk-free discount rate.

Each of these elements, particularly the forfeiture factor and the volatility assumptions used in valuing certain awards, are subject to significant judgment and variability and the impact of changes in such elements on equity-based compensation expense could be material. Increases in the assumed forfeiture factor would decrease compensation expense. Increases in

## **Table of Contents**

the volatility assumption would (i) decrease compensation expense related to RSUs with no service conditions since the discount for delayed delivery would have increased, and (ii) increase compensation expense related to the LTIP since the value of the LTIP would have increased. Increases in the assumed risk-free rate would (i) decrease compensation expense related to RSUs which do not entitle recipients to dividend equivalents since the estimated value of the foregone dividends would have increased, thereby increasing the discount related to their non-receipt, (ii) decrease compensation expense related to RSUs with no service conditions since the discount for delayed delivery would have increased, and (iii) increase compensation expense related to the LTIP since the value of the LTIP would have increased. Except for the forfeiture factor, changes in these assumptions will only affect awards made in the future and awards whose accounting is impacted by changes in their fair value (generally those to non-employees, known as liability awards).

## **Recent Accounting Pronouncements**

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements. SFAS 157 defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants in the market in which the reporting entity transacts, establishes a framework for measuring fair value, and expands disclosures about fair value measurements. SFAS 157 applies to reporting periods beginning after November 15, 2007. Fortress adopted SFAS 157 on January 1, 2008. To the extent they are measured at fair value, SFAS 157 did not materially change Fortress's fair value measurements for any of its existing financial statement elements. As a result, the adoption of SFAS 157 did not have a material impact on Fortress's financial condition, liquidity or results of operations.

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities. SFAS 159 permits entities to choose to measure many financial instruments, and certain other items, at fair value. SFAS 159 also establishes presentation and disclosure requirements designed to facilitate comparisons between entities that choose different measurement attributes for similar types of assets and liabilities. SFAS 159 applies to reporting periods beginning after November 15, 2007. Fortress adopted SFAS 159 on January 1, 2008. Fortress elected to measure its equity investments in Newcastle and Eurocastle, as well as its options in Newcastle, at fair value pursuant to the provisions of SFAS 159 upon adoption. As a result, Fortress recorded an aggregate increase to the carrying amounts of these assets as of January 1, 2008 of \$22.9 million, which was recorded as a cumulative effect adjustment to retained earnings (\$2.1 million) and also impacted the Principals' interests in the equity of consolidated subsidiaries (Fortress Operating Group) (\$17.6 million), our deferred tax assets (\$1.9 million), and accumulated other comprehensive income (\$1.2 million). Fortress made this election to simplify its accounting for these publicly traded equity securities, which were previously recorded based on the equity method of accounting. The adoption of SFAS 159 did not have any other material impact on Fortress's financial condition, liquidity or results of operations.

In June 2007, Emerging Issues Task Force issue No. 06-11 Accounting for Income Tax Benefits of Dividends on Share-Based Payment Awards (EITF 06-11) was issued. EITF 06-11 specified that a realized tax benefit from dividend equivalents that are charged to retained earnings and are paid to employees for equity classified nonvested equity share units should be recognized as an increase to paid-in capital. EITF 06-11 applies to reporting periods beginning after December 15, 2007 and is applied prospectively. We adopted EITF 06-11 on January 1, 2008. The adoption of EITF 06-11 had no effect on our financial condition, liquidity or results of operations.

In December 2007, the FASB issued SFAS No. 160 Accounting for Non-controlling Interests. SFAS 160 clarifies the classification of non-controlling interests in consolidated statements of financial position and the accounting for and reporting of transactions between the reporting entity and holders of such non-controlling interests. SFAS 160 applies to reporting periods beginning after December 15, 2008. SFAS 160 is expected to have the following effects on Fortress's financial statements: (i) reclassification of Principals' and Others' Interests in Equity of Consolidated Subsidiaries from the mezzanine section of the balance sheet (between liabilities and equity) to equity, (ii) removal of Principals' and Others' Interests in Income of Consolidated Subsidiaries from the calculation of Net Income (Loss) on the statement of operations, and disclosure thereof below Net Income (Loss), and (iii) with respect to potential future transactions in which Fortress could acquire Fortress Operating Group units from the Principals pursuant to their exchange (along with Class B shares) for Class A shares (or otherwise), these transactions would be accounted for as equity transactions rather than as a step acquisition of Fortress Operating Group (as would be required under current accounting principles). There will be no effect from adoption of SFAS 160 on the equity which pertains to Class A shareholders, or net income (loss) allocable to Class A shareholders, or on Fortress's liquidity.

## **Market Risks**

Our predominant exposure to market risk is related to our role as investment manager for the Fortress Funds and the sensitivities to movements in the fair value of their investments on management fee and incentive income revenue, as well as on returns on our principal investments in such funds. For a discussion of the impact of market risk factors on our financial instruments refer to Part I, Item 3 Quantitative and Qualitative Disclosures About Market Risk and Critical Accounting Policies Valuation of Investments.

## **Off-Balance Sheet Arrangements**

We do not have any off-balance sheet arrangements.

**Table of Contents**

**Contractual Obligations**

As of June 30, 2008, our material contractual obligations are our capital commitments to our funds, our lease obligations and our debt obligations as described above.

Our future contractual obligations increased from \$1.3 billion as of December 31, 2007 to \$1.6 billion as of June 30, 2008.

Our debt obligations payable increased from \$671.3 million as of December 31, 2007 to \$884.8 million as of June 30, 2008, including estimates for interest payments. This increase was primarily attributable to the \$450 million delayed term loan drawn by us in February 2008, partially offset by the simultaneous paydown of the \$185 million revolving debt facility.

Our capital commitments, including our commitments to our funds, have increased by \$49.3 million from \$134.0 million as of December 31, 2007 to \$183.3 million as of June 30, 2008. The increase is primarily attributable to both our capital commitment to our newly formed fund, Credit Opportunities Fund, in which we have an outstanding capital commitment of \$19.7 million, as well as an increase in our capital commitment to Fund V of \$100.0 million, in which we have a remaining capital commitment of \$89.8 million. The increased commitments to these funds were partially offset by capital draws made by other Fortress funds, which decreased our remaining commitments.

**Table of Contents****ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

Our predominant exposure to market risk is related to our role as investment manager for the Fortress Funds and the sensitivities to movements in the fair value of their investments on management fee and incentive income revenue.

The fair value of the financial assets and liabilities of the Fortress Funds may fluctuate in response to changes in the value of securities, foreign exchange, commodities and interest rates. Fluctuations in the fair value of the Fortress Funds will continue to directly affect the carrying value of our investments in the Fortress Funds and thereby our earnings from equity method investees, as well as the management fees and incentive income we record, to the extent that they are earned based on fair value or NAV.

Risks are analyzed across funds from the bottom up and from the top down with a particular focus on asymmetric risk. Management gathers and analyzes data, monitors investments and markets in detail, and constantly strives to better quantify, qualify and circumscribe relevant risks.

Although the Fortress Funds share many common themes, each segment within the investment companies runs their own investment and risk management process subject to the company's overall risk tolerance and philosophy:

the investment process of our private equity funds involves a detailed analysis of potential acquisitions, and asset management teams assigned to oversee the strategic development, financing and capital deployment decisions of each portfolio investment;

our hybrid hedge funds and Castles perform extensive credit and cash-flow analysis of borrowers, tenants and credit-based assets, and have extensive asset management teams that monitor covenant compliance by, and relevant financial data of, borrowers, tenants and other obligors, asset pool performance statistics, tracking of cash payments relating to investments, and ongoing analysis of the credit status of investments; and

our liquid hedge funds continuously monitor a variety of markets for attractive trading opportunities, applying a number of traditional and customized risk management metrics to analyze risk related to specific assets or portfolios, as well as fund-wide risks. Each segment has an institutional risk management process and related infrastructure to address these risks. The following table summarizes our financial assets and liabilities that may be impacted by various market risks such as equity prices, interest rates and exchange rates as of June 30, 2008 (in thousands):

<b>Assets</b>	
Equity method investees	\$ 961,123
Options in affiliates	871
	\$ 961,994
<b>Liabilities</b>	
Debt obligations payable	\$ 800,000

Since Fortress's investments in the various Fortress Funds are not equal, Fortress's risks from a management fee and incentive income perspective (which mirror the funds' investments) and its risks from an investment perspective are not proportional.

*Fortress Funds' Market Risk Impact on GAAP Management Fees*

Our management fees are based on either: (i) capital commitments to a Fortress Fund, (ii) capital invested in a Fortress Fund, or (iii) the NAV of a Fortress Fund, as described in our historical consolidated financial statements. Management fees will only be impacted by changes in market risk factors to the extent they are based on NAV. These management fees will be increased (or reduced) in direct proportion to the impact of changes in market risk factors on our investments in the related funds and would occur only in periods subsequent to the change, as opposed to having an immediate impact. The proportion of our management fees that are based on NAV is dependent on the number and types of Fortress

## Edgar Filing: Fortress Investment Group LLC - Form 10-Q

Funds in existence and the current stage of each fund's life cycle. As of June 30, 2008, approximately 63% of our management fees earned were based on the NAV of the applicable funds.

For private equity funds, management fees of 1% to 1.5% are charged on committed capital during the investment period of a new fund, and then generally on invested capital after the investment period, with the exception of funds formed after March 2006. For funds formed after March 2006 that are no longer in the investment period, management fees are earned on the NAV of investments in publicly traded entities. Reductions in net asset value below invested capital for any fund investment will also cause reductions in management fees.

---

**Table of Contents**

For Castles, management fees are not calculated based on NAV but instead a 1.5% fee is charged based on the funds' contributed capital.

For hedge funds, management fees are based on their NAV, which in turn is dependent on the estimated fair values of their investments.

Changes in values of investments could indirectly affect future management fees by, among other things, reducing the funds' access to capital or liquidity and their ability to currently pay the management fees.

*Fortress Funds' Market Risk Impact on GAAP Incentive Income*

Our incentive income is generally based on a percentage of profits of the various Fortress Funds subject to the achievement of performance criteria. Our incentive income will be impacted by changes in market risk factors. However, several major factors will influence the degree of impact: (i) the performance criteria for each individual fund in relation to how that fund's results of operations are impacted by changes in market risk factors, (ii) whether such performance criteria are annual or over the life of the fund, (iii) to the extent applicable, the previous performance of each fund in relation to its performance criteria, and (iv) whether each fund's incentive income is subject to contingent repayment. As a result, the impact of changes in market risk factors on incentive income will vary widely from fund to fund, as summarized below, and is heavily dependent on the prior performance of each fund, and is therefore not readily predicted or estimated.

Incentive income from our private equity funds is not recorded as revenue but instead is deferred under GAAP until the related clawback contingency is resolved. Deferred incentive income, which is subject to contingencies, will be recognized as revenue to the extent it is received and all the associated contingencies are resolved. Assuming that the deferred incentive income earned to date would be equal to what would be recognized when all contingencies are resolved, a 10% increase or decrease in the fair values of investments held by all of the private equity funds where incentive income is subject to contingencies at June 30, 2008 would increase or decrease future incentive income by \$78.4 million or (\$22.8 million), respectively; however, this would have no effect on our current reported financial condition or results of operations. One fund's incentive income is not subject to contingencies.

Incentive income from the Castles is not impacted by changes in the fair values of their investments, except to the extent they represent impairment, since these changes do not impact the measure of current operating results (i.e. FFO in excess of specified returns to the company's shareholders) upon which the incentive income is calculated. The definition of FFO excludes unrealized changes in the values of the Castles' investments (primarily real estate, loans and securities), except for minor items (for example, the unrealized gain or loss on non-hedge derivatives which make up only an immaterial portion of their assets).

Incentive income from our hedge funds is directly impacted by changes in the fair value of their investments. Incentive income from certain of our hedge funds is earned based on achieving quarterly or annual performance criteria. For the hedge funds with quarterly performance criteria, a 10% decrease to the NAV of the fund on June 30, 2008 would have resulted in a loss to investors for the quarter. In future quarters, this loss would be a high water mark (minimum future return to recover the loss to the investors) for our funds' performance prior to any incentive income being earned by us. This high water mark is reset on an annual basis. For the hedge funds with annual performance criteria, a 10% decrease to the NAV of the fund on June 30, 2008, assuming that NAV is constant for the rest of the current year, would result in no incentive income recorded as revenue at year end (in the fourth quarter of the year).

*Fortress Funds' Market Risk Impact on GAAP Investment Income*

Our investments in the Fortress Funds, other than the Castles, are accounted for under the equity method. To the extent they are investment companies, our investments are directly affected by the impact of changes in market risk factors on the investments held by such funds, which could vary significantly from fund to fund.



**Table of Contents***Market Risk Quantitative Analysis*

The following table presents information on the impact to Fortress of a 10% change in the fair values of all of the investments held by the Fortress Funds at June 30, 2008 (in millions).

	GAAP Revenues		10% Positive Change		Segment Revenues (A)	
	Management Fees (B)	Incentive Income	Earnings from Equity Method Investees (G)		Incentive Income	Investment Income
			Management Fees (B)	Management Fees (B)		
Private Equity						
Funds	\$ 3.1	\$ N/A (E)	\$ 63.9	\$ 3.1	\$ N/A (E)	\$ N/A
Castles (D)	N/A	N/A	N/A	N/A	N/A	N/A
Hedge Funds						
Liquid	23.2	130.6	4.2	23.2	130.6	3.3
Hybrid	14.7	N/A (F)	26.0	14.7	108.0	14.6
Total	\$ 41.0	\$ 130.6	\$ 94.1	\$ 41.0	\$ 238.6	\$ 17.9

	GAAP Revenues		10% Negative Change		Segment Revenues (A)	
	Management Fees (B)	Incentive Income	Earnings from Equity Method Investees (G)		Incentive Income	Investment Income
			Management Fees (B)	Management Fees (B)		
Private Equity						
Funds	\$ (6.5)	\$ N/A (E)	\$ (63.9)	\$ (6.5)	\$ N/A (C) (E)	\$ N/A (C)
Castles (D)	N/A	N/A	N/A	N/A	N/A	N/A (C)
Hedge Funds						
Liquid	(23.2)	(14.7)	(4.2)	(23.2)	(14.7)	(3.3)
Hybrid	(14.7)	N/A (F)	(26.0)	(14.7)		(14.6)
Total	\$ (44.4)	\$ (14.7)	\$ (94.1)	\$ (44.4)	\$ (14.7)	\$ (17.9)

(A) See Management's Discussion and Analysis of Financial Condition and Results of Operations - Segment Analysis for a discussion of the differences between GAAP and segment basis revenues.

(B) Changes in management fees represent an annual change for the one year period following the measurement date assuming there is no change to the investments held by the funds during that period. For private equity funds, it assumes that the management fees reset as of June 30, 2008. Private equity fund management fees would be generally unchanged as, for investments in non-publicly traded securities, they are not based on the value of the funds, but rather on the amount of capital invested in the funds. However, if the NAV of a portfolio company of a private equity fund is reduced below its invested capital, there would be a reduction in management fees. As of June 30, 2008, \$7.3 billion of private equity portfolio companies were carried at or below their invested capital and are in funds which are no longer in their commitment period.

(C)

## Edgar Filing: Fortress Investment Group LLC - Form 10-Q

A reduction in the fair value of investments could impact our conclusion regarding the potential impairment of our investments or a potential segment basis incentive income reserve for funds which are subject to clawback.

- (D) Our investments in the Castles are held at fair value, based on the market value of the shares we own, as of January 1, 2008 pursuant to the provisions of SFAS 159. Furthermore, the Castles' management fees and incentive income are not directly impacted by changes in the fair value of their investments (unless the changes are deemed to be impairment, which would impact incentive income).
- (E) For GAAP Revenues, private equity fund incentive income would be unchanged as it is not recognized until received and all contingencies are resolved. Furthermore, incentive income would be based on the actual price realized in a transaction, not based on a valuation. For Segment Revenues, private equity fund incentive income is based on realizations.
- (F) For GAAP Revenues, hybrid hedge fund incentive income would be unchanged as it is not recognized until all contingencies are resolved in the fourth quarter. Incentive income is generally not charged on amounts invested by hybrid hedge funds in funds managed by external managers.

(G) Presented on a gross basis, before Principals' and others' interests in income of consolidated subsidiaries.

### *Interest Rate Risk*

Fortress Operating Group has debt obligations payable that accrue interest at variable rates. Interest rate changes may therefore impact the amount of interest payments, future earnings and cash flows. Based on debt obligations payable as of June 30, 2008, we estimate that interest expense relating to variable rate debt obligations payable would increase \$8.0 million on an annual basis in the event interest rates were to increase by one percentage point.

### *Equity Prices and Exchange Rate Risk*

Our investment in Eurocastle is directly exposed to foreign exchange risk. As of June 30, 2008, we had a \$9.7 million investment in Eurocastle which is accounted for at fair value.

Gains (losses) on options granted to us by the Castles are affected by movements in (i) the equity price of the underlying shares and (ii) in the case of Eurocastle, the rate of exchange between the U.S. dollar and the Euro. Analyzed separately, we estimate that a 10% increase (decrease) in the equity price of the underlying shares of the options on June 30, 2008 would affect gains and (losses) for the six months ended June 30, 2008 by \$0.3 million and (\$0.3 million), respectively. In the event of a 10% change in the applicable foreign exchange rate against the U.S. dollar on June 30, 2008, we estimate the gains and losses for the six months ended June 30, 2008 in relation to the value of the options would increase or decrease by \$0.1 million.

---

**Table of Contents****ITEM 4. CONTROLS AND PROCEDURES****Disclosure Controls and Procedures**

The Company's management, with the participation of the Company's Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of the Company's disclosure controls and procedures (as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the Exchange Act)) as of the end of the period covered by this report. The Company's disclosure controls and procedures are designed to provide reasonable assurance that information is recorded, processed, summarized and reported accurately and on a timely basis. Based on such evaluation, the Company's Chief Executive Officer and Chief Financial Officer have concluded that, as of the end of such period, the Company's disclosure controls and procedures were effective.

**Changes in Internal Control Over Financial Reporting**

There have not been any changes in the Company's internal control over financial reporting (as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) during the most recent fiscal quarter to which this report relates that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

**PART II. OTHER INFORMATION****Item 1. Legal Proceedings**

On September 15, 2005, a lawsuit captioned David T. Atkins et al. v. Apollo Real Estate Advisors, L.P. et al., which we refer to as the Brookdale Action, was brought in the United States District Court for the Eastern District of New York on behalf of current and former limited partners in certain investing partnerships related to the sale of certain facilities to Ventas Realty Limited Partnership, or Ventas, an unaffiliated real estate investment trust. It names as defendants, among others, Brookdale Senior Living, Inc. (one of our portfolio companies, which we refer to as Brookdale), Brookdale Living Communities, Inc. (a subsidiary of Brookdale, which we refer to as BLC), GFB-AS Investors, LLC (which we refer to as GFB-AS), a subsidiary of BLC, the general partners of 14 investing partnerships which are alleged to be subsidiaries of GFB-AS, Fortress, and the Chief Financial Officer of Brookdale at that time. Fortress was the investment manager of consolidated Fortress Funds which were controlling shareholders of the private equity portfolio company during the relevant time periods. The suit alleges that the defendants improperly obtained certain rights with respect to such facilities from the investing partnerships. The plaintiffs' nine count third amended complaint alleges, among other things, (i) that the defendants converted for their own use the property of the limited partners of 11 partnerships, including through the failure to obtain consents the plaintiffs contend were required for the sale of facilities indirectly owned by those partnerships to Ventas; (ii) that the defendants fraudulently persuaded the limited partners of three partnerships to give up a valuable property right based upon incomplete, false and misleading statements in connection with certain consent solicitations; (iii) that certain defendants, not including the company, committed mail fraud in connection with the sale of facilities indirectly owned by the 14 partnerships at issue in the Brookdale Action to Ventas; (iv) that certain defendants committed wire fraud in connection with certain communications with plaintiffs in the Brookdale Action and another investor in a limited partnership; (v) that the defendants committed substantive violations of the Racketeer Influenced and Corrupt Organizations Act, or RICO; (vi) that the defendants conspired to violate RICO; (vii) that GFB-AS and the general partners violated the partnership agreements of the 14 investing partnerships; (viii) that GFB-AS, the general partners, and Brookdale's Chief Financial Officer breached fiduciary duties to the plaintiffs; and (ix) that the defendants were unjustly enriched. The plaintiffs have asked for damages in excess of \$100 million on each of nine counts, as to which Fortress is a defendant on seven counts, including treble damages with respect to certain counts. On April 18, 2006, we filed a motion to dismiss the claims with prejudice. On April 30, 2008, the court entered a memorandum and order granting the motion and dismissing the plaintiff's complaint in its entirety. The plaintiffs were granted a period of 30 days from April 30, 2008 in which to file an amended complaint, after which the parties entered into a preliminary settlement, which will be paid in its entirety by Brookdale.

We may from time to time be involved in litigation and claims incidental to the conduct of our business. Our industry is always subject to scrutiny by government regulators, which could result in litigation related to regulatory compliance matters. As a result, we maintain insurance policies in amounts and with the coverage and deductibles we believe are adequate, based on the nature and risks of our business, historical experience and industry standards. We believe that the cost of defending any pending or future litigation or challenging any pending or future regulatory compliance matter will not have a material adverse effect on our business. However, increased regulatory scrutiny of hedge fund trading activities combined with extensive trading in our liquid hedge funds may cause us to re-examine our beliefs regarding the likelihood that potential investigation and defense-related costs could have a material adverse effect on our business.



---

## **Table of Contents**

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

*We face a variety of significant and diverse risks, many of which are inherent in our business. Described below are certain risks that we currently believe could materially affect us. Other risks and uncertainties that we do not presently consider to be material or of which we are not presently aware may become important factors that affect us in the future. The occurrence of any of the risks discussed below could materially and adversely affect our business, prospects, financial condition, results of operations or cash flow.*

#### ***Risks Related To Our Business***

**We depend on Messrs. Briger, Edens, Kauffman, Nardone and Novogratz, and the loss of any of their services would have a material adverse effect on us.**

The success of our business depends on the efforts, judgment and personal reputations of our principals, Peter Briger, Wesley Edens, Robert Kauffman, Randal Nardone and Michael Novogratz. Our principals' reputations, expertise in investing, relationships with our investors and relationships with members of the business community on whom our funds depend for investment opportunities and financing, are each critical elements in operating and expanding our businesses. We believe our performance is strongly correlated to the performance of these individuals. Accordingly, the retention of our principals is crucial to our success. In addition, if any of our principals were to join or form a competitor, some of our investors could choose to invest with that competitor rather than in our funds. The loss of the services of any of our principals would have a material adverse effect on us, including our ability to retain and attract investors and raise new funds, and the performance of our funds. Two or more of our principals occasionally fly together, which concentrates the potential impact of an accident on our company. We do not carry any key man insurance that would provide us with proceeds in the event of the death or disability of any of our principals.

Each of our principals has entered into an employment agreement with us. The initial term of these agreements is five years from the date of our initial public offering in February 2007, with automatic one-year renewals until a non-renewal notice is given by us or the principal. If a principal terminates his employment voluntarily or we terminate his employment for cause (as defined in the agreement), the principal will be subject to eighteen-month post-employment covenants requiring him not to compete with us. However, if we terminate a principal's employment without cause, the principal will not be subject to the non-competition provisions.

The principals have also entered into an agreement among themselves, which provides that, in the event a principal voluntarily terminates his employment with us for any reason prior to the fifth anniversary of the consummation of our initial public offering, the principal may be required to forfeit a portion of his Fortress Operating Group units (and the corresponding Class B shares) to the other principals who continue to be employed by the Fortress Operating Group. However, this agreement may be amended by the principals who are then employed by the Fortress Operating Group. We, our shareholders and the Fortress Operating Group have no ability to enforce any provision of this agreement or to prevent the principals from amending the agreement or waiving any of its obligations.

There is no guarantee that our principals will not resign, join our competitors or form a competing company, or that the non-competition provisions in the employment agreements would be upheld by a court. If any of these events were to occur, our business, prospects, financial condition and results of operation would be materially adversely affected.

**Several of our funds have key man provisions pursuant to which the failure of one or more of our principals to be actively involved in the business provides investors with the right to redeem from the funds or otherwise limits our rights to manage the funds. The loss of the services of any one of Messrs. Briger, Edens or Novogratz, or both of Mr. Kauffman and Mr. Nardone, would have a material adverse effect on certain of our funds and on us.**

Investors in most of our hedge funds may generally redeem their investment without paying redemption fees if the relevant principal ceases to perform his functions with respect to the fund for 90 consecutive days. In addition, the terms of certain of our hedge funds' financing arrangements contain key man provisions, which may result, under certain circumstances, in the acceleration of such funds' debt or the inability to continue funding certain investments if the relevant principal ceases to perform his functions with respect to the fund and a replacement has not been approved.

The loss or inability of Mr. Novogratz to perform his services for 90 days could result in substantial withdrawal requests from investors in our Drawbridge Global Macro funds (which as of June 30, 2008, had AUM of approximately \$8.8 billion) and, in the event that a replacement is not approved, the termination of a substantial portion of the funds' financing arrangements. Such withdrawals and terminations would have a material adverse effect on the Drawbridge Global Macro funds by reducing our management fees from those funds and, since the funds would have fewer assets, such withdrawals would reduce the amount of incentive income potential of those funds. Further, such withdrawals and terminations could lead possibly to the liquidation of the funds and a corresponding elimination of our management fees and potential to earn incentive income from those funds. The loss of Mr. Novogratz could, therefore, ultimately result in a loss of substantially all of our earnings

attributable to our liquid hedge fund business segment.

---

## Table of Contents

The loss or inability of Mr. Briger to perform his services for 90 days could result in substantial withdrawal requests from investors in our Drawbridge Special Opportunities funds (which as of June 30, 2008, had AUM of approximately \$6.6 billion) and, in the event that a replacement for him is not approved, the termination of a substantial portion of the funds' financing arrangements. Such withdrawals and terminations would have a material adverse effect on the Drawbridge Special Opportunities funds by reducing our management fees from those funds and, since the funds would have fewer assets, such withdrawals would reduce the amount of incentive income potential of those funds. Further, such withdrawals and terminations could lead possibly to the eventual liquidation of the funds and a corresponding elimination of our management fees and potential to earn incentive income from those funds. The loss or inability of Mr. Briger to perform his services or devote an appropriate portion of his business time to the long dated value funds for 90 days would (unless approved by a majority of fund investors) prevent the Drawbridge long dated value funds from making additional investments. This could have a material adverse effect on the long dated value funds, resulting in us receiving reduced management fees and incentive income. The loss of Mr. Briger could, therefore, ultimately result in a loss of substantially all of our earnings attributable to our hybrid hedge fund business segment with respect to the Drawbridge Special Opportunities funds, and a relatively small loss of earnings attributable to our private equity fund business segment with respect to the long dated value funds.

If either Mr. Edens or both of Mr. Kauffman and Mr. Nardone cease to devote certain minimum portions of their business time to the affairs of certain of our private equity funds, the funds will not be permitted to make further investments, and then-existing investments may be liquidated if investors vote to do so. Our ability to earn management fees and realize incentive income from our private equity funds therefore would be adversely affected if we cannot make further investments or if we are required to liquidate fund investments at a time when market conditions result in our obtaining less for investments than could be obtained at later times. In addition, we may be unable to raise additional private equity funds if existing private equity fund key-man provisions are triggered. The loss of either Mr. Edens or both of Mr. Kauffman and Mr. Nardone could, therefore, ultimately result in a loss of substantially all of our earnings attributable to our private equity funds, which as of June 30, 2008, had AUM of approximately \$17.0 billion.

Any such events would have a direct material adverse effect on our revenues and earnings, and would likely harm our ability to maintain or grow management fee paying assets under management in existing funds or raise additional funds in the future.

### **Our ability to retain our managing directors is critical to our success and our ability to grow depends on our ability to attract additional key personnel.**

Our success depends on our ability to retain our managing directors and the other members of our investment management team and recruit additional qualified personnel. We collectively refer to these key employees (other than our principals) as our investment professionals. We anticipate that it will be necessary for us to add investment professionals as we pursue our growth strategy. However, we may not succeed in recruiting additional personnel or retaining current personnel, as the market for qualified investment professionals is extremely competitive. Our investment professionals possess substantial experience and expertise in investing, are responsible for locating and executing our funds' investments, have significant relationships with the institutions which are the source of many of our funds' investment opportunities, and in certain cases have strong relationships with our investors. Therefore, if our investment professionals join competitors or form competing companies it could result in the loss of significant investment opportunities and certain existing investors. As a result, the loss of even a small number of our investment professionals could jeopardize the performance of our funds, which could have a material adverse effect on our results of operations as well as our ability to retain and attract investors and raise new funds. Also, while we have non-competition and non-solicitation agreements with certain investment professionals, there is no guarantee that the agreements to which our investment professionals are subject, together with our other arrangements with them, will prevent them from leaving us, joining our competitors or otherwise competing with us or that these agreements will be enforceable in all cases. In addition, these agreements will expire after a certain period of time, at which point each of our investment professionals would be free to compete against us and solicit investors in our funds, clients and employees.

Efforts to retain or attract investment professionals may result in significant additional expenses, which could adversely affect our profitability, and changes in law could hamper our recruitment and retention efforts. For example, we might not be able to provide future investment professionals with equity interests in our business to the same extent or with the same tax consequences as our existing investment professionals. Therefore, in order to recruit and retain existing and future investment professionals, we may need to increase the level of compensation that we pay to them. Accordingly, as we promote or hire new investment professionals over time, we may increase the level of compensation we pay to our investment professionals, which would cause our total employee compensation and benefits expense as a percentage of our total revenue to increase and adversely affect our profitability. In addition, we may deem it necessary to maintain compensation levels to retain employees even during periods when we generate less revenues than in previous periods, which would reduce our profit margins. Also, if legislation were to be enacted by the U.S. Congress to treat carried interest as ordinary income rather than as capital gain for U.S. federal income tax purposes, such legislation would materially increase the amount of taxes that we and possibly our equityholders would be required to pay, thereby adversely affecting our ability to recruit, retain and motivate our current and future professionals. See Our structure involves complex





## **Table of Contents**

provisions of U.S. federal income tax law for which no clear precedent or authority may be available. Our structure also is subject to potential legislative, judicial or administrative change and differing interpretations, possibly on a retroactive basis. Lastly, issuance of certain equity interests in our business to future investment professionals would dilute Class A shareholders.

### **We have experienced rapid growth, which may be difficult to sustain and which may place significant demands on our administrative, operational and financial resources.**

Our management fee paying assets under management have grown from approximately \$28.6 billion as of June 30, 2007 to \$35.1 billion as of June 30, 2008. Our rapid growth has caused, and if it continues will continue to cause, significant demands on our legal, accounting and operational infrastructure, and increased expenses. The complexity of these demands, and the expense required to address them, is a function not simply of the amount by which our fee paying assets under management have grown, but of significant differences in the investing strategies of our different funds. In addition, we are required to continuously develop our systems and infrastructure in response to the increasing sophistication of the investment management market and legal, accounting and regulatory developments. Moreover, the strains upon our resources caused by our growth are compounded by the additional demands imposed upon us now that we are a public company with shares listed on the New York Stock Exchange and, thus, subject to an extensive body of regulations that did not apply to us prior to our initial public offering.

Our future growth will depend, among other things, on our ability to maintain an operating platform and management system sufficient to address our growth and will require us to incur significant additional expenses and to commit additional senior management and operational resources. As a result, we face significant challenges:

in maintaining adequate accounting, financial, compliance, trading and other business controls,

implementing new or updated information, financial and disclosure systems and procedures, and

in recruiting, training, managing and appropriately sizing our work force and other components of our business on a timely and cost-effective basis.

There can be no assurance that we will be able to manage our expanding operations effectively or that we will be able to continue to grow, and any failure to do so could adversely affect our ability to generate revenue and control our expenses.

### **Operational risks may disrupt our businesses, result in losses or limit our growth.**

We face operational risk from errors made in the execution, confirmation or settlement of transactions. We also face operational risk from transactions not being properly recorded, evaluated or accounted for in our funds. In particular, our liquid and hybrid hedge fund businesses are highly dependent on our ability to process and evaluate, on a daily basis, transactions across markets and geographies in a time-sensitive, efficient and accurate manner. Consequently, we rely heavily on our financial, accounting and other data processing systems. In addition, new investment products we introduce create (and recently introduced products created) a significant risk that our existing systems may not be adequate to identify or control the relevant risks in the investment strategies employed by such new investment products. If any of these systems do not operate properly or are disabled, we could suffer financial loss, a disruption of our businesses, liability to our funds, regulatory intervention and reputational damage.

In addition, we operate in an industry that is highly dependent on its information systems and technology. We believe that we have designed, purchased and installed high-quality information systems to support our business. There can be no assurance, however, that our information systems and technology will continue to be able to accommodate our growth, or that the cost of maintaining such systems will not increase from its current level. Such a failure to accommodate growth, or an increase in costs related to such information systems, could have a material adverse effect on us.

Furthermore, we depend on our headquarters, which is located in New York City, for the operation of our business. A disaster or a disruption in the infrastructure that supports our businesses, including a disruption involving electronic communications or other services used by us or third parties with whom we conduct business, or directly affecting our headquarters, may have an adverse impact on our ability to continue to operate our business without interruption, which could have a material adverse effect on us. Although we have disaster recovery programs in place, there

## Edgar Filing: Fortress Investment Group LLC - Form 10-Q

can be no assurance that these will be sufficient to mitigate the harm that may result from such a disaster or disruption. In addition, insurance and other safeguards might only partially reimburse us for our losses.

Finally, we rely on third party service providers for certain aspects of our business, including certain financial operations of our hedge funds. Any interruption or deterioration in the performance of these third parties could impair the quality of the funds' operations and could impact our reputation and adversely affect our business and limit our ability to grow.

**The historical and unaudited pro forma financial information included in this report is not necessarily indicative of our future performance.**

## Table of Contents

The historical combined financial information through March 31, 2007, included in this report is not necessarily indicative of our future financial results. Such historical combined financial information consolidated a large number of our significant funds, which were not consolidated after that date as a result of the consummation of the deconsolidation of such funds on March 31, 2007. In addition, such historical combined financial information included in this report does not reflect the added costs that we now incur as a public company or the impact of changes in our structure that we implemented immediately after the consummation of our initial public offering in February 2007, for periods prior to that date. Moreover, because we operated through limited liability companies prior to our initial public offering, we paid little or no taxes on profits. However, we are now subject to certain taxation on our profits as a result of the changes we made to our structure in connection with our initial public offering.

The results of future periods are likely to be materially different as a result of:

the impact of transactions occurring in connection with our initial public offering in relation to the size of the company during earlier periods;

fund performance in the future which differs from the historical performance reflected in our financial information for earlier periods; and

the pace of growth of our business in the future, including the formation of new funds, which differs from the historical growth reflected in our financial information for earlier periods.

Accordingly, our historical combined financial information is not intended to be, and should not be regarded as, indicative of our future performance.

In addition, we have provided in this report pro forma financial information regarding the impact of the deconsolidation of a number of Fortress Funds, which took place on March 31, 2007, on our historical combined financial information for the six months ended June 30, 2007. The pro forma adjustments, which are based on available information and certain assumptions that we believe are reasonable, have been applied to this historical combined financial information. The pro forma financial information is provided for informational purposes only and does not purport to represent or be indicative of the results that actually would have been obtained had the deconsolidation occurred on January 1, 2007, or that may be obtained for any future period. See Note 12 to Part I, Item 1, Financial Statements Pro Forma Financial Information (Unaudited).

### **We derive a substantial portion of our revenues from funds managed pursuant to management agreements that may be terminated or fund partnership agreements that permit investors to request liquidation of investments in our funds on short notice.**

The terms of our funds generally give either the general partner of the fund or the fund's board of directors the right to terminate our investment management agreement with the fund. However, insofar as we control the general partner of our funds which are limited partnerships, the risk of termination of investment management agreement for such funds is limited, subject to our fiduciary or contractual duties as general partner. This risk is more significant for our offshore hedge funds where we do not serve as the general partner, which represent a significant portion of our hedge fund AUM.

With respect to our private equity funds formed as registered investment companies, each fund's investment management agreement must be approved annually by the independent members of such fund's board of directors and, in certain cases, by its members, as required by law. Termination of these agreements would reduce the fees we earn from the relevant funds, which could have a material adverse effect on our results of operations.

In addition, following the deconsolidation, investors in any private equity fund and certain hedge funds have the ability to act, without cause, to accelerate the date on which the fund must be wound down. Our ability to realize incentive income from such funds therefore would be adversely affected if we are required to liquidate fund investments at a time when market conditions result in our obtaining less for investments than could be obtained at later times.

In addition, management agreements of our funds that are registered investment companies under the Investment Company Act of 1940 would terminate if we were to experience a change of control without obtaining investor consent. Such a change of control could be deemed to occur in the event our principals exchange enough of their interests in the Fortress Operating Group into our Class A shares such that our principals no

## Edgar Filing: Fortress Investment Group LLC - Form 10-Q

longer own a controlling interest in us. We cannot be certain that consents required for the assignment of our investment management agreements will be obtained if such a deemed change of control occurs. In addition, the board of directors of certain hedge funds have the right under certain circumstances to terminate the investment management agreements with the applicable fund. Termination of these agreements would affect the fees we earn from the relevant funds, which could have a material adverse effect on our results of operations.

**We are subject to third-party litigation risk that could result in significant liabilities and reputational harm, which could materially adversely affect our results of operations, financial condition and liquidity.**

---

## Table of Contents

In general, we will be exposed to risk of litigation by our investors if our management of any fund is alleged to constitute gross negligence or willful misconduct. Investors could sue us to recover amounts lost by our funds due to our alleged misconduct, up to the entire amount of loss. Further, we may be subject to litigation arising from investor dissatisfaction with the performance of our funds or from allegations that we improperly exercised control or influence over companies in which our funds have large investments. By way of example, we, our funds and certain of our employees, are each exposed to the risks of litigation relating to investment activities in our funds and actions taken by the officers and directors (some of whom may be Fortress employees) of portfolio companies, such as risks relating to a funds' high-yield lending activities and the risk of shareholder litigation by other shareholders of public companies in which our funds have large investments. In addition, we are exposed to risks of litigation or investigation relating to transactions which presented conflicts of interest that were not properly addressed. In such actions we would be obligated to bear legal, settlement and other costs (which may be in excess of available insurance coverage). In addition, although we are indemnified by the funds we manage, our rights to indemnification may be challenged. If we are required to incur all or a portion of the costs arising out of litigation or investigations as a result of inadequate insurance proceeds or failure to obtain indemnification from our funds, our results of operations, financial condition and liquidity could be materially adversely affected.

In our liquid hedge funds, we are exposed to the risk of litigation if the funds suffer catastrophic losses due to the failure of a particular investment strategy or due to the trading activity of an employee who has violated market rules and regulations. Any litigation arising in such circumstances is likely to be protracted, expensive and surrounded by circumstances which are materially damaging to our reputation and our business. In addition, we face the risk of litigation from investors in our private equity funds and hybrid hedge funds if we violate restrictions in such funds' organizational documents (for example, by failing to seek approval for related party transactions requiring approval or by exceeding the mandate of such funds).

Our liquid hedge funds, our offshore hybrid hedge fund and many of our private equity funds are incorporated or formed under the laws of the Cayman Islands. Cayman Islands laws, particularly with respect to shareholders rights, partner rights and bankruptcy, may differ from the laws of the United States. Cayman Islands laws could change, possibly to the detriment of our funds and investment management subsidiaries.

Also, as a public company, we are subject to the risk of investigation or litigation by regulators or our public shareholders arising from an array of possible claims, including investor dissatisfaction with the performance of our businesses or our share price, allegations of misconduct by our officers and directors or claims that we have inappropriately dealt with conflicts of interest or investment allocations. It is also possible that the public company may be brought into a lawsuit involving any of the fund-related litigation risks described above. As with the funds, while the public company maintains insurance, there can be no assurance that its insurance will prove to be adequate. If the public company is required to incur all or a portion of the costs arising out of litigation or investigations, our results of operations could be materially adversely affected. Furthermore, any such litigation or investigation could be protracted, expensive and highly damaging to the public company's reputation, even if the underlying claims are without merit. In addition, we may participate in transactions that involve litigation (including the enforcement of property rights) from time to time, and such transactions may expose us to reputational risk and increased risk from countersuits.

In addition, with a workforce consisting of many very highly paid investment professionals, we face the risk of lawsuits relating to claims for compensation, which may individually or in the aggregate be significant in amount. The cost of settling such claims could adversely affect our results of operations.

**Our reputation, business and operations could be adversely affected by regulatory compliance failures, the potential adverse effect of changes in laws and regulations applicable to our business and effects of negative publicity surrounding the alternative asset management industry in general.**

Potential regulatory action poses a significant risk to our reputation and thereby to our business. Our business is subject to extensive regulation in the United States and in the other countries in which our investment activities occur. The Securities and Exchange Commission, or SEC, oversees our activities as a registered investment adviser under the Investment Advisers Act of 1940. In addition, we are subject to regulation under the Investment Company Act of 1940, the Securities Exchange Act of 1934, and various other statutes. We are subject to regulation by the Department of Labor under the Employee Retirement Income Security Act of 1974 or ERISA. We and our Castles, as public companies, are subject to applicable stock exchange regulations, and both we and Newcastle are subject to the Sarbanes-Oxley Act of 2002. A number of our investing activities, such as our lending business, are subject to regulation by various U.S. state regulators. In the United Kingdom, we are subject to regulation by the U.K. Financial Services Authority. Our other European operations, and our investment activities around the globe, are subject to a variety of regulatory regimes that vary country by country.

Each of the regulatory bodies with jurisdiction over us has regulatory powers dealing with many aspects of financial services, including the authority to grant, and in specific circumstances to cancel, permissions to carry on particular businesses. A failure to comply with the obligations imposed by the Investment Advisers Act of 1940 on investment advisers, including record-keeping, advertising and operating requirements, disclosure obligations and prohibitions on fraudulent activities, or by the Investment Company Act of 1940, could result in investigations, sanctions and reputational



---

## Table of Contents

damage. Our liquid hedge fund business, and, to a lesser degree, our hybrid hedge fund business, are involved regularly in trading activities which implicate a broad number of U.S. and foreign securities law regimes, including laws governing trading on inside information, market manipulation and a broad number of technical trading requirements that implicate fundamental market regulation policies. Violation of such laws could result in severe restrictions on our activities and in damage to our reputation.

Some of our private equity funds currently qualify as venture capital operating companies, or VCOC, and therefore are not subject to the fiduciary requirements of ERISA with respect to their assets. However, it is possible that the U.S. Department of Labor may amend the relevant regulations or the characteristics of our funds may change. If these funds fail to qualify as VCOCs or otherwise satisfy the requirements of ERISA, including the requirement of investment prudence and diversification or the prohibited transaction rules, it could materially interfere with our activities in relation to these funds or expose us to risks related to our failure to comply with such requirements.

Our failure to comply with applicable laws or regulations could result in fines, censure, suspensions of personnel or investing activities or other sanctions, including revocation of our registration as an investment adviser. The regulations that our businesses are subject to are designed primarily to protect investors in our funds and to ensure the integrity of the financial markets. They are not designed to protect our Class A shareholders. Even if a sanction imposed against us or our personnel by a regulator is for a small monetary amount, the adverse publicity related to such sanction against us by regulators could harm our reputation, result in redemptions by investors from our hedge funds and impede our ability to raise additional capital or new funds.

As a result of recent highly-publicized financial scandals, investors have exhibited concerns over the integrity of the U.S. financial markets, and the regulatory environment in which we operate is subject to heightened regulation. In recent years, there has been debate in both the U.S. and foreign governments about new rules or regulations to be applicable to hedge funds or other alternative investment products. For example, certain officials in Germany have called for implementing these types of additional regulations, which, if enacted, could potentially apply to our business activities throughout the European Union. We may be adversely affected if new or revised legislation or regulations are enacted, or by changes in the interpretation or enforcement of existing rules and regulations imposed by the SEC, other U.S. or foreign governmental regulatory authorities or self-regulatory organizations that supervise the financial markets. Such changes could place limitations on the type of investor that can invest in alternative asset funds or on the conditions under which such investors may invest. Further, such changes may limit the scope of investing activities that may be undertaken by alternative asset managers.

Our results of operations may also be negatively impacted if the recently proposed tax legislation is enacted. If legislation were to be enacted by the U.S. Congress to treat carried interest as ordinary income rather than as capital gain for U.S. federal income tax purposes, such legislation would materially increase the amount of taxes that we and possibly our equityholders are required to pay, thereby reducing the value of our common units and adversely affecting our ability to recruit, retain and motivate our current and future professionals. See Our structure involves complex provisions of U.S. federal income tax law for which no clear precedent or authority may be available. Our structure also is subject to potential legislative, judicial or administrative change and differing interpretations, possibly on a retroactive basis and Legislation has been introduced that would, if enacted, preclude us from qualifying for treatment as a partnership for U.S. federal income tax purposes under the publicly traded partnership rules. Our structure also is subject to potential judicial or administrative change and differing interpretations, possibly on a retroactive basis. Any such changes could increase our costs of doing business or materially adversely affect our profitability.

### **Our failure to deal appropriately with conflicts of interest could damage our reputation and adversely affect our business.**

As we have expanded the number and scope of our businesses, we increasingly confront potential conflicts of interest relating to our funds investment activities. Certain of our funds have overlapping investment objectives, including funds which have different fee structures, and potential conflicts may arise with respect to our decisions regarding how to allocate investment opportunities among those funds. For example, a decision to acquire material non-public information about a company while pursuing an investment opportunity for a particular fund gives rise to a potential conflict of interest when it results in our having to restrict the ability of other funds to take any action. In addition, holders of Class A shares may perceive conflicts of interest regarding investment decisions for funds in which our principals, who have and may continue to make significant personal investments in a variety of Fortress Funds, are personally invested. Similarly, conflicts of interest may exist or develop regarding decisions about the allocation of specific investment opportunities between Fortress and the Fortress Funds. In addition, because the Operating Entities are held, in part, by FIG Corp., which is subject to tax, conflicts of interest may exist regarding decisions about which of Fortress's holdings should be held by Operating Entities and which by Principal Holdings.

Pursuant to the terms of our operating agreement, whenever a potential conflict of interest exists or arises between any of the principals, one or more directors or their respective affiliates, on the one hand, and the company, any subsidiary of the company or any member other than a principal, on the other, any resolution or course of action by our board of directors shall be permitted and deemed approved by all shareholders if the resolution or course of action (i) has been specifically





## **Table of Contents**

approved by a majority of the members of a committee composed entirely of two or more independent directors, or it is deemed approved because it complies with rules or guidelines established by such committee, (ii) has been approved by a majority of the total votes that may be cast in the election of directors that are held by disinterested parties, (iii) is on terms no less favorable to the company or shareholders (other than a principal) than those generally being provided to or available from unrelated third parties or (iv) is fair and reasonable to the company taking into account the totality of the relationships between the parties involved. Notwithstanding the foregoing, it is possible that potential or perceived conflicts could give rise to investor dissatisfaction or litigation or regulatory enforcement actions. Appropriately dealing with conflicts of interest is complex and difficult and our reputation could be damaged if we fail, or appear to fail, to deal appropriately with one or more potential or actual conflicts of interest. Regulatory scrutiny of, or litigation in connection with, conflicts of interest would have a material adverse effect on our reputation, which would materially adversely affect our business in a number of ways, including as a result of redemptions by our investors from our hedge funds, an inability to raise additional funds and a reluctance of counterparties to do business with us.

### **Employee misconduct could harm us by impairing our ability to attract and retain investors and by subjecting us to significant legal liability, regulatory scrutiny and reputational harm.**

Our reputation is critical to maintaining and developing relationships with the investors in our funds, potential investors and third-parties with whom we do business. In recent years, there have been a number of highly-publicized cases involving fraud, conflicts of interest or other misconduct by individuals in the financial services industry in general and the hedge fund industry in particular. There is a risk that our employees could engage in misconduct that adversely affects our business. For example, if an employee were to engage in illegal or suspicious activities (such as improper trading, disclosure of confidential information or breach of fiduciary duties), we could be subject to regulatory sanctions and suffer serious harm to our reputation, financial position, investor relationships and ability to attract future investors. It is not always possible to deter employee misconduct, and the precautions we take to detect and prevent this activity may not be effective in all cases. Misconduct by our employees, or even unsubstantiated allegations, could result in a material adverse effect on our reputation and our business.

### **The investment management business is intensely competitive.**

Over the past several years, the size and number of hedge funds and private equity funds has continued to increase. If this trend continues, it is possible that it will become increasingly difficult for our funds to raise capital. More significantly, the allocation of increasing amounts of capital to alternative investment strategies by institutional and individual investors may lead to a reduction in profitable investment opportunities, including by driving prices for investments higher and increasing the difficulty of achieving targeted returns. In addition, if interest rates were to rise or there were to be a prolonged bull market in equities, the attractiveness of our funds relative to investments in other investment products could decrease. Competition is based on a variety of factors, including:

investment performance;

investor perception of investment managers' drive, focus and alignment of interest;

quality of service provided to and duration of relationship with investors;

business reputation; and

level of fees and expenses charged for services.

We compete in all aspects of our business with a large number of investment management firms, private equity fund sponsors, hedge fund sponsors and other financial institutions. A number of factors serve to increase our competitive risks:

investors may develop concerns that we will allow a business to grow to the detriment of its performance;

## Edgar Filing: Fortress Investment Group LLC - Form 10-Q

some of our competitors have greater capital, a lower cost of capital, lower targeted returns or greater sector or investment strategy specific expertise than we do, which creates competitive disadvantages with respect to investment opportunities;

some of our competitors may have greater technical, marketing and other resources than we possess;

some of our competitors may perceive risk differently than we do, which could allow them either to outbid us for investments in particular sectors or, generally, to consider a wider variety of investments;

our competitors that are corporate buyers may be able to achieve synergistic cost savings in respect of an investment, which may provide them with a competitive advantage in bidding for an investment, particularly if conditions in the debt markets increase our financing costs;

some investors may prefer to invest with an investment manager that is not publicly traded;

there are relatively few barriers to entry impeding new private equity and hedge fund management firms, and the successful efforts of new entrants into our various lines of business, including former star portfolio managers at large diversified financial institutions as well as such institutions themselves, will continue to result in increased competition; and

other industry participants continuously seek to recruit our investment professionals, particularly our best and brightest, away from us.

## **Table of Contents**

These and other factors could reduce our earnings and revenues and materially adversely affect our business. In addition, if we are forced to compete with other alternative asset managers on the basis of price, we may not be able to maintain our current management and performance fee structures. We have historically competed primarily on the performance of our funds, and not on the level of our fees relative to those of our competitors. However, there is a risk that fees in the alternative investment management industry will decline, without regard to the historical performance of a manager. Fee reductions on existing or future funds, without corresponding decreases in our cost structure, would adversely affect our revenues and profitability.

### **The due diligence process that we undertake in connection with investments by our investment funds may not reveal all facts that may be relevant in connection with an investment.**

Before making investments, we conduct due diligence that we deem reasonable and appropriate based on the facts and circumstances applicable to each investment. When conducting due diligence, we may be required to evaluate important and complex business, financial, tax, accounting, environmental and legal issues. Outside consultants, legal advisors, accountants and investment banks may be involved in the due diligence process in varying degrees depending on the type of investment. Nevertheless, when conducting due diligence and making an assessment regarding an investment, we rely on the resources available to us, including information provided by the target of the investment and, in some circumstances, third-party investigations. The due diligence investigation that we will carry out with respect to any investment opportunity may not reveal or highlight all relevant facts that may be necessary or helpful in evaluating such investment opportunity. Moreover, such an investigation will not necessarily result in the investment being successful.

### **Failure to maintain effective internal control over financial reporting in accordance with Section 404 of the Sarbanes-Oxley Act could have a material adverse effect on our business and stock price.**

As a public company, we are required to maintain effective internal control over financial reporting in accordance with Section 404 of the Sarbanes-Oxley Act of 2002. While management has certified that our internal controls over financial reporting were effective as of December 31, 2007, because internal control over financial reporting is complex and may be revised over time to adapt to changes in our business, we cannot assure you that our internal control over financial reporting will be effective in the future. If we are not able to maintain effective internal control over financial reporting, our independent registered public accounting firm may not be able to certify as to the effectiveness of our internal control over financial reporting for future required dates (which begin with our fiscal 2008 annual report). Matters impacting our internal controls may cause us to be unable to report our financial information on a timely basis and thereby subject us to adverse regulatory consequences, including sanctions or investigations by the SEC, or violations of applicable stock exchange listing rules, and result in a breach of the covenants under our credit agreement. There could also be a negative reaction in the financial markets due to a loss of investor confidence in us and the reliability of our financial statements. Confidence in the reliability of our financial statements is also likely to suffer if we or our independent registered public accounting firm reports a material weakness in our internal control over financial reporting. This could materially adversely affect us and lead to a decline in our share price and impair our ability to raise capital.

### **Our organizational documents do not limit our ability to enter into new lines of businesses, and we may enter into new businesses, make future strategic investments or acquisitions or enter into joint ventures, each of which may result in additional risks and uncertainties in our business.**

We intend, to the extent that market conditions warrant, to grow our business by increasing management fee paying assets under management in existing businesses and creating new investment products. Our organizational documents, however, do not limit us to the investment management business. Accordingly, we may pursue growth through strategic investments, acquisitions or joint ventures, which may include entering into new lines of business, such as the insurance, broker-dealer or financial advisory industries, and which may involve assuming responsibility for the actual operation of assets or entire companies. In addition, we expect opportunities will arise to acquire other alternative or traditional asset managers. To the extent we make strategic investments or acquisitions, enter into joint ventures, or enter into a new line of business, we will face numerous risks and uncertainties, including risks associated with (i) the required investment of capital and other resources, (ii) the possibility that we have insufficient expertise to engage in such activities profitably or without incurring inappropriate amounts of risk, and (iii) combining or integrating operational and management systems and controls. Entry into certain lines of business may subject us to new laws and regulations with which we are not familiar, or from which we are currently exempt, and may lead to increased litigation and regulatory risk and negative publicity. If a new business generates insufficient revenues or if we are unable to efficiently manage our expanded operations, our results of operations will be adversely affected. In the case of joint ventures, we are subject to additional risks and uncertainties in that we may be dependent upon, and subject to liability, losses or reputational damage relating to, systems, controls and personnel that are not under our control.

### **Our revenue and profitability fluctuate, particularly inasmuch as we cannot predict the timing of realization events in our private equity business, which may make it difficult for us to achieve steady earnings growth on a quarterly basis and may cause volatility in the price of our Class A shares.**



---

**Table of Contents**

We experience significant variations in revenues and profitability during the year and among years because we are paid incentive income from certain funds only when investments are realized, rather than periodically on the basis of increases in the funds' net asset values. The timing and receipt of incentive income generated by our private equity funds is event driven and thus highly variable, which contributes to the volatility of our segment revenue, and our ability to realize incentive income from our private equity funds may be limited. It takes a substantial period of time to identify attractive investment opportunities, to raise all the funds needed to make an investment and then to realize the cash value (or other proceeds) of an investment through a sale, public offering, recapitalization or other exit. Even if an investment proves to be profitable, it may be several years before any profits can be realized in cash (or other proceeds). We cannot predict when, or if, any realization of investments will occur, and the current challenging conditions in the financing markets have made it more difficult for potential buyers to finance purchases with third-party funds on favorable terms, thereby reducing the likelihood of investment realizations at favorable prices in the near term. If we were to have a realization event in a particular quarter, it may have a significant impact on our segment revenues and profits for that particular quarter which may not be replicated in subsequent quarters. In addition, our private equity investments are adjusted for accounting purposes to fair value at the end of each quarter, resulting in revenue (loss) attributable to our principal investments, even though we receive no cash distributions from our private equity funds, which could increase the volatility of our quarterly earnings. To the extent that our principal investments in our private equity funds (or direct investments in private equity transactions) are marked down, such mark downs will flow through our statements of operations as a GAAP loss, even in circumstances where we have a long investment horizon and have no present intention of selling the investment.

With respect to our hedge funds, our incentive income is paid annually or quarterly if the net asset value of a fund has increased for the period. The amount (if any) of the incentive income we earn from our hedge funds depends on the increase in the net asset value of the funds, which is subject to market volatility. Our liquid hedge funds have historically experienced significant fluctuations in net asset value from month to month. Certain of our hedge funds also have high water marks whereby we do not earn incentive income for a particular period even though the fund had positive returns in such period if the fund had greater losses in prior periods. Therefore, if a hedge fund experiences losses in a period, we will not be able to earn incentive income from that fund until it surpasses the previous high water mark.

These quarterly fluctuations in our revenues and profits in any of our businesses could lead to significant volatility in the price of our Class A shares.

**An increase in our borrowing costs may adversely affect our earnings and liquidity.**

On May 10, 2007, we refinanced our existing credit agreement with a new \$1 billion credit agreement. Under the new credit agreement, we have a \$200 million revolving credit facility and an \$800 million term loan facility. As of June 30, 2008, we had an \$800 million term loan outstanding and no amounts outstanding under our revolving credit facility (although \$11 million of letters of credit were outstanding under a letter of credit subfacility). Borrowings under the credit agreement mature on May 10, 2012. As our facilities mature, we will be required to either refinance them by entering into new facilities or issuing new debt, which could result in higher borrowing costs, or issuing equity, which would dilute existing shareholders. We could also repay them by using cash on hand (if available) or cash from the sale of our assets. No assurance can be given that we will be able to enter into new facilities, issue new debt or issue equity in the future on attractive terms, or at all.

Our credit facility loans are typically LIBOR-based floating-rate obligations and the interest expense we incur will vary with changes in the applicable LIBOR reference rate. As a result, an increase in short-term interest rates will increase our interest costs and will reduce the spread between the returns on our investments and the cost of our borrowings. An increase in interest rates would adversely affect the market value of any fixed-rate debt investments and/or subject them to prepayment or extension risk, which may adversely affect our earnings and liquidity.

**We have recently participated in large-sized investments, which involve certain complexities and risks that are not encountered in small- and medium-sized investments.**

Our private equity funds have recently participated in several large transactions. The increased size of these investments involves certain complexities and risks that may not be encountered in small- and medium-sized investments. For example, larger transactions may be more difficult to finance and complete, and exiting larger deals may present challenges in many cases. In addition, larger transactions may entail greater scrutiny by regulators, labor unions, political bodies and other third parties and greater risk of litigation. Recently, labor unions and members of Congress have been more active in opposing and investigating certain larger investments by private equity firms generally.

Larger transactions may be structured as consortium transactions due to the size of the investment and the amount of capital required to be invested. A consortium transaction involves an equity investment in which two or more private equity firms serve together or collectively as equity sponsors. We may participate in a meaningful number of consortium transactions in the future. Consortium transactions generally entail a reduced level of control by Fortress over the investment because governance rights must be shared with the other private equity investors. Accordingly, we may not be able to control decisions relating to the investment, including decisions relating to the management and operation of the company and the timing and nature of any exit, which could result in the risks described in . Our investment funds make investments in

companies that we do not control .

---

## **Table of Contents**

Any of these factors could increase the risk that our larger investments could be unsuccessful. The consequences to our investment funds of an unsuccessful larger investment could be more severe than a small investment given the size of the investment.

### **Our investment funds often make investments in companies that we do not control.**

Investments by most of our investment funds will include debt instruments and equity securities of companies that we do not control. Such instruments and securities may be acquired by our investment funds through trading activities or through purchases of securities from the issuer. In addition, our private equity funds may possibly acquire minority equity interests (particularly in consortium transactions, as described in We have recently participated in large-sized investments, which involve certain complexities and risks that are not encountered in small- and medium-sized investments ) and may also dispose of a portion of their majority equity investments in portfolio companies over time in a manner that results in the investment funds retaining a minority investment. Those investments will be subject to the risk that the company in which the investment is made may make business, financial or management decisions with which we do not agree or that the majority stakeholders or the management of the company may take risks or otherwise act in a manner that does not serve our interests. If any of the foregoing were to occur, the values of investments by our investment funds could decrease and our financial condition, results of operations and cash flow could suffer as a result.

### **There can be no assurance that we will be successful in developing a market for our investment products in Asia or that our relationship with Nomura will yield profitable investment opportunities for the funds we manage.**

On December 18, 2006, our principals entered into an agreement with Nomura pursuant to which Nomura acquired a 15% stake in Fortress for \$888.0 million on January 17, 2007. Pursuant to the terms of the agreement, the parties agreed that Nomura will work with us to develop a strategy to market and sell our investment products. We believe that a strategic relationship with Nomura, the largest leading Japanese financial institution, could provide us with access to Nomura's distribution capabilities in Asia. In addition, we believe that our relationship will provide us with potential investment opportunities for the funds we manage. However, there can be no assurance that we will be able to develop a strategy and enter into a mutually satisfactory distribution agreement with Nomura, or that if reached, a market for our investment products will ever develop in Asia.

### ***Risks Related to Our Funds***

Our results of operations are dependent on the performance of our funds. Poor fund performance will result in reduced revenues, reduced returns on our principal investments in the funds and reduced earnings. Poor performance of our funds will also make it difficult for us to retain or attract investors to our funds and to grow our business. The performance of each fund we manage is subject to some or all of the following risks.

### **The historical performance of our funds should not be considered as indicative of the future results of our funds or of our future results or of any returns expected on our Class A shares.**

The historical and potential future returns of the funds we manage are not directly linked to returns on our Class A shares. Therefore, readers should not conclude that continued positive performance of the funds we manage will necessarily result in positive returns on our Class A shares. However, poor performance of the funds we manage will cause a decline in our revenue from such funds, and would therefore have a negative effect on our performance and the returns on our Class A shares.

Moreover, with respect to the historical performance of our funds:

the historical performance of our funds should not be considered indicative of the future results that should be expected from such funds or from any future funds we may raise;

our private equity funds' performance, which is calculated on the basis of net asset value of the funds' investments, reflect unrealized gains that may never be realized;

our private equity funds' performance has been influenced by a select number of investments that experienced significant fluctuations in value following the initial public offerings of the private equity portfolio companies in which those investments were made;

our funds' returns have benefited from investment opportunities and general market conditions that currently do not exist and may not repeat themselves, and there can be no assurance that our current or future funds will be able to avail themselves of profitable investment opportunities; and

several of our private equity portfolio companies have become public companies and have experienced significant subsequent fluctuations in their public market value. There can be no assurance that we will be able to realize such investments at profitable sale prices, particularly if market conditions are weak or the market perceives that the companies will perform less well when Fortress reduces its investment in them.



---

**Table of Contents**

**Poor performance of our funds would cause a decline in our revenue and results of operations, may obligate us to repay incentive income previously paid to us, and could adversely affect our ability to raise capital for future funds.**

Our revenue from the Fortress Funds is derived principally from three sources: (1) management fees, based on the size of our funds; (2) incentive income, based on the performance of our funds; and (3) investment income from our investments in the funds, which we refer to as our principal investments. In the event that any of our funds perform poorly, our revenue and results of operations will decline, and it will likely be more difficult for us to raise new capital. In addition, hedge fund investors may withdraw their investments in our funds, while investors in private equity funds may decline to invest in future funds we raise, as a result of poor performance of our funds or otherwise. Furthermore, if, as a result of poor performance of later investments in a private equity fund's life, the fund does not achieve total investment returns that exceed a specified investment return threshold for the life of the fund, we will be obligated to repay the amount by which incentive income that was previously distributed to us and our Principals exceeds the amounts to which we are ultimately entitled. We have contractually agreed to guarantee the payment in certain circumstances of such clawback obligations for our managed investment funds that are structured as private equity funds. If all of our existing private equity funds were liquidated at their NAV as of June 30, 2008, the cumulative clawback obligation to investors in these funds would be approximately \$59.4 million (net of amounts that would be due back from employees pursuant to profit sharing arrangements, and without regard to potential tax adjustments). Our investors and potential investors continually assess our funds performance and our ability to raise capital.

**Difficult market conditions can adversely affect our funds in many ways, including by reducing the value or performance of the investments made by our funds and reducing the ability of our funds to raise or deploy capital, which could materially reduce our revenue and adversely affect results of operations.**

If economic conditions are unfavorable, our funds may not perform well, and we may not be able to raise money in existing or new funds. Our funds are materially affected by conditions in the global financial markets and economic conditions throughout the world. The global market and economic climate may deteriorate because of many factors beyond our control, including rising interest rates or inflation, deterioration in the credit and finance markets, terrorism or political uncertainty. In the event of a market downturn, each of our businesses could be affected in different ways. Our private equity funds may face reduced opportunities to sell and realize value from their existing investments, a lack of financing on acceptable terms, and a lack of suitable investments for the funds to make. In addition, adverse market or economic conditions as well as a slowdown of activities in a particular sector in which portfolio companies of these funds operate could have an adverse effect on the earnings of those portfolio companies, and therefore, our earnings.

A general market downturn, or a specific market dislocation, may cause our revenue and results of operations to decline by causing:

AUM to decrease, lowering management fees;

increases in costs of financial instruments;

lower investment returns, reducing incentive income;

reduced demand to purchase assets held by our funds, which would negatively affect the funds ability to realize value from such assets;

material reductions in the value of our private equity fund investments in portfolio companies which reduce our surplus and, therefore, our ability to realize incentive income from these investments;

investor redemptions, resulting in lower fees; and

decreases in the value of our principal investments.

Furthermore, while difficult market conditions may increase opportunities to make certain distressed asset investments, such conditions also increase the risk of default with respect to investments held by our funds with debt investments, such as the hybrid hedge funds and the Castles. Our liquid hedge funds may also be adversely affected by difficult market conditions if they fail to predict the adverse effect of such conditions on particular investments, resulting in a significant reduction in the value of those investments. In addition, the Castles, as well as the publicly traded portfolio companies owned by our private equity funds, currently pay a material amount of dividends. This makes their share prices vulnerable to increases in interest rates, which would, by causing declines in the value of the share prices, in turn result in lower management fees and incentive income for us, as well as potential decreases in the value of Castle shares and options held as principal investments on our balance sheet.

**Changes in the debt financing markets may negatively impact the ability of our investment funds and their portfolio companies to obtain attractive financing for their investments, and may increase the cost of such financing if it is obtained, leading to lower-yielding investments and potentially decreasing our incentive income.**

Over the past year, the markets for debt financing have contracted significantly, particularly in the area of acquisition financings for private equity and leveraged buyout transactions. Large commercial banks, which have traditionally provided such financing, have demanded higher rates, more restrictive covenants and generally more onerous terms (including posting additional margin) in order to provide such financing, and in some cases are refusing, or renegeing on existing commitments, to provide any financing for acquisitions which would have been readily financed under credit conditions present for the past several years.

---

## **Table of Contents**

In the event that Fortress private equity funds are unable to obtain committed debt financing for potential acquisitions (including as a result of a default by our lenders on financing commitments they have provided to us) or can only obtain debt at an increased rate, this may prevent those funds from completing otherwise profitable acquisitions or may lower the profit that the funds would otherwise have achieved from such transactions, either of which could lead to a decrease in the incentive income earned by us. Similarly, the portfolio companies owned by the Fortress private equity funds regularly utilize the corporate debt markets, particularly the structured finance market, in order to obtain efficient financing for their operations. To the extent that the current credit markets have rendered such financing difficult to obtain or more expensive, this may negatively impact the operating performance of those portfolio companies and therefore the investment returns on our funds.

Our Castles rely on the structured finance and mortgage markets in order to obtain leverage and therefore increase the yield on substantially all of their investments. To the extent that volatility in those credit markets leads to a situation where financing of that type is unavailable or limited (as has been the case for Newcastle since mid 2007), our Castles may be unable to make investments on an accretive basis. This could slow the rate of growth of our fee paying assets under management in those funds, and cause a commensurate decrease in the rate of growth of our management and incentive income fees. Furthermore, it could significantly reduce the yield available for reinvesting capital received from prior investments, thereby reducing profits which would lead to a decrease in the incentive income earned by us. As a result of impairments recorded in connection with this market disruption, we do not expect to earn incentive income from one of the Castles for an indeterminate period of time.

Our hedge funds often utilize the structured finance markets in order to obtain leverage and thereby increase the yield on certain of their investments. To the extent that volatility in those credit markets leads to a situation where financing of that type is unavailable or limited, our hedge funds may be unable to make certain types of investments as the yield on those investments will be outside of the funds' target range without leverage. This could lead to those hedge funds making fewer overall investments and slowing the rate of growth of the fee paying assets under management in those funds, and a commensurate decrease in the rate of growth of our management fees.

### **We and our funds are subject to counterparty default risks.**

Our funds enter into numerous types of financing arrangements with a wide array of counterparties around the world, including loans, hedge contracts, swaps, repurchase agreements and other derivative and non-derivative contracts. The terms of these contracts are often customized and complex, and many of these arrangements occur in markets or relate to products that are not subject to regulatory oversight. In particular, some of our funds utilize prime brokerage arrangements with a relatively limited number of counterparties, which has the effect of concentrating the transaction volume (and related counterparty default risk) of these funds with these counterparties.

Our funds are subject to the risk that the counterparty to one or more of these contracts defaults, either voluntarily or involuntarily, on its performance under the contract. Any such default may occur rapidly and without notice to us. Moreover, if a counterparty defaults, we may be unable to take action to cover our exposure, either because we lack the contractual ability or because market conditions make it difficult to take effective action. This inability could occur in times of market stress, which are precisely the times when defaults may be most like to occur.

In addition, our risk-management models may not accurately anticipate the impact of market stress or counterparty financial condition, and as a result, we may not take sufficient action to reduce our risks effectively. Although each of our funds monitors its credit exposures, default risk may arise from events or circumstances that are difficult to detect, foresee or evaluate. In addition, concerns about, or a default by, one large participant could lead to significant liquidity problems for other participants, which may in turn expose us to significant losses.

In the event of a counterparty default, particularly a default by a major investment bank, one or more of our funds could incur material losses, and the resulting market impact of a major counterparty default could harm our business, results of operation and financial condition. In the event that one of our counterparties becomes insolvent or files for bankruptcy, our ability to eventually recover any losses suffered as a result of that counterparty's default may be limited by the liquidity of the counterparty or the applicable legal regime governing the bankruptcy proceeding.

Because the public company is dependent on receiving cash from our funds, any loss suffered by a fund as a result of a counterparty default would also affect the results of the public company. In addition, the public company has no ability to influence any fund's choice of, or the amount of a fund's exposure to, any given counterparty. As a result, our funds may have concentrated exposure to one or more counterparties and thus be exposed to a heightened risk of loss if that counterparty defaults.

**Investors in our hedge funds may redeem their investments, and investors in our private equity funds may elect to dissolve the funds, at any time without cause. These events would lead to a decrease in our revenues, which could be substantial and lead, therefore, to a material adverse effect on our business.**



## **Table of Contents**

Investors in our hedge funds may generally redeem their investments on an annual or quarterly basis, subject to the applicable fund's specific redemption provisions (e.g., a redeeming Drawbridge Special Opportunities Fund investor is not entitled to cash at the redemption date, but retains instead an interest in the investments as of the redemption date and receives monies from the fund only as and when such investments are realized). Investors may decide to move their capital away from us to other investments for any number of reasons in addition to poor investment performance. Factors that could result in investors leaving our funds include changes in interest rates that make other investments more attractive, the publicly traded nature of the indirect parent of their manager, changes in investor perception regarding our focus or alignment of interest, unhappiness with changes in or broadening of a fund's investment strategy, changes in our reputation, and departures or changes in responsibilities of key investment professionals. In a declining financial market, the pace of redemptions and consequent reduction in our fee paying assets under management could accelerate. The decrease in our revenues that would result from significant redemptions in our hedge fund business would have a material adverse effect on our business.

In addition, the investors in our private equity and domestic hedge funds may, subject to certain conditions, act at any time to accelerate the liquidation date of the fund without cause, resulting in a reduction in management fees we earn from such funds, and a significant reduction in the amounts of total incentive income we could earn from those funds. Incentive income could be significantly reduced as a result of our inability to maximize the value of a fund's investments in a liquidation. The occurrence of such an event with respect to any of our funds would, in addition to the significant negative impact on our revenue and earnings, likely result in significant reputational damage as well.

**Many of our funds invest in relatively high-risk, illiquid assets that often have significantly leveraged capital structures, and we may fail to realize any profits from these activities for a considerable period of time or lose some or all of the principal amount we invest in these activities.**

Many of our funds invest in securities that are not publicly traded. In many cases, our funds may be prohibited by contract or by applicable securities laws from selling such securities for a period of time. Our funds will generally not be able to sell these securities publicly unless their sale is registered under applicable securities laws, or unless an exemption from such registration requirements is available. Accordingly, our funds may be forced to sell securities at a loss under certain conditions. The ability of many of our funds, particularly our private equity funds, to dispose of investments is heavily dependent on the public equity markets, inasmuch as our ability to realize any value from an investment may depend upon our ability to sell equity of the portfolio company in the public equity markets through an initial public offering (an IPO) of the portfolio company in which such investment is held. Furthermore, large holdings even of publicly traded equity securities can often be disposed of only over a substantial period of time, exposing the investment returns to risks of downward movement in market prices during the disposition period.

In addition, many of our funds invest in businesses with capital structures that have significant leverage. The large amount of borrowing in the leveraged capital structure of such businesses increases the risk of losses due to factors such as rising interest rates, downturns in the economy or deteriorations in the condition of the investment or its industry. In the event of defaults under borrowings, the assets being financed would be at risk of foreclosure, and the fund could lose its entire investment.

**Our hedge funds are subject to risks due to potential illiquidity of assets.**

Our hedge funds may make investments or hold trading positions in markets that are volatile and which may become illiquid. Timely divestiture or sale of trading positions can be impaired by decreased trading volume, increased price volatility, concentrated trading positions, limitations on the ability to transfer positions in highly specialized or structured transactions to which we may be a party, and changes in industry and government regulations. When a fund holds a security or position it is vulnerable to price and value fluctuations and may experience losses to the extent the value of the position decreases and it is unable to timely sell, hedge or transfer the position. Therefore, it may be impossible or costly for our funds to liquidate positions rapidly, particularly if the relevant market is moving against a position or in the event of trading halts or daily price movement limits on the market or otherwise. Alternatively, it may not be possible in certain circumstances for a position to be purchased or sold promptly, particularly if there is insufficient trading activity in the relevant market or otherwise.

The hedge funds we manage may operate with a substantial degree of leverage. They may borrow, invest in derivative instruments and purchase securities using borrowed money, so that the positions held by the funds may in aggregate value exceed the net asset value of the funds. This leverage creates the potential for higher returns, but also increases the volatility of a fund, including the risk of a total loss of the amount invested.

The risks identified above will be increased if a fund is required to rapidly liquidate positions to meet margin requests, margin calls or other funding requirements on that position or otherwise. The inability to rapidly sell positions due to a lack of liquidity has historically been the cause of substantial losses in the hedge fund industry. The ability of counterparties to force liquidations following losses or a failure to meet a margin call can result in the rapid sale of highly leveraged positions in declining markets, which would likely subject our hedge funds to substantial losses. We may fail to adequately predict the liquidity that our hedge funds require to address counterparty requirements due to falling values of

fund investments being

---

## **Table of Contents**

financed by such counterparties, which could result not only in losses related to such investments, but in losses related to the need to liquidate unrelated investments in order to meet the fund's obligations. Our hedge funds may incur substantial losses in the event significant capital is invested in highly leveraged investments or investment strategies. Such losses would result in a decline in AUM, lead to investor requests to redeem remaining AUM, and damage our reputation, each of which would materially and adversely impact our earnings.

### **Valuation methodologies for certain assets in our funds can be subject to significant subjectivity and the values of assets established pursuant to such methodologies may never be realized, which could result in significant losses for our funds.**

There are no readily-ascertainable market prices for a very large number of illiquid investments in our private equity and hybrid hedge funds. The value of the investments of our funds is determined periodically by us based on the fair value of such investments. The fair value of investments is determined using a number of methodologies described in the funds' valuation policies. These policies are based on a number of factors, including the nature of the investment, the expected cash flows from the investment, bid or ask prices provided by third parties for the investment, the length of time the investment has been held, the trading price of securities (in the case of publicly traded securities), restrictions on transfer and other recognized valuation methodologies. The methodologies we use in valuing individual investments are based on a variety of estimates and assumptions specific to the particular investments, and actual results related to the investment therefore often vary materially as a result of the inaccuracy of such assumptions or estimates. In addition, because many of the illiquid investments held by our funds are in industries or sectors which are unstable, in distress, or undergoing some uncertainty, such investments are subject to rapid changes in value caused by sudden company-specific or industry-wide developments. In addition, in many markets, transaction flow is limited due to uncertainty about accurate asset valuations which may cause hedge fund investors to become concerned about valuations of funds that have illiquid or hard-to-value assets. This concern may lead to increased redemptions by investors irrespective of the performance of the funds. In addition, uncertainty about asset values on redemptions from our investments in our hedge funds may lead to an increased risk of litigation by investors over net asset values.

Because there is significant uncertainty in the valuation of, or in the stability of the value of, illiquid investments, the fair values of such investments as reflected in a fund's net asset value do not necessarily reflect the prices that would actually be obtained by us on behalf of the fund when such investments are sold. Realizations at values significantly lower than the values at which investments have been reflected in fund net asset values would result in losses for the applicable fund, a decline in asset management fees and the loss of potential incentive income. Also, a situation where asset values turn out to be materially different than values reflected in fund net asset values will cause investors to lose confidence in us which would, in turn, result in redemptions from our hedge funds or difficulties in raising additional private equity funds.

In some cases, the Fortress Funds realize value from an illiquid portfolio company when the portfolio company is able to sell equity in the public markets through an IPO. An IPO of a portfolio company increases the liquidity of the funds' investment in the company and can create significant value when the dividend yield on the company's shares after the IPO is lower than the return being generated by the company's net assets, thereby increasing the value of its equity. Therefore, Fortress values illiquid portfolio companies for which an IPO is being contemplated, or is in process, at fair value without regard to the theoretical value which may be created by the IPO, and such theoretical value may never be realized if the IPO is never consummated.

### **Certain of our funds utilize special situation, distressed debt and mortgage-backed investment strategies that involve significant risks.**

Our private equity and hybrid hedge funds invest in obligors and issuers with weak financial conditions, poor operating results, substantial financial needs, negative net worth, and/or special competitive problems. These funds also invest in obligors and issuers that are involved in bankruptcy or reorganization proceedings. With such investments, it may be difficult to obtain full information as to the exact financial and operating conditions of these obligors and issuers. Additionally, the fair values of such investments are subject to abrupt and erratic market movements and significant price volatility if they are widely traded securities, and are subject to significant uncertainty in general if they are not widely traded securities or may have no recognized market. A fund's exposure to such investments may be substantial in relation to the market for those investments, and the assets are likely to be illiquid and difficult to sell or transfer. As a result, it may take a number of years for the fair value of such investments to ultimately reflect their intrinsic value as perceived by us. For example, several of our funds have significant investments in mortgage-backed securities and other investments that are directly or indirectly related to the value of real estate in various locations around the world. Several funds have recently increased their investments in this sector to take advantage of perceived investment opportunities, and we have recently raised a number of funds targeted specifically toward mortgages. As a result, the results of a number of our funds will be affected, in some cases materially, by fluctuations in the value of real estate and real estate-related investments. Such fluctuations could have a meaningful impact on the performance of the applicable fund and potentially on the operating results of the public company.

A central feature of our distressed investment strategy is our ability to successfully predict the occurrence of certain corporate events, such as debt and/or equity offerings, restructurings, reorganizations, mergers, takeover offers and other transactions. If the corporate event we predict is delayed, changed or never completed, the market price and value of the applicable fund's investment could decline sharply.





## **Table of Contents**

In addition, these investments could subject our private equity and hedge funds to certain potential additional liabilities that may exceed the value of their original investment. Under certain circumstances, payments or distributions on certain investments may be reclaimed if any such payment or distribution is later determined to have been a fraudulent conveyance, a preferential payment or similar transaction under applicable bankruptcy and insolvency laws. In addition, under certain circumstances, a lender that has inappropriately exercised control of the management and policies of a debtor may have its claims subordinated or disallowed, or may be found liable for damages suffered by parties as a result of such actions. In the case where the investment in securities of troubled companies is made in connection with an attempt to influence a restructuring proposal or plan of reorganization in bankruptcy, our funds may become involved in substantial litigation.

### **If our risk management systems for our hedge fund business are ineffective, we may be exposed to material unanticipated losses.**

In our hedge fund business, we continue to refine our risk management techniques, strategies and assessment methods. However, our risk management techniques and strategies do not fully mitigate the risk exposure of our funds in all economic or market environments, or against all types of risk, including risks that we might fail to identify or anticipate. Some of our strategies for managing risk in our funds are based upon our use of historical market behavior statistics. We apply statistical and other tools to these observations to measure and analyze the risks to which our funds are exposed. Any failures in our risk management techniques and strategies to accurately quantify such risk exposure could limit our ability to manage risks in the funds or to seek adequate risk-adjusted returns. In addition, any risk management failures could cause fund losses to be significantly greater than the historical measures predict. Further, our mathematical modeling does not take all risks into account. Our more qualitative approach to managing those risks could prove insufficient, exposing us to material unanticipated losses.

### **Some of our funds invest in foreign countries and securities of issuers located outside of the United States, which may involve foreign exchange, political, social and economic uncertainties and risks.**

Some of our funds invest a portion of their assets in the equity, debt, loans or other securities of issuers located outside the U.S. In addition to business uncertainties, such investments may be affected by changes in exchange values as well as political, social and economic uncertainty affecting a country or region. Many financial markets are not as developed or as efficient as those in the U.S., and as a result, liquidity may be reduced and price volatility may be higher. The legal and regulatory environment may also be different, particularly with respect to bankruptcy and reorganization, and may afford us less protection as a creditor than we may be entitled to under U.S. law. Financial accounting standards and practices may differ, and there may be less publicly available information in respect of such companies.

Restrictions imposed or actions taken by foreign governments may adversely impact the value of our fund investments. Such restrictions or actions could include exchange controls, seizure or nationalization of foreign deposits and adoption of other governmental restrictions which adversely affect the prices of securities or the ability to repatriate profits on investments or the capital invested itself. Income received by our funds from sources in some countries may be reduced by withholding and other taxes. Any such taxes paid by a fund will reduce the net income or return from such investments. While our funds will take these factors into consideration in making investment decisions, including when hedging positions, no assurance can be given that the funds will be able to fully avoid these risks or generate sufficient risk-adjusted returns.

### **Investments by our hedge funds will frequently rank junior to investments made by others in the same company.**

In most cases, the companies in which our investment funds invest will have indebtedness or equity securities, or may be permitted to incur indebtedness or to issue equity securities, that rank senior to our investment. By their terms, such instruments may provide that their holders are entitled to receive payments of dividends, interest or principal on or before the dates on which payments are to be made in respect of our investment. Also, in the event of insolvency, liquidation, dissolution, reorganization or bankruptcy of a company in which an investment is made, holders of securities ranking senior to our investment would typically be entitled to receive payment in full before distributions could be made in respect of our investment. After repaying senior security holders, the company may not have any remaining assets to use for repaying amounts owed in respect of our fund's investment. To the extent that any assets remain, holders of claims that rank equally with our investment would be entitled to share on an equal and ratable basis in distributions that are made out of those assets. Also, during periods of financial distress or following an insolvency, the ability of our investment funds to influence a company's affairs and to take actions to protect their investments may be substantially less than that of the senior creditors.

### **Our hedge fund investments are subject to numerous additional risks.**

Our hedge fund investments, including investments by our funds of hedge funds in other hedge funds, are subject to numerous additional risks, including the following:

## Edgar Filing: Fortress Investment Group LLC - Form 10-Q

Certain of the funds are newly established funds without any operating history or are managed by management companies or general partners who do not have a significant track record as an independent manager.

---

**Table of Contents**

Generally, there are few limitations on the execution of our hedge funds' investment strategies, which are subject to the sole discretion of the management company or the general partner of such funds. The execution of a particular fund's strategy—for example a strategy involving the enforcement of property rights through litigation—may negatively impact one or more other Fortress funds.

Hedge funds may engage in short-selling, which is subject to the theoretically unlimited risk of loss because there is no limit on how much the price of a security may appreciate before the short position is closed out. A fund may be subject to losses if a security lender demands return of the lent securities and an alternative lending source cannot be found or if the fund is otherwise unable to borrow securities that are necessary to hedge its positions.

Hedge funds are exposed to the risk that a counterparty will not settle a transaction in accordance with its terms and conditions because of a dispute over the terms of the contract (whether or not bona fide) or because of a credit or liquidity problem, thus causing the fund to suffer a loss. Counterparty risk is increased for contracts with longer maturities where events may intervene to prevent settlement, or where the fund has concentrated its transactions with a single or small group of counterparties. Generally, hedge funds are not restricted from dealing with any particular counterparty or from concentrating any or all of their transactions with one counterparty. Moreover, the funds' internal consideration of the creditworthiness of their counterparties may prove insufficient. The absence of a regulated market to facilitate settlement may increase the potential for losses.

Credit risk may arise through a default by one of several large institutions that are dependent on one another to meet their liquidity or operational needs, so that a default by one institution causes a series of defaults by the other institutions. This systemic risk may adversely affect the financial intermediaries (such as clearing agencies, clearing houses, banks, investment banks, securities firms and exchanges) with which the hedge funds interact on a daily basis.

The efficacy of investment and trading strategies depend largely on the ability to establish and maintain an overall market position in a combination of financial instruments. A hedge fund's trading orders may not be executed in a timely and efficient manner due to various circumstances, including systems failures or human error. In such event, the funds might only be able to acquire some but not all of the components of the position, or if the overall position were to need adjustment, the funds might not be able to make such adjustment. As a result, the funds would not be able to achieve the market position selected by the management company or general partner of such funds, and might incur a loss in liquidating their position.

Hedge fund investments are subject to risks relating to investments in commodities, futures, options and other derivatives, the prices of which are highly volatile and may be subject to the theoretically unlimited risk of loss in certain circumstances, including if the fund writes a call option. Price movements of commodities, futures and options contracts and payments pursuant to swap agreements are influenced by, among other things, interest rates, changing supply and demand relationships, trade, fiscal, monetary and exchange control programs and policies of governments and national and international political and economic events and policies. The value of futures, options and swap agreements also depends upon the price of the commodities underlying them. In addition, hedge funds' assets are subject to the risk of the failure of any of the exchanges on which their positions trade or of their clearinghouses or counterparties. Most U.S. commodities exchanges limit fluctuations in certain commodity interest prices during a single day by imposing daily price fluctuation limits or daily limits, the existence of which may reduce liquidity or effectively curtail trading in particular markets.

**We are subject to risks in using prime brokers and custodians.**

The funds in our liquid hedge funds business depend on the services of prime brokers and custodians to carry out certain securities transactions. In the event of the insolvency of a prime broker and/or custodian, the funds might not be able to recover equivalent assets in full as they will rank among the prime broker and custodian's unsecured creditors in relation to assets which the prime broker or custodian borrows, lends or otherwise uses. In addition, the funds' cash held with a prime broker or custodian will not be segregated from the prime broker's or custodian's own cash, and the funds will therefore rank as unsecured creditors in relation to the cash they have deposited.

***Risks Related to Our Organization and Structure***

**Control by our principals of the combined voting power of our shares and holding their economic interest through Fortress Operating Group may give rise to conflicts of interests.**

Our principals control a majority of the combined voting power of our Class A and Class B shares. Accordingly, our principals have the ability to elect all of the members of our board of directors, subject to Nomura's right to nominate one designee, and thereby to control our management and affairs. In addition, they are able to determine the outcome of all matters requiring shareholder approval and are able to cause or prevent a change of control of our company or a change in the composition of our board of directors, and could preclude any unsolicited acquisition of our company. The control of

## Table of Contents

voting power by our principals could deprive Class A shareholders of an opportunity to receive a premium for their Class A shares as part of a sale of our company, and might ultimately affect the market price of the Class A shares.

In addition, the shareholders agreement among us and the principals provides the principals who are then employed by the Fortress Operating Group holding shares greater than 50% of the total combined voting power of all shares held by such principals, so long as the principals and their permitted transferees continue to hold more than 40% of the total combined voting power of our outstanding Class A and Class B shares, with approval rights over a variety of significant corporate actions, including:

ten percent indebtedness: any incurrence of indebtedness, in one transaction or a series of related transactions, by us or any of our subsidiaries in an amount in excess of approximately 10% of the then existing long-term indebtedness of us and our subsidiaries;

ten percent share issuance: any issuance by us, in any transaction or series of related transactions, of equity or equity-related securities which would represent, after such issuance, or upon conversion, exchange or exercise, as the case may be, at least 10% of the total combined voting power of our outstanding Class A and Class B shares other than (1) pursuant to transactions solely among us and our wholly-owned subsidiaries, or (2) upon conversion of convertible securities or upon exercise of warrants or options, which convertible securities, warrants or options are either outstanding on the date of, or issued in compliance with, the shareholders agreement;

investment of \$250 million or greater: any equity or debt commitment or investment or series of related equity or debt commitments or investments in an entity or related group of entities in an amount greater than \$250 million;

new business requiring investment in excess of \$100 million: any entry by us or any of our controlled affiliates into a new line of business that does not involve investment management and that requires a principal investment in excess of \$100 million;

the adoption of a shareholder rights plan;

any appointment of a chief executive officer or co-chief executive officer; or

the termination of the employment of a principal with us or any of our material subsidiaries without cause.

Furthermore, the principals have certain consent rights with respect to structural changes involving our company.

In addition, our principals are entitled to a majority of our economic returns through their holdings of Fortress Operating Group units. Because they hold their economic interest in our business directly through Fortress Operating Group, rather than through the public company, our principals may have conflicting interests with holders of Class A shares. For example, our principals may have different tax positions from us which could influence their decisions regarding whether and when to dispose of assets, and whether and when to incur new or refinance existing indebtedness, especially in light of the existence of the tax receivable agreement. In addition, the structuring of future transactions may take into consideration the principals' tax considerations even where no similar benefit would accrue to us. Moreover, any distribution by the Fortress Operating Group to us to satisfy our tax obligations will result in a corresponding pro rata distribution to our principals.

**We intend to pay regular dividends but our ability to do so may be limited by our holding company structure; we are dependent on distributions from the Fortress Operating Group to pay dividends, taxes and other expenses. Our ability to pay dividends is also subject to not defaulting on our credit agreement.**

As a holding company, our ability to pay dividends is subject to the ability of our subsidiaries to provide cash to us. We intend to distribute quarterly dividends to our Class A shareholders. Accordingly, we expect to cause the Fortress Operating Group to make distributions to its unitholders, including our wholly-owned subsidiaries, pro rata in an amount sufficient to enable us to pay such dividends to our Class A

## Edgar Filing: Fortress Investment Group LLC - Form 10-Q

shareholders; however, no assurance can be given that such distributions will or can be made. Our board can reduce or eliminate our dividend at any time, in its discretion. In addition, Fortress Operating Group is required to make minimum tax distributions to its unitholders. See also **Risks Related to Taxation**. There can be no assurance that amounts paid as dividends on Class A shares will be sufficient to cover the tax liability arising from ownership of Class A shares. If Fortress Operating Group has insufficient funds, we may have to borrow additional funds or sell assets, which could materially adversely affect our liquidity and financial condition. In addition, Fortress Operating Group's earnings may be insufficient to enable it to make required minimum tax distributions to unitholders.

We are also subject to certain contingent repayment obligations that may affect our ability to pay dividends. We earn incentive income generally 20% of the profits from each of our private equity funds based on a percentage of the profits earned by the fund as a whole, provided that the fund achieves specified performance criteria. We generally receive, however, our percentage share of the profits on each investment in the fund as it is realized, before it is known with certainty that the fund as a whole will meet the specified criteria. As a result, the incentive income paid to us as a particular investment made by the funds is realized is subject to contingent repayment (or clawback) if, upon liquidation of the fund, the aggregate amount paid to us as incentive income exceeds the amount actually due to us based upon the aggregate

---

**Table of Contents**

performance of the fund. If we are required to repay amounts to a fund in order to satisfy a clawback obligation, any such repayment will reduce the amount of cash available to distribute as a dividend to our Class A shareholders. Moreover, we intend to distribute a portion of the incentive income that we receive as quarterly dividend payments to our Class A shareholders. Once we distribute such funds, we have no ability to recall the funds from our Class A shareholders and would, thus, be required to satisfy any subsequent clawback obligation using other sources. While the principals have personally guaranteed, subject to certain limitations, this clawback obligation, our shareholders agreement with them contains our agreement to indemnify the principals for all amounts which the principals pay pursuant to any of these personal guaranties in favor of our private equity funds. Consequently, any requirement to satisfy a clawback obligation could impair our ability to pay dividends on our Class A shares.

There may also be circumstances under which we are restricted from paying dividends under applicable law or regulation (for example due to Delaware limited partnership or limited liability company act limitations on making distributions if liabilities of the entity after the distribution would exceed the value of the entity's assets). In addition, under our credit agreement, we are permitted to make cash distributions subject to the following restrictions: (a) no event of default exists immediately prior to or subsequent to the distribution, (b) the amount of distributions over the prior 12 months do not exceed free cash flow (as defined in our credit agreement as net income plus (i) taxes, depreciation and private equity incentive income presented on an as-received basis less (ii) capital expenditures, permitted tax distributions and certain other adjustments) for the prior 12 month period, and (c) after giving effect to the distribution, we have cash on hand of not less than accrued but unpaid taxes (based on estimated entity level taxes due and payable by the Fortress Operating Group entities, primarily New York City unincorporated business tax) and amortization obligations (including scheduled principal payments) under the credit agreement which are required in the next 90 days. The events of default under the credit agreement are typical of such agreements and include payment defaults, failure to comply with credit agreement covenants, cross-defaults to material indebtedness, bankruptcy and insolvency, change of control, and adverse events with respect to our material funds. Our lenders may also attempt to exercise their security interests over substantially all of the assets of the Fortress Operating Group upon the occurrence of an event of default.

**Tax consequences to the principals may give rise to conflicts of interests.**

As a result of unrealized built-in gain attributable to the value of our assets held by the Fortress Operating Group entities at the time of our initial public offering, upon the sale or, refinancing or disposition of the assets owned by the Fortress Operating Group entities, our principals will incur different and significantly greater tax liabilities as a result of the disproportionately greater allocations of items of taxable income and gain to the principals upon a realization event. As the principals will not receive a corresponding greater distribution of cash proceeds, they may, subject to applicable fiduciary or contractual duties, have different objectives regarding the appropriate pricing, timing and other material terms of any sale, refinancing, or disposition, or whether to sell such assets at all. Decisions made with respect to an acceleration or deferral of income or the sale or disposition of assets may also influence the timing and amount of payments that are received by an exchanging or selling principal under the tax receivable agreement. All other factors being equal, earlier disposition of assets following a transaction will tend to accelerate such payments and increase the present value of the tax receivable agreement, and disposition of assets before a transaction will increase a principal's tax liability without giving rise to any rights to receive payments under the tax receivable agreement. Decisions made regarding a change of control also could have a material influence on the timing and amount of payments received by the principals pursuant to the tax receivable agreement.

**We are required to pay our principals for most of the tax benefits we realize as a result of the tax basis step-up we receive in connection with taxable exchanges by our principals of units held in the Fortress Operating Group entities or our acquisitions of units from our principals.**

At any time and from time to time, each principal has the right to exchange his Fortress Operating Group units for our Class A shares in a taxable transaction. These taxable exchanges, as well as our acquisitions of units from our principals, may result in increases in the tax depreciation and amortization deductions, as well as an increase in the tax basis of other assets, of the Fortress Operating Group that otherwise would not have been available. These increases in tax depreciation and amortization deductions, as well as the tax basis of other assets, may reduce the amount of tax that FIG Corp. or FIG Asset Co. LLC and any other corporate taxpayers would otherwise be required to pay in the future, although the IRS may challenge all or part of increased deductions and tax basis increase, and a court could sustain such a challenge.

We have entered into a tax receivable agreement with our principals that provides for the payment by the corporate taxpayers to our principals of 85% of the amount of tax savings, if any, that the corporate taxpayers actually realize (or are deemed to realize in the case of an early termination payment by the corporate taxpayers or a change of control, as discussed below) as a result of these increases in tax deductions and tax basis of the Fortress Operating Group. The payments that the corporate taxpayers may make to our principals could be material in amount.

Although we are not aware of any issue that would cause the IRS to challenge a tax basis increase, our principals will not reimburse the corporate taxpayers for any payments that have been previously made under the tax receivable agreement. As a result, in certain circumstances, payments could be made to our principals under the tax receivable agreement in excess of the corporate taxpayers' cash tax savings. The

## Edgar Filing: Fortress Investment Group LLC - Form 10-Q

corporate taxpayers' ability to achieve benefits from any tax basis increase, and the payments to be made under this agreement, will depend upon a number of factors, including the timing and amount of our future income.



---

## **Table of Contents**

In addition, the tax receivable agreement provides that, upon a merger, asset sale or other form of business combination or certain other changes of control, the corporate taxpayers (or their successors) obligations with respect to exchanged or acquired units (whether exchanged or acquired before or after such change of control) would be based on certain assumptions, including that the corporate taxpayers would have sufficient taxable income to fully utilize the deductions arising from the increased tax deductions and tax basis and other benefits related to entering into the tax receivable agreement.

**If we were deemed an investment company under the Investment Company Act of 1940, applicable restrictions could make it impractical for us to continue our business as contemplated and could have a material adverse effect on our business and the price of our Class A shares.**

We do not believe that we are an investment company under the Investment Company Act of 1940 because the nature of our assets and the sources of our income exclude us from the definition of an investment company pursuant to Rule 3a-1 under the Investment Company Act of 1940. In addition, we believe the company is not an investment company under Section 3(b)(1) of the Investment Company Act because it is primarily engaged in a non-investment company business. If one or more of the Fortress Operating Group entities ceased to be a wholly-owned subsidiary of ours, our interests in those subsidiaries could be deemed an investment security for purposes of the Investment Company Act of 1940. Generally, a person is an investment company if it owns investment securities having a value exceeding 40% of the value of its total assets (exclusive of U.S. government securities and cash items) on an unconsolidated basis. We intend to conduct our operations so that we will not be deemed an investment company. However, if we were to be deemed an investment company, restrictions imposed by the Investment Company Act of 1940, including limitations on our capital structure and our ability to transact with affiliates, could make it impractical for us to continue our business as contemplated and would have a material adverse effect on our business and the price of our Class A shares.

### ***Risks Related To Our Class A Shares***

**An active market for our Class A shares may not be sustained.**

Our Class A shares are listed on the New York Stock Exchange under the symbol FIG. However, we cannot provide any assurance that a regular trading market of our Class A shares will be sustained on that exchange or elsewhere.

Accordingly, we cannot provide any assurance of the liquidity of any trading market, holders' ability to sell their Class A shares when desired, or at all, or the prices that they may obtain for their Class A shares.

**The market price and trading volume of our Class A shares may be volatile, which could result in rapid and substantial losses for our shareholders.**

The market price of our Class A shares may be highly volatile and could be subject to wide fluctuations. In addition, the trading volume in our Class A shares may fluctuate and cause significant price variations to occur, which may limit or prevent investors from readily selling their Class A shares and may otherwise negatively affect the liquidity of our Class A shares. If the market price of our Class A shares declines significantly, holders may be unable to resell their Class A shares at or above their purchase price, if at all. We cannot provide any assurance that the market price of our Class A shares will not fluctuate or decline significantly in the future. Some of the factors that could negatively affect the price of our Class A shares or result in fluctuations in the price or trading volume of our Class A shares include:

variations in our quarterly operating results or dividends;

failure to meet analysts' earnings estimates or failure to meet, or the lowering of, our own earnings guidance;

publication of research reports about us or the investment management industry or the failure of securities analysts to cover our Class A shares;

additions or departures of our principals and other key management personnel;

adverse market reaction to any indebtedness we may incur or securities we may issue in the future;

actions by shareholders;

changes in market valuations of similar companies;

speculation in the press or investment community;

changes or proposed changes in laws or regulations or differing interpretations thereof affecting our business or enforcement of these laws and regulations, or announcements relating to these matters;

litigation or governmental investigations;

fluctuations in the performance or share price of other alternative asset managers;

poor performance or other complications affecting our funds or current or proposed investments;

adverse publicity about the asset management industry generally or individual scandals, specifically; and

general market and economic conditions.

---

## **Table of Contents**

In addition, when the market price of a stock has been volatile in the past, holders of that stock have, at times, instituted securities class action litigation against the issuer of the stock. If any of our shareholders brought a lawsuit against us, we may be required to incur substantial costs defending any such suit, even those without merit. Such a lawsuit could also divert the time and attention of our management from our business and lower our Class A share price.

### **Our Class A share price may decline due to the large number of shares eligible for future sale and for exchange into Class A shares.**

The market price of our Class A shares could decline as a result of sales of a large number of our Class A shares or the perception that such sales could occur. These sales, or the possibility that these sales may occur, also might make it more difficult for us to sell equity securities in the future at a time and price that we deem appropriate. As of June 30, 2008, we had 406,571,901 outstanding Class A shares on a fully diluted basis, 52,933,476 restricted Class A share units granted to employees and affiliates (net of forfeitures) and 104,455 restricted Class A shares granted to directors pursuant to our equity incentive plan, and 61,962,069 Class A shares and Fortress Operating Group units that remain available for future grant under our equity incentive plan. Beginning in 2008, the Class A shares reserved under our equity incentive plan will be increased on the first day of each fiscal year during the plan's term by the lesser of (x) the excess of (i) 15% of the number of outstanding Class A and Class B shares of the company on the last day of the immediately preceding fiscal year over (ii) the number of shares reserved and available for issuance under our equity incentive plan as of such date or (y) 60,000,000 shares. We may issue and sell in the future additional Class A shares or any securities issuable upon conversion of, or exchange or exercise for, Class A shares (including Fortress Operating Group units) at any time.

Our principals own an aggregate of 312,071,550 Fortress Operating Group units. Each principal has the right to exchange each of his Fortress Operating Group units for one of our Class A shares at any time, subject to the Principals Agreement. These Class A shares and Fortress Operating Group units are eligible for resale from time to time, subject to certain contractual restrictions and Securities Act limitations.

In addition, In April 2008, Fortress granted 31 million Fortress Operating Group restricted partnership units ( RPU ) to a senior employee. The RPUs will vest into full capital interests in Fortress Operating Group units in three equal portions on the first business day of 2011, 2012 and 2013, respectively, subject to continued employment with Fortress. If and when vested, these 31 million Fortress Operating Group units will be exchangeable into Class A shares on a one-for-one basis. In addition, such units will have the same resale terms and restrictions as those applicable to the principals' Fortress Operating Group units.

Our principals and Nomura are parties to shareholders agreements with us. The principals have the ability to cause us to register the Class A shares they acquire upon exchange for their Fortress Operating Group units. Nomura has the ability to cause us to register any of its 55,071,450 Class A shares.

### **Our principals' beneficial ownership of Class B shares and anti-takeover provisions in our charter documents and Delaware law could delay or prevent a change in control.**

Our principals beneficially own all of our Class B shares. The principals' Class B shares will represent a majority of the total combined voting power of our outstanding Class A and Class B shares. As a result, if they vote all of their shares in the same manner, they will be able to exercise control over all matters requiring the approval of shareholders and will be able to prevent a change in control of our company. In addition, provisions in our operating agreement may make it more difficult and expensive for a third party to acquire control of us even if a change of control would be beneficial to the interests of our shareholders. For example, our operating agreement provides for a staggered board, requires advance notice for proposals by shareholders and nominations, places limitations on convening shareholder meetings, and authorizes the issuance of preferred shares that could be issued by our board of directors to thwart a takeover attempt. In addition, certain provisions of Delaware law may delay or prevent a transaction that could cause a change in our control. The market price of our Class A shares could be adversely affected to the extent that our principals' control over us, as well as provisions of our operating agreement, discourage potential takeover attempts that our shareholders may favor.

### **There are certain provisions in our operating agreement regarding exculpation and indemnification of our officers and directors that differ from the Delaware General Corporation Law (DGCL) in a manner that may be less protective of the interests of our Class A shareholders.**

Our operating agreement provides that to the fullest extent permitted by applicable law our directors or officers will not be liable to us. However, under the DGCL, a director or officer would be liable to us for (i) breach of duty of loyalty to us or our shareholders, (ii) intentional misconduct or knowing violations of the law that are not done in good faith, (iii) improper redemption of shares or declaration of dividend, or (iv) a transaction from which the director or officer derived an improper personal benefit. In addition, our operating agreement provides that we indemnify our directors and officers for acts or omissions to the fullest extent provided by law. However, under the DGCL, a corporation can

## Edgar Filing: Fortress Investment Group LLC - Form 10-Q

only indemnify directors and officers for acts or omissions if the director or officer acted in good faith, in a manner he reasonably believed to be in the best interests of the corporation, and, in a criminal action, if the officer or director had no reasonable cause to believe his

---

## **Table of Contents**

conduct was unlawful. Accordingly, our operating agreement may be less protective of the interests of our Class A shareholders, when compared to the DGCL, insofar as it relates to the exculpation and indemnification of our officers and directors.

### ***Risks Related to Taxation***

#### **Class A shareholders may be subject to U.S. federal income tax on their share of our taxable income, regardless of whether they receive any cash dividends from us.**

So long as we are not required to register as an investment company under the Investment Company Act of 1940 and 90% of our gross income for each taxable year constitutes qualifying income within the meaning of the Internal Revenue Code of 1986, as amended (the Code), on a continuing basis, we will be treated, for U.S. federal income tax purposes, as a partnership and not as an association or a publicly traded partnership taxable as a corporation. Class A shareholders may be subject to U.S. federal, state, local and possibly, in some cases, foreign income taxation on their allocable share of our items of income, gain, loss, deduction and credit (including our allocable share of those items of any entity in which we invest that is treated as a partnership or is otherwise subject to tax on a flow through basis) for each of our taxable years ending with or within their taxable year, regardless of whether or not they receive cash dividends from us. They may not receive cash dividends equal to their allocable share of our net taxable income or even the tax liability that results from that income. In addition, certain of our holdings, including holdings, if any, in a Controlled Foreign Corporation (CFC) and a Passive Foreign Investment Company (PFIC), may produce taxable income prior to the receipt of cash relating to such income, and holders of our Class A shares will be required to take such income into account in determining their taxable income. Under our operating agreement, in the event of an inadvertent partnership termination in which the Internal Revenue Service (IRS) has granted us limited relief, each holder of our Class A shares also is obligated to make such adjustments as are required by the IRS to maintain our status as a partnership. Such adjustments may require persons who hold our Class A shares to recognize additional amounts in income during the years in which they hold such shares. We may also be required to make payments to the IRS.

#### **Our intermediate holding company, FIG Corp., is subject to corporate income taxation in the United States, and we may be subject to additional taxation in the future.**

A significant portion of our investments and activities may be made or conducted through FIG Corp. Dividends paid by FIG Corp. from time to time will, as is usual in the case of a U.S. corporation, then be included in our income. Income received as a result of investments made or activities conducted through FIG Asset Co. LLC (but excluding through its taxable corporate affiliates) is not subject to corporate income taxation in our structure, but we cannot provide any assurance that it will not become subject to additional taxation in the future, which would negatively impact our results of operations.

#### **There can be no assurance that amounts paid as dividends on Class A shares will be sufficient to cover the tax liability arising from ownership of Class A shares.**

Any dividends paid on Class A shares will not take into account a shareholder's particular tax situation (including the possible application of the alternative minimum tax) and, therefore, because of the foregoing as well as other possible reasons, may not be sufficient to pay their full amount of tax based upon their share of our net taxable income. In addition, the actual amount and timing of dividends will always be subject to the discretion of our board of directors and we cannot provide any assurance that we will in fact pay cash dividends as currently intended. In particular, the amount and timing of dividends will depend upon a number of factors, including, among others:

our actual results of operations and financial condition;

restrictions imposed by our operating agreement or applicable law;

restrictions imposed by our credit agreements;

reinvestment of our capital;

## Edgar Filing: Fortress Investment Group LLC - Form 10-Q

the timing of the investment of our capital;

the amount of cash that is generated by our investments or to fund liquidity needs;

levels of operating and other expenses;

contingent liabilities; or

factors that our board of directors deems relevant.

Even if we do not distribute cash in an amount that is sufficient to fund a shareholder's tax liabilities, they will still be required to pay income taxes on their share of our taxable income.

### **Tax gain or loss on disposition of our common units could be more or less than expected.**

If a Class A shareholder sells common units, such shareholder will recognize a gain or loss equal to the difference between the amount realized and the adjusted tax basis in those common units. Prior distributions to such common shareholder in

---

**Table of Contents**

excess of the total net taxable income allocated to such shareholder, which decreased the tax basis in its common units, will increase the gain recognized upon a sale when the common units are sold at a price greater than such shareholder's tax basis in those common units, even if the price is less than the original cost. A portion of the amount realized, whether or not representing gain, may be ordinary income to such shareholder.

**We currently do not intend to make an election under Section 754 of the Internal Revenue Code to adjust our asset basis, so a holder of common units could be allocated more taxable income in respect of those common units prior to disposition than if such an election were made.**

We currently do not intend to make an election under Section 754 of the Internal Revenue Code to adjust our asset basis. If no Section 754 election is made, there will generally be no adjustment to the basis of our assets in connection with our initial public offering, or upon a subsequent transferee's acquisition of common units from a prior holder of such common units, even if the purchase price for those interests or units, as applicable, is greater than the share of the aggregate tax basis of our assets attributable to those interests or units immediately prior to the acquisition. Consequently, upon our sale of an asset, gain allocable to a holder of common units could include built-in gain in the asset existing at the time such holder acquired such units, which built-in gain would otherwise generally be eliminated if a Section 754 election had been made.

**If we are treated as a corporation for U.S. federal income tax purposes, the value of the Class A shares would be adversely affected.**

We have not requested, and do not plan to request, a ruling from the IRS on our treatment as a partnership for U.S. federal income tax purposes, or on any other matter affecting us. As of the date of the consummation of our initial public offering, under then current law and assuming full compliance with the terms of our operating agreement (and other relevant documents) and based upon factual statements and representations made by us, our outside counsel opined, as of that date, that we would be treated as a partnership, and not as an association or a publicly traded partnership taxable as a corporation for U.S. federal income tax purposes. However, opinions of counsel are not binding upon the IRS or any court, and the IRS may challenge this conclusion and a court may sustain such a challenge. The factual representations made by us upon which our outside counsel relied related to our organization, operation, assets, activities, income, and present and future conduct of our operations. In general, if an entity that would otherwise be classified as a partnership for U.S. federal income tax purposes is a publicly traded partnership (as defined in the Code) it will be nonetheless treated as a corporation for U.S. federal income tax purposes, unless the exception described below, and upon which we intend to rely, applies. A publicly traded partnership will, however, be treated as a partnership, and not as a corporation for U.S. federal income tax purposes, so long as 90% or more of its gross income for each taxable year constitutes qualifying income within the meaning of the Code and it is not required to register as an investment company under the Investment Company Act of 1940. We refer to this exception as the qualifying income exception.

Qualifying income generally includes dividends, interest, capital gains from the sale or other disposition of stocks and securities and certain other forms of investment income. We expect that our income generally will consist of interest, dividends, capital gains and other types of qualifying income, including dividends from FIG Corp. and interest on indebtedness from FIG Corp. No assurance can be given as to the types of income that will be earned in any given year. If we fail to satisfy the qualifying income exception described above, items of income and deduction would not pass through to holders of the Class A shares and holders of the Class A shares would be treated for U.S. federal (and certain state and local) income tax purposes as shareholders in a corporation. In such a case, we would be required to pay income tax at regular corporate rates on all of our income. In addition, we would likely be liable for state and local income and/or franchise taxes on all of such income. Dividends to holders of the Class A shares would constitute ordinary dividend income taxable to such holders to the extent of our earnings and profits, and the payment of these dividends would not be deductible by us. Taxation of us as a publicly traded partnership taxable as a corporation could result in a material adverse effect on our cash flow and the after-tax returns for holders of Class A shares and thus could result in a substantial reduction in the value of the Class A shares.

**Our structure involves complex provisions of U.S. federal income tax law for which no clear precedent or authority may be available. Our structure also is subject to potential legislative, judicial or administrative change and differing interpretations, possibly on a retroactive basis.**

The U.S. federal income tax treatment of holders of the Class A shares depends in some instances on determinations of fact and interpretations of complex provisions of U.S. federal income tax law for which no clear precedent or authority may be available. Readers should be aware that the U.S. federal income tax rules are constantly under review by persons involved in the legislative process, the IRS, and the U.S. Treasury Department, frequently resulting in revised interpretations of established concepts, statutory changes, revisions to regulations and other modifications and interpretations. The IRS pays close attention to the proper application of tax laws to partnerships. The present U.S. federal income tax treatment of an investment in the Class A shares may be modified by administrative, legislative or judicial interpretation at any time, possibly on a retroactive basis, and any such action may affect investments and commitments previously made. For example, changes to the U.S. federal tax laws and interpretations thereof could make it more difficult or impossible to meet the qualifying income exception for us to be

Edgar Filing: Fortress Investment Group LLC - Form 10-Q

treated as a partnership for U.S. federal income tax purposes that is not taxable as a



## Table of Contents

corporation, affect or cause us to change our investments and commitments, change the character or treatment of portions of our income (including, for instance, treating carried interest as ordinary fee income rather than capital gain) affect the tax considerations of an investment in us and adversely affect an investment in our Class A shares.

Our organizational documents and agreements permit the board of directors to modify our operating agreement from time to time, without the consent of the holders of Class A shares, in order to address certain changes in U.S. federal income tax regulations, legislation or interpretation. In some circumstances, such revisions could have a material adverse impact on some or all of the holders of our Class A shares. Moreover, we will apply certain assumptions and conventions in an attempt to comply with applicable rules and to report income, gain, deduction, loss and credit to holders in a manner that reflects such holders' beneficial ownership of partnership items, taking into account variation in ownership interests during each taxable year because of trading activity. However, these assumptions and conventions may not be in compliance with all aspects of applicable tax requirements. It is possible that the IRS will assert successfully that the conventions and assumptions used by us do not satisfy the technical requirements of the Code and/or Treasury regulations and could require that items of income, gain, deductions, loss or credit, including interest deductions, be adjusted, reallocated, or disallowed, in a manner that adversely affects holders of the Class A shares.

**Legislation has been introduced that would, if enacted, preclude us from qualifying for treatment as a partnership for U.S. federal income tax purposes under the publicly traded partnership rules. Our structure also is subject to potential judicial or administrative change and differing interpretations, possibly on a retroactive basis.**

On June 14, 2007, legislation was introduced in the Senate that would tax as corporations publicly traded partnerships that directly or indirectly derive income from investment adviser or asset management services. In addition, the Chairman and the Ranking Republican Member of the Senate Committee on Finance concurrently issued a press release stating that they do not believe that proposed public offerings of private equity and hedge fund management firms are consistent with the intent of the existing rules regarding publicly traded partnerships because the majority of their income is from the active provision of services to investment funds and limited partner investors in such funds. As explained in the technical explanation accompanying the proposed legislation:

Under the bill, the exception from corporate treatment for a publicly traded partnership does not apply to any partnership that, directly or indirectly, has any item of income or gain (including capital gains or dividends), the rights to which are derived from services provided by any person as an investment adviser, as defined in the Investment Advisers Act of 1940, or as a person associated with an investment adviser, as defined in that Act. Further, the exception from corporate treatment does not apply to a partnership that, directly or indirectly, has any item of income or gain (including capital gains or dividends), the rights to which are derived from asset management services provided by an investment adviser, a person associated with an investment adviser, or any person related to either, in connection with the management of assets with respect to which investment adviser services were provided.

If enacted in its proposed form, the transition rules of the proposed legislation would delay the application of these rules for five years. Legislation also has been introduced that is substantially similar to the proposed legislation introduced in the Senate that would apply the legislation to us with respect to our 2008 taxable year. In addition, legislation has been introduced in the House, and passed by the House Ways and Means Committee, that would have the effect of treating income recognized from carried interests as ordinary fee income, thereby effectively causing such income to be treated as nonqualifying income under the publicly traded partnership rules, which would preclude us from qualifying for treatment as a partnership for U.S. federal income tax purposes. The proposal did not discuss transition relief.

If any version of these legislative proposals were to be enacted into law, or if other similar legislation were to be enacted or any other change in the tax laws, rules, regulations or interpretations were to preclude us from qualifying for treatment as a partnership for U.S. federal income tax purposes under the publicly traded partnership rules, holders would be negatively impacted because we would incur a material increase in our tax liability as a public company from the date any such changes became applicable to us, which could result in a reduction in the value of our Class A shares.

**We cannot match transferors and transferees of common units, and we have therefore adopted certain income tax accounting positions that may not conform with all aspects of applicable tax requirements. The IRS may challenge this treatment, which could adversely affect the value of our common units.**

Because we cannot match transferors and transferees of common units, we have adopted depreciation, amortization and other tax accounting positions that may not conform with all aspects of existing Treasury regulations. A successful IRS challenge to those positions could adversely affect the amount of tax benefits available to our common unitholders. It also could affect the timing of these tax benefits or the amount of gain on the sale of common units and could have a negative impact on the value of our common units or result in audits of and adjustments to our common unitholders' tax returns.

## Edgar Filing: Fortress Investment Group LLC - Form 10-Q

The sale or exchange of 50% or more of our capital and profit interests will result in the termination of our partnership for U.S. federal income tax purposes. We will be considered to have been terminated for U.S. federal income tax purposes if there is a sale or exchange of 50% or more of the total interests in our capital and profits within a 12-month period. Our

---

**Table of Contents**

termination would, among other things, result in the closing of our taxable year for all common unitholders and could result in a deferral of depreciation deductions allowable in computing our taxable income.

**FIG Asset Co. LLC may not be able to invest in certain assets, other than through a taxable corporation.**

In certain circumstances, FIG Asset Co. LLC or one of its subsidiaries may have an opportunity to invest in certain assets through an entity that is characterized as a partnership for U.S. federal income tax purposes, where the income of such entity may not be qualifying income for purposes of the publicly traded partnership rules. In order to manage our affairs so that we will meet the qualifying income exception, we may either refrain from investing in such entities or, alternatively, we may structure our investment through an entity classified as a corporation for U.S. federal income tax purposes. If the entity were a U.S. corporation, it would be subject to U.S. federal income tax on its operating income, including any gain recognized on its disposal of its interest in the entity in which the opportunistic investment has been made, as the case may be, and such income taxes would reduce the return on that investment.

**Complying with certain tax-related requirements may cause us to forego otherwise attractive business or investment opportunities or enter into acquisitions, borrowings, financings or arrangements we may not have otherwise entered into.**

In order for us to be treated as a partnership for U.S. federal income tax purposes, and not as an association or publicly traded partnership taxable as a corporation, we must meet the qualifying income exception discussed above on a continuing basis and we must not be required to register as an investment company under the Investment Company Act of 1940. In order to effect such treatment we (or our subsidiaries) may be required to invest through foreign or domestic corporations, forego attractive business or investment opportunities or enter into borrowings or financings we may not have otherwise entered into. This may adversely affect our ability to operate solely to maximize our cash flow. Our structure also may impede our ability to engage in certain corporate acquisitive transactions because we generally intend to hold all of our assets through the Fortress Operating Group. In addition, we may be unable to participate in certain corporate reorganization transactions that would be tax free to our holders if we were a corporation. To the extent we hold assets other than through the Fortress Operating Group, we will make appropriate adjustments to the Fortress Operating Group agreements so that distributions to principals and us would be the same as if such assets were held at that level.

**The IRS could assert that we are engaged in a U.S. trade or business, with the result that some portion of our income is properly treated as effectively connected income with respect to non-U.S. holders. Moreover, certain REIT dividends and other stock gains may be treated as effectively connected income with respect to non-U.S. holders.**

While we expect that our method of operation will not result in a determination that we are engaged in a U.S. trade or business, there can be no assurance that the IRS will not assert successfully that we are engaged in a U.S. trade or business, with the result that some portion of our income is properly treated as effectively connected income with respect to non-U.S. holders.

Moreover, dividends paid by an investment that we make in a REIT that is attributable to gains from the sale of U.S. real property interests will, and sales of certain investments in the stock of U.S. corporations owning significant U.S. real property may, be treated as effectively connected income with respect to non-U.S. holders. To the extent our income is treated as effectively connected income, non-U.S. holders generally would be subject to withholding tax on their allocable shares of such income, would be required to file a U.S. federal income tax return for such year reporting their allocable shares of income effectively connected with such trade or business, and would be subject to U.S. federal income tax at regular U.S. tax rates on any such income. Non-U.S. holders may also be subject to a 30% branch profits tax on such income in the hands of non-U.S. holders that are corporations.

**An investment in Class A shares will give rise to UBTI to certain tax-exempt holders.**

We will not make investments through taxable U.S. corporations solely for the purpose of limiting unrelated business taxable income, or UBTI, from debt-financed property and, thus, an investment in Class A shares will give rise to UBTI to certain tax-exempt holders. For example, FIG Asset Co. LLC will invest in or hold interests in entities that are treated as partnerships, or are otherwise subject to tax on a flow-through basis, that will incur indebtedness. FIG Asset Co. LLC may borrow funds from FIG Corp. or third parties from time to time to make investments. These investments will give rise to UBTI from debt-financed property. However, we expect to manage our activities to avoid a determination that we are engaged in a trade or business, thereby limiting the amount of UBTI that is realized by tax-exempt holders of our Class A shares.

**We may hold or acquire certain investments through an entity classified as a PFIC or CFC for U.S. federal income tax purposes.**

Certain of our investments may be in foreign corporations or may be acquired through a foreign subsidiary that would be classified as a corporation for U.S. federal income tax purposes. Such an entity may be a PFIC or a CFC for U.S. federal income tax purposes. U.S. holders of

Edgar Filing: Fortress Investment Group LLC - Form 10-Q

Class A shares indirectly owning an interest in a PFIC or a CFC may experience adverse U.S. tax consequences.

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

None.

**Item 3. Defaults upon Senior Securities**

None.

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

On May 29, 2008, the Company held its Annual Meeting of Shareholders at which the shareholders voted upon (i) the election of Richard Haass, Randal Nardone and Howard Rubin to the Board of Directors as Class I directors for three-year terms and (ii) the ratification of the appointment of Ernst & Young LLP as the Company's independent registered public accounting firm for the 2008 fiscal year.

The shareholders elected each of the directors and approved the ratification of the appointment of Ernst & Young LLP as the Company's independent registered public accounting firm for the 2008 fiscal year. The number of votes cast for or against and the number of abstentions with respect to each matter voted upon, as applicable, is set forth below (broker non-votes do not apply to these proposals):

<b>Proposal</b>	<b>For</b>	<b>Against</b>	<b>Abstain</b>
Election of Directors			
Richard Haass	340,076,060	N/A	443,630
Randal Nardone	339,997,726	N/A	521,965
Howard Rubin	340,073,468	N/A	446,222
Ratification of the Appointment of Independent Registered Public Accounting Firm	340,223,344	254,414	41,933

**Item 5. Other Information**

None.

**Table of Contents**

**Item 6. Exhibits**

(a) and (c) Financial statements and schedules:  
See Part I, Item 1, Financial Statements

(b) Exhibits filed with this Quarterly Report on Form 10-Q:

- 3.1 Certificate of Formation of the Registrant (incorporated by reference to the Registrant's Registration Statement on Form S-1 (File No. 333-138514), Exhibit 3.1).
- 3.2 Certificate of Amendment to Certificate of Formation of the Registrant (incorporated by reference to the Registrant's Registration Statement on Form S-1 (File No. 333-138514), Exhibit 3.2).
- 3.3 Third Amended and Restated Limited Liability Company Agreement of the Registrant (incorporated by reference to the Registrant's Annual Report on Form 10-K filed with the SEC on March 28, 2008 (File No. 001-33294), Exhibit 3.3).
- 10.1 Second Amendment to the Second Amended and Restated Credit Agreement, dated April 17, 2008, among FIG LLC, a Delaware limited liability company, and certain of its affiliates, as borrowers, certain subsidiaries and affiliates of the borrowers, as guarantors, the Lenders party hereto and Bank of America, N.A., as Administrative Agent and L/C Issuer (incorporated by reference to the Registrant's Current Report on Form 8-K dated April 23, 2008 (File No. 001-33294), Exhibit 10.1).
- 10.2 Third Amended and Restated Credit Agreement, entered into effective as of May 29, 2008, among FIG LLC, as Borrower, certain subsidiaries and affiliates of the Borrower, as Guarantor, the Lenders party hereto and Bank of America, N.A., as Administrative Agent and L/C Issuer (incorporated by reference to the Registrant's Current Report on Form 8-K dated May 30, 2008 (File No. 001-33294), Exhibit 10.1).
- 31.1 Certification of Chief Executive Officer as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Certification of Chief Financial Officer as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1 Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 32.2 Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

**Table of Contents**

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:

FORTRESS INVESTMENT GROUP LLC  
August 11, 2008

By: /s/ Wesley R. Edens  
Wesley R. Edens  
Chairman of the Board

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following person on behalf of the registrant and in the capacities and on the dates indicated.

By: /s/ Wesley R. Edens  
Wesley R. Edens  
Chief Executive Officer  
August 11, 2008

By: /s/ Daniel N. Bass  
Daniel N. Bass  
Chief Financial Officer  
August 11, 2008

By: /s/ Jonathan R. Brown  
Jonathan R. Brown  
Chief Accounting Officer  
August 11, 2008