

EQUUS TOTAL RETURN, INC.  
Form 10-Q  
May 15, 2014

**UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

**Washington, D.C. 20549**

**FORM 10-Q**

(Mark One)

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

For the quarterly period ended March 31, 2014

or

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

For the transition period \_\_\_\_\_ to \_\_\_\_\_

Commission File Number 814-00098

**EQUUS TOTAL RETURN, INC.**

**(Exact name of registrant as specified in its charter)**

<b>Delaware</b> <b>(State or other jurisdiction of</b>	<b>76-0345915</b> <b>(I.R.S. Employer</b>
<b>incorporation or organization)</b>	<b>Identification No.)</b>

<b>Eight Greenway Plaza, Suite 930 Houston, Texas</b>	<b>77046</b>
<b>(Address of principal executive offices)</b>	<b>(Zip Code)</b>
<b>Registrant's telephone number, including area code: (713) 529-0900</b>	

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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 has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of “accelerated filer and large accelerated filer” in Rule 12b-2 of the Exchange Act.

Large accelerated filer  Accelerated filer  Non-accelerated filer  Smaller Reporting Company

Indicate by check mark whether the registrant is a shell company. Yes  No

There were 12,673,646 shares of the registrant’s common stock, \$.001 par value, outstanding, as of May 15, 2014.

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EQUUS TOTAL RETURN, INC.

(A Delaware Corporation)

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EQUUS TOTAL RETURN, INC.BALANCE SHEETS**Part I. Financial Information****Item 1. Financial Statements**

	March 31, 2014 (unaudited)	December 31, 2013
(in thousands, except per share amounts)		
Assets		
Investments in portfolio securities at fair value:		
Control investments (cost at \$15,863 and \$15,789 respectively)	\$ 11,179	\$ 11,105
Affiliate investments (cost at \$350 and \$350 respectively)	250	250
Non-affiliate investments (cost at \$1,321 and \$1,321 respectively)	2,081	2,149
Total investments in portfolio securities at fair value	13,510	13,504
Cash and cash equivalents	18,690	19,065
Restricted cash and temporary cash investments	—	15,150
Accounts receivable from investments	386	372
Accrued interest receivable	444	228
Accounts receivable and other	28	30
Total assets	33,058	48,349
Liabilities and net assets		
Accounts payable and accrued liabilities	254	106
Accounts payable to related parties	125	26
Borrowing under margin account	—	15,000
Total liabilities	379	15,132
Commitments and contingencies		
Net assets	\$ 32,679	\$ 33,217
Net assets consist of:		
Common stock, par value	\$ 10	\$ 10
Capital in excess of par value	51,700	51,701
Undistributed net investment losses	(15,007 )	(14,538 )
Unrealized depreciation of portfolio securities, net	(4,024 )	(3,956 )
Total net assets	\$ 32,679	\$ 33,217
Shares of common stock issued and outstanding, \$.001 par value, 50,000 shares authorized	10,562	10,562
Shares of preferred stock issued and outstanding, \$.001 par value, 5,000 shares authorized	—	—
Net asset value per share	\$ 3.09	\$ 3.14

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

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EQUUS TOTAL RETURN, INC.STATEMENTS OF OPERATIONS

(Unaudited)

(in thousands, except per share amounts)	Three months ended March 31,	
	2014	2013
Investment income (loss):		
Interest income (loss), net:		
Control investments	\$ 198	\$(132 )
Non-affiliate investments	59	36
Total interest income	257	(96 )
Interest from temporary cash investments	—	—
Total investment income (loss)	257	(96 )
Expenses:		
Professional fees	291	268
Compensation expense	212	239
General and administrative expense	100	38
Director fees and expenses	96	102
Mailing, printing and other expenses	21	23
Taxes	6	5
Total expenses	726	675
Net investment loss	(469 )	(771 )
Net realized loss:		
Temporary cash investments	(1 )	—
Net realized loss	(1 )	—
Net unrealized depreciation of portfolio securities:		
End of period	(4,024 )	(17,910)
Beginning of period	(3,956 )	(17,222)
Net change in unrealized depreciation of portfolio securities	(68 )	(688 )
Net decrease in net assets resulting from operations	\$(538 )	\$(1,459 )
Net decrease in net assets resulting from operations per share:		
Basic and diluted	\$(0.05 )	\$(0.14 )
Weighted average shares outstanding:		
Basic and diluted	10,562	10,562

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

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EQUUS TOTAL RETURN, INC.

STATEMENTS OF CHANGES IN NET ASSETS

(Unaudited)

(in thousands)	Three months ended March 31,	
	2014	2013
Net decrease in net assets resulting from operations	\$(538 )	\$(1,459 )
Net assets at beginning of period	33,217	32,875
Net assets at end of period	\$32,679	\$31,416

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





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EQUUS TOTAL RETURN, INC.STATEMENTS OF CASH FLOWS

(Unaudited)

(in thousands)	Three months ended March 31,	
	2014	2013
Reconciliation of decrease in net assets resulting from operations to net cash provided by (used in) operating activities:		
Net decrease in net assets resulting from operations	\$(538 )	\$(1,459 )
Adjustments to reconcile net decrease in net assets resulting from operations to net cash provided by (used in) operating activities:		
Net realized loss	1	—
Net change in unrealized depreciation of portfolio securities	68	688
Changes in operating assets and liabilities:		
Purchase of portfolio securities	(74 )	(90 )
Principal payments received from portfolio securities	—	9
Sales of temporary cash investments, net	15,149	—
Increase in accounts receivable from investments	(4 )	—
Increase in accounts receivable and other	(8 )	(150 )
(Increase) decrease in accrued interest receivable	(216 )	126
Increase in accounts payable and accrued liabilities	148	107
Increase (decrease) in accounts payable to related parties	99	(157 )
Net cash provided by (used in) operating activities	14,625	(926 )
Cash flows from financing activities:		
Repayments under margin account	(15,000)	—
Net cash used in financing activities	(15,000)	—
Net decrease in cash and cash equivalents	(375 )	(926 )
Cash and cash equivalents at beginning of period	19,065	23,687
Cash and cash equivalents at end of period	\$18,690	\$22,761
Supplemental disclosure of cash flow information:		
Income taxes paid	\$11	\$5

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

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EQUUS TOTAL RETURN, INC.SUPPLEMENTAL INFORMATION—SELECTED PER SHARE DATA AND RATIOS

(Unaudited)

	Three months ended March 31,	
	2014	2013
Investment income (loss)	\$0.03	\$(0.01 )
Expenses	0.07	0.06
Net investment loss	(0.04 )	(0.07 )
Net realized loss	(0.00 )	—
Net change in unrealized depreciation of portfolio securities	(0.01 )	(0.07 )
Net decrease in net assets resulting from operations	(0.05 )	(0.14 )
Net assets at beginning of period	3.14	3.11
Net assets at end of period	\$3.09	\$2.97
Weighted average number of shares outstanding during period, in thousands	10,562	10,562
Market price per share:		
Beginning of period	\$1.99	\$2.36
End of period	\$1.92	\$2.16
Selected information and ratios:		
Ratio of expenses to average net assets	2.20 %	2.10 %
Ratio of net investment loss to average net assets	(1.42 %)	(2.40 %)
Ratio of net decrease in net assets resulting from operations to average net assets	(1.63 %)	(4.54 %)
Total return on market price <sup>(1)</sup>	(3.52 %)	(8.47 %)

<sup>(1)</sup> Total return = [(ending market price per share - beginning price per share) / beginning market price per share].

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

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**EQUUS TOTAL RETURN, INC.****SCHEDULE OF INVESTMENTS****MARCH 31, 2014****(Unaudited)***(in thousands, except share data)*

Name and Location of Portfolio Company	Industry	Date of Initial Investment	Investment	Principal	Cost of Investment	Fair Value <sup>(1)</sup>
Control Investments: Majority-owned (3):						
Equus Energy, LLC	Energy	December 2011	Member interest (100%)		\$ 7,050	\$ 8,000
Houston, TX Equus Media Development Company, LLC	Media	January 2007	Member interest (100%)		3,000	
Houston, TX Spectrum Management, Carrolton, TX	Business products and services	December 1999	285,000 units of Class A member interest (92.1%/82.5% fully diluted)		2,850	
			16% subordinated promissory note due 11/11 (2)	\$ 2,963	2,963	2,963
Total Control Investments: Majority-owned (represents 82.7% of total investments at fair value)					\$ 15,863	\$ 11,179
Affiliate Investments (4):						
PalletOne, Inc. Bartow, FL	Shipping products and services	October 2001	350,000 shares of common stock (18.70%)		\$ 350	\$ 250
Total Affiliate Investments (represents 1.9% of total investments at fair value)					\$ 350	\$ 250
Non-Affiliate Investments (less than 5% owned):						
Orco Property Group		April 2011			\$ 125	\$ 101

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Paris, France	Real estate	73,666 shares common stock			
		10% promissory note due 2/18 <sup>(2)</sup>	\$	696	696
				821	
Security Monitor Holding, LLC	Business products and services	November 2013	14% promissory note due 6/14 <sup>(2)</sup>	500	500
Boston, MA					
Total Non-Affiliate Investments (represents 15.4% of total investments at fair value)				\$ 1,321	\$ 2,081
Total Investment in Portfolio Securities				\$ 17,534	\$ 13,510

<sup>(1)</sup> See Note 3 to the financial statements, Valuation of Investments.

<sup>(2)</sup> Income-producing.

<sup>(3)</sup> Majority owned investments are generally defined under the Investment Company Act of 1940 as companies in which we own more than 50% of the voting securities of the company.

<sup>(4)</sup> Affiliate investments are generally defined under the Investment Company Act of 1940 as companies in which we own at least 5% but not more than 25% voting securities of the company.

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

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**EQUUS TOTAL RETURN, INC.****SCHEDULE OF INVESTMENTS – (Continued)****MARCH 31, 2014****(Unaudited)**

Except for our holding of ordinary shares of Orco Property Group S.A. (“OPG”), substantially all of our portfolio securities are restricted from public sale without prior registration under the Securities Act of 1933 or other relevant foreign regulatory authority. We negotiate certain aspects of the method and timing of the disposition of our investment in each portfolio company, including registration rights and related costs.

We may invest up to 30% of our assets in non-qualifying portfolio investments, as permitted by the Investment Company Act of 1940 (hereafter, the “1940 Act”). Specifically, we may invest up to 30% of our assets in entities that are not considered “eligible portfolio companies” (as defined in the 1940 Act), including companies located outside of the United States, entities that are operating pursuant to certain exceptions under the 1940 Act, and publicly-traded entities with a market capitalization exceeding \$250 million. As of March 31, 2014, except for our holdings in OPG, all of our investments are in enterprises that are considered eligible portfolio companies under the 1940 Act. We provide significant managerial assistance to portfolio companies that comprise 82.7% of the total value of the investments in portfolio securities as of March 31, 2014.

Our investments in portfolio securities consist of the following types of securities as of March 31, 2014 (in thousands):

Type of Securities	Cost	Fair Value	Percentage of	Fair Value as
			Net Assets	
Limited liability company investments	\$12,900	\$8,216	25.1	%
Secured and subordinated debt	4,159	4,943	15.1	%
Common stock	475	351	1.1	%
Total	\$17,534	\$13,510	41.3	%

Interest payments are being received and/or accrued on notes with a fair value of \$2.0 million, while accrued interest has been impaired on notes receivable included in secured and subordinated debt with a fair value of \$3.0 million.

The following is a summary by industry of the Fund’s investments in portfolio securities as of March 31, 2014 (in thousands):

Industry

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	Fair Value	Fair Value as Percentage of	
			<b>Net Assets</b>
Energy	\$8,000	24.5 %	
Business products and services	3,463	10.6 %	
Real estate	1,581	4.8 %	
Shipping products and services	250	0.8 %	
Media	216	0.6 %	
Total	\$13,510	41.3 %	

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

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**EQUUS TOTAL RETURN, INC.****SCHEDULE OF INVESTMENTS****DECEMBER 31, 2013***(in thousands, except share data)*

<b><u>Name and Location of Portfolio Company</u></b>	<b><u>Industry</u></b>	<b><u>Date of Initial Investment</u></b>	<b><u>Investment</u></b>	<b><u>Principal</u></b>	<b><u>Cost of Investment</u></b>	<b><u>Fair Value<sup>(1)</sup></u></b>
<b>Control Investments: Majority-owned <sup>(3)</sup>:</b>						
Equus Energy, LLC	Energy	December 2011	Member interest (100%)		\$ 7,050	\$ 8,000
Houston, TX						
Equus Media Development Company, LLC	Media	January 2007	Member interest (100%)		3,000	216
Houston, TX						
Spectrum Management, LLC	Business products and services	December 1999	285,000 units of Class A member interest (92.1%/82.5% fully diluted)		2,850	-
Carrolton, TX						
			16% subordinated promissory note due 11/11 <sup>(2)</sup>	\$ 2,889	2,889	2,889
					5,739	2,889
<b>Total Control Investments: Majority-owned (represents 39.0% of total investments at fair value)</b>					<b>\$ 15,789</b>	<b>\$ 11,105</b>
<b>Affiliate Investments <sup>(4)</sup>:</b>						
PalletOne, Inc.	Shipping products and services	October 2001	350,000 shares of common stock (18.70%)		\$ 350	\$ 250
Bartow, FL						
<b>Total Affiliate Investments (represents 0.9% of total investments at fair value)</b>					<b>\$ 350</b>	<b>\$ 250</b>
<b>Non-Affiliate Investments (less than 5% owned):</b>						
Orco Property Group	Real estate	April 2011	73,666 shares common stock		\$ 125	\$ 169
Paris, France						
			10% promissory note due 2/18 <sup>(2)</sup>	\$ 696	696	1,480
					821	1,649
		November 2013		500	500	500

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Security Monitor Holding, LLC	Business products and services	14% promissory note due 5/14 <sup>(2)</sup>			
Boston, MA					
<b>Total Non-Affiliate Investments (represents 7.5% of total investments at fair value)</b>			\$	<b>1,321</b>	\$ <b>2,149</b>
<b>Total Investment in Portfolio Securities</b>			\$	<b>17,460</b>	<b>13,504</b>
<b>Temporary Cash Investments</b>					
U.S. Treasury Bill	Government	December 2013 UST 0% 2/14	15,000	\$ 15,000	\$ 15,000
<b>Total Temporary Cash Investments (represents 52.6% of total investments at fair value)</b>			\$	<b>15,000</b>	\$ <b>15,000</b>
<b>Total Investments</b>			\$	<b>32,460</b>	\$ <b>28,504</b>

(1) See Note 3 to the financial statements, Valuation of Investments.

(2) Income-producing.

(3) Majority owned investments are generally defined under the Investment Company Act of 1940 as companies in which we own more than 50% of the voting securities of the company.

(4) Affiliate investments are generally defined under the Investment Company Act of 1940 as companies in which we own at least 5% but not more than 25% voting securities of the company.

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

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**EQUUS TOTAL RETURN, INC.****SCHEDULE OF INVESTMENTS – (Continued)****DECEMBER 31, 2013****(in thousands, except share data)**

Except for our holding of ordinary shares of OPG, substantially all of our portfolio securities are restricted from public sale without prior registration under the Securities Act of 1933 or other relevant foreign regulatory authority. We negotiate certain aspects of the method and timing of the disposition of our investment in each portfolio company, including registration rights and related costs.

We may invest up to 30% of our assets in non-qualifying portfolio investments, as permitted by the 1940 Act. Specifically, we may invest up to 30% of our assets in entities that are not considered “eligible portfolio companies” (as defined in the 1940 Act), including companies located outside of the United States, entities that are operating pursuant to certain exceptions under the 1940 Act, and publicly-traded entities with a market capitalization exceeding \$250 million. As of December 31, 2013, except for our holdings in OPG, all of our investments are in enterprises that are considered eligible portfolio companies under the 1940 Act. We provide significant managerial assistance to portfolio companies that comprise 82.2% of the total value of the investments in portfolio securities as of December 31, 2013.

Our investments in portfolio securities consist of the following types of securities as of December 31, 2013 (in thousands):

<b>Type of Securities</b>	<b>Cost</b>	<b>Fair Value</b>	<b>Fair Value as</b>	
			<b>Percentage of</b>	<b>Net Assets</b>
Limited liability company investments	\$12,900	\$8,216	24.7	%
Secured and subordinated debt	4,085	4,869	14.7	%
Common stock	475	419	1.3	%
Total	\$17,460	\$13,504	40.7	%

Interest payments are being received and/or accrued on notes with a fair value of \$2.0 million, while accrued interest has been impaired on notes receivable included in secured and subordinated debt with a fair value of \$2.9 million.

The following is a summary by industry of our investments in portfolio securities as of December 31, 2013 (in thousands):

<b>Industry</b>	<b>Fair Value</b>	<b>Fair Value as Percentage of</b>	
		<b>Net Assets</b>	
Energy	\$8,000	24.1	%
Business products and services	3,389	10.2	%
Real estate	1,649	5.0	%
Shipping products and services	250	0.8	%
Media	216	0.6	%
Total	\$13,504	40.7	%

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

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**EQUUS TOTAL RETURN, INC.**

**NOTES TO FINANCIAL STATEMENTS**

**MARCH 31, 2014**

**(Unaudited)**

(1) **Description of Business and Basis of Presentation**

**Description of Business**— Equus Total Return, Inc. (“we,” “us,” “our,” “Equus,” the “Company,” and the “Fund”), a Delaware corporation, was formed by Equus Investments II, L.P. (the “Partnership”) on August 16, 1991. On July 1, 1992, the Partnership was reorganized and all of the assets and liabilities of the Partnership were transferred to the Fund in exchange for shares of common stock of the Fund. Our shares trade on the New York Stock Exchange under the symbol ‘EQS’. On August 11, 2006, our shareholders approved a change of the Fund’s investment strategy to a total return investment objective. This new strategy seeks to provide the highest total return, consisting of capital appreciation and current income. In connection with this strategic investment change, the shareholders also approved the change of name from Equus II Incorporated to Equus Total Return, Inc.

We attempt to maximize the return to stockholders in the form of current investment income and long-term capital gains by investing in the debt and equity securities of companies with a total enterprise value of between \$5.0 million and \$75.0 million, although we may engage in transactions with smaller or larger investee companies from time to time. We seek to invest primarily in companies pursuing growth either through acquisition or organically, leveraged buyouts, management buyouts and recapitalizations of existing businesses or special situations. Our income-producing investments consist principally of debt securities including subordinate debt, debt convertible into common or preferred stock, or debt combined with warrants and common and preferred stock. Debt and preferred equity financing may also be used to create long-term capital appreciation through the exercise and sale of warrants received in connection with the financing. We seek to achieve capital appreciation by making investments in equity and equity-oriented securities issued by privately-owned companies in transactions negotiated directly with such companies. Given market conditions over the past several years and the performance of our portfolio, our management and Board of Directors believe it is prudent to continue to review alternatives to refine and further clarify the current strategies.

We elected to be treated as a Business Development Company (“BDC”) under the Investment Company Act of 1940 (“1940 Act”). We currently qualify as a regulated investment company (“RIC”) for federal income tax purposes and, therefore, are not required to pay corporate income taxes on any income or gains that we distribute to our stockholders. We have certain wholly owned taxable subsidiaries (“Taxable Subsidiaries”) each of which holds one or more portfolio investments listed on our Schedules of Investments. The purpose of these Taxable Subsidiaries is to permit us to hold certain income-producing investments or portfolio companies organized as limited liability companies, or LLCs, (or other forms of pass-through entities) and still satisfy the RIC tax requirement that at least 90% of our gross revenue for income tax purposes must consist of investment income. Absent the Taxable



Subsidiaries, a portion of the gross income of these income-producing investments or of any LLC (or other pass-through entity) portfolio investment, as the case may be, would flow through directly to us for the 90% test. To the extent that such income did not consist of investment income, it could jeopardize our ability to qualify as a RIC and, therefore, cause us to incur significant federal income taxes. The income of the LLCs (or other pass-through entities) owned by Taxable Subsidiaries is taxed to the Taxable Subsidiaries and does not flow through to us, thereby helping us preserve our RIC status and resultant tax advantages. We do not consolidate the Taxable Subsidiaries for income tax purposes and they may generate income tax expense because of the Taxable Subsidiaries' ownership of the portfolio investments. We reflect any such income tax expense on our Statements of Operations.

**Basis of Presentation**—In accordance with Article 6 of Regulation S-X under the Securities Act of 1933 and Securities Exchange Act of 1934, we do not consolidate portfolio company investments, including those in which we have a controlling interest. Our interim unaudited financial statements were prepared in accordance with accounting principles generally accepted in the United States of America, or GAAP, for interim financial information and in accordance with the requirements of reporting on Form 10-Q and Article 10 of Regulation S-X, under the Securities Exchange Act of 1934, as amended. Accordingly, they are unaudited and exclude some disclosures required for annual financial statements. Management believes it has made all adjustments, consisting solely of normal recurring accruals, necessary for the fair presentation of these interim financial statements.

The results of operations for the three months ended March 31, 2014 are not necessarily indicative of results that ultimately may be achieved for the year. The interim unaudited financial statements and notes thereto should be read in conjunction with the financial statements and notes thereto included in the Fund's Form 10-K for the fiscal year ended December 31, 2013, as filed with the Securities and Exchange Commission ("SEC").

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(2) **Liquidity and Financing Arrangements**

**Liquidity**—There are several factors that may materially affect our liquidity during the reasonably foreseeable future. We view this period as the twelve month period from the date of the financial statements in this Form 10-Q, *i.e.*, the period through March 31, 2015. We are evaluating the impact of current market conditions on our portfolio company valuations and their ability to provide current income. We have followed valuation techniques in a consistent manner; however, we are cognizant of current market conditions that might affect future valuations of portfolio securities. We believe that our operating cash flow and cash on hand will be sufficient to meet operating requirements and to finance routine capital expenditures through the next twelve months.

**Cash and Cash Equivalents**—As of March 31, 2014, we had cash and cash equivalents of \$18.7 million. We had \$13.5 million of our net assets of \$32.7 million invested in portfolio securities.

As of December 31, 2013, we had cash and cash equivalents of \$19.1 million. We had \$13.5 million of our net assets of \$33.2 million invested in portfolio securities. We also had \$15.2 million of restricted cash and temporary cash investments, including primarily the proceeds of a quarter-end margin loan that we incurred to maintain the diversification requirements applicable to a RIC to maintain our pass-through tax treatment. Of this amount, \$15.0 million was invested in U.S. Treasury bills and \$0.2 million represented a required 1% brokerage margin deposit. These securities were held by a securities brokerage firm and pledged along with other assets to secure repayment of the margin loan. The U.S. Treasury bills were sold on January 2, 2014 and we subsequently repaid this margin loan. The margin interest was paid on January 22, 2014.

**Dividends**— We will pay out net investment income and/or realized capital gains, if any, on an annual basis as required under the 1940 Act.

**Investment Commitments**—As of March 31, 2014, we had no outstanding commitments to our portfolio company investments.

Under certain circumstances, we may be called on to make follow-on investments in certain portfolio companies. If we do not have sufficient funds to make follow-on investments, the portfolio company in need of the investment may be negatively impacted. Also, our equity interest in the estimated fair value of the portfolio company could be reduced.

**RIC Borrowings, Restricted Cash and Temporary Cash Investments**—We may periodically borrow sufficient funds to maintain the Fund’s RIC status by utilizing a margin account with a securities brokerage firm. There is no assurance that such arrangement will be available in the future. If we are unable to borrow funds to make qualifying investments, we may no longer qualify as a RIC. We would then be subject to corporate income tax on the Fund’s net investment income and realized capital gains, and distributions to stockholders would be subject to income tax as ordinary dividends. Failure to continue to qualify as a RIC could be materially adverse to us and our stockholders.

We had no RIC borrowings or restricted cash as of March 31, 2014.

As of December 31, 2013, we borrowed \$15.0 million to make qualifying investments to maintain our RIC status by utilizing a margin account with a securities brokerage firm. We collateralized such borrowings with restricted cash and temporary cash investments in U.S. Treasury bills of \$15.2 million. The U.S. Treasury bills were sold on January 2, 2014 and the total amount borrowed was repaid at that time. The margin interest was paid on January 22, 2014.

**Certain Risks and Uncertainties**—Economic conditions since 2008 and resulting market dislocations have resulted in a significant decline in the availability of debt and equity. Generally, the limited amount of available debt financing has shorter maturities, higher interest rates and fees, and more restrictive terms than debt facilities available in the past. In addition, during these years and continuing into the first three months of 2014, the price of our common stock continued to fall well below our net asset value, thereby making it undesirable to issue additional shares of our common stock. Because of these challenges, our near-term strategies shifted from originating debt and equity investments to preserving liquidity necessary to meet our operational needs. Key initiatives that we have previously undertaken to provide necessary liquidity include monetizations, the suspension of dividends and the internalization of management. Although we cannot assure you that such initiatives will be sufficient, we believe we have sufficient liquidity to meet our 2014 operating requirements.

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(3) **Significant Accounting Policies**

The following is a summary of significant accounting policies followed by the Fund in the preparation of its financial statements:

**Use of Estimates**—The preparation of financial statements in accordance with GAAP requires us to make estimates and assumptions that affect the reported amounts and disclosures in the financial statements. Although we believe the estimates and assumptions used in preparing these financial statements and related notes are reasonable in light of known facts and circumstances, actual results could differ from those estimates.

**Valuation of Investments**—Portfolio investments are carried at fair value with the net change in unrealized appreciation or depreciation included in the determination of net assets. Valuations of portfolio securities are performed in accordance with accounting principles generally accepted in the United States of America and the financial reporting policies of the SEC. The applicable methods prescribed by such principles and policies are described below:

*Publicly-traded portfolio securities*—Investments in companies whose securities are publicly traded are generally valued at their quoted market price at the close of business on the valuation date.

*Privately-held portfolio securities*—The fair value of investments for which no market exists is determined on the basis of procedures established in good faith by our Board of Directors. As a general principle, the current “fair value” of an investment would be the amount we might reasonably expect to receive for it upon its current sale, in an orderly manner. Appraisal valuations are necessarily subjective and the estimated values arrived at by the Fund may differ materially from amounts actually received upon the disposition of portfolio securities.

*Thinly Traded and Over-the-Counter Securities*—Generally, we value securities that are traded in the over-the-counter market or on a stock exchange at the average of the prevailing bid and ask prices on the date of the relevant period end. However, we may apply a discount to the market value of restricted or thinly traded public securities to reflect the impact that these restrictions have on the value of these securities. We review factors, including the trading volume, total securities outstanding and our percentage ownership of securities to determine whether the trading levels are active (Level 1) or inactive (Level 2) or unobservable (Level 3). These types of securities represented 11.0% of our investments in portfolio securities as of March 31, 2014 and December 31, 2013, respectively. We utilized independent pricing services with certain of our fair value estimates. To corroborate “bid/ask” quotes from independent pricing services, we perform a market-yield approach to validate prices obtained or obtain other evidence.

During the first twelve months after an investment is made, the original investment value is utilized to determine the fair value unless significant developments have occurred during this twelve month period which would indicate a material effect on the portfolio company (such as results of operations or changes in general market conditions). After the twelve month period, or if material events have occurred within the twelve month period, we consider a two-step process when appraising investments of privately held companies. The first step involves determining the enterprise value of the portfolio company. During this step, we consider three different valuation approaches: a market approach, an income approach, and an asset approach. The particular facts and circumstances of each portfolio company determine which approach, or combination of approaches, will be utilized. The second step when appraising equity investments of privately held companies involves allocating value to the various debt and equity securities of the company. We allocate value to these securities based on their relative priorities. For equity securities such as warrants, we may also incorporate alternative methodologies including the Black-Scholes Option Pricing Model.

**Market approach**—The market approach typically employed by our management calculates the enterprise value of a company as a multiple of earnings before interest, taxes, depreciation and amortization (“EBITDA”) generated by the company for the trailing twelve month period. Adjustments to the company’s EBITDA, including those for non-recurring items, may be considered. Multiples are estimated based on current market conditions and past experience in the private company marketplace and are subjective in nature. We will apply liquidity and other discounts it deems appropriate to equity valuations where applicable. We may also use, when available, third-party transactions in a portfolio company’s securities as the basis of valuation (the “private market method”). The private market method will be used only with respect to completed transactions or firm offers made by sophisticated, independent investors.

**Income approach**—The income approach typically utilized by our management calculates the enterprise value of a company utilizing a discounted cash flow model incorporating projected future cash flows of the company. Projected future cash flows consider the historical performance of the company as well as current and projected market participant performance. Discount rates are estimated based on current market conditions and past experience in the private company marketplace and are subjective in nature. We will apply liquidity and other discounts we deem appropriate to equity valuations where applicable.

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**Asset approach**—We consider the asset approach to determine the fair value of significantly deteriorated investments demonstrating circumstances indicative of a liquidation analysis. This situation may arise when a portfolio company: 1) cannot generate adequate cash flow to meet the principal and interest payments on its indebtedness; 2) is not successful in refinancing its debt upon maturity; 3) we believe the credit quality of a loan has deteriorated due to changes in the business and underlying asset or market conditions which may result in the company's inability to meet future obligations; or 4) the portfolio company's reorganization or bankruptcy. Consideration is also given as to whether a liquidation event would be orderly or forced.

We base adjustments upon such factors as the portfolio company's earnings, cash flow and net worth, the market prices for similar securities of comparable companies, an assessment of the company's current and future financial prospects and various other factors and assumptions. In the case of unsuccessful operations, we may base a portfolio company's fair value upon the company's estimated liquidation value. Fair valuations are necessarily subjective, and management's estimate of fair value may differ materially from amounts actually received upon the disposition of its portfolio securities. Also, any failure by a portfolio company to achieve its business plan or obtain and maintain its financing arrangements could result in increased volatility and result in a significant and rapid change in its value.

Our general intent is to hold our loans to maturity when appraising our privately held debt investments. As such, we believe that the fair value will not exceed the cost of the investment. However, in addition to the previously described analysis involving allocation of value to the debt instrument, we perform a yield analysis to determine if a debt security has been impaired.

The Audit Committee of the Board of Directors may engage independent, third-party valuation firms to conduct independent appraisals and review management's preliminary valuations of each privately-held investment in order to make their own independent assessment. Any third-party valuation data would be considered as one of many factors in a fair value determination. The Audit Committee then would recommend the fair values for all privately-held securities based on all relevant factors to the Board of Directors for final approval.

Because of the inherent uncertainty of the valuation of portfolio securities which do not have readily ascertainable market values, amounting to \$13.4 million and \$13.3 million as of March 31, 2014 and December 31, 2013, respectively, our fair value determinations may materially differ from the values that would have been used had a ready market existed for the securities. As of March 31, 2014 and December 31, 2013 respectively, one of the Fund's portfolio investments, the 73,666 ordinary shares of Orco Property Group, S.A. ("OPG"), was publicly listed on the NYSE Euronext Paris Exchange, along with €1,200,790 [\$1.5 million] in newly-issued 6-year OPG Notes. However, as of March 31, 2014 and December 31, 2013 respectively, there had been no significant trading activity in the OPG Notes.

On a daily basis, we adjust our net asset value for the changes in the value of our publicly held securities, if applicable, and material changes in the value of private securities, generally determined on a quarterly basis or as

announced in a press release, and reports those amounts to Lipper Analytical Services, Inc. Weekly and daily net asset values appear in various publications, including *Barron's* and *The Wall Street Journal*.

**Foreign Exchange**—We record temporary changes in foreign exchange rates of portfolio securities denominated in foreign currencies as changes in fair value. These changes are therefore reflected as unrealized gains or losses until realized.

**Investment Transactions**—Investment transactions are recorded on the accrual method. Realized gains and losses on investments sold are computed on a specific identification basis.

We classify our investments in accordance with the requirements of the 1940 Act. Under the 1940 Act, “Control Investments” are defined as investments in companies in which we own more than 25% of the voting securities or maintain greater than 50% representation on the portfolio company’s governing board. Under the 1940 Act, “Affiliate Investments” are defined as those non-control investments in companies in which we own between 5% and 25% of the voting securities. Under the 1940 Act, “Non-affiliate Investments” are defined as investments that are neither Control Investments nor Affiliate Investments.

**Interest Income Recognition**—We record interest income, adjusted for amortization of premium and accretion of discount, on an accrual basis to the extent that we expect to collect such amounts. We stop accruing interest on investments when we determine that interest is no longer collectible. We may also impair the accrued interest when we determine that all or a portion of the current accrual is uncollectible. If we receive any cash after determining that interest is no longer collectible, we treat such cash as payment on the principal balance until the entire principal balance has been repaid, before we recognize any additional interest income. We accrete or amortize discounts and premiums on securities purchased over the life of the respective security using the effective yield method. The amortized cost of investments represents the original cost adjusted for the accretion of discount and/or amortization of premium on debt securities.

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**Payment in Kind Interest (PIK)**—We have loans in our portfolio that may pay PIK interest. We add PIK interest, if any, computed at the contractual rate specified in each loan agreement, to the principal balance of the loan and record it as interest income. To maintain our status as a RIC, we must pay out to stockholders this non-cash source of income in the form of dividends even if we have not yet collected any cash in respect of such investments.

**Cash Flows**—For purposes of the Statements of Cash Flows, we consider all highly liquid temporary cash investments purchased with an original maturity of three months or less to be cash equivalents. We include our investing activities within cash flows from operations. We exclude “Restricted Cash & Temporary Cash Investments” used for purposes of complying with RIC requirements from cash equivalents. See Note 2 for further discussion of the Fund’s RIC borrowings.

**Income Taxes**—We intend to comply with the requirements of the Internal Revenue Code necessary for us to qualify as a RIC. So long as we comply with these requirements, we generally will not be subject to corporate-level federal income taxes on otherwise taxable income (including net realized capital gains) distributed to stockholders. Therefore, we did not record a provision for federal income taxes in our financial statements. We borrow money from time to time to maintain our tax status under the Internal Revenue Code as a RIC. See Note 2 for further discussion of our RIC borrowings.

All corporations incorporated in the State of Delaware are required to file an Annual Report and to pay a franchise tax. As a result, we paid Delaware Franchise tax in the amount of \$0.01 million for the year ended December 31, 2013.

Texas margin tax applies to legal entities conducting business in Texas. The margin tax is based on our Texas sourced taxable margin. The tax is calculated by applying a tax rate to a base that considers both revenue and expenses and therefore has the characteristics of an income tax. As a result, we did not owe state income tax for the year ended December 31, 2013.

**Fair Value Measurement**—Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. We have categorized all investments recorded at fair value based upon the level of judgment associated with the inputs used to measure their fair value. Hierarchical levels, directly related to the amount of subjectivity associated with the inputs to fair valuation of these assets and liabilities, are as follows:

Level 1—Inputs are unadjusted, quoted prices in active markets for identical assets at the measurement date. The types of assets carried at Level 1 fair value generally are equities listed in active markets.



Level 2—Inputs (other than quoted prices included in Level 1) are either directly or indirectly observable for the asset in connection with market data at the measurement date and for the extent of the instrument’s anticipated life. Fair valued assets that are generally included in this category are warrants held in a public company.

Level 3—Inputs reflect our best estimate of what market participants would use in pricing the asset at the measurement date. It includes prices or valuations that require inputs that are both significant to the fair value measurement and unobservable. Generally, assets carried at fair value and included in this category are debt, warrants and/or other equity investments held in a private company. As previously described, we consider a two step process when appraising investments of privately held companies. The first step involves determining the enterprise value of the portfolio company. During this step, we consider three different valuation approaches: a market approach, an income approach, and a cost approach. The particular facts and circumstances of each portfolio company determine which approach, or combination of approaches, will be utilized. The second step when appraising equity investments of privately held companies involves allocating value to the various debt and equity securities of the company. We allocate value to these securities based on their relative priorities. For equity securities such as warrants, we may also incorporate alternative methodologies including the Black-Scholes Option Pricing Model. Yield analysis is also employed to determine if a debt security has been impaired.

We will record unrealized depreciation on investments when we determine that the fair value of a security is less than its cost basis, and will record unrealized appreciation when we determine that the fair value is greater than its cost basis.

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As of March 31, 2014, investments measured at fair value on a recurring basis are categorized in the tables below based on the lowest level of significant input to the valuations:

<b>Fair Value Measurements as of March 31, 2014 (unaudited)</b>					
(in thousands)	Total	Quoted Prices in Active Markets for Identical Assets  (Level 1)	Significant Other Observable Inputs  (Level 2)	Significant Unobservable Inputs  (Level 3)	
Assets					
Investments:					
Control investments	\$11,179	\$ —	\$ —	\$ 11,179	
Affiliate investments	250	—	—	250	
Non-affiliate investments	2,081	101	—	1,980	
Total investments	\$13,510	\$ 101	\$ —	\$ 13,409	

As of December 31, 2013, investments measured at fair value on a recurring basis are categorized in the tables below based on the lowest level of significant input to the valuations:

<b>Fair Value Measurements as of December 31, 2013</b>					
(in thousands)	Total	Quoted Prices in Active Markets for Identical Assets  (Level 1)	Significant Other Observable Inputs  (Level 2)	Significant Unobservable Inputs  (Level 3)	
Assets					
Investments:					
Control investments	\$11,105	\$—	\$ —	\$ 11,105	
Affiliate investments	250	—	—	250	
Non-affiliate investments	2,149	169	—	1,980	
Total investments	13,504	169	—	13,335	
Temporary cash investments	15,150	15,150	—	—	
Total investments and temporary cash investments	\$28,654	\$15,319	\$ —	\$ 13,335	

The following table provides a reconciliation of fair value changes during the three months ended March 31, 2014 for all investments for which we determine fair value using unobservable (Level 3) factors:

(in thousands)	<b>Fair value measurements using significant unobservable inputs (Level 3)</b>			
	Control Investments	Affiliate Investments	Non-affiliate Investments	Total
Fair value as of December 31, 2013	\$11,105	\$ 250	\$ 1,980	\$13,335
Purchases of portfolio securities	74	—	—	74
Fair value as of March 31, 2014 (unaudited)	\$11,179	\$ 250	\$ 1,980	\$13,409

The following table provides a reconciliation of fair value changes during the three months ended March 31, 2013 for all investments for which we determine fair value using unobservable (Level 3) factors:

(in thousands)	<b>Fair value measurements using significant unobservable inputs (Level 3)</b>			
	Control Investments	Affiliate Investments	Non-affiliate Investments	Total
Fair value as of December 31, 2012	\$7,419	\$ 150	\$ 1,425	\$8,994
Change in unrealized appreciation (depreciation)	(616 )	—	(36 )	(652 )
Purchases of portfolio securities	90	—	—	90
Proceeds from sales/dispositions	—	—	(9 )	(9 )
Fair value as of March 31, 2013 (unaudited)	\$6,893	\$ 150	\$ 1,380	\$8,423

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**Significant Unobservable Inputs** — Our investment portfolio is not composed of homogeneous debt and equity securities that can be valued with a small number of inputs. Instead, the majority of our investment portfolio is composed of complex debt and equity securities with distinct contract terms and conditions. As such, our valuation of each investment in our portfolio is unique and complex, often factoring in numerous different inputs, including historical and forecasted financial and operational performance of the portfolio company, project cash flows, market multiples comparable market transactions, the priority of our securities compared with those of other investors, credit risk, interest rates, independent valuations and reviews and other inputs.

The following table summarizes the significant observable inputs in the fair value measurements of our level 3 investments by category of investment and valuation technique as of March 31, 2014:

(in thousands)	Fair Value	Valuation Techniques	Unobservable Inputs	Range		
				Minimum	Maximum	
Secured and subordinated debt	\$4,943	Yield Analysis	Market interest rate	2.5 %	10.5 %	
		Yield Analysis	Discount for lack of marketability	2.5 %	12.0 %	
		Yield Analysis	Discount for lack of marketability	7.2 %	25 %	
		Yield Analysis	Control Premium	12 %	171 %	
Common stock	250	New Transaction	Discount	0 %	100 %	
		Pending Transaction	Discount	0 %	100 %	
Limited liability company investments	8,216	Asset Approach	Recovery Rate	0 %	100 %	
		Income/Market Approach	Reserve Adjustment Factors	75 %	100 %	
	\$13,409					

#### (4) Related Party Transactions and Agreements

Except as noted below, as compensation for services to the Fund, each Independent Director receives an annual fee of \$20,000 paid quarterly in arrears, a fee of \$2,000 for each meeting of the Board of Directors attended in person, a fee of \$1,000 for participation in each telephonic meeting of the Board and a fee of \$1,000 for each committee meeting attended, and reimbursement of all out-of-pocket expenses relating to attendance at such meetings. A quarterly fee of \$15,000 is paid to the Chairman of the Audit Committee and a quarterly fee of \$3,750 is paid to the Chairman of the Independent Directors. We may also pay other one-time or recurring fees to members of our Board of Directors in special circumstances. None of our interested directors receive annual fees for their service on the Board of Directors.

In 2011, Equus Energy, LLC, a wholly-owned subsidiary of the Fund, entered into a consulting agreement with Global Energy Associates, LLC (“Global Energy”) to provide consulting services for energy related investments. Henry

W. Hankinson, Director, is a managing partner and co-founder of Global Energy. Payments to Global Energy totaled \$18,750 for each of the three months ended March 31, 2014 and 2013.

In respect of services provided to the Fund by members of the Board not in connection with their roles and duties as directors, the Fund pays a rate of \$250 per hour for services rendered.

(5)

**Dividends**

We will pay out net investment income and/or realized capital gains, if any, on an annual basis as required under the 1940 Act.

(6)

**Portfolio Securities**

During the three months ended March 31, 2014, we capitalized legal and consulting expenses of \$0.7 million relating to Spectrum Management. We also received a semi-annual interest payment of \$0.04 million in respect of our €1.2 million [\$1.5 million] in OPG notes.

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During the three months ended March 31, 2014, we did not realize any significant gains or losses on sales of portfolio securities.

Net unrealized depreciation on investments increased \$0.07 million during the three months ended March 31, 2014, to a net unrealized depreciation of \$4.0 million. Such increase in unrealized depreciation is due to the decrease in fair value of our holdings in OPG of \$0.07 million due to a decline in the price of our OPG shares.

During the three months ended March 31, 2013, we capitalized legal and consulting expenses of \$0.1 million relating to Spectrum. We also received a semi-annual interest payment of \$0.03 million and a 5.75% partial principal repayment of \$9,000 in respect of our €1.2 million [\$1.5 million] in OPG notes.

During the three months ended March 31, 2013, we did not realize any significant gains or losses on sales of portfolio securities.

Net unrealized depreciation on investments increased \$0.7 million during the three months ended March 31, 2013, to a net unrealized depreciation of \$17.9 million. Such decrease in unrealized depreciation is largely due to the following changes:

- (i) Decrease in fair value of Equus Energy, LLC of \$0.2 million due to operating expenses;
- (ii) Decrease in fair value of our holdings in OPG of \$0.1 million due to a decline in the price of our OPG shares and foreign exchange translation; and
- (iii) Decrease in fair value of Spectrum of \$0.4 million due to a decline in operating performance.

(7)

**Equus Energy, LLC**

Equus Energy, LLC (“Equus Energy”) was formed in November 2011 as a wholly-owned subsidiary of the Fund to make investments in companies in the energy sector, with particular emphasis on income-producing oil & gas properties. In December 2011, we contributed \$250,000 to the capital of Equus Energy. On December 27, 2012, we invested an additional \$6.8 million in Equus Energy for the purpose of additional working capital and to fund the purchase of \$6.6 million in working interests in 129 producing and non-producing oil and gas wells. The working interests include associated development rights of approximately 21,120 acres situated on 13 separate properties in Texas and Oklahoma. The working interests range from a *de minimus* amount to 50% of the leasehold that includes

these wells.

The wells are operated by a number of experienced operators, including Chevron USA, Inc., which has operating responsibility for all of Equus Energy's 40 producing well interests located in the Conger Field, a productive oil and gas field on the edge of the Permian Basin that has experienced successful gas and hydrocarbon extraction in multiple formations. Equus Energy, which holds a 50% working interest in each of these Conger Field wells, is working with Chevron in a recompletion program of existing Conger Field wells to the Wolfcamp formation, a zone containing oil as well as gas and natural gas liquids. Two recompletions in the Conger Field have been effected since the closing date of the acquisition of the working interests and a third recompletion is planned during the second quarter of 2014, with additional recompletions anticipated for the remainder of 2014 and beyond. Part of Equus Energy's acreage rights described above also includes a 50% working interest in possible new drilling to the base of the Canyon formation (appx. 8,500 feet) on 2,400 acres in the Conger Field. Also included in the interests acquired by Equus Energy are working interests of 7.5% and 2.5% in the Burnell and North Pettus Units, respectively, which collectively comprise approximately 13,000 acres located in the area known as the "Eagle Ford Shale" play.

We do not consolidate Equus Energy or its wholly owned subsidiaries and accordingly only the value of our investment in Equus Energy is included on our statement of assets and liabilities. Our investment in Equus Energy is valued in accordance with our normal valuation procedures and is based on the values of the underlying assets held by EQS Energy Holdings, Inc. a wholly-owned subsidiary of Equus Energy, net of associated liabilities.

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Below is summarized consolidated financial information for Equus Energy as of March 31, 2014 and December 31, 2013 and for the three months ended March 31, 2014 and 2013 respectively (in thousands).

	March 31, 2014 (Unaudited)	December 31, 2013 (Unaudited)
Assets		
CURRENT ASSETS:		
Cash	\$ 406	\$ 486
Accounts receivable	209	288
Total current assets	615	774
Oil and gas properties	7,725	7,700
Less: accumulated depletion, depreciation and amortization	(1,178 )	(983 )
Net oil and gas properties	6,547	6,717
Total assets	\$ 7,162	\$ 7,491
Liabilities and members' capital		
CURRENT LIABILITIES:		
Accounts payable and other	\$ 121	\$ 324
Due to affiliate	378	364
Total current liabilities	499	\$ 688
Asset retirement obligations	180	178
Total non-current liabilities	180	178
Total liabilities	679	866
Members' capital		
Total members' capital	6,483	6,625
Total liabilities and members' capital	\$ 7,162	\$ 7,491

Revenue and direct operating expenses for the various oil and gas assets included in the accompanying statements represent the net collective working and revenue interests acquired by Equus Energy. The revenue and direct operating expenses presented herein relate only to the interests in the producing oil and natural gas properties and do not represent all of the oil and natural gas operations of all of these properties. Direct operating expenses include lease operating expenses and production and other related taxes. General and administrative expenses, depletion, depreciation and amortization (“DD&A”) of oil and gas properties and federal and state taxes have been excluded from direct operating expenses in the accompanying statements of revenue and direct operating expenses because the allocation of certain expenses would be arbitrary and would not be indicative of what such costs would have been had



Equus Energy been operated as a stand-alone entity. The statements of revenue and direct operating expenses presented are not indicative of the financial condition or results of operations of Equus Energy on a go forward basis due to changes in the business and the omission of various operating expenses.

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	<b>Three months ended March 31</b>	
	2014	2013
	<b>(Unaudited)</b>	
Operating revenue	\$540	\$ 605
Operating expenses		
Direct operating expenses	335	328
Depletion, depreciation, amortization and accretion	196	322
General and administrative	151	187
Total operating expenses	682	837
Operating income (loss) before income tax expense	(142)	(232 )
Income tax	—	—
Net income (loss)	\$(142)	\$ (232 )

**Critical Accounting Policies for Equus Energy** – Equus Energy and its wholly-owned subsidiary EQS Energy Holdings, Inc. (collectively, the “Company”) follow the *Full Cost Method of Accounting* for oil and gas properties. Under the full cost method, all costs associated with property acquisition, exploration, and development activities are capitalized. Capitalized costs include lease acquisitions, geological and geophysical work, delay rentals, costs of drilling, completing and equipping successful and unsuccessful oil and gas wells and related costs. Gains or losses are normally not recognized on the sale or other disposition of oil and gas properties. Gains or losses are normally reflected as an adjustment to the full cost pool.

The capitalized costs of oil and gas properties, plus estimated future development costs relating to proved reserves and estimated cost of dismantlement and abandonment, net of salvage value, are amortized on a unit-of-production method over the estimated productive life of the proved oil and gas reserves. Unevaluated oil and gas properties are excluded from this calculation. Depletion, depreciation and amortization expense for the Company’s oil and gas properties totaled \$0.2 million and \$0.3 million for the quarters ended March 31, 2014 and March 31, 2013, respectively.

Capitalized oil and gas property costs are limited to an amount (the ceiling limitation) equal to the sum of the following:

- (a) As of March 31, 2014, the present value of estimated future net revenue from the projected production of proved oil and gas reserves, calculated at the simple arithmetic average, first-day-of-the-month prices during the twelve-month period before the balance sheet date (with consideration of price changes only to the extent provided by contractual arrangements) and a discount factor of 10%;
- (b) The cost of investments in unproved and unevaluated properties excluded from the costs being amortized; and

(c) The lower of cost or estimated fair value of unproved properties included in the costs being amortized.

When it is determined that oil and gas property costs exceed the ceiling limitation, an impairment charge is recorded to reduce its carrying value to the ceiling limitation. The Company did not recognize an impairment loss on their oil and gas properties during 2013 or during the three months ended March 31, 2014.

The costs of certain unevaluated leasehold acreage and certain wells being drilled are not amortized. The Company excludes all costs until proved reserves are found or until it is determined that the costs are impaired. Costs not amortized are periodically assessed for possible impairment or reduction in value. If a reduction in value has occurred, costs being amortized are increased accordingly.

**Revenue Recognition** - Revenue is recognized for oil and natural gas sales under the sales method of accounting. Under this method, revenue is recognized on production as it is taken and delivered to its purchasers. The volumes sold may be more or less than the volumes entitled to, based on the owner's net leasehold interest. These differences result from production imbalances, which are not significant, and are reflected as adjustments to proven reserves and future cash flows in the unaudited summarized oil and gas information included herein.

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**Accounting Policy on Depletion** - The Company employs the "Units of Production" method in calculating depletion of its proved oil and gas properties, wherein capitalized costs, as adjusted for future development costs and asset retirement obligations, are amortized over the total estimated proved reserves.

**Asset Retirement Obligations** - The fair value of asset retirement obligations are recorded in the period in which they are incurred if a reasonable estimate of fair value can be made, and the corresponding cost is capitalized as part of the carrying amount of the related long-lived asset. The fair value of the asset retirement obligation is measured using expected future cash outflows discounted at the Company's credit-adjusted risk-free interest rate. Fair value, to the extent possible, should include a market risk premium for unforeseeable circumstances. No market risk premium was included in the Company's asset retirement obligation fair value estimate since a reasonable estimate could not be made. The liability is accreted to its then present value each period, and the capitalized cost is depleted or amortized over the estimated recoverable reserves using the units-of-production method.

(8)

**Subsequent Events**

Management performed an evaluation of the Fund's activity through the date the financial statements were issued, noting the following subsequent events:

On April 3, 2014, we sold all of our 73,666 remaining shares of OPG, wherein we received \$61,867 in net proceeds.

On May 15, 2014, the Fund announced that it had adopted a Plan of Reorganization (also referred to hereinafter as the "Plan") within the meaning of Section 2(a)(33) of the 1940 Act. Under the terms of the Plan, Equus intends to pursue a merger or consolidation with MVC Capital, Inc. ("MVC"), a BDC traded on the New York Stock Exchange, or a subsidiary of MVC, or one or more of MVC's portfolio companies (referred to in the Plan as a "Consolidation") within the next twelve months. Absent Equus merging or consolidating with/into MVC, the present intention is for Equus to (i) consummate the Consolidation, (ii) terminate its election to be classified as a BDC, and (iii) be restructured as a publicly-traded operating company focused on the energy and/or financial services sectors.

On May 14, 2014, a Share Exchange Agreement was entered into between MVC and Equus as a first step in the Plan, wherein MVC received 2,112,000 shares of the Fund in exchange for Equus receiving 395,839 shares of MVC. The exchange was determined based on each company's respective net asset values per share, calculated as of May 12, 2014. The number of MVC shares that were received by Equus is subject to adjustment following MVC's release of its Form 10-Q, which will include its published net asset value per share for the quarter ended April 30, 2014. If a Consolidation has not occurred within one year from the date of the share exchange, MVC has the right, to the extent permitted by applicable law, to rescind the exchange, recover its shares that have been issued to Equus, and return to Equus the 2,112,000 shares issued by the Fund. As part of the reorganization, MVC may also acquire additional Equus shares from time to time, either through Equus' direct sale to MVC of newly-issued shares from treasury (which

would require the approval of a majority of Equus shareholders) or through the purchase of Equus shares from existing shareholders.

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## **Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**

### **Overview**

Equus Total Return, Inc. (“we,” “us,” “our,” “Equus,” the “Company,” and the “Fund”), a Delaware corporation, was formed by Equus Investments II, L.P. (the “Partnership”) on August 16, 1991. On July 1, 1992, the Partnership was reorganized and all of the assets and liabilities of the Partnership were transferred to the Fund in exchange for shares of common stock of the Fund. Our shares trade on the New York Stock Exchange under the symbol EQS. On August 11, 2006, our shareholders approved the change of the Fund’s investment strategy to a total return investment objective. This new strategy seeks to provide the highest total return, consisting of capital appreciation and current income. In connection with this strategic investment change, the shareholders also approved the change of name from Equus II Incorporated to Equus Total Return, Inc.

We attempt to maximize the return to stockholders in the form of current investment income and long-term capital gains by investing in the debt and equity securities of companies with a total enterprise value of between \$5.0 million and \$75.0 million, although we may engage in transactions with smaller or larger investee companies from time to time. We seek to invest primarily in companies pursuing growth either through acquisition or organically, leveraged buyouts, management buyouts and recapitalizations of existing businesses or special situations. Our income-producing investments consist principally of debt securities including subordinate debt, debt convertible into common or preferred stock, or debt combined with warrants and common and preferred stock. Debt and preferred equity financing may also be used to create long-term capital appreciation through the exercise and sale of warrants received in connection with the financing. We seek to achieve capital appreciation by making investments in equity and equity-oriented securities issued by privately-owned companies in transactions negotiated directly with such companies. Given market conditions over the past several years and the performance of our portfolio, our management and Board of Directors believe it is prudent to continue to review alternatives to refine and further clarify the current strategies.

We elected to be treated as a Business Development Company (“BDC”) under the Investment Company Act of 1940 Act (“1940 Act”). We currently qualify as a regulated investment company (“RIC”) for federal income tax purposes and, therefore, are not required to pay corporate income taxes on any income or gains that we distribute to our stockholders. We have certain wholly owned Taxable Subsidiaries each of which holds one or more portfolio investments listed on our Schedules of Investments. The purpose of these Taxable Subsidiaries is to permit us to hold certain income-producing investments or portfolio companies organized as limited liability companies, or LLCs, (or other forms of pass-through entities) and still satisfy the RIC tax requirement that at least 90% of our gross revenue for income tax purposes must consist of investment income. Absent the Taxable Subsidiaries, a portion of the gross income of these income-producing investments or of any LLC (or other pass-through entity) portfolio investment, as the case may be, would flow through directly to us for the 90% test. To the extent that such income did not consist of investment income, it could jeopardize our ability to qualify as a RIC and, therefore, cause us to incur significant federal income taxes. The income of the LLCs (or other pass-through entities) owned by Taxable Subsidiaries is taxed to the Taxable Subsidiaries and does not flow through to us, thereby helping us preserve our RIC status and resultant tax advantages. We do not consolidate the Taxable Subsidiaries for income tax purposes and they may generate income tax expense because of the Taxable Subsidiaries’ ownership of the portfolio investments. We reflect any such

income tax expense on our Statements of Operations.

### **Critical Accounting Policies**

Our financial statements are based on the selection and application of significant accounting policies, which require management to make significant estimates and assumptions. We believe that the following are some of the more critical judgment areas in the application of our accounting policies that currently affect our financial condition and results of operations.

**Valuation of Investments**— Portfolio investments are carried at fair value with the net change in unrealized appreciation or depreciation included in the determination of net assets. Valuations of portfolio securities are performed in accordance with accounting principles generally accepted in the United States of America and the financial reporting policies of the SEC. The applicable methods prescribed by such principles and policies are described below:

*Publicly-traded portfolio securities*—Investments in companies whose securities are publicly traded are generally valued at their quoted market price at the close of business on the valuation date.

*Privately-held portfolio securities*—The fair value of investments for which no market exists is determined on the basis of procedures established in good faith by our Board of Directors. As a general principle, the current “fair value” of an investment would be the amount we might reasonably expect to receive for it upon its current sale, in an orderly manner. Appraisal valuations are necessarily subjective and the estimated values arrived at by the Fund may differ materially from amounts actually received upon the disposition of portfolio securities.

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*Thinly Traded and Over-the-Counter Securities*—Generally, we value securities that are traded in the over-the-counter market or on a stock exchange at the average of the prevailing bid and ask prices on the date of the relevant period end. However, we may apply a discount to the market value of restricted or thinly traded public securities to reflect the impact that these restrictions have on the value of these securities. We review factors, including the trading volume, total securities outstanding and our percentage ownership of securities to determine whether the trading levels are active (Level 1) or inactive (Level 2) or unobservable (Level 3). These types of securities represented 11.0% of our investments in portfolio securities as of March 31, 2014 and December 31, 2013, respectively. We utilized independent pricing services with certain of our fair value estimates. To corroborate “bid/ask” quotes from independent pricing services, we perform a market-yield approach to validate prices obtained or obtain other evidence.

During the first twelve months after an investment is made, the original investment amount is utilized to determine the fair value unless significant developments have occurred during this twelve month period which would indicate a material effect on the portfolio company (such as results of operations or changes in general market conditions). After the twelve month period, or if material events have occurred within the twelve month period, Fund management considers a two-step process when appraising investments of privately held companies. The first step involves determining the enterprise value of the portfolio company. During this step, our management considers three different valuation approaches: a market approach, an income approach, and an asset approach. The particular facts and circumstances of each portfolio company determine which approach, or combination of approaches, will be utilized. The second step when appraising equity investments of privately held companies involves allocating value to the various debt and equity securities of the company. Fund management allocates value to these securities based on their relative priorities. For equity securities such as warrants, the Fund may also incorporate alternative methodologies including the Black-Scholes Option Pricing Model.

**Market approach**—The market approach typically employed by our management calculates the enterprise value of a company as a multiple of earnings before interest, taxes, depreciation and amortization (“EBITDA”) generated by the company for the trailing twelve month period. Adjustments to the company’s EBITDA, including those for non-recurring items, may be considered. Multiples are estimated based on current market conditions and past experience in the private company marketplace and are subjective in nature. We will apply liquidity and other discounts we deem appropriate to equity valuations where applicable. We may also use, when available, third-party transactions in a portfolio company’s securities as the basis of valuation (the “private market method”). The private market method will be used only with respect to completed transactions or firm offers made by sophisticated, independent investors.

**Income approach**—The income approach typically utilized by our management calculates the enterprise value of a company utilizing a discounted cash flow model incorporating projected future cash flows of the company. Projected future cash flows consider the historical performance of the company as well as current and projected market participant performance. Discount rates are estimated based on current market conditions and past experience in the private company marketplace and are subjective in nature. We will apply liquidity and other discounts we deem appropriate to equity valuations where applicable.



**Asset approach**—We consider the asset approach to determine the fair value of significantly deteriorated investments demonstrating circumstances indicative of a liquidation analysis. This situation may arise when a portfolio company: 1) cannot generate adequate cash flow to meet the principal and interest payments on its indebtedness; 2) is not successful in refinancing its debt upon maturity; 3) we believe the credit quality of a loan has deteriorated due to changes in the business and underlying asset or market conditions which may result in the company's inability to meet future obligations; or 4) the portfolio company's reorganization or bankruptcy. Consideration is also given as to whether a liquidation event would be orderly or forced.

We base adjustments upon such factors as the portfolio company's earnings, cash flow and net worth, the market prices for similar securities of comparable companies, an assessment of the company's current and future financial prospects and various other factors and assumptions. In the case of unsuccessful operations, we may base a portfolio company's fair value upon the company's estimated liquidation value. Fair valuations are necessarily subjective, and management's estimate of fair value may differ materially from amounts actually received upon the disposition of its portfolio securities. Also, any failure by a portfolio company to achieve its business plan or obtain and maintain its financing arrangements could result in increased volatility and result in a significant and rapid change in its value.

Our general intent is to hold our loans to maturity when appraising its privately held debt investments. As such, we believe that the fair value will not exceed the cost of the investment. However, in addition to the previously described analysis involving allocation of value to the debt instrument, we perform a yield analysis to determine if a debt security has been impaired.

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The Audit Committee of the Board of Directors may engage independent, third-party valuation firms to conduct independent appraisals and review management's preliminary valuations of each privately-held investment in order to make their own independent assessment. Any third-party valuation data would be considered as one of many factors in a fair value determination. The Audit Committee then would recommend the fair values for all privately-held securities based on all relevant factors to the Board of Directors for final approval.

Because of the inherent uncertainty of the valuation of portfolio securities which do not have readily ascertainable market values, amounting to \$13.4 million and \$13.3 million as of March 31, 2014 and December 31, 2013, respectively, our fair value determinations may materially differ from the values that would have been used had a ready market existed for the securities. As of March 31, 2014 and December 31, 2013 respectively, one of the Fund's portfolio investments, the 73,666 ordinary shares of Orco Property Group, S.A. ("OPG"), was publicly listed on the NYSE Euronext Paris Exchange, along with €1,200,790 [\$1.5 million] in newly-issued 6-year OPG Notes. However, as of March 31, 2014 and December 31, 2013 respectively, there had been no significant trading activity in the OPG Notes.

On a daily basis, we adjust our net asset value for the changes in the value of our publicly held securities, if applicable, and material changes in the value of private securities, generally determined on a quarterly basis or as announced in a press release, and reports those amounts to Lipper Analytical Services, Inc. Weekly and daily net asset values appear in various publications, including Barron's and *The Wall Street Journal*.

### **Federal Income Taxes**

On May 15, 2014, we announced that we had adopted a Plan of Reorganization, which may involve the transformation of the Fund into an operating company, which will likely result in the loss of our status as a RIC for Federal income tax purposes. However, if we do not effect a transformation of the Fund into an operating company, we intend to comply with the requirements of the Internal Revenue Code necessary for us to qualify as a RIC. So long as we comply with these requirements, we generally will not be subject to corporate-level federal income taxes on otherwise taxable income (including net realized capital gains) distributed to stockholders. Therefore, we did not record a provision for federal income taxes in our financial statements. As of December 31, 2013, we had a capital loss carry-forward of \$32.5 million which may be used to offset future capital gains. We may borrow money from time to time to maintain our status as a RIC under the Internal Revenue Code. See Note 2 for further discussion of our RIC borrowings. See also "*Subsequent Events*" and "*Risk Factors*" on pages 27 and 30.

### **Interest Income Recognition**

We record interest income, adjusted for amortization of premium and accretion of discount, on an accrual basis to the extent that we expect to collect such amounts. We stop accruing interest on investments when we determine that interest is no longer collectible. We may also impair the accrued interest when we determine that all or a portion of the current accrual is uncollectible. If we receive any cash after determining that interest is no longer collectible, we treat such cash as payment on the principal balance until the entire principal balance has been repaid, before we recognize any additional interest income. We accrete or amortize discounts and premiums on securities purchased over the life of the respective security using the effective yield method. The amortized cost of investments represents the original cost adjusted for the accretion of discount and/or amortization of premium on debt securities.

### **Payment in Kind Interest**

We have loans in our portfolio that may pay PIK interest. We add PIK interest, if any, computed at the contractual rate specified in each loan agreement, to the principal balance of the loan and record it as interest income. To maintain the Fund's status as a RIC, we must pay out to our stockholders this non-cash source of income in the form of dividends even if we have not yet collected any cash in respect of such investments.

### **Current Market Conditions**

Overall economic conditions in the United States have improved, albeit marginally. However, the economic recovery has been hampered by slower growth and persistent high unemployment levels. The U.S. Congressional Budget Office is forecasting higher growth in 2014 (3.1%), with a projected unemployment rate exceeding 6.0% until 2017.

Further, the banking industry continues to experience additional bank failures as regulators continue to impose strict capital requirements. Additionally, future economic expansion and business investment is threatened by perceptions of higher taxes and healthcare costs, as well as the high levels of government deficit spending.

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Market conditions for business transactions including mergers and acquisitions and private equity investments improved significantly in 2013 compared with previous years, and has continued through the first quarter of 2014, as corporations have been deleveraging and are holding significant amounts of cash and many have begun to focus on acquisitions as part of future growth plans. Private equity firms as a group enjoyed more success in 2013 in monetizing their investments through sales and public listings.

During the first quarter of 2014, our net asset value decreased to \$3.09 per share from \$3.14 per share. As of March 31, 2014, the closing price of our common stock closed was \$1.92, which is a discount of 37.9% to our net asset value.

Over the past several years, we have executed certain initiatives to enhance liquidity, achieve a lower operational cost structure, provide more assistance to portfolio companies and realize certain of our portfolio investments. Specifically, we changed the composition of our Board of Directors and management, terminated certain of our follow-on investments, internalized the management of the Fund, suspended our managed distribution policy, modified our investment strategy to pursue shorter term liquidation opportunities, pursued non-cash investment opportunities, and sold certain of our legacy and underperforming investment holdings. We believe these actions continue to be necessary to protect capital and liquidity during this turbulent economic period in order to preserve and enhance shareholder value. Because our management is internalized, certain of our expenses should not increase commensurate with an increase in the size of the Fund and, therefore, we expect to achieve efficiencies in our cost structure if we are able to grow the Fund.

### **Liquidity and Capital Resources**

We generate cash primarily from maturities, sales of securities and borrowings, as well as capital gains realized upon the sale of portfolio investments. We use cash primarily to make additional investments, either in new companies or as follow-on investments in the existing portfolio companies and to pay the dividends to our stockholders.

Because of the nature and size of the portfolio investments, we may periodically borrow funds to make qualifying investments to maintain our tax status as a RIC. We often borrow such funds by utilizing a margin account with a securities brokerage firm. There is no assurance that such arrangement will be available in the future. If the Fund is unable to borrow funds to make qualifying investments, it may no longer qualify as a RIC. The Fund would then be subject to corporate income tax on its net investment income and realized capital gains, and distributions to stockholders would be subject to income tax as ordinary dividends.

The Fund has the ability to borrow funds and issue forms of senior securities representing indebtedness or stock, such as preferred stock, subject to certain restrictions. Net taxable investment income and net taxable realized gains from

the sales of portfolio investments are intended to be distributed at least annually, to the extent such amounts are not reserved for payment of expenses and contingencies or to make follow-on or new investments.

The Fund reserves the right to retain net long-term capital gains in excess of net short-term capital losses for reinvestment or to pay contingencies and expenses. Such retained amounts, if any, will be taxable to the Fund as long-term capital gains and stockholders will be able to claim their proportionate share of the federal income taxes paid on such gains as a credit against their own federal income tax liabilities. Stockholders will also be entitled to increase the adjusted tax basis of their Fund shares by the difference between their undistributed capital gains and their tax credit.

We are evaluating the impact of current market conditions on our portfolio company valuations and their ability to provide current income. We have followed valuation techniques in a consistent manner; however, we are cognizant of current market conditions that might affect future valuations of portfolio securities. We believe that our operating cash flow and cash on hand will be sufficient to meet operating requirements and to finance routine capital expenditures through the next twelve months.

## **Results of Operations**

### **Investment Income and Expense**

Net investment loss was \$0.5 million and \$0.8 million for the three months ended March 31, 2014 and March 31, 2013, respectively. Investment income was \$0.3 million for the three months ended March 31, 2014. The investment income of (\$0.1) generated for the three months ended March 31, 2013 is due primarily to due to the impairment of accrued interest income from Spectrum.

Total expenses were relatively unchanged at \$0.7 million for the three months ended March 31, 2014 and March 31, 2013, respectively.

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### **Realized Gains and Losses on Sales of Portfolio Securities**

During the three months ended March 31, 2014, we realized a loss of \$0.1 million from the sale of temporary cash investments. We did not realize any net capital gains or losses for the three months ended March 31, 2013.

### **Changes in Unrealized Appreciation/Depreciation of Portfolio Securities**

Net unrealized depreciation on investments increased \$0.07 million during the three months ended March 31, 2014, to a net unrealized depreciation of \$4.0 million. Such increase in unrealized depreciation is largely due to the decrease in fair value of our holdings in OPG of \$0.1 million due to a decline in the price of OPG shares.

Net unrealized depreciation on investments increased \$0.7 million during the three months ended March 31, 2013, to a net unrealized depreciation of \$17.9 million. Such decrease in unrealized depreciation is largely due to the following changes:

- (i) Decrease in fair value of Equus Energy of \$0.2 million due to operating expenses;
- (ii) Decrease in fair value of our holdings in OPG of \$0.1 million due to a decline in the price of OPG shares and foreign exchange translation; and
- (iii) Decrease in fair value of our holdings in Spectrum of \$0.4 million due to a decline in operating performance.

### **Dividends**

We will pay out net investment income and/or realized capital gains, if any, on an annual basis as required under the Investment Company Act of 1940.

### **Portfolio Investments**

During the three months ended March 31, 2014, we capitalized consulting expenses of \$0.07 million relating to Spectrum Management. We also received a semi-annual interest payment of \$0.04 million in respect of our €1.2 million [\$1.5 million] in OPG notes.

During the three months ended March 31, 2013, we capitalized legal and consulting expenses of \$0.1 million relating to Spectrum Management. We also received a semi-annual interest payment of \$0.03 million and a 5.75% partial principal repayment of \$9,000 in respect of our €1.2 million [\$1.5 million] in OPG notes.

### **Subsequent Events**

Management performed an evaluation of the Fund's activity through the date the financial statements were issued, noting the following subsequent events:

On April 3, 2014, we sold all of our 73,666 remaining shares of OPG, wherein we received \$61,867 in net proceeds.

On May 15, 2014, the Fund announced that it had adopted a Plan of Reorganization (also referred to hereinafter as the "Plan") within the meaning of Section 2(a)(33) of the 1940 Act. Under the terms of the Plan, Equus intends to pursue a merger or consolidation with MVC Capital, Inc. ("MVC"), a BDC traded on the New York Stock Exchange, or a subsidiary of MVC, or one or more of MVC's portfolio companies (referred to in the Plan as a "Consolidation") within the next twelve months. Absent Equus merging or consolidating with/into MVC, the present intention is for Equus to (i) consummate the Consolidation, (ii) terminate its election to be classified as a BDC, and (iii) be restructured as a publicly-traded operating company focused on the energy and/or financial services sectors.

On May 14, 2014, a Share Exchange Agreement was entered into between MVC and Equus as a first step in the Plan, wherein MVC received 2,112,000 shares of the Fund in exchange for Equus receiving 395,839 shares of MVC. The exchange was determined based on each company's respective net asset values per share, calculated as of May 12, 2014. The number of MVC shares that were received by Equus is subject to adjustment following MVC's release of its Form 10-Q, which will include its published net asset value per share for the quarter ended April 30, 2014. If a Consolidation has not occurred within one year from the date of the share exchange, MVC has the right, to the extent permitted by applicable law, to rescind the exchange, recover its shares that have been issued to Equus, and return to Equus the 2,112,000 shares issued by the Fund. As part of the reorganization, MVC may also acquire additional Equus shares from time to time, either through Equus' direct sale to MVC of newly-issued shares from treasury (which would require the approval of a majority of Equus shareholders) or through the purchase of Equus shares from existing shareholders.

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### **Item 3. Quantitative and Qualitative Disclosure about Market Risk**

We are subject to financial market risks, including changes in interest rates with respect to investments in debt securities and outstanding debt payable, as well as changes in marketable equity security prices. In the future, in addition to our investment in OPG shares and the OPG Notes, we may invest in companies outside the United States, including in Europe and Asia, which would give rise to exposure to foreign currency value fluctuations. We do not use derivative financial instruments to mitigate any of these risks. The return on investments is generally not affected by foreign currency fluctuations.

Our investments in portfolio securities consist of some fixed-rate debt securities. Since the debt securities are generally priced at a fixed rate, changes in interest rates do not directly affect interest income. In addition, changes in market interest rates are not typically a significant factor in the determination of fair value of these debt securities, since the securities are generally held to maturity. We determine their fair values based on the terms of the relevant debt security and the financial condition of the issuer.

A major portion of our investment portfolio consists of debt and equity investments in private companies. Modest changes in public market equity prices generally do not significantly impact the estimated fair value of these investments. However, significant changes in market equity prices can have a longer-term effect on valuations of private companies, which could affect the carrying value and the amount and timing of gains or losses realized on these investments. A small portion of the investment portfolio also consists of common stock in publicly traded companies. These investments are directly exposed to equity price risk, in that a hypothetical ten percent change in these equity prices would result in a similar percentage change in the fair value of these securities.

We are classified as a “non-diversified” investment company under the 1940 Act, which means we are not limited in the proportion of our assets that may be invested in the securities of a single user. The value of one segment called “Energy” includes one portfolio company and was 24.5% of the net asset value and 59.2% of our investments in portfolio company securities (at fair value) as of March 31, 2014. Changes in business or industry trends or in the financial condition, results of operations, or the market’s assessment of any single portfolio company will affect the net asset value and the market price of our common stock to a greater extent than would be the case if we were a “diversified” company holding numerous investments.

### **Item 4. Controls and Procedures**

The Fund maintains disclosure controls and other procedures that are designed to ensure that information required to be disclosed by the Fund in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC’s rules and forms, and that such information is



accumulated and communicated to the Fund's management, including its Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure.

The Fund's management, with the participation of the Fund's Chief Executive Officer and Chief Financial Officer, have evaluated the effectiveness of the design and operations of the Fund's "disclosure controls and procedures" (as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934) as of March 31, 2014. Based on their evaluation, the Fund's Chief Executive Officer and Chief Financial Officer concluded that the Fund's disclosure controls and procedures were effective at a reasonable assurance level. There has been no change in the Fund's internal control over financial reporting during the quarter ended March 31, 2014, that has materially affected, or is reasonably likely to materially affect, the Fund's internal control over financial reporting.

## **Part II. Other Information**

### **Item 1. Legal Proceedings**

**Champion Window Arbitration Claim**—In January 2006, we sold our 31.5% ownership interest in Champion Window, Inc. ("Champion"), a portfolio company of the Fund, to Atrium Companies Inc. ("Atrium") pursuant to a Stock Purchase Agreement ("SPA") dated December 22, 2005. The SPA contained certain limited rights of indemnification for Atrium in connection with its purchase of such ownership interest.

More than five years after the closing of the sale of our Champion interest, Atrium filed suit in the District Court of Harris County, Texas against two former officers of Atrium's subsidiary, Champion, alleging, amongst other matters, that the former officers breached their fiduciary duties to Champion by hiring undocumented workers. This action was commenced primarily as a result of an investigation by the U.S. Immigration and Customs Enforcement agency ("ICE") into Atrium's hiring practices. On March 12, 2012, to protect its interests, we filed a Petition in Intervention in the State Court Action seeking a declaration from the Court that Equus did not owe any obligation to indemnify Atrium or Champion for any penalties, costs or fees associated with the investigation by ICE.

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On March 16, 2012, Atrium and Champion filed a claim with the American Arbitration Association in Dallas, Texas, against Equus and a number of the other sellers under the SPA. In September 2013, all of Atrium and Champion's claims including claims against its former officers described above, were also consolidated in the Arbitration Action.

In the Arbitration Action, Atrium and Champion seek damages arising from Equus' and the other sellers' indemnity obligations set forth in the SPA. Atrium claims it is entitled to indemnification under the SPA for costs it has incurred in responding to an ongoing investigation by ICE. Atrium entered into a Non-Prosecution Agreement with ICE. It appears that one condition of the Non-Prosecution Agreement required Atrium to pay ICE \$2,000,000. Atrium and Champion asserted two counts of breach of contract against Equus, both arising out of the alleged obligation to indemnify Atrium and Champion pursuant to certain provisions of the SPA. Atrium and Champion also asserted claims for fraudulent inducement against two former officers and directors of Champion. Through the arbitration, Atrium and Champion seek to recover an unspecified amount in the form of alleged "losses, damages, assessments, penalties, interest, reasonable attorneys' and accountants' fees, settlement costs, and other costs and expenses arising directly or indirectly out of or incident to," the alleged breach of the indemnity provisions in the SPA. As a consequence of their fraudulent inducement claim against the two former officers and directors, Atrium and Champion alternatively seek equitable rescission of the SPA and exemplary damages from the two former officers and directors.

Atrium and Champion have yet to specify the amount of damages they seek from Equus or the other sellers pursuant to the alleged indemnity obligations under the SPA. Atrium and Champion have disclosed the payment of \$2 million to ICE to resolve the investigation and avoid prosecution for their hiring practices.

We filed an answer to Atrium and Champion's claims on December 6, 2013. In our answer, we denied that we owed any indemnity obligations to Atrium or Champion and further denied that the Fund is in any way liable to Atrium or Champion. To the extent Atrium and Champion are able to establish a right to an indemnity, we will further contest the amount of the claimed indemnity, inasmuch as we believe (among other defenses) that the indemnity obligation can only exist, if at all, with respect to damages arising as a direct and proximate result of employees who were hired prior to the closing date of the 2006 sale of Champion and remained in continuous employment after the 2006 sale, and not to any employee who may have been hired in the six years after the sale.

While we believe the Atrium claim is without merit and we intend to continue to vigorously dispute the claim, there is a reasonable possibility of an adverse ruling which may require the Fund to indemnify Atrium. If Equus is required to indemnify Atrium and Champion, we estimate that such indemnity obligation could vary from \$2.0 million to \$3.0 million. Pursuant to the SPA, the indemnification obligation of Equus and the other sellers is several and not joint, and any such indemnity, however uncertain, would likely be reduced proportionately to our percentage ownership in Champion at the time of sale, which was 31.5% of Champion's shares outstanding.

**Indemnification Settlement**—Effective June 13, 2013, the Fund entered into a settlement agreement with Sam Douglass, a former director and executive officer of the Fund, in respect of a claim for indemnification pursuant to the General Corporation Law of Delaware and an indemnification agreement entered into by the Fund with Mr. Douglass on May 3, 2001. The settlement agreement provides for the reimbursement to Mr. Douglass of actual expenses incurred, excluding any fines or penalties, in connection with an enforcement action initiated by the Securities and Exchange Commission against Mr. Douglass in 2009. The settlement payment of \$125,000 was made on June 24, 2013.

**Lawsuit Settlement**—On August 12, 2012, Paula Douglass filed a lawsuit against the Fund and members of the Board of Directors in the District Court of Harris County, Texas. Ms. Douglass' complaint alleged various causes of action, including minority shareholder oppression, dilution, and breach of fiduciary duty, and sought unspecified damages and attorney's fees. Effective June 13, 2013, the Fund entered into a settlement agreement with Ms. Douglass, Sam Douglass, as well as certain trusts controlled by them. Pursuant to the settlement agreement and in view of the estimated costs of protracted litigation and the associated disruption to the operations of the Fund, the Board of Directors approved a payment of \$402,254, in complete settlement of the lawsuit, as being in the best interests of the Fund and its shareholders. The settlement payment was made on July 30, 2013. Ms. Douglass filed a motion to dismiss the lawsuit with prejudice on August 8, 2013.

From time to time, the Fund is also a party to certain proceedings incidental to the normal course of our business including the enforcement of our rights under contracts with our portfolio companies. While the outcome of these legal proceedings cannot at this time be predicted with certainty, we do not expect that these proceedings will have a material effect upon the Fund's financial condition or results of operations.

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**Item 1A. Risk Factors**

In addition to the various risks identified in the Fund's Annual Report on Form 10-K for the year ended December 31, 2013, filed on March 31, 2014, are the following:

*If we reorganize as an operating company, we will likely not continue to qualify as a RIC under the Code.*

On May 15, 2014, we announced that we had adopted a Plan of Reorganization (also referred to hereinafter as the "Plan") within the meaning of Section 2(a)(33) of the 1940 Act. The Plan contemplates the possible merger of the Fund with and into another BDC, or the restructuring of the Fund as an operating company no longer subject to the 1940 Act. If we were to reorganize as an operating company, we may lose our status as a RIC. If we fail to qualify as a RIC, we will be subject to corporate income tax, which would substantially reduce the amount of income we might otherwise distribute to our shareholders. See "Subsequent Events" on page 27.

*If we reorganize as an operating company, we will not continue to operate as a BDC.*

We have elected to be classified as a BDC under the 1940 Act. In connection with our announcement on May 15, 2014 to effect a Plan of Reorganization, if we effect a reorganization of the Fund into an operating company, we will seek to terminate our BDC classification. If we were to terminate our election to be classified as a BDC and were still determined by the Securities and Exchange Commission to constitute an "investment company," we would be subject to significantly greater regulatory requirements and constraints than under which we presently operate, the result of which would have a material adverse effect on our results and financial condition.

*If we reorganize as an operating company, we may not be able to utilize our capital losses.*

As of March 31, 2014, we have incurred cumulative capital losses of \$32.5 million, of which \$15.6 million will begin expiring after 2017, with the remainder carried over indefinitely. Pursuant to the Plan of Reorganization announced on May 15, 2014, we may reorganize as an operating company. If we reorganize as an operating company, we may lose our ability to offset future income against our cumulative capital losses, including capital losses that would otherwise continue past 2017. If we reorganized as an operating company and were unable to offset future income against these capital losses, the result could have a material adverse effect on our future operating results and our financial condition.

Other than the foregoing, there have been no material changes to the Fund's risk factors from the disclosure set forth in the Annual Report on Form 10-K for the year ended December 31, 2013.

Readers should carefully consider these risks and all other information contained in the annual report on Form 10-K, including the Fund's financial statements and the related notes thereto. The risks and uncertainties described below are not the only ones facing the Fund. Additional risks and uncertainties not presently known to the Fund, or not presently deemed material by the Fund, may also impair its operations and performance.

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**Item 6. Exhibits**

3. Articles of Incorporation and by-laws

- (a) Restated Certificate of Incorporation of the Fund, as amended. [Incorporated by reference to Exhibit 3(a) to Registrant's Annual Report on Form 10-K for the year ended December 31, 2007]
- (b) Certificate of Merger dated June 30, 1993, between the Fund and Equus Investments Incorporated [Incorporated by reference to Exhibit 3(c) to Registrant's Annual Report on Form 10-K for the year ended December 31, 2007]
- (c) Amended and Restated Bylaws of the Fund. [Incorporated by reference to Exhibit 3(b) to Registrant's Current Report on Form 8-K filed on December 16, 2010.]w

10. Material Contracts.

- (c) Safekeeping Agreement between the Fund and Amegy Bank dated August 16, 2008. [Incorporated by reference to Exhibit 10(c) to Registrant's Annual Report on Form 10-K for the year ended December 31, 2008.]
- (d) Form of Indemnification Agreement between the Fund and its directors and certain officers. [Incorporated by reference to Exhibit 10(d) to Registrant's Annual Report on Form 10-K for the year ended December 31, 2011.]
- (e) Form of Release Agreement between the Fund and certain of its officers and former officers. [Incorporated by reference to Exhibit 10(h) to Registrant's Annual Report on Form 10-K for the year ended December 31, 2004.]
- (f) Code of Ethics of the Fund (Rule 17j-1) [Incorporated by reference to Exhibit 10(f) to Registrant's Annual Report on Form 10-K for the year ended December 31, 2009.]
- (g) Share Exchange Agreement between the Fund and MVC Capital, Inc., dated May 14, 2014. [Incorporated by reference to Exhibit 10.1 to Current Report on Form 8-K, filed on May 15, 2014.]

- 31. Rule 13a-14(a)/15d-14(a) Certifications
  - 1. Certification by Chief Executive Officer
  - 2. Certification by Chief Financial Officer

- 32. Section 1350 Certifications
  - 1. Certification by Chief Executive Officer
  - 2. Certification by Chief Financial Officer

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SIGNATURE

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has caused this report to be signed by the undersigned, thereunto duly authorized.

EQUUS TOTAL RETURN, INC.

/s/ John A. Hardy

Date: May 15, 2014

**John A. Hardy**  
**Chief Executive Officer**





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