

CLEVELAND CLIFFS INC

Form 424B3

July 22, 2004

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Filed Pursuant To Rule 424(b)(3)
Registration File Nos. 333-113252

PROSPECTUS

172,500 Shares

Cleveland-Cliffs Inc

172,500 SHARES OF 3.25% REDEEMABLE CUMULATIVE CONVERTIBLE PERPETUAL PREFERRED STOCK

\$172,500,000 PRINCIPAL AGGREGATE AMOUNT OF 3.25% CONVERTIBLE SUBORDINATED

DEBENTURES ISSUABLE IN EXCHANGE FOR THE PREFERRED STOCK

*2,782,253 COMMON SHARES ISSUABLE UPON CONVERSION OF THE PREFERRED STOCK OR
CONVERTIBLE SUBORDINATED DEBENTURES*

*We originally issued the preferred stock in a private placement on January 21, 2004. This prospectus relates to resales of preferred stock and to sales of convertible subordinated debentures that may be issued in exchange for preferred stock and common shares that may be issued upon conversion of preferred stock or convertible subordinated debentures by the securityholders named under the caption *Selling Securityholders* in this prospectus. The selling securityholders may offer the securities at fixed prices, at prevailing market prices at the time of sale, at varying prices or negotiated prices. We will not receive any cash proceeds from the selling securityholders' sales of these securities.*

Each share of preferred stock has an initial liquidation preference of \$1,000 and is convertible initially into 16.1290 of our common shares, based on an initial conversion price of \$62.00 per share, subject in each case to specified adjustments, only under the following circumstances: (1) the closing sale price of our common shares reaches, or the trading price of the preferred stock falls below, specified thresholds, (2) the preferred stock is called for redemption, or (3) specified corporate transactions have occurred.

Cash dividends on the preferred stock are payable, when and as declared by our board of directors, out of funds legally available therefor, at the rate of 3.25% per annum, quarterly in arrears, commencing April 15, 2004. Dividends on the preferred stock will be cumulative from the date of issuance. Accumulated but unpaid dividends will not cumulate additional dividends or interest. If we fail to pay, or to set apart funds to pay, dividends on the preferred stock for any quarterly dividend period, then holders of the preferred stock will be entitled to receive, when and as declared by our board of directors, out of funds legally available therefor, cash dividends at an increased rate per annum as described herein for each subsequent quarterly dividend period until we have paid or provided for the payment of all dividends on the preferred stock for all dividend periods up to and including the dividend payment date on which the accumulated and unpaid dividends are paid in full.

Beginning January 20, 2009, we may redeem shares of the preferred stock by paying cash, our common shares valued at a discount of 2.5% from their market price or any combination thereof in an amount equal to the liquidation preference, plus any accumulated and unpaid dividends to the redemption date, but only if the closing sale price of our common shares has exceeded 135% of the conversion price for at least 20 trading days within a period of 30 consecutive trading days ending on the trading day prior to the date we give the notice of redemption. Following a designated event, as defined herein, holders of the preferred stock may require us to purchase any or all of their shares of preferred stock at the liquidation preference, plus any accumulated and unpaid dividends to the date of purchase, which we may pay in either cash, our common shares valued at a discount of 2.5% from their market price or any combination thereof.

We also have the right, subject to certain conditions, to require holders of the preferred stock to exchange their shares for convertible subordinated debentures with similar terms.

*For a more detailed description of the preferred stock, see *Description of Preferred Stock* beginning on page 17. For a more detailed description of the convertible subordinated debentures, see *Description of the Convertible Subordinated Debentures* beginning on page 36.*

*Our common shares trade on the New York Stock Exchange under the symbol *CLF*. On July 20, 2004, the closing sale price of our common shares was \$55.75 per share.*

Investing in the preferred stock, the convertible subordinated debentures or the common shares involves risks. See Risk Factors beginning on page 9.

NEITHER THE SECURITIES AND EXCHANGE COMMISSION NOR ANY STATE SECURITIES COMMISSION HAS APPROVED OR DISAPPROVED OF THESE SECURITIES OR DETERMINED IF THIS PROSPECTUS IS TRUTHFUL OR COMPLETE. ANY REPRESENTATION TO THE CONTRARY IS A CRIMINAL OFFENSE.

The date of this prospectus is July 22, 2004

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You should rely only on the information contained or incorporated by reference in this prospectus. We have not authorized anyone to provide you with different information. We are not making an offer of these securities in any jurisdiction where an offer is not permitted. You should not assume that the information provided in this prospectus is accurate as of any date other than the date on the front cover of this prospectus.

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ABOUT THIS PROSPECTUS

This prospectus is part of a registration statement that we filed with the Securities and Exchange Commission, or SEC, using a shelf registration process or continuous offering process. Under this shelf registration process, the selling securityholders may, from time to time, sell the securities described in this prospectus in one or more offerings. This prospectus provides you with a general description of the securities that may be offered by the selling securityholders. Each time a selling securityholder sells securities, the selling securityholder is required to provide you with this prospectus and, in certain cases, a prospectus supplement containing specific information about the selling securityholder and the terms of the securities being offered. That prospectus supplement may include additional risk factors or other special considerations applicable to those securities. Any prospectus supplement may also add, update, or change information in this prospectus. If there is any supplement, you should rely on the information in that prospectus supplement. You should read both this prospectus and any prospectus supplement together with additional information described under [Where You Can Find More Information](#).

The data included in this prospectus regarding industries and ranking, including the size of specific industries and our position and the position of our competitors within these industries, are based on independent industry publications or other published industry sources and our estimates. Our estimates are based on information obtained from our customers, distributors, suppliers, trade and business organizations and other contacts in the industries in which we operate and our management's knowledge and experience. Although we believe these estimates to be accurate as of the date of this prospectus and these sources to be reliable, we have not independently verified and do not guarantee the accuracy and completeness of those estimates and this information.

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WHERE YOU CAN FIND MORE INFORMATION

Available Information

We file reports, proxy statements and other information with the SEC. You may obtain copies of this information by mail from the Public Reference Room of the SEC, 450 Fifth Street, N.W., Room 1024, Washington, D.C. 20549, at prescribed rates. Further information on the operation of the SEC's Public Reference Room in Washington, D.C. can be obtained by calling the SEC at 1-800-SEC-0330. The SEC also maintains an internet site at www.sec.gov that contains reports, proxy statements and other information regarding public companies like us that file SEC reports and other documents electronically. Reports, proxy statements and other information concerning us also may be inspected at the offices of the New York Stock Exchange, 20 Broad Street, New York, New York 10005. We also maintain an internet site at www.cleveland-cliffs.com that contains information concerning us and our affiliates. The information at our internet site is not incorporated by reference in this prospectus, and you should not consider it to be a part of this prospectus.

Incorporation by Reference

We incorporate by reference into this prospectus the following documents that we have filed with the SEC:

Annual Report on Form 10-K for the fiscal year ended December 31, 2003;

Quarterly Report on Form 10-Q for the quarter ended March 31, 2004;

Amendment No. 1 to Quarterly Report on Form 10-Q for the quarter ended March 31, 2004;

Current Report on Form 8-K filed on January 13, 2004;

Current Report on Form 8-K filed on January 15, 2004;

Current Report on Form 8-K filed on January 20, 2004;

Current Report on Form 8-K filed on January 22, 2004;

The Description of Common Shares contained in the Current Report on Form 8-K filed on March 2, 2004;

Current Report on Form 8-K furnished on July 13, 2004;

Current Report on Form 8-K furnished on July 14, 2004; and

Current Report on Form 8-K furnished on July 19, 2004.

We also are incorporating by reference into this prospectus the documents that we subsequently file with the SEC pursuant to Section 13(a), 13(c), 14 or 15(d) of the Securities Exchange Act of 1934 until this offering is complete. In no event, however, will any of the information that we furnish under Item 9 or Item 12 of any Current Report on Form 8-K that we may from time to time provide to the SEC be incorporated by reference into, or otherwise part of, this prospectus. Any statement contained in a document incorporated by reference herein shall be deemed to be modified or superseded for all purposes to the extent that a statement contained in this prospectus, or in any other subsequently filed document that is also incorporated or deemed to be incorporated by reference, modifies or supersedes such statement. Any statement so modified or superseded shall not be deemed, except as so modified or superseded, to constitute a part of this prospectus.

We will provide without charge to each person to whom a copy of this prospectus has been delivered a copy of any and all of these filings. You may request a copy of these filings by writing or telephoning us at:

Cleveland-Cliffs Inc

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Investor Relations
1100 Superior Avenue
Cleveland, Ohio 44114-2589
(216) 694-5459

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SUMMARY

This summary highlights information contained elsewhere or incorporated by reference in this prospectus. This summary does not contain all of the information that you should consider before investing in the preferred stock, the convertible subordinated debentures issuable upon exchange of the preferred stock and the common shares issuable upon conversion of the preferred stock or the convertible subordinated debentures. Before investing in the preferred stock, the convertible subordinated debentures or the common shares, you should read this entire prospectus carefully, including the Risk Factors section and the summary consolidated financial data and related notes, as well as the other information incorporated by reference in this prospectus. The term preferred stock refers to our 3.25% redeemable cumulative convertible perpetual preferred stock, without par value, the term convertible subordinated debentures refers to our convertible subordinated debentures we may issue in exchange for the preferred stock and the term common shares refers to our common shares, par value \$1.00 per share.

The Company

Business Description

Founded in 1847, we are the largest producer of iron ore pellets in North America and sell the majority of our pellets to integrated steel companies in the United States and Canada. We operate six iron ore mines located in Michigan, Minnesota and Eastern Canada that currently have a rated capacity of 36.9 million tons of iron ore pellet production annually. Based on our percentage ownership of the mines we operate, our share of the rated pellet production capacity is currently 22.6 million tons annually, representing approximately 28 percent of total North American annual pellet capacity. We sell our share of iron ore production to integrated steel producers, generally pursuant to term supply agreements with various price adjustment provisions.

Recent Developments

Cliffs and Associates Limited

On May 12, 2004, we announced that our affiliate, Cliffs and Associates Limited, or CAL, which is jointly owned by a subsidiary of ours and Outokumpu Technology GmbH, a German company, has entered into an agreement to sell CAL's idled Circore™ hot briquette iron facility located in Trinidad and Tobago to ISG Venture Inc., a wholly owned subsidiary of International Steel Group Inc., or ISG. In the fourth quarter of 2002, we abandoned our investment in CAL and exited the ferrous metalics business.

International Pellet Price

The major iron ore producers of Brazil and Eastern Canada annually negotiate and publish the price of their seaborne iron ore products. On February 6, 2004, Companhia Vale do Rio Doce, Brazil's principal iron ore producer, reached settlement on its 2004 price for blast furnace pellets with a major European consumer. The price represents an increase of 19.0 percent and 20.1 percent for 2004 versus 2003, depending on the point of sale. On February 27, 2004, Iron Ore Company of Canada and Quebec Cartier Mining Company, Eastern Canadian iron ore pellet producers, reached settlement on a 21.2 percent price increase with their European customers. This negotiated international price is one of several price adjustment factors included in our term supply agreements with our customers. The estimated effect of this international pellet price adjustment factor on our revenues per ton from iron ore sales and services for 2004 will be an average increase of approximately five percent from 2003. This would represent an improvement in operating earnings of approximately \$40 million, based on the 22 million tons of estimated pellet sales for 2004. Our 2004 revenues will also be affected by certain steel customers' average hot rolled coil prices for 2004, pursuant to both term supply agreements and spot sales. Based on projected pellet sales of 22 million tons, we estimate that our 2004 revenues would increase by approximately \$.22 per ton of pellets sold, or roughly \$5 million, for every \$10 per ton increment that the customers' actual average annual realization for basic hot rolled coil exceeds approximately \$300.

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The estimated 2004 impact of the other price adjustment factors included in our term supply agreements, including the adjustments based on general industrial inflation rates, cannot be determined at this time; however, additional price increases will be limited by annual collars.

Weirton Steel Corporation

On May 19, 2003, Weirton Steel Corporation, or Weirton, filed for protection under chapter 11 of the U.S. Bankruptcy Code in the United States Bankruptcy Court for the Northern District of West Virginia. On May 18, 2004, a subsidiary of ISG, or ISG-Weirton, purchased the assets of Weirton for \$253 million. ISG-Weirton, as part of the acquisition of the assets of Weirton, has assumed the existing term supply agreement between Weirton and us with modifications. The agreement with ISG-Weirton continues through 2018. For the first two years, ISG-Weirton will purchase the greater of 67 percent or 1.5 million tons of ISG-Weirton's annual iron ore pellet requirements from us. For years 2006-2018, ISG-Weirton will purchase 100 percent of its annual iron ore pellet requirements from us.

In addition, as a part of the acquisition of the assets of Weirton, ISG-Weirton agreed to purchase the power-generating assets of MABCO Steam Company, LLP, or MABCO. MABCO is a joint venture, of which we are a 40.5 percent participant, that purchased certain steam generation facilities that provide steam power to Weirton. MABCO purchased the steam-generation assets from FW Holdings, Inc., a subsidiary of Weirton, in a purchase-leaseback arrangement prior to Weirton's bankruptcy filing. On February 26, 2004, FW Holdings filed a petition for chapter 11 bankruptcy protection. As a result, FW Holdings did not make its quarterly lease payment due on March 31, 2004, of which our share was \$.5 million. The sale of the MABCO assets to ISG-Weirton required a payment to MABCO on closing (\$4.0 million at our share) and annual payments (\$.2 million at our share) including interest at the rate of five percent for 15 years.

In conjunction with the sale of the assets of Weirton and MABCO to ISG-Weirton, the lawsuit previously initiated by FW Holdings against MABCO was settled, and MABCO and its members and their affiliates, including us, received a release.

USWA Negotiations

On June 18, 2004, we reported that we and the United Steel Workers of America, or the USWA, have made progress toward new labor agreements covering the bargaining unit employees at our Empire, Tilden, Hibbing Taconite and United Taconite mines. The current agreements covering those employees are due to expire at midnight on July 31, 2004. While we and the USWA have reached tentative agreement on a number of issues, additional bargaining will be required to resolve the challenging issues which remain, and we may not be able to reach a new agreement before August 1, 2004. Our negotiations with the USWA resumed on July 19, 2004.

Kipling Furnace Site

By letter dated November 19, 1991, the Michigan Department of Natural Resources, now the Michigan Department of Environmental Quality, or the MDEQ, notified us that it believed we were liable for contamination at the Kipling Furnace Site in Kipling, Michigan and requested that we voluntarily undertake actions to remediate the site. We owned and operated a portion of the site from approximately 1902 through 1925 when we sold the property to CITGO Petroleum Company, or CITGO. CITGO in turn operated at the site and thereafter sold the southern portion of the site to a third party. This southern portion of the site was the location of the majority of our former operations. CITGO was working formally with MDEQ to address the portions of the site impacted by CITGO's operations on the property, which occurred between 1925 and 1986. CITGO submitted a remedial action plan in August 2003 to the MDEQ. However, the MDEQ subsequently rejected this remedial action plan as being inadequate.

We responded to the 1991 letter by performing a hydrogeological investigation at the site pursuant to Michigan's Natural Resources and Environmental Protection Act, which allows parties to conduct environmental response activity without state agency oversight. Our initial investigation took place in 1996, with follow up monitoring occurring in 1998 through 2003. We have developed a proposed remedial action plan to

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address materials associated with our former operations at the site. We currently estimate the cost of implementing our proposed remedial action to be between \$300,000 and \$350,000. We have not yet implemented the proposed remedial action plan.

By a letter dated June 10, 2004, the MDEQ made a new demand to both CITGO and us to take responsive activities at the property, including development and submittal of a remedial action plan to the MDEQ for approval. We will be meeting with the MDEQ to discuss this letter and are preparing a response. At this time, it is unclear whether the MDEQ, once it is apprised of our responsive activities at the site to date, will require us to conduct further investigations or implement a remedial action plan going beyond what we have already developed internally. Conducting further investigations, revising our proposed remedial action plan or implementing the plan could result in much higher costs than currently anticipated.

Wabush Mine Strike

Our collective bargaining agreement with the USWA employees at the Wabush mine expired on March 1, 2004. We had been in negotiations with the USWA for the resolution to a new agreement. On July 5, 2004, the USWA initiated a strike that idled the Wabush mine's mining and concentrating facilities in Labrador, Newfoundland. This action was followed by a strike that idled the Wabush pelletizing and shipping facilities in Pointe Noire, Quebec. As of July 21, 2004, discussions with the USWA are ongoing; however, we cannot assure that we will succeed in reaching collective bargaining agreements with the USWA to replace the expired Wabush agreement.

The Wabush Mines joint venture is owned jointly by Stelco Inc. (44.6 percent), Dofasco Inc. (28.6 percent) and a subsidiary of ours (26.8 percent). Wabush has the capacity to produce 6 million tons of iron ore pellets per year and was most recently projected to produce 5.7 million tons in 2004. The mine has produced approximately 2.7 million tons year-to-date. It is currently projected that for each week the mine is idle, the annual pellet production will be reduced by an estimated 120,000 tons with our share being approximately 32,000 tons. The financial impact on our pre-tax earnings due to this strike is estimated to be approximately \$500,000 per week.

Our principal executive offices are currently located at 1100 Superior Avenue, Cleveland, Ohio 44114-2589, and our telephone number is (216) 694-5459.

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THE OFFERING

The following is a brief summary of the material terms of the preferred stock and the convertible subordinated debentures. For a more complete description of the terms of the preferred stock and the convertible subordinated debentures, see the sections of this prospectus entitled Description of Preferred Stock and Description of the Convertible Subordinated Debentures, respectively.

Summary of the Terms of the Series A-2 Preferred Stock

Issuer	Cleveland-Cliffs Inc
Securities offered by the selling securityholders	172,500 shares of preferred stock
Liquidation preference	\$1,000 per share of preferred stock
Dividends	<p> Holders of preferred stock are entitled to receive, when and as declared by our board of directors, out of funds legally available therefor, cash dividends at the rate of 3.25% per annum, payable quarterly in arrears on January 15, April 15, July 15 and October 15 of each year, commencing April 15, 2004. Dividends on the preferred stock will be cumulative from the date of original issuance. Accumulated but unpaid dividends will not cumulate additional dividends or interest.</p> <p> If we fail to pay, or to set apart funds to pay, dividends on the preferred stock for any quarterly dividend period, then holders of preferred stock will be entitled to receive, when and as declared by our board of directors, out of funds legally available therefor, cash dividends at the rate per annum equal to:</p> $3.25\% + [N * (3.25\%^2) * 0.25]$ <p> Where:</p> <p> N = the number of quarterly dividend periods for which we have failed to pay or to set apart funds to pay dividends on the preferred stock,</p> <p> for each subsequent quarterly dividend period until we have paid or provided for the payment of all dividends on the preferred stock for all dividend periods up to and including the dividend payment date on which the accumulated and unpaid dividends are paid in full.</p>
Conversion	<p> A holder may convert its preferred stock into a number of our common shares equal to the conversion rate only under the following circumstances:</p> <p> during any fiscal quarter after the fiscal quarter ending March 31, 2004 and only during such quarter, if the closing sale price of our common shares for at least 20 trading days in a period of 30 consecutive trading days ending on the last trading day of the preceding fiscal quarter exceeds 110 percent of the applicable conversion price on such trading day (initially 110 percent of \$62.00, or \$68.20);</p> <p> during the five business day period after any five consecutive trading-day period in which the trading price per share of preferred stock for each day of that period was less than</p>

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98 percent of the product of the closing sale price of our common shares and the applicable conversion rate on each such day;

if the preferred stock has been called for redemption; or

upon the occurrence of certain corporate transactions described under [Description of Preferred Stock Conversion Rights Events Triggering Conversion Rights Conversion Rights Upon Occurrence of Certain Corporate Transactions](#).

The initial conversion price is \$62.00 per common share, subject to specified adjustments, but will not be adjusted for accumulated and unpaid dividends or liquidated damages, if any. Upon conversion, any accumulated dividends will be cancelled, and holders will not receive any cash payment representing accumulated dividends.

Optional redemption

We may not redeem any shares of preferred stock before January 20, 2009. On or after January 20, 2009, we may redeem some or all of the preferred stock at a redemption price equal to 100 percent of the liquidation preference, plus accumulated but unpaid dividends, and liquidated damages, if any, to the redemption date, but only if the closing sale price of our common shares for 20 trading days within a period of 30 consecutive trading days ending on the trading day before the date we give the redemption notice exceeds 135 percent of the conversion price of the preferred stock, subject to adjustment in a number of circumstances described under [Description of Preferred Stock Conversion Rights Adjustments to Conversion Rate](#). We may choose to pay the redemption price in cash, our common shares, or a combination of cash and our common shares.

If full cumulative dividends on the preferred stock are not paid, the preferred stock may not be redeemed, and we may not purchase or acquire any shares of preferred stock other than pursuant to a purchase or exchange offer made on the same terms to all holders of preferred stock and any parity stock.

The preferred stock is not subject to any mandatory redemption or sinking fund provision.

Designated event

If a designated event (as described under [Description of Preferred Stock Designated Event Requires Us to Purchase Shares of Preferred Stock at the Option of the Holder](#)) occurs, each holder of shares of preferred stock will have the right to require us to purchase any or all of its shares at a purchase price equal to 100 percent of the liquidation preference, plus accumulated and unpaid dividends, and liquidated damages, if any, to, but excluding, the date of purchase. We may choose to pay the purchase price in cash, our common shares, or a combination thereof. See [Description of Preferred Stock Designated Event Requires Us to Purchase Shares of Preferred Stock at the Option of the Holder](#).

Voting rights

Holders of preferred stock will be entitled to one vote for each share of preferred stock held upon all matters presented to our shareholders and shall vote together with the holders of our common shares as one class.

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If we fail to pay, or to set apart funds to pay, dividends on the preferred stock or any other series of Class A Preferred Stock in an amount equivalent to six full quarterly dividends on any such series, whether or not consecutive and whether or not earned or declared, the holders of preferred stock and any other outstanding series of our Class A Preferred Stock will also be entitled to vote separately as a class to elect two directors. This special class voting right will terminate when all accrued and unpaid dividends on the preferred stock and any other series of our Class A Preferred Stock then outstanding are paid or funds are set apart for their payment.

Ranking

The preferred stock will be, with respect to dividend rights and rights upon liquidation, dissolution or winding up of our company:

junior to all our existing and future debt obligations;

junior to each class or series of our capital stock that has terms which provide that such class or series will rank senior to the preferred stock;

on a parity with parity stock, which is any other class or series of our capital stock that has terms which provide that class or series will rank on a parity with the preferred stock;

senior to our common shares and any other class or series of our capital stock that has terms that provide that class or series will rank junior to the preferred stock; and

effectively junior to all of our subsidiaries' existing and future liabilities and capital stock held by others.

Exchange right

We have the right, subject to certain restrictions, to require all holders of outstanding preferred stock to exchange their preferred stock for our convertible subordinated debentures having an aggregate principal amount equal to the aggregate liquidation preference of the preferred stock and having a conversion rate and interest rate equal to the conversion rate and dividend rate for the preferred stock. The maturity date of the convertible subordinated debentures will be the thirtieth anniversary of the exchange date.

Tax consequences to U.S. holders exercising the exchange right

The exchange of preferred stock for our convertible subordinated debentures under the exchange right would be taxable to the U.S. holders of the preferred stock and may be treated as a taxable distribution in the amount of the fair market value of the convertible subordinated debentures. See "Certain Federal Income Tax Consequences - U.S. Holders - Preferred Stock and Common Shares - Exchange of Preferred Stock for Convertible Subordinated Debentures." Based upon the advice of our counsel, we intend to treat such exchange as generally giving rise to capital gain or loss.

Trading

We have not applied and do not intend to apply for the listing of the preferred stock or the convertible subordinated debentures on any securities exchange.

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PORTAL trading of the preferred stock The preferred stock is currently eligible for trading on the Private Offerings, Resales and Trading through Automated Linkages, or PORTAL, System of the National Association of Securities Dealers, Inc.

NYSE symbol for the common shares Our common shares are traded on the New York Stock Exchange under the symbol CLF.

Summary of the Terms of the Convertible Subordinated Debentures

Securities offered The convertible subordinated debentures will be convertible into shares of our common shares and will have terms and conditions substantially similar to the preferred stock, except as described below.

Principal amount The aggregate principal amount of the convertible subordinated debentures will be limited to the aggregate liquidation preference of the preferred stock outstanding on the effective date of the exchange. The convertible subordinated debentures will be issued in denominations equal to integral multiples of the liquidation preference of one share of preferred stock.

Ranking The convertible subordinated debentures will be unsecured obligations of ours and will rank equally with all of our other unsecured subordinated indebtedness.

Subordination The payment of principal and interest on the convertible subordinated debentures is subordinated in right of payment to the prior payment in full of all of our future senior debt.

Interest Interest on the convertible subordinated debentures will accrue at an annual rate of 3.25 percent of the principal amount from the dividend payment date of the preferred stock immediately preceding the exchange date or, if the exchange date is a dividend payment date, from the exchange date, and thereafter from the most recent interest payment date. Interest will be payable in cash semi-annually in arrears on January 15 and July 15 of each year. We will not have the right to defer interest payments or to accrete the principal amount of the convertible subordinated debentures.

Maturity The thirtieth anniversary of the exchange date.

Optional redemption Our rights to redeem the convertible subordinated debentures will be substantially identical to our rights to redeem the preferred stock.

Conversion The conversion rights of the convertible subordinated debentures will be substantially identical to the conversion rights of the preferred stock, except that on the date of any conversion upon satisfaction of a trading price condition as described in Description of Preferred Stock Conversion Rights Events Triggering Conversion Rights Conversion Upon Satisfaction of Trading Condition that is on or after the twenty-fifth anniversary of the exchange date, holders may not convert their convertible subordinated debentures upon satisfaction of such condition if on any trading day during the relevant measurement period for determin-

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ing whether such condition has been met, the closing sale price of the common shares was between 100 percent and 110 percent of the then-current conversion price of the convertible subordinated debentures.

Voting rights

The holders of convertible subordinated debentures will not have the right to vote in the election of our directors or any other voting rights as holders of our common shares prior to the holders' receipt of common shares upon conversion of their convertible subordinated debentures.

Designated event

The designated event repurchase rights of holders of the convertible subordinated debentures will be substantially identical to the designated event repurchase rights of holders of the preferred stock.

Events of default

A default in payment of principal or interest, the failure to deliver common shares upon conversion, the failure to comply with our other agreements in the indenture governing the convertible subordinated debentures or the occurrence of specified events of bankruptcy, insolvency or reorganization affecting us will constitute an event of default with respect to the convertible subordinated debentures.

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RISK FACTORS

An investment in the preferred stock, the convertible subordinated debentures that we may issue in exchange for the preferred stock and the common shares issuable upon the conversion of the preferred stock and the convertible subordinated debentures involves risks. You should consider carefully the following risk factors, and the risk factors included in our annual report on Form 10-K for the fiscal year ended December 31, 2003, which is incorporated by reference into this prospectus, in addition to the other information contained in this prospectus before deciding to purchase any shares of the preferred stock, the convertible subordinated debentures or the common shares. If any of the following risks actually occur, we may not be able to conduct our business as currently planned and our revenues and financial condition could be seriously harmed.

Risks Relating to the Preferred Stock, the Convertible Subordinated Debentures and the Common Shares Issuable Upon Conversion of the Preferred Stock and the Convertible Subordinated Debentures

The preferred stock ranks junior to all of our liabilities.

The preferred stock ranks junior to all of our liabilities. In the event of our bankruptcy, liquidation or winding-up, our assets will be available to pay obligations on the preferred stock, including the purchase of your shares of the preferred stock for cash upon a designated event, only after all our indebtedness and other liabilities have been paid. In addition, the preferred stock will effectively rank junior to all existing and future liabilities of our subsidiaries and any capital stock of our subsidiaries held by others. The rights of holders of the preferred stock to participate in the distribution of assets of our subsidiaries will rank junior to the prior claims of that subsidiary's creditors and any such other equity holders. As of December 31, 2003, we had total consolidated liabilities of approximately \$646.9 million. Consequently, if we are forced to liquidate our assets to pay our creditors, we may not have sufficient assets remaining to pay amounts due on any or all of the preferred stock then outstanding. We and our subsidiaries may incur substantial amounts of additional debt and other obligations that will rank senior to the preferred stock.

We may not be able to pay the repurchase price of the preferred stock or the convertible subordinated debentures upon a designated event. We also could be prevented from paying dividends on shares of the preferred stock.

Upon the occurrence of a designated event, you will have the right to require us to purchase all your shares of preferred stock or your convertible subordinated debentures, as the case may be. However, we may not have sufficient cash to purchase your shares of preferred stock or convertible subordinated debentures, as the case may be, upon the occurrence of a designated event.

The terms of any indebtedness that we may enter into in the future may also restrict us from repurchasing, or paying dividends with respect to, the preferred stock. Even if the terms of any future indebtedness allow us to pay dividends and to repurchase the preferred stock or the convertible subordinated debentures, we would only be able to make such payments if then permitted to under applicable Ohio statutory limitations on the payment of dividends or redemption, and we may not be able to pay dividends to you or to repurchase your shares of preferred stock or convertible subordinated debentures.

In addition, because we are a holding company, our ability to repurchase the preferred stock or the convertible subordinated debentures or to pay dividends on the preferred stock or interest on the convertible subordinated debentures may be limited by restrictions on our ability to obtain funds for such repurchase, dividends or interest, as the case may be, through dividends from our subsidiaries.

An active trading market for the preferred stock or the convertible subordinated debentures, as the case may be, may not develop, and you may be unable to resell your shares of preferred stock or convertible subordinated debentures at or above the purchase price.

Under the registration rights agreement applicable to the preferred stock, the convertible subordinated debentures and the common stock issuable upon conversion of the preferred stock and the convertible

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subordinated debentures, we are required to file and to use our reasonable best efforts to have declared effective a shelf registration statement registering the preferred stock, the convertible subordinated debentures and the common shares issuable upon the conversion of the preferred stock and the convertible subordinated debentures, as case may be. We filed the registration statement on March 3, 2004. However, we cannot assure you that we will be successful in having that registration statement declared effective.

No trading market for the preferred stock or the convertible subordinated debentures currently exists, and we have not applied and do not intend to apply for the listing of the preferred stock or the convertible subordinated debentures on any securities exchange or for the inclusion of the preferred stock or the convertible subordinated debentures in any automated quotation system. The initial purchaser has advised us that it intends to make a market in the preferred stock. However, it is not obligated to do so and it may discontinue any market-making activities at any time without notice. Consequently, a liquid trading market for the preferred stock or the convertible subordinated debentures may not develop and the market price of the preferred stock or the convertible subordinated debentures may be volatile. As a result, you may be unable to sell your shares of preferred stock or your convertible subordinated debentures at a price equal to or greater than that you paid, if at all.

You may be unable to convert the preferred stock or the convertible subordinated debentures into our common shares and, if you are able to and do convert, you will experience immediate dilution.

You may convert your shares of preferred stock or your convertible subordinated debentures, as the case may be, into common shares only if (1) the closing sale price of our common shares reaches, or the trading price of the preferred stock falls below, specified thresholds, (2) the preferred stock is called for redemption, or (3) specified corporate transactions have occurred. You may not convert your shares of preferred stock or your convertible subordinated debentures unless you will be in compliance with the Ohio statutes relating to control share acquisitions immediately after such conversion. Your inability to convert the preferred stock or the convertible subordinated debentures may adversely affect their value.

If you convert your shares of preferred stock or your convertible subordinated debentures into common shares, you will experience immediate dilution because the per share conversion price of the preferred stock or the convertible subordinated debentures immediately after this offering will be higher than the net tangible book value per common share then outstanding. In addition, you will also experience dilution when and if we issue additional common shares.

The price of our common shares, and therefore of the preferred stock or the convertible subordinated debentures, may fluctuate significantly, which may make it difficult for you to resell the preferred stock, the convertible subordinated debentures or common shares issuable upon conversion of the preferred stock or the convertible subordinated debentures, as the case may be, when you want or at prices you find attractive.

The price of our common shares on the New York Stock Exchange constantly changes. For example, the intra-day market price of our common shares has ranged from \$14.75 to \$69.16 in the period beginning May 1, 2003 and ending on July 20, 2004 and from \$38.80 to \$69.16 in the period beginning January 1, 2004 and ending on July 20, 2004. We expect that the market price of our common shares will continue to fluctuate. Because shares of the preferred stock and the convertible subordinated debentures are convertible into our common shares, volatility or depressed prices for our common shares could have a similar effect on the trading price of the preferred stock or the convertible subordinated debentures, as the case may be. Holders who have received common shares upon conversion of such securities will also be subject to the risk of volatility and depressed prices.

Our stock price can fluctuate as a result of a variety of factors, many of which are beyond our control. These factors include, among others:

quarterly variations in our operating results;

operating results that vary from the expectations of management, securities analysts and investors;

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changes in expectations as to our future financial performance, including financial estimates by securities analysts and investors;

developments generally affecting our industry and the steel industry;

announcements by us or our competitors of significant contracts, acquisitions, joint ventures or capital commitments;

announcements by third parties of significant claims or proceedings against us;

our dividend policy;

future sales of our equity or equity-linked equities; and

general domestic and international economic conditions.

In addition, the stock market in general has experienced extreme volatility that has often been unrelated to the operating performance of a particular company. These broad market fluctuations may adversely affect the market price of our common shares.

The trading price for the preferred stock or the convertible subordinated debentures, as the case may be, will be directly affected by the trading prices for our common shares, which are impossible to predict.

The price of our common shares could be affected by possible sales of our common shares by investors who view the preferred stock or the convertible subordinated debentures, as the case may be, as a more attractive means of equity participation in our company and by hedging or arbitrage activity that may develop involving the common shares. The arbitrage could, in turn, affect the trading prices of the preferred stock or the convertible subordinated debentures, as the case may be.

Our ability to pay dividends may be limited, and we do not anticipate paying cash dividends on our common shares in the near term.

We currently do not pay dividends on our common shares. In the future, we may agree to contractual restrictions on our ability to pay dividends. In addition, to maintain our credit ratings, we may be limited in our ability to pay dividends so that we can maintain an appropriate level of debt. We do not anticipate making any cash dividend payments to our common shareholders for the near term.

The Ohio takeover statutes and our rights plan could deter, delay or prevent a third party from acquiring us and that could deprive you of an opportunity to obtain a takeover premium for our common shares.

We are subject to the Ohio statutes relating to control share acquisitions, which restrict the ability of an acquiror to acquire a significant amount of our outstanding common shares without shareholder approval, as well as Ohio's merger moratorium statute, which restricts the ability of certain interested shareholders to effect transactions involving us or our assets. In addition, we have a shareholder rights plan that under certain circumstances would significantly impair the ability of third parties to acquire control of us without prior approval of our board of directors. We adopted our current rights plan in 1997 upon the expiration of our 1987 rights plan. Both rights plans were adopted to protect us and our shareholders from potentially coercive takeover practices or takeover bids that are inconsistent with the interests of our company and our shareholders, and not in response to any pending takeover or proposed change in control.

Together, these provisions of the Ohio corporate law and our rights plan may discourage transactions that otherwise could provide for the payment of a premium over prevailing market prices for our common shares and could also limit the price that investors may be willing to pay in the future for our common shares. Further, the designated event purchase feature of the preferred stock may in certain circumstances make more difficult or discourage a takeover of our company.

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The exchange of the preferred stock for the convertible subordinated debentures may be treated as a dividend for U.S. federal income tax purposes.

We have the right, subject to certain conditions, to require holders of preferred stock to exchange their shares for convertible subordinated debentures. Any exchange of the preferred stock for convertible subordinated debentures may be treated as a taxable dividend in the amount of the fair market value of the convertible subordinated debentures at the time of the exchange. Based upon the advice of our counsel, we intend, however, to treat the exchange of preferred stock for our convertible subordinated debentures under the exchange right as generally giving rise to capital gain or loss. We cannot assure you that the IRS or the courts will agree with this treatment.

Risks Relating to the Steel Industry

Increased imports of steel into the United States could adversely impact North American steel sales, which could adversely affect demand for our products and our sales, margins and profitability.

From time to time, global overcapacity in steel manufacturing and a weakening of certain foreign economies, particularly in Eastern Europe, Asia and Latin America, may negatively impact steel prices in those foreign economies and result in high levels of steel imports from those countries into the United States at depressed prices. Based on the American Iron and Steel Institute's Apparent Steel Supply (excluding semi-finished steel products), imports of steel into the United States constituted 15.8 percent, 20.4 percent and 20.2 percent of the domestic steel market supply for 2003, 2002 and 2001, respectively. Significant imports of steel into the United States have substantially reduced sales, margins and profitability of North American steel producers, and therefore, have reduced demand for iron ore. The purchase by North American steel producers of semi-finished steel products from foreign suppliers also will decrease demand for our iron ore products.

The U.S. government established various protective actions during 2001 and 2002, including the enactment of various steel import quotas and tariffs, which contributed to a decrease of some steel imports during 2002. However, on December 4, 2003, these steel import quotas and tariffs were lifted. At this time it is uncertain how the lifting of these measures will affect the North American steel industry, but the removal of these measures may lead to a resurgence of steel imports and result in downward pressure on North American steel prices. The decreased North American steel sales could decrease demand for iron ore products and have a substantial negative impact on our sales, margins and profitability.

Natural disasters, equipment failures and other unexpected events may lead our steel industry customers to curtail production or shut down their operations.

Operating levels at our steel industry customers are subject to conditions beyond their control, including raw material shortages, weather conditions, natural disasters, interruptions in electrical power or other energy services, interruptions in transportation services, equipment failures, strikes, lock-outs and other unexpected events. Any of those events could also affect other suppliers to the North American steel industry. In either case, those events could cause our steel industry customers to curtail production or shut down a portion or all of their operations, which could reduce their demand for our iron ore products. For example, in late 2003, a fire occurred in a mine of a major coal supplier to United States Steel Corporation, or U.S. Steel, which supplies a majority of the coke, a processed form of coal, used by our steel industry customers to operate their blast furnaces. The fire caused U.S. Steel to curtail its production of coke, and to reduce its coke shipments to at least two of our steel industry customers. As a result, one of our steel industry customers had to curtail its steel production, and its demand for our iron ore products decreased. Accordingly, as discussed below, that customer invoked the force majeure provision of its term supply agreement with us and reduced its requirements for our iron ore products in the first quarter of 2004 by 180,000 long tons. Another of our steel industry customers announced that it is exploring alternatives, including temporary curtailments of some of its steel-making operations, in order to deal with the coke shortage. Production of steel by our other steel industry customers may also be adversely affected by the failure of U.S. Steel to ship adequate supplies of coke to them. Decreased demand for our iron ore products could adversely affect our sales, margins and profitability.

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If the rate of steel consumption in China slows, the demand for iron ore could decrease.

Although we do not have significant international sales, the price of iron ore is strongly influenced by international demand. The current growing level of international demand for iron ore and steel is largely due to the rapid industrial growth in China. A large quantity of steel is currently being used in China to build roads, bridges, railroads and factories. If the economic growth rate in China slows, which may be difficult to forecast, less steel will be used in construction and manufacturing, which would decrease demand for iron ore. Additionally, according to the Wall Street Journal, China has begun to tighten its monetary policies in an attempt to curb an excessive credit expansion that has helped to finance high levels of investment. Several economists have opined that China's central bank eventually will be forced to raise interest rates in a bid to slow China's economic expansion. This could adversely impact the world iron ore market, which would impact the North American iron ore market, and could also adversely impact our United Taconite LLC, or United Taconite, joint venture with Laiwu Steel Group Ltd., or Laiwu, of China.

Our sales, margins and profitability may be significantly affected by the bankruptcy or reorganization of our customers.

The volatility, fluctuating prices, level of imports and low demand affecting the North American steel industry have severely impacted the ability of many North American steelmakers to generate profits. Many North American steelmakers, particularly large integrated steel producers, have been hampered with significant legacy costs, particularly underfunded pension obligations and significant retiree health obligations. Since 1997, approximately 49 North American steelmakers have filed for bankruptcy, reorganization, restructuring or similar protection including Acme Steel Corporation, Algoma Steel Inc., Bethlehem Steel Corporation, Geneva Steel Holdings Corp., Gulf States Steel, LTV Steel Company, National Steel Corporation, Slater Steel Inc. and Wheeling-Pittsburgh Steel Corporation. Since May 2003, four of our North American steel industry customers, WCI Steel Inc., or WCI, Weirton, Rouge Industries, Inc., and Stelco Inc. have petitioned for protection under bankruptcy or other similar laws.

Financially distressed customers may be unable to perform under their agreements with us and, if they file for protection under bankruptcy or other similar laws, they may be able to reject their agreements with us pursuant to the operation of those laws. Such laws may enable a customer under bankruptcy protection to reject its existing term supply agreement with us, which may adversely affect our sales and profitability. In effect, such laws may allow the customer (or a party that might acquire the customer's business through the bankruptcy process) to renegotiate the customer's existing term supply agreement with us or to pursue arrangements with another pellet supplier without penalty.

In June 2004, WCI proposed a chapter 11 plan of reorganization. Also during June 2004, Wilmington Trust Company, as successor indenture trustee for \$300 million principal amount of senior notes of WCI secured by substantially all real property, plant and equipment owned by WCI, together with certain holders of the senior notes, proposed a chapter 11 plan of reorganization, which is a competing plan to the plan proposed by WCI. A hearing before the bankruptcy court on the confirmation of the competing plans is scheduled to commence on July 21, 2004. Accordingly, we cannot determine at this time whether or not one of the competing plans will be confirmed. Moreover, the specific treatment of our claim against WCI and the ongoing supplier relationship between us and WCI has not been resolved at this time. Additionally, we cannot assure that WCI and Stelco will successfully emerge from bankruptcy or restructuring or that they will continue to meet their obligations under their agreements with us. We currently have trade receivable exposure of \$4.9 million to WCI (which was reserved against in the third quarter of 2003). The bankruptcy or reorganization of our largest customers could have a significant impact on our sales, margins and profitability.

Our ISG shares are subject to lock-up provisions, and we cannot predict the value of those shares if we sell them after those provisions lapse.

As of July 20, 2004, we owned approximately 5.4 million shares of ISG's common stock (4.6 million owned directly and .8 million through pension fund investments), which represented approximately 5.5 per-

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cent of the outstanding ISG shares as of March 31, 2004. As of July 20, 2004, the closing trading price for the ISG common stock was \$31.44 per share.

Our ability to sell our ISG shares may be restricted by applicable federal securities laws and the terms of the ISG registration rights agreement, which impose 180-day lock-up periods under some circumstances in the event ISG conducts additional primary or secondary offerings. We cannot assure you that we will sell all our ISG shares or that any sale of our ISG shares will result in a gain to us. If we do sell our ISG shares, we may sell only limited quantities of the shares at any one time.

Our profitability could be negatively affected if we fail to maintain satisfactory labor relations.

The USWA represents all hourly employees at our Empire, Hibbing, Tilden and United Taconite mines, as well as the Wabush mine in Canada. The collective bargaining agreements for the employees at the Empire, Hibbing, Tilden and United Taconite mines will expire on August 1, 2004, and the collective bargaining agreements for the employees at the Wabush mine expired on March 1, 2004. As noted in Summary Recent Developments USWA Negotiations, while we and the USWA have reached tentative agreement on a number of issues, additional bargaining will be required to resolve the challenging issues which remain, and we may not be able to reach a new agreement before August 1, 2004. If we are unsuccessful in our efforts to negotiate a new agreement, we may be required to bring in replacement workers to satisfy the requirements of our term supply agreements. If we are unable to sustain our operations with replacement workers during work stoppages or labor strikes, our sales, margins and profitability may be adversely affected. Even if we are successful in negotiating a new agreement, the new agreement could call for higher wages or benefits paid to the employees, which would increase our operating costs and could adversely affect our profitability.

As noted in Summary Recent Developments Wabush Mine Strike, the USWA initiated a strike on July 5, 2004 that idled the Wabush mine's mining and concentrating facilities in Labrador, Newfoundland. This action was followed by a strike that idled the Wabush pelletizing and shipping facilities in Point Noire, Quebec. As of July 21, 2004, discussions with the USWA are ongoing; however, we cannot assure that we will succeed in reaching collective bargaining agreements with the USWA to replace the expired Wabush agreement.

Hourly employees at the railroads we own that transport products among our facilities are represented by multiple unions with labor agreements that expire at various dates. If the collective bargaining agreements relating to the employees at our mines are not successfully renegotiated in a timely manner, we could face work stoppages or labor strikes.

The workforce at our Northshore mine is currently not represented by a union. If our Northshore operations were to become unionized, we would incur an increased risk of work stoppages, reduced productivity and higher labor costs.

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FORWARD-LOOKING STATEMENTS

This prospectus contains statements that constitute forward-looking statements. These forward-looking statements may be identified by the use of predictive, future-tense or forward-looking terminology, such as believes, anticipates, expects, estimates, intends, may, will or similar terms. These statements speak only as of the date of this prospectus and we undertake no ongoing obligation, other than that imposed by law, to update these statements. These statements appear in a number of places in this prospectus and include statements regarding our intent, belief or current expectations of our directors or our officers with respect to, among other things:

trends affecting our financial condition, results of operations or future prospects;

estimates of our economic iron ore reserves;

our business and growth strategies; and

our financing plans and forecasts.

You are cautioned that any such forward-looking statements are not guarantees of future performance and involve significant risks and uncertainties, and that actual results may differ materially from those contained in the forward-looking statements as a result of various factors, some of which are unknown. The factors that could adversely affect our actual results and performance include those described under Risk Factors beginning on page 9 of this prospectus and in Management's Discussion and Analysis of Financial Conditions and Results of Operations Risks Relating to the Company in our Annual Report on Form 10-K for the fiscal year ended December 31, 2003. You are urged to carefully consider these factors. All forward-looking statements attributable to us are expressly qualified in their entirety by the foregoing cautionary statements.

Table of Contents**USE OF PROCEEDS**

All sales of the preferred stock, the convertible subordinated debentures and common shares will be by or for the account of the selling securityholders named in this prospectus or in any amendment or supplement to this prospectus. We will not receive any proceeds from the sale by any selling securityholder of the preferred stock, the issue of or subsequent sale by any selling securityholder of the convertible subordinated debentures that may be issued in exchange for the preferred stock or the issue of or subsequent sale by any selling securityholder of the common shares issuable upon exercise of the conversion privilege attached to the preferred stock or convertible subordinated debentures.

We used approximately \$25.0 million of the net proceeds from the private placement of the preferred stock to repay all our outstanding senior notes due December 15, 2004, which as of January 1, 2004 had an interest rate of 9.5% per year. We have used approximately \$25.4 million of the remaining net proceeds to fund our underfunded salaried pension plans and intend to use at least an additional \$19.6 million for pension funding in 2004. We expect to use any remaining proceeds from that private placement for working capital and general corporate purposes, including capital expenditures, increased investments in our existing mines and additional contributions to our pension plans.

RATIO OF EARNINGS TO COMBINED FIXED CHARGES**AND PREFERRED STOCK DIVIDEND REQUIREMENTS**

The following table sets forth our consolidated ratios of earnings to combined fixed charges and preferred stock dividend requirements for the periods shown.

	Three Months	Year Ended December 31,				
	Ended March 31, 2004	2003	2002	2001	2000	1999
Ratio of earnings to combined fixed charges and preferred stock dividend requirements	(1)	(2)	(3)	(4)	3.5x	2.1x

- (1) For the three months ended March 31, 2004, earnings were inadequate to cover fixed charges and preferred stock dividend requirements. We would need an additional \$1.6 million of earnings in order to cover our fixed charges and preferred stock dividend requirements.
- (2) For the year ended December 31, 2003, earnings were inadequate to cover fixed charges. We would need an additional \$35.1 million of earnings in order to cover our fixed charges.
- (3) For the year ended December 31, 2002, earnings were inadequate to cover fixed charges. We would need an additional \$58.6 million of earnings in order to cover our fixed charges.
- (4) For the year ended December 31, 2001, earnings were inadequate to cover fixed charges. We would need an additional \$28.7 million of earnings in order to cover our fixed charges.

For purposes of determining the ratios of earnings to combined fixed charges and preferred stock dividend requirements and the insufficiency of earnings to cover combined fixed charges and preferred stock dividend requirements, earnings are defined as income (loss) from continuing operations before income taxes, less interest capitalized, less undistributed earnings of non-consolidated affiliates plus fixed charges and preferred stock dividends. Fixed charges consist of interest expenses on all indebtedness and that portion of operating lease rental expense that is representative of the interest factor. Preferred stock dividend requirements consist of the amount of pre-tax earnings that is required to pay the dividends on the outstanding preferred stock.

RATIO OF EARNINGS TO FIXED CHARGES

Because we had no preferred stock dividend requirements prior to the issuance of our preferred stock, our consolidated ratios of earnings to fixed charges for the years ended December 31, 2000 and 1999 and the deficiency of our earnings to cover our fixed charges for the years ended

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December 31, 2003, 2002 and 2001 are the same as our consolidated ratios of earnings to combined fixed charges and preferred stock dividend requirements for the years ended December 31, 2000 and 1999 and the deficiency of our earnings to cover combined fixed charges and preferred stock dividend requirements for the years ended December 31, 2003, 2002 and 2001. See Ratio of Earnings to Combined Fixed Charges and Preferred Stock Dividend Requirements. For the three months ended March 31, 2004, our earnings were inadequate to cover fixed charges. We would need an additional \$.5 million of earning in order to cover our fixed charges.

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DESCRIPTION OF PREFERRED STOCK

The shares of preferred stock are to be issued pursuant to the terms of our amended articles of incorporation. The preferred stock, and the common shares issuable upon conversion of the preferred stock, will be covered by a registration rights agreement. You may request a copy of our amended articles of incorporation and the registration rights agreement from us in the manner described above under [Where You Can Find More Information](#).

The following description is a summary of the material provisions of the preferred stock, our amended articles of incorporation related to the preferred stock and the registration rights agreement. It does not purport to be complete. This summary is subject to and is qualified by reference to all the provisions of our amended articles of incorporation, including the definitions of terms used in our amended articles of incorporation and the registration rights agreement. Wherever particular provisions or defined terms of our amended articles of incorporation or the registration rights agreement are referred to, these provisions or defined terms are incorporated in this prospectus by reference. We urge you to read our amended articles of incorporation because it, and not this description, defines your rights as a holder of shares of preferred stock.

General

Under our amended articles of incorporation, our board of directors is authorized to issue up to 3,000,000 shares of Serial Preferred Stock, Class A, without par value (the [Class A Preferred Stock](#)), of which 2,975,226 shares may be issued as convertible shares, in one or more series, with such rights and restrictions as set forth as the express terms of the [Class A Preferred Stock](#) in our amended articles of incorporation and with such additional provisions as our board of directors may determine, including dividend, redemption, sinking fund, liquidation and conversion rights, and additional restrictions. The preferred stock constitutes a separate series of the [Class A Preferred Stock](#). We also have authorized 4,000,000 shares of Serial Preferred Stock, Class B, without par value (the [Class B Preferred Stock](#)). Immediately prior to the offering, no shares of [Class A Preferred Stock](#) or [Class B Preferred Stock](#) were outstanding.

On January 21, 2004, we issued 172,500 shares of our 3.25% Redeemable Cumulative Convertible Perpetual Preferred Stock without par value and with a liquidation preference of \$1,000 per share. The shares of preferred stock were validly issued, fully paid and nonassessable.

The holders of the shares of preferred stock have no preemptive rights. Under Ohio law, we may not:

pay dividends (a) if the dividends exceed the sum of (1) our surplus (as defined and calculated under Ohio law) and (2) the difference between (A) the reduction in surplus that would result from the immediate recognition of the transition obligation under Statement of Financial Accounting Standards No. 106 and (B) the aggregate amount of the transition obligation that would have been recognized as of the date of declaration had we elected to amortize our recognition of such obligation, (b) to the holders of shares of any class in violation of the rights of the holders of any other class and (c) when we are insolvent or there is a reasonable ground to believe that by such payment we would be rendered insolvent, and

redeem the preferred stock, whether we pay the redemption price in cash or our common shares, or exchange the preferred stock for convertible subordinated debentures if (a) immediately thereafter our assets would be less than our liabilities plus our stated capital, if any, (b) we would be insolvent or (c) there is a reasonable ground to believe that by such redemption or exchange we would be rendered insolvent.

When any portion of a dividend or distribution is paid out of capital surplus, we must notify the shareholders receiving the dividend or distribution as to the kind of surplus out of which the dividend or distribution is paid.

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Ranking

The preferred stock, with respect to rights to dividends and distributions in the event of a voluntary or involuntary liquidation, dissolution or winding up of our company, ranks:

junior to all our existing and future debt obligations;

junior to senior stock, which is all of our shares in respect of which the rights of the holders thereof either as to the payment of dividends or as to distributions in the event of our voluntary or involuntary liquidation, dissolution or winding up are given preference over the rights of the holders of Class A Preferred Stock;

on a parity with parity stock, which is all shares of Class B Preferred Stock and all of our other shares in respect of which the rights of the holders thereof (i) are not given preference over the rights of the holders of Class A Preferred Stock either as to the payment of dividends or as to distributions in the event of our voluntary or involuntary liquidation, dissolution or winding up and (ii) either as to the payment of dividends or as to distribution in the event of our voluntary or involuntary liquidation, dissolution or winding up, or as to both, rank on an equality (except as to the amounts fixed therefor) with the rights of the holders of Class A Preferred Stock;

senior to junior stock, which is all of our shares in respect of which the rights of the holders thereof both as to the payment of dividends and as to distributions in the event of our voluntary or involuntary liquidation, dissolution or winding up are junior and subordinate to the rights of the holders of the Class A Preferred Stock, including our common shares; and

effectively junior to all of our subsidiaries (i) existing and future liabilities and (ii) capital stock held by others.

The term senior stock includes warrants, rights, calls or options exercisable for or convertible into that type of stock. We currently have no authorized or outstanding senior stock.

Dividends

Holders of the shares of preferred stock, in preference to the holders of common shares and of any other class of shares ranking junior to the preferred stock, are entitled to receive, when and as declared by our board of directors, out of funds legally available therefor, cumulative cash dividends on each outstanding share of preferred stock at the annual rate of 3.25% of the liquidation preference per share. The dividend rate is initially equivalent to \$32.50 per share annually. If we fail to pay or to set apart funds to pay, dividends on the preferred stock for any quarterly dividend period, then holders of preferred stock will be entitled to receive, when and as declared by our board of directors, out of funds legally available therefor, cash dividends at the rate per annum equal to:

$$3.25\% + [N * (3.25\%²) * 0.25]$$

where:

N = the number of quarterly dividend periods for which we have failed to pay or to set apart funds to pay dividends on the preferred stock, for each subsequent quarterly dividend period until we have paid or provided for the payment of all dividends on the preferred stock for all dividend periods up to and including the dividend payment date on which the accumulated and unpaid dividends are paid in full. The right of holders of the shares of preferred stock to receive dividend payments is subject to the rights of any holders of shares of senior stock and parity stock.

Dividends are payable quarterly in arrears on January 15, April 15, July 15 and October 15 of each year, beginning on April 15, 2004. If any of those dates is not a business day, then dividends will be payable on the next succeeding business day. Dividends will accumulate from the most recent date as to which dividends will have been paid or, if no dividends have been paid, from the date of original issuance of the preferred stock. Dividends are payable to holders of record as they appear in our stock records at the close of business on

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January 1, April 1, July 1 and October 1 of each year or on a record date that may be fixed by our board of directors and that will be not more than 60 days nor fewer than ten days before the applicable quarterly dividend payment date. Dividends will be cumulative from each quarterly dividend payment date, whether or not we have funds legally available for the payment of those dividends.

Dividends payable on the shares of preferred stock for any period shorter than a full quarterly period will be computed on the basis of a 360-day year consisting of twelve 30-day months. Dividends on the shares of preferred stock will be payable in cash. Accumulated unpaid dividends will not bear interest.

No dividend may be paid upon or set apart for any shares of preferred stock on any dividend payment date unless (i) all dividends upon all Class A Preferred Stock then outstanding and all classes of senior stock and parity stock then outstanding for all dividend payment dates prior to such date have been paid or funds therefor set apart and (ii) at the same time a like dividend upon all series of Class A Preferred Stock then outstanding and all classes of senior stock and parity stock then outstanding and having a dividend payment date on such date, ratably in proportion to the respective dividend rates of such series or class, is paid or funds therefor set apart.

In no event so long as any preferred stock is outstanding will any dividends, except a dividend payable in common shares or other junior stock, be paid or declared or any distribution be made except as aforesaid on the common shares or other junior stock, nor may any common shares or other junior stock be purchased, retired or otherwise acquired by us (except out of the proceeds of the sale of common shares or other junior stock received by us on or subsequent to the date on which shares of any series of preferred stock are first issued), unless (i) all accrued and unpaid dividends upon all Class A Preferred Stock then outstanding for all dividend payment dates on or prior to the date of such action have been paid or funds therefor set apart and (ii) as of the date of such action there are no arrearages with respect to the redemption of Class A Preferred Stock of any series from any sinking fund provided for shares of such series.

Holders of the preferred stock will not have any right to receive dividends that we may declare on our common shares, unless the record date for the payment of such dividends falls on or after the conversion date (as defined below) for such holder's shares of preferred stock.

Conversion Rights

General

Each share of preferred stock will be convertible, only on or after the occurrence of the conversion triggering events described below at the option of the holder, into fully paid and nonassessable common shares at a conversion rate of 16.1290 shares, subject to adjustments as described under Adjustments to the Conversion Rate.

A holder of shares of the preferred stock may convert any or all of those shares by surrendering to us at our principal office or at the office of our transfer agent the certificate or certificates for those shares of the preferred stock accompanied by a written notice stating that the holder elects to convert all or a specified whole number of those shares in accordance with the provisions described in this prospectus and specifying the name or names in which the holder wishes the certificate or certificates for common shares to be issued. As promptly as practicable after the surrender of that certificate or certificates and the receipt of the notice relating to the conversion and payment of all required transfer taxes, if any, we will deliver or cause to be delivered (a) certificates representing the number of validly issued, fully paid and nonassessable full common shares to which the holder, or the holder's transferee, of shares of the preferred stock being converted will be entitled and (b) if less than the full number of shares of preferred stock evidenced by the surrendered certificate or certificates is being converted, a new certificate or certificates, of like tenor, for the number of shares evidenced by the surrendered certificate or certificates less the number of shares being converted. This conversion will be deemed to have been made at the close of business on the date of giving the notice and of surrendering the certificate or certificates representing the shares of preferred stock to be converted (the conversion date) so that the rights of the holder thereof as to the shares being converted will cease except

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for the right to receive common shares, and the person entitled to receive the common shares will be treated for all purposes as having become the record holder of those common shares at that time.

In lieu of the foregoing procedures, if the preferred stock is held in global form, you must comply with the procedures of The Depository Trust Company (DTC) to convert your beneficial interest in respect of preferred stock evidenced by a global share of preferred stock.

In case any shares of preferred stock are to be redeemed, the right to convert those shares of the preferred stock will terminate at 5:00 p.m., New York City time, on the business day immediately preceding the date fixed for redemption unless we default in the payment of the redemption price of those shares.

We will at all times reserve and keep available, free from preemptive rights out of our authorized but unissued shares or treasury shares, for issuance upon the conversion of shares of preferred stock, a number of our authorized but unissued common shares that will from time to time be sufficient to permit the conversion of all outstanding shares of preferred stock.

Before the delivery of any securities that we will be obligated to deliver upon conversion of the preferred stock, we will comply with all applicable federal and state laws and regulations that require action to be taken by us. All common shares delivered upon conversion of the preferred stock will upon delivery be duly and validly issued, fully paid and nonassessable, free of all liens and charges and not subject to any preemptive rights.

Effect of Conversion on Dividends. If a holder of shares of preferred stock exercises conversion rights, upon delivery of the shares for conversion, those shares will cease to cumulate dividends as of the end of the day immediately preceding the date of conversion. Holders of shares of preferred stock who convert their shares into our common shares will not be entitled to, nor will the conversion rate be adjusted for, any accumulated and unpaid dividends, which will instead be cancelled. Accordingly, shares of preferred stock surrendered for conversion after the close of business on any record date for the payment of dividends declared and before the opening of business on the dividend payment date relating to that record date must be accompanied by a payment in cash of an amount equal to the dividend payable in respect of those shares for the dividend period in which the shares are converted. A holder of shares of preferred stock on a dividend payment record date who converts such shares into common shares on the corresponding dividend payment date will be entitled to receive the dividend payable on such shares of preferred stock on such dividend payment date.

	8,348,494
Prepaid expenses and other current assets	509,572
	646,805
Total current assets	11,745,045
	15,644,906
Property, plant and equipment:	
Machinery and equipment	18,668,917
	18,451,428

Building	2,602,922
	2,614,271
Office furniture and equipment	1,975,948
	1,926,371
Land	250,000
	250,000
Leasehold improvements	657,760
	640,428
Fixtures and equipment at customer locations	2,330,483
	2,286,814
Projects under construction	97,848
	55,650
	26,583,878
	26,224,962
Less : accumulated depreciation and amortization	
)	(16,726,770)
)	(15,636,451)
Total property, plant and equipment, net	

	9,857,108
	10,588,511
Other assets:	
Deferred financing costs, net	53,878
	120,375
Goodwill	1,113,108
	1,113,108
Net deferred income tax asset	144,130
	175,288
Other assets	59,379
	245,376
Total other assets	1,370,495
	1,654,147
TOTAL ASSETS	
\$	22,972,648
\$	27,887,564

LIABILITIES AND STOCKHOLDERS' EQUITY

Checks written in excess of bank balance	
\$	329,310

\$	513,417
Trade payables	5,489,177
	6,147,969
Line of credit	3,915,663
	6,401,225
Notes payable - current portion (related party \$45,000 and \$60,000)	2,735,411
	3,560,669
Accrued liabilities	1,145,507
	1,811,775
Total current liabilities	13,615,068
	18,435,055
Long-term liabilities:	
Other liabilities (related parties \$667,000 and \$517,000)	1,608,898
	1,371,364
Notes payable	2,823,181
	2,864,129
Notes payable - officers	2,196,174

	2,255,616
Total long-term liabilities	
	6,628,253
	6,491,109
Minority interest	
	11,368
	10,230
Commitments and contingency	
	—
	—
Stockholders' equity:	
Preferred Stock - no par value, 2,000,000 shares authorized, 0 shares issued and outstanding	
	—
	—
Common stock - no par value, 5,000,000 shares authorized, 2,268,216 and 2,185,896 shares issued, 2,036,474 and 1,954,100 shares outstanding, respectively	
	3,764,020
	3,764,020
Class B Common stock - no par value, 500,000 shares authorized, 0 shares issued and outstanding	
	—
	—
Paid-in-capital	
	5,869,828

	5,615,411
Warrants issued in connection with subordinated debt and bank debt	
	595,174
	595,174
Accumulated deficit	
)	(6,392,832)
)	(6,007,437)
Accumulated other comprehensive earnings	
)	(179,117)
)	(76,884)
Less:	
Treasury stock - 231,796 shares	
)	(939,114)
)	(939,114)
Total stockholders' equity	
	2,717,959
	2,951,170
TOTAL LIABILITIES & STOCKHOLDERS' EQUITY	
\$	22,972,648
\$	27,887,564

See accompanying notes to condensed consolidated unaudited statements

CTI Industries Corporation and Subsidiaries
Consolidated Statements of Operations

	Three Months Ended September 30,		Nine Months Ending September 30,	
	2005	2004	2005	2004
Net Sales	\$ 6,033,831	\$ 8,125,521	\$ 22,709,784	\$ 28,611,290
Cost of Sales	4,791,645	6,455,743	18,010,651	22,762,114
Gross profit	1,242,186	1,669,778	4,699,133	5,849,176
Operating expenses:				
General and administrative	987,069	1,077,502	3,027,127	3,241,292
Selling	246,623	380,300	795,789	1,127,586
Advertising and marketing	165,738	242,490	602,346	917,980
Total operating expenses	1,399,430	1,700,292	4,425,262	5,286,858
(Loss) income from operations	(157,244)	(30,514)	273,871	562,318
Other (expense) income :				
Interest expense	(281,047)	(339,953)	(868,154)	(1,009,917)
Gain on sale of assets	—	107,475	—	122,499
Foreign currency (loss) gain	(3,798)	62,202	216,853	126,044
Other (loss) gain		(40,553)		370,249
Total other expense	(284,845)	(210,829)	(651,301)	(391,125)
(Loss) income before income taxes and minority interest	(442,089)	(241,343)	(377,430)	171,193
Income tax (benefit) expense	(25,544)	(90,850)	8,168	84,279
(Loss) income before minority interest	(416,545)	(150,493)	(385,598)	86,914
Minority interest in (income) loss of subsidiary	(278)	(123)	(203)	1,064
Net (loss) income	\$ (416,267)	\$ (150,370)	\$ (385,395)	\$ 85,850
(Loss) income applicable to common shares	\$ (416,267)	\$ (150,370)	\$ (385,395)	\$ 85,850
Basic (loss) income per common share	\$ (0.21)	\$ (0.08)	(0.20)	\$ 0.04
Diluted (loss) income per common share	\$ (0.21)	\$ (0.08)	(0.20)	\$ 0.04
Weighted average number of shares and equivalent shares of common stock outstanding:				

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Basic	1,963,615	1,932,692	1,957,283	1,923,212
Diluted	1,963,615	1,932,692	1,957,283	1,991,766

See accompanying notes to condensed consolidated unaudited statements

CTI Industries Corporation and Subsidiaries
Consolidated Statements of Cash Flows

	For the 9 Months Ended September 30,	
	2005	2004
Cash flows from operating activities:		
Net (loss) income	\$(385,395)	\$85,850
Adjustment to reconcile net (loss) income to cash (used in) provided by operating activities:		
Depreciation and amortization	1,105,608	1,288,416
Deferred gain on sale/leaseback	—	(175,273)
Amortization of debt discount	30,558	188,619
Minority interest in (loss) income of subsidiary	(278)	967
Provision for losses on accounts receivable, net	8,000	150,000
Provision for losses on inventories, net	48,000	160,000
Shares issued for services	200,916	—
Deferred income taxes	31,158	84,298
Change in operating assets and liabilities:		
Accounts receivable	2,099,025	(760,830)
Inventories	1,287,736	(720,482)
Current and other assets	389,723	(241,391)
Trade payables, accrued and other liabilities	(1,323,641)	(393,130)
Net cash provided by (used in) operating activities	3,487,410	(332,956)
Cash flows from investing activities:		
Purchases of property, plant and equipment	(289,000)	(160,614)
Proceeds from sale of property and equipment	—	2,185
Net cash used in investing activities	(289,000)	(158,429)
Cash flows from financing activities:		
Checks written in excess of bank balance	(184,107)	366,185
Net change in revolving line of credit	(2,485,562)	2,213,039
Proceeds from issuance of long-term debt (received from related parties \$150,000 and \$130,000)	267,040	74,224
Repayment of long-term debt (related parties \$45,000 and \$45,000)	985,711	(2,188,062)
Proceeds from exercise of stock options	53,501	—
Cash paid for deferred financing fees	—	(12,880)
Net cash (used in) provided by financing activities	(3,334,839)	452,506
Effect of exchange rate changes on cash	(187,439)	116,616
Net (decrease) increase in cash	(323,867)	77,737
Cash at beginning of period	526,470	329,742
Cash at end of period	\$202,603	\$407,479

See accompanying notes to condensed consolidated unaudited statements

Supplemental disclosure of cash flow information:

Cash payments for interest	896,945	868,764
Cash payments for taxes	86,120	—

Supplemental disclosure of non-cash activity:

Settlement of liability with third party via ownership transfer of long-term asset	—	\$ 241,268
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Stock issued for investment banking services at fair value	—	\$ 61,079
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Stock issued to select consultants in lieu of cash	200,916	—
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See accompanying notes to condensed consolidated Unaudited
statements

CTI Industries Corporation and Subsidiaries
Consolidated Earnings per Share

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2005	2004	2005	2004
Basic				
Weighted average number of shares of common stock outstanding during the period	1,963,615	1,932,692	1,957,283	1,923,212
Net (loss) income	\$ (416,267)	\$ (150,370)	\$ (385,395)	\$ 85,850
Amount for per share computation	\$ (416,267)	\$ (150,370)	\$ (385,395)	\$ 85,850
Per share amount	\$ (0.21)	\$ (0.08)	\$ (0.20)	\$ 0.04
Diluted				
Weighted average number of shares of common stock outstanding during the period	1,963,615	1,932,692	1,957,283	1,923,212
Net additional shares assuming stock options and warrants exercised and proceeds used to purchase treasury stock	—	—	—	68,554
Weighted average number of shares and equivalent shares of common stock outstanding during the period	1,963,615	1,932,692	1,957,283	1,991,766
Net (loss) income	\$ (416,267)	\$ (150,370)	\$ (385,395)	\$ 85,850
Amount for per share computation	\$ (416,267)	\$ (150,370)	\$ (385,395)	\$ 85,850
Per share amount	\$ (0.21)	\$ (0.08)	\$ (0.20)	\$ 0.04

See accompanying notes to consolidated unaudited statements

CTI Industries Corporation and Subsidiaries Notes to
Unaudited Condensed Consolidated Financial Statements

Note 1 - Basis of Presentation

The accompanying financial statements are unaudited but in the opinion of management contain all the adjustments (consisting of those of a normal recurring nature) considered necessary to present fairly the financial position and the results of operations and cash flows for the periods presented in conformity with generally accepted accounting principles for interim financial information and the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all the information and footnotes required by accounting principles generally accepted in the United States of America for complete financial statements. Operating results for the nine months ended September 30, 2005 are not necessarily indicative of the results that may be expected for the fiscal year ending December 31, 2005. For further information, refer to the consolidated financial statements and footnotes thereto included in the Company's annual report on Form 10-K for the fiscal year ended December 31, 2004.

Principles of consolidation and nature of operations:

The consolidated financial statements include the accounts of ("CTI-US") and its wholly-owned subsidiaries, CTI Balloons Limited and CTF International S.A. de C.V., as well as its majority-owned subsidiaries CTI Mexico S.A. de C.V., and Flexo Universal, S.A. de C.V. (The "Company"). All significant intercompany transactions and accounts have been eliminated in consolidation. The Company (i) designs, manufactures and distributes balloon products throughout the world and (ii) operates systems for the production, lamination, coating and printing of films used for food packaging and other commercial uses and for conversion of films to flexible packaging containers and other products.

The accompanying financial statements have been prepared assuming that CTI Industries Corporation (the "Company") will continue as a going concern. The Company has incurred significant recurring operating losses and has an accumulated deficit of \$6,393,000 as of September 30, 2005. The Company also has limited ability to borrow additional funds under its line of credit and the Company and its bank have agreed that the loan agreement among them will terminate on December 31, 2005. The Company is dependent on the completion of new senior debt financing in order to continue operations. Management of the Company is engaged in an effort to obtain **replacement** senior debt, or other, financing. The Company has received non-binding proposals from several institutions for senior debt financing and certain shareholders of the Company have communicated a willingness to the Company to provide additional financing. Management believes that it will be able to conclude **replacement** senior debt financing at or about December 31, 2005. Without any **replacement** financing, or an agreement on the part of the existing lender to provide an extension of the existing line of credit after December 31, 2005, the ability of the Company to continue operations will be adversely affected. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

The Company has certain notes outstanding to vendors, payment on some of which are past the due date. The Company continues to make payment on such notes with the informal consent of the note holders.

Use of estimates:

In preparing financial statements in conformity with accounting principles generally accepted in the United States of America, management makes estimates and assumptions that affect the amounts reported of the assets and liabilities, disclosure of contingent assets and liabilities at the date of the financial statements and the reported amount of revenue and expenses during the reporting period in the financial statements and accompanying notes. Actual results may differ from those estimates. The company's significant estimates include reserves for doubtful accounts, reserves for the lower of cost or market of inventory and recovery value of goodwill.

Stock-Based Compensation

As of September 30, 2005, the Company had four stock-based compensation plans. The Company accounts for those plans under the recognition and measurement principles of APB Opinion No. 25, "Accounting for Stock Issued to Employees" and related interpretations. The Company recognizes compensation cost for stock-based compensation awards equal to the difference between the quoted market price of the stock at the date of grant or award and the price to be paid by the employee upon exercise in accordance with the provisions of APB No. 25. Based upon the terms of Company's current stock option plans, the stock price on the date of grant and price paid upon exercise are the same. Accordingly, no stock-based employee compensation cost has been recognized, as all options granted under those plans had an exercise price equal to the market value of the underlying common stock on the date of grant. No stock options were granted during the three or nine months ended September 30, 2005 or 2004. The Company has adopted the disclosure provisions of Statement of Financial Accounting Standards ("SFAS") No 148, "Accounting for Stock-Based Compensation-Transition and Disclosure", an amendment of SFAS Statement no. 123 ("SFAS NO. 148"). The following table illustrates the effect on net income and earnings per share had compensation cost for all of the stock-based compensation plans been determined based on the grant date fair value of awards.

	For the Three Months Ending September 30,		For the Nine Months Ending September 30,	
	2005	2004	2005	2004
Net (Loss) Income:				
Reported	\$ (416,267)	\$ (150,370)	\$ (385,395)	\$ 85,850
Deduct total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	0	0	0	0
Proforma net (loss) income	(416,267)	(150,370)	(385,395)	85,850
Net (loss) income per share:				
Basic - As reported	(0.21)	(0.08)	(0.20)	0.04
Basic - Proforma	(0.21)	(0.08)	(0.20)	0.04
Diluted - As reported	(0.21)	(0.08)	(0.20)	0.04
Diluted - Proforma	(0.21)	(0.08)	(0.20)	0.04

Note 2 - Legal Proceedings

On September 5, 2003, Airgas, Inc., Airgas-Southwest, Inc., Airgas-South, Inc. and Airgas-East, Inc. filed a joint action against CTI Industries Corporation for claimed breach of contract in the Circuit Court of Lake County, Illinois claiming as damages the aggregate amount of \$162,242. The Company filed an answer denying the material claims of the complaint, affirmative defenses and a counterclaim. In the action, the plaintiffs claimed that CTI Industries Corporation owed them certain sums for (i) helium sold and delivered, (ii) rental charges with respect to helium tanks and (iii) replacement charges for tanks claimed to have been lost. On November 2, 2004, this matter was settled. The amount agreed to be paid by the Company in settlement totaled \$100,000. The first payment of \$50,000 was paid on November 15, 2004. The balance of \$50,000 was paid in five consecutive \$10,000 monthly installments. This amount was fully accrued as of the settlement date. Final payment was made in May 2005.

On June 4, 2004, Spar Group, Inc. initiated an arbitration proceeding in New York City against the Company. In the proceeding, Spar Group claimed that there was due from the Company to Spar Group a sum for services rendered in the amount of \$180,043, plus interest. Spar Group claimed to have rendered services to the Company in various Eckerd stores with respect to the display and ordering of metalized and latex balloons for sale in those stores. The Company filed an answer denying liability with respect to the claim and asserted a counterclaim for damages against Spar Group for breach of its agreement to provide such services. On January 13, 2005, this matter was settled. The amount agreed to be paid by the Company in settlement totaled \$100,000. The first payment of \$30,000 was paid on February 1, 2005. The balance of \$70,000 was payable in seven consecutive \$10,000 monthly installments, which commenced on March 1, 2005. The settlement amount was fully accrued as of December 31, 2004. Final payment was made in September 2005.

In addition, the Company is party to certain lawsuits arising in the normal course of business. The ultimate outcome of these matters is unknown but, in the opinion of management, the settlement of these matters is not expected to have a significant effect on the future financial position or results of operations of the Company.

Note 3 - Comprehensive (Loss) Income

Other comprehensive loss comprised of loss from foreign currency translation amounted to (\$14,866) and (\$11,982) for the three months ending September 30, 2005 and 2004, respectively. Other comprehensive (loss) income comprised of (loss) income from foreign currency translation amounted to (\$102,233) and \$116,616 for the nine months ending September 30, 2005 and 2004, respectively.

Note 4 - Inventories, net

	September 30, 2005	December 31, 2004
Raw materials	\$ 602,143	\$ 888,644
Work in process	694,468	806,495
Finished goods	5,954,991	6,840,068
Allowance, excess quantities	(234,844)	(186,713)
Inventories, net	\$ 7,016,758	\$ 8,348,494

Note 5 - Geographic Segment Data

The Company has determined that it operates primarily in one business segment which designs, manufactures and distributes film products for use in packaging and novelty balloon products. The Company operates in foreign and domestic regions. Information about the Company's operations by geographic areas is as follows:

	Net Sales For the Three Months Ended September 30,		Net Sales For the Nine Months Ended September 30,	
	2005	2004	2005	2004
United States	\$ 4,507,000	\$ 6,835,000	\$ 17,766,000	\$ 24,508,000
Mexico	932,000	638,000	2,906,000	2,049,000
United Kingdom	595,000	653,000	2,038,000	2,054,000
	\$ 6,034,000	\$ 8,126,000	\$ 22,710,000	\$ 28,611,000

Total Assets at	
September 30, 2005	December 31, 2004

United States	\$	20,065,000	\$	24,072,000
Mexico		5,043,000		5,319,000
United Kingdom		1,695,000		1,989,000
Eliminations		(3,830,000)		(3,492,000)
	\$	22,973,000	\$	27,888,000

Note 6 - Concentration of Credit Risk

Concentration of credit risk with respect to trade accounts receivable is generally limited due to the number of entities comprising the Company's customer base. The Company performs ongoing credit evaluations and provides an allowance for potential credit losses against the portion of accounts receivable which is estimated to be uncollectable. Such losses have historically been within management's expectations. During the three months ending September 30, 2005, there were two customers whose purchases represented more than 10% of the Company's sales. The sales to each of these customers for the three months ended September 30, 2005 were, respectively, \$1,201,000 or 20% of net sales for the quarter and \$1,062,000 or 18% of net sales respectively. Sales to these customers in the same period of 2004 were \$1,532,000 or 19% of net sales and \$1,271,000 or 16% of net sales, respectively. For the quarter ending September 30, 2005, the total amount owed by these customers was \$638,000 and \$234,000, respectively. The balances owed at September 30, 2004 were \$932,000 and \$241,000, respectively. During the first nine months of 2005, there were three customers whose purchases represented more than 10% of the Company's sales. Sales to each of these customers for the nine months ended September 30, 2005 were, respectively: \$5,403,000 or 24% of net sales, \$3,219,000 or 14% of total sales and \$2,454,000 or 11% of net sales. Sales to these customers for the same period in 2004 were \$5,478,000 or 19%, \$3,694,000 or 13% and \$3,060,000 or 11%, respectively.

Note 7 - Bank Loan

The Company is party to a loan agreement with a bank providing for a term loan and revolving loan to the Company. As of September 30, 2005, the aggregate balances outstanding under these loans was \$5,856,000. The Company relies on the availability of advances under this loan agreement for liquidity. The Company and the bank have agreed that the loan agreement will expire on December 31, 2005. The Company is engaged in an effort to obtain **replacement** senior debt financing and has received several non-binding proposals for such financing. In the event that the Company is unable to secure **replacement** senior debt financing by December 31, 2005, or an extension of its current line of credit, the Company's ability to continue operations will be adversely affected. There can be no assurance that the Company will be able to obtain the required **replacement** financing on terms acceptable to the Company, if at all, or to obtain an extension of its current line of credit beyond December 31, 2005. However, the Company has, historically, been able to obtain financing adequate to its needs and management believes that the Company will be able to obtain such **replacement** financing.

Certain terms of the loan agreement among the Company and its bank require the Company to maintain a specified level of tangible net worth and a ratio of EBITDA to fixed charges. The Company was in compliance with the covenant related to tangible net worth as of September 30, 2005 and has received a waiver from the bank regarding the EBITDA to fixed charges covenant.

Note 8 - Related Party Transactions

John H. Schwan, is Chairman of the Company. Mr. Schwan is President of Packaging Systems, L.L.C. and affiliated companies. The Company made purchases of packaging materials from Packaging Systems in the amount of \$108,000 and \$110,000 during the three months ended September 30, 2005 and 2004, respectively. For the nine-month period, the amount purchased was \$219,000 and \$240,000, respectively. Mr. Schwan was paid \$6,000 for services provided to the Company for each of the first three quarters of 2005. John Schwan and Howard W. Schwan are brothers.

Stephen M. Merrick, Executive Vice President and Secretary of the Company, is a principal of the law firm of Merrick & Associates, P.C., which serves as general counsel of the Company. In addition, Mr. Merrick is a principal stockholder of the Company. Legal fees incurred from the firm of Merrick & Associates, P.C. for the quarter ending September 30, 2005 and September 30, 2004 were \$11,000 and \$22,000, respectively. For the nine-month period, the amount paid was \$78,000 and \$113,000. During the quarter, Mr. Merrick was paid \$12,000 for services provided to the company, the same amount as the first two quarters.

Interest payments have been made to John H. Schwan and Stephen M. Merrick for loans made to the Company. These interest payments for the three months ending September 30, 2005 totaled \$37,000 and \$12,000, respectively. In 2004, for the three months ending September 30, 2004, the amounts were \$37,000 and \$14,000, respectively.

The total debt due to Mssrs. Schwan and Merrick classified as long-term debt approximating \$2,225,000 will not be due before October 1, 2006.

In the second quarter Mssrs. Schwan and Merrick secured a short-term note to Cole Taylor Bank in the amount of \$600,000 pledging marketable securities and real estate interests. At the end of the third quarter, the balance on this note was \$195,000. The note will be paid in full during the fourth quarter.

During the third quarter, Mssrs. Schwan and Merrick loaned an aggregate of \$150,000 to Flexo Universal. The loans bear interest at the rate of 7% per annum, **and are not due before October 1, 2006.**

The Company entered into a 10-year lease agreement for office and warehouse facilities in November 1999, requiring monthly payments of \$17,404, to Pepper Road, Inc., a company related through common ownership. In 2003, the rent was reduced to \$15,500 per month. Approximately 50% of the facility was subleased through March 2002, and after

that, the Company assumed the remaining 50% of the facility. In the three months ended March 31, 2004 the Company paid \$47,000 rent to Pepper Road, Inc. In July of 2004, the Company cancelled its lease with Pepper Road, Inc.

Note 9 - Reclassifications

Reclassifications were made to the year-end 2004 balance sheet to conform to the third quarter 2005 presentation.

Note 10 - New Accounting Pronouncements

In May 2005, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 154, "Accounting Changes and Error Corrections - a replacement of APB No. 20 and FASB Statement No. 3" ("SFAS 154"). SFAS 154 replaces APB No. 20, "Accounting Changes" and FASB Statement No. 3, "Reporting Accounting Changes in Interim Financial Statements" and changes the requirements for the accounting for and reporting of a change in accounting principles. SFAS 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. The Company does not anticipate that adoption of SFAS 154 will have a material impact on its financial position, results of operations or its cash flows.