

COSTAR GROUP INC
Form DEF 14A
April 25, 2012

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

SCHEDULE 14A

PROXY STATEMENT PURSUANT TO SECTION 14(a) OF THE SECURITIES
EXCHANGE ACT OF 1934

Filed by the Registrant x
Filed by a Party other than the Registrant o
Check the appropriate box:

- o Preliminary Proxy Statement
- o Confidential, for Use of the Commission Only (as permitted by Rule 14a-6(e)(2))
- x Definitive Proxy Statement
- o Definitive Additional Materials
- o Soliciting Material Pursuant to §240.14a-12

COSTAR GROUP, INC.

(Name of Registrant as Specified in Its Charter)

(Name of Person(s) Filing Proxy Statement if other than the Registrant)

Payment of Filing Fee (Check the appropriate box):

- x No fee required.
- o Fee computed on table below per Exchange Act Rules 14a-6(i)(1) and 0-11.

(1) Title of each class of securities to which transaction applies:

(2) Aggregate number of securities to which transaction applies:

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Fee paid previously with preliminary materials.

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(1) Amount previously paid:

(2) Form, schedule or registration statement no.:

(3) Filing party:

(4) Date filed:

April 25, 2012

Dear Stockholder:

You are cordially invited to attend the 2012 Annual Meeting of Stockholders of CoStar Group, Inc., to be held at 10:00 a.m., local time, on Tuesday, June 5, 2012 at 1331 L Street N.W., Washington, DC 20005.

At the Annual Meeting, you will be asked (1) to elect the seven directors named in the Proxy Statement, (2) to approve an amendment to the CoStar Group, Inc. Restated Certificate of Incorporation to increase the authorized number of shares of common stock by 30,000,000 shares, (3) to approve the qualifying performance criteria under the CoStar Group, Inc. 2007 Stock Incentive Plan, as amended, (4) to approve an amendment to the CoStar Group, Inc. 2007 Stock Incentive Plan, as amended, to increase the number of authorized shares of common stock issuable under the plan by 900,000 shares, (5) to ratify the appointment of Ernst & Young LLP as our independent registered public accounting firm for 2012, and (6) to approve, on an advisory basis, CoStar Group, Inc.'s executive compensation. The accompanying Notice of 2012 Annual Meeting of Stockholders and Proxy Statement describe these matters.

The Board of Directors recommends that stockholders vote in favor of each of the director nominees and the other proposals.

**Important Notice Regarding the Availability of Proxy Materials
for the 2012 Annual Meeting of Stockholders:**

We are mailing many of our stockholders a Notice of Internet Availability of Proxy Materials rather than a full set of our proxy materials. The Notice contains instructions on how to access our proxy materials on the Internet, as well as instructions on how to obtain a paper copy of the full set of proxy materials if a stockholder so desires. This process is more environmentally friendly and reduces our costs to print and distribute these materials to stockholders. All stockholders who do not receive this Notice of Availability, including stockholders who have previously requested to receive a paper copy of the materials, will receive a full set of our proxy materials by mail.

In order to ensure your representation at the meeting, whether or not you plan to attend the Annual Meeting, please vote your shares as promptly as possible over the Internet by following the instructions on your Notice or, if you receive a complete set of proxy materials by U.S. mail, by following the instructions on your proxy card. Your participation will help to ensure the presence of a quorum at the meeting and save CoStar the extra expense associated with additional solicitation. Voting your shares over the Internet or otherwise will not prevent you from attending the meeting, revoking your proxy, or voting your stock in person.

Sincerely,

Andrew C. Florance
Chief Executive Officer and President

COSTAR GROUP, INC.

April 25, 2012

NOTICE OF 2012 ANNUAL MEETING OF STOCKHOLDERS
TO BE HELD TUESDAY, JUNE 5, 2012

The 2012 Annual Meeting of Stockholders (the "Annual Meeting") of CoStar Group, Inc. ("CoStar", "we" or the "Company") will be held at 1331 L Street, N.W., Washington, DC 20005, at 10:00 a.m., local time, on Tuesday, June 5, 2012, for the following purposes:

1. To elect the seven directors named in the Proxy Statement to hold office until the next Annual Meeting of Stockholders, or until their respective successors are elected and qualified;
2. To approve an amendment to the CoStar Group, Inc. Restated Certificate of Incorporation to increase the authorized number of shares of common stock by 30,000,000 shares;
3. To approve the qualifying performance criteria under the CoStar Group, Inc. 2007 Stock Incentive Plan, as amended;
4. To approve an amendment to the CoStar Group, Inc. 2007 Stock Incentive Plan, as amended, to increase the number of authorized shares of common stock issuable under the plan by 900,000 shares;
5. To ratify the appointment of Ernst & Young LLP as the Company's independent registered public accounting firm for 2012;
6. To approve, on an advisory basis, the Company's executive compensation; and
7. To transact any other business properly presented before the Annual Meeting.

The Board of Directors has fixed Monday, April 9, 2012 as the record date for determining stockholders entitled to receive notice of and to vote at the Annual Meeting (or any adjournment or postponement of it). Only stockholders of record at the close of business on that date are entitled to notice of and to vote at the Annual Meeting. For specific instructions on voting, please refer to the instructions provided in your Notice of Internet Availability of Proxy Materials or, if you receive a complete set of our proxy materials by U.S. mail, on the proxy card.

INTERNET AVAILABILITY

We are taking advantage of the Securities and Exchange Commission rules that allow companies to furnish proxy materials to their stockholders through the Internet. We believe these rules allow us to provide you with the information you need while lowering the costs of delivery and reducing the environmental impact of the Annual Meeting. On or about April 25, 2012, we mailed to stockholders as of the record date a Notice Regarding the Availability of Proxy Materials. If you received a Notice by mail, you will not receive printed copies of the proxy materials, unless you specifically request them. Instead, the Notice instructs you on how to access and review all of the important information contained in this Proxy Statement and in our 2011 Annual Report on Form 10-K (which we posted on the same date), as well as how to submit your proxy over the Internet. If you received the Notice and would still like to receive a printed copy of our proxy materials, you may request a printed copy of the proxy materials by following the instructions in the Notice.

WE INVITE YOU TO ATTEND THE ANNUAL MEETING IN PERSON, BUT WHETHER OR NOT YOU EXPECT TO ATTEND, PLEASE VOTE YOUR SHARES AS SOON AS POSSIBLE.

By Order of the Board of Directors,

Jonathan Coleman

Secretary

NOTICE: Brokers are not permitted to vote on the election of directors, the amendment to the Restated Certificate of Incorporation to increase the authorized number of shares of common stock, the approval of qualifying performance criteria under the stock incentive plan, the amendment to the stock incentive plan, or the advisory resolution on executive compensation without instructions from the beneficial owner, as discussed in more detail in the Proxy Statement. Therefore, if your shares are held through a brokerage firm, bank or other nominee, they will not be voted on these matters unless you affirmatively vote your shares in one of the ways described in the Notice.

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COSTAR GROUP, INC.

PROXY STATEMENT

ANNUAL MEETING OF STOCKHOLDERS
TO BE HELD ON TUESDAY, JUNE 5, 2012

The Board of Directors (the “Board”) of CoStar Group, Inc. (“CoStar”, “we” or the “Company”) solicits your proxy for use at the Annual Meeting of Stockholders (the “Annual Meeting”) to be held at 10:00 a.m., local time, on Tuesday, June 5, 2012, at the Company’s principal executive offices at 1331 L Street N.W., Washington, DC 20005, and at any adjournment or postponement of the Annual Meeting.

We are mailing the Notice Regarding the Availability of Proxy Materials to our stockholders eligible to vote at the Annual Meeting on or about April 25, 2012.

IMPORTANT NOTICE REGARDING THE AVAILABILITY OF PROXY MATERIALS FOR THE
STOCKHOLDER MEETING TO BE HELD ON JUNE 5, 2012

The Notice of Meeting and this Proxy Statement are available on our corporate website at www.CoStar.com/Investors/SECFilings.aspx and our 2011 annual report to stockholders is available on our corporate website at www.CoStar.com/Investors/Reports.aspx.

OUTSTANDING SECURITIES, VOTING RIGHTS AND QUORUM

At the close of business on the record date, Monday, April 9, 2012, there were 25,805,916 shares of common stock outstanding and entitled to vote at the Annual Meeting. Each outstanding share of common stock is entitled to one vote on each of the seven director nominees and on each of the other proposals.

The presence at the Annual Meeting, in person or by proxy, of a majority of the outstanding shares as of the record date constitutes a quorum (the minimum number of shares required to take action) for the Annual Meeting. Both abstentions and broker non-votes will be counted as shares present for purposes of obtaining a quorum.

The required vote and the calculation method for each of the matters scheduled for consideration at the Annual Meeting are as follows:

Election of Directors. Directors are elected by a plurality of votes cast, which means that the seven nominees who receive the most votes will be elected as directors.

Approval of the Charter Amendment to Increase the Authorized Common Stock of the Company. Approval of the charter amendment to increase the authorized common stock of the Company requires a majority of the total number of shares of common stock outstanding and entitled to vote on the proposal.

Each of the Other Proposals. Approval of each of the other proposals to be voted on at the Annual Meeting requires a majority of votes cast, which means that the number of votes cast in favor must exceed the number of votes cast against the proposal.

Treatment of Abstentions

With respect to the election of directors, votes may be cast for or withheld from the nominees. Votes that are withheld from a nominee will not be voted with respect to the election of that nominee. Therefore, they do not affect whether a nominee has received sufficient votes to be elected. With respect to the other proposals, stockholders may vote or abstain from voting. Abstentions will have the same effect as a vote against the charter amendment to increase the authorized common stock of the Company. Abstentions will not affect the outcome of the other proposals because they are disregarded in calculating the total number of votes cast.

Treatment of Broker Non-Votes

If your shares are held in street name through a broker, bank or other nominee, you are considered the beneficial owner of shares held in street name. As the beneficial owner, you have the right to direct your broker, bank or other nominee on how to vote your shares. Your broker, bank or other nominee has the discretion to vote on routine corporate matters (routine matters include ratification of the appointment of the Company's independent registered public accounting firm) presented in the proxy materials without your specific voting instructions. For non-routine matters (non-routine matters include election of directors, approval of the amendment to the Company's Restated Certificate of Incorporation to increase the authorized number of shares of common stock, approval of the qualifying performance criteria under the CoStar Group, Inc. Stock Incentive Plan, approval of the amendment to the CoStar Group, Inc. 2007 Stock Incentive Plan, and approval of the advisory resolution on executive compensation), your shares will not be voted without your specific voting instructions, resulting in a "broker non-vote."

Because CoStar has a plurality voting standard, broker non-votes will not affect the outcome of the vote on director elections. Broker non-votes will have the same effect as a vote against the charter amendment to increase the authorized common stock of the Company because it requires the approval of a majority of all issued and outstanding shares of common stock. Finally, broker non-votes will not affect the outcome of the other proposals because they are disregarded in calculating the total number of votes cast on the proposal.

PROXY VOTING AND REVOCATION

There are four ways you can vote:

1. By Internet (www.proxyvote.com): You may vote over the Internet by following the instructions provided in the Notice or, if you receive a complete set of proxy materials by U.S. mail, by following the instructions on the proxy card.
2. By Telephone: If you receive a complete set of proxy materials by U.S. mail, you may vote by telephone by following the instructions on your proxy card.
3. By Mail: If you receive a complete set of proxy materials by U.S. mail, you may complete, sign and return the accompanying proxy card in the postage-paid envelope provided or return it to Vote Processing, c/o Broadridge, 51 Mercedes Way, Edgewood, NY 11717.
4. In Person: If you are a stockholder as of the Record Date, you may vote in person at the Annual Meeting. Submitting a proxy will not prevent a stockholder from attending the Annual Meeting, revoking their earlier-submitted proxy or voting in person.

If you properly complete and execute your proxy card in one of the ways set forth above:

- Your shares will be voted in accordance with your instructions.

If there are any items for which you do not provide instructions, your shares will be voted in accordance with the Board's recommendations as follows: "FOR" election of each of the director nominees, "FOR" approval of the amendment to the Company's Restated Certificate of Incorporation to increase the authorized number of shares of common stock, "FOR" approval of the qualifying performance criteria under the CoStar Group, Inc. 2007 Stock Incentive Plan, "FOR" approval of the amendment to the CoStar Group, Inc. 2007 Stock Incentive Plan, "FOR" ratification of the independent registered public accounting firm, and "FOR" approval of the advisory resolution on executive compensation.

You may revoke your proxy at any time before it is voted by:

- delivering to the Corporate Secretary written notice that you are revoking your proxy;
- submitting a properly executed proxy bearing a later date; or

attending the Annual Meeting and voting in person. If you are not the owner of record, but rather hold your shares through a broker or bank, you should take appropriate steps to obtain a legal proxy from the owner of record if you wish to attend and vote at the Annual Meeting.

Simply attending the Annual Meeting will not revoke your proxy. If you instructed a broker to vote your shares, you must follow your broker's directions for changing those instructions.

ATTENDING THE ANNUAL MEETING

Only stockholders as of the record date, their proxy holders and our invited guests may attend the Annual Meeting. Beneficial owners whose ownership is registered under another party's name and who plan to attend the Annual Meeting in person should obtain an admission ticket in advance by sending written requests, along with proof of beneficial ownership, such as a bank or brokerage firm account statement, to: Rich Simonelli, Director of Strategic Communications, CoStar Group, Inc., 1331 L Street N.W., Washington, DC 20005. Beneficial owners who do not present valid admission tickets at the registration counter at the Annual Meeting will be admitted at CoStar's sole discretion and may be required to verify share ownership, which may be established by providing a bank or brokerage firm account statement and photo identification, at the registration counter at the Annual Meeting. Stockholders as of the record date or their proxy holders who plan to attend the Annual Meeting may also be asked to present photo identification at the registration counter at the Annual Meeting to gain admittance to the Annual Meeting.

ITEM 1
ELECTION OF DIRECTORS

The Board has currently fixed the number of directors constituting the Board at seven. The Nominating & Corporate Governance Committee has recommended and the Board has nominated the seven current directors for reelection, each of whom was last elected at the 2011 Annual Meeting of Stockholders. The persons named as proxy holders on the proxy card will vote your shares “FOR” each of the seven nominees unless you instruct otherwise on your proxy card.

Each of our directors elected at the Annual Meeting will serve until the next Annual Meeting of Stockholders or until his successor is elected and qualified. We know of no reason why any nominee would be unable to serve. However, if any of the nominees should become unable to serve prior to the Annual Meeting, proxies that do not withhold authority to vote for directors may be voted for any other nominee or nominees selected by the Board unless the Board votes to reduce the size of the Board to match the actual number of nominees. In no event may proxies be voted for a greater number of persons than the number of nominees named. We did not receive any stockholder nominations for director in connection with the 2012 Annual Meeting.

Board Composition

Our Nominating & Corporate Governance Committee is responsible for reviewing and assessing with the Board the Board’s membership criteria. The criteria include independence; judgment; integrity; ability to commit sufficient time and attention to the activities of the Board; an individual's business experience, skills and background, including an understanding of and experience with commercial real estate, information services, and technology industries; finance and marketing expertise; and absence of potential conflicts with the Company’s interests. The Nominating and Corporate Governance Committee seeks a diversity of occupational and personal backgrounds on the Board in order to obtain a range of viewpoints and perspectives. In addition, the Nominating and Corporate Governance Committee evaluates the composition of the Board to assess the skills and experience that are currently represented on the Board, as well as the skills and experience that the Board will find valuable in the future, given the Company’s current situation and strategic plans. This evaluation enables the Nominating and Corporate Governance Committee to assess its effectiveness at achieving these Board membership objectives.

We do not expect or intend that each director will have the same skills, experience and background. We expect that our Board members will have a diverse portfolio of skills, experiences and backgrounds and that each will contribute to the composition of the Board so that collectively the Board will possess the necessary skills, experience and background to oversee the business and affairs of the Company. Below is a list of key skills and experience that our directors bring to our Board that we consider important in light of our current business and structure. The directors’ individual biographies below describe each director’s most relevant experience, qualifications and skills.

- **Industry Expertise.** We seek directors with experience in the commercial real estate, data provider and technology industries. Experience in those areas is valuable in understanding our growth and development efforts, as well as the market segments in which we operate.
- **Financial Expertise.** We believe that an understanding of accounting and financial reporting processes is important because it assists our directors in understanding, advising and overseeing our investing activities, financial reporting and internal controls. We measure our operating performance by reference to financial targets. We expect all of our directors to be financially knowledgeable.
- **Mergers & Acquisitions Experience.** We have grown over the years in part through mergers & acquisitions activity and believe directors who have a background in mergers & acquisitions transactions can provide insight into developing and implementing strategies for growing our operations through business combinations and also provide relevant input regarding our business strategy. Relevant experience in this area includes experience identifying and

valuing proposed transactions, analyzing the 'fit' of a proposed acquisition target with the Company's strategy, and integrating acquired companies with our existing operations.

- **Business Development.** We expect to grow organically by identifying and developing new services and new markets for our services. Directors who have expertise in business development can provide insight into developing and implementing strategies for growing our business organically.
- **Public Company Board and Management Experience.** Directors who have served on other public company boards or as executives of a public company can offer advice and insight with regard to the dynamics and operation of a board of directors, the relationship between a board and the CEO and other management personnel, and an understanding of good corporate governance practices and risk management.
- **Leadership Experience.** Directors who have served in a leadership capacity or as executives at other companies provide valuable operational insight and can help the Board operate efficiently and effectively.

Nominees for the Board of Directors

The following table lists the seven director nominees and their current committee memberships:

Name	Employment	Years as a Director	Committee Membership
Michael R. Klein	Chairman, CoStar Group, Inc.; Chairman, The Sunlight Foundation	25	Compensation; Nominating & Corporate Governance
Andrew C. Florance*	CEO & President, CoStar Group, Inc.	25	None
David Bonderman	Founding Partner, TPG Capital, L.P.	17	Compensation; Nominating & Corporate Governance
Michael J. Glosserman	Managing Member, The JBG Companies	4	Audit; Nominating & Corporate Governance
Warren H. Haber	Chairman of the Board & CEO, Founders Equity Inc.; Managing General Partner of FEF Management Services, LLC	17	Audit
Christopher J. Nassetta	CEO & President, Hilton Worldwide	10	Compensation; Nominating & Corporate Governance
David J. Steinberg	CEO, SnappCloud, Inc.	1	Audit

* Executive Officer

Nominees' Business Experience, Qualifications and Directorships

Michael R. Klein has been the Chairman of our Board of Directors since he and Mr. Florance started the Company in 1987. Mr. Klein also currently serves as Chairman of the board of directors and Chief Executive Officer of The Sunlight Foundation, a non-profit public education organization which he founded in 2005, and as Vice Chairman of the board of directors and Lead Director of Tutor Perini Corporation, a publicly-held construction company. He also serves as Chairman of the board of directors of The Shakespeare Theatre Company, as a director of the American Himalayan Foundation, as a trustee of the NAACP Legal Defense and Education Fund and as a trustee of the Aspen Music Festival and School and the Aspen Institutes. From 1974 through 2005, he was a partner of the law firm now

known as Wilmer Cutler Pickering Hale & Dorr, LLP. Mr. Klein received a B.B.A. and a J.D. from the University of Miami and an L.L.M. from Harvard University. Mr. Klein is 70 years old.

As a result of his service on our Board of Directors since the Company's inception, Mr. Klein has extensive knowledge of the commercial real estate, data provider and technology industries, as well as the Company's products, services and business strategies. In addition to his role and tenure on our Board, Mr. Klein brings to the Board of Directors extensive experience through his service over the past 25 years on the boards of directors of the foregoing and other publicly-held companies, as well as several privately held businesses and non-profit organizations, including in the role of Chairman and Lead Director. Mr. Klein's experience gained as a result of his involvement as a founder, director and/or investor in those entities over the past 25 years, including active participation in their business development and management, enables him to contribute significantly to the oversight and governance of the Company. Mr. Klein also has three decades of service as a corporate and securities lawyer with significant participation in corporate financings and mergers & acquisitions allowing him to provide valuable insight when evaluating or overseeing the Company's business and growth strategies.

Andrew C. Florance founded the Company in 1987. As President and CEO of CoStar, Mr. Florance has directed CoStar's successful expansion from start-up, to its IPO in July 1998, to its market-leading position today with approximately 1,500 employees worldwide, a client base that includes the commercial real estate industry's leading brokerage firms and property owners and an international service platform that includes the entire United States, London, England, other parts of the United Kingdom and Paris, France. Mr. Florance is a recognized authority for analysis of commercial real estate markets. He is a frequent speaker on commercial real estate at industry events. He conceived and co-authored the study resulting in the 2010 launch of the CoStar Commercial Repeat-Sale Indices (CCRSI), which is believed to be the most comprehensive and thorough commercial real estate repeat-sale price index available in the market today. The study was recognized as "Best Manuscript" by the James R. Webb American Real Estate Society (ARES) Foundation. He also co-authored the first comprehensive analysis of leasing and sales activity in energy-efficient office buildings in the United States. The study, which was published in *The Journal of Real Estate Portfolio Management*, was selected by the ARES as the "Best Paper" published in this prestigious academic real estate journal in 2008. The groundbreaking study was also cited as a critical factor in the Company's selection as the only commercial real estate-related company to win an ENERGY STAR award for excellence from the U.S. Environmental Protection Agency in 2009. In addition, Mr. Florance is the recipient of numerous other awards recognizing his accomplishments as an entrepreneur and corporate leader, including: Cornell Real Estate Review's Real Estate Industry Executive of the Year for 2009; Transwestern's 2007 Public Company Trendsetter of the Year for revolutionizing the way the commercial real estate industry gathers, analyzes and uses information on commercial property and markets; and Ernst & Young's Entrepreneur of the Year award in 2000 for his pioneering work in real estate information services. He serves on the Board of Directors of ARES, an association of real estate thought leaders, and as a Trustee of the National Building Museum and the Shakespeare Theatre Company in Washington, D.C. He also serves on the Governing Board for Beauvoir, the National Cathedral Elementary School. Mr. Florance received a B.A. in economics from Princeton University. He is 48 years old.

As the founder of the Company and the only member of the Company's senior management team who serves on our Board, Mr. Florance brings to the Board significant knowledge and understanding of the commercial real estate and information services industries, unique expertise on the Company's products and services, and extensive leadership experience. Over his 25-year tenure with the Company, Mr. Florance has served as the Chief Executive Officer and has been actively involved in all facets of the Company's business, including developing the Company's products and services, identifying and developing markets for the Company's products and services and identifying and integrating acquisition targets. This experience enables Mr. Florance to make significant contributions to the Company's business development and strategy.

David Bonderman is a Founding Partner of TPG Capital, LP ("TPG"), one of the world's largest private equity investment firms, which was established in 1992. Through its global buyout platform, TPG generally makes significant investments in operating companies through acquisitions and restructurings across a broad range of industries throughout the United States, Europe and Asia. Mr. Bonderman currently serves on the boards of directors of the following public companies: Armstrong World Industries, Inc.; Caesars Entertainment Corporation; Energy Future Holdings Corp.; General Motors Company; JSC VTB Bank; and RyanAir Holdings, plc, of which he is Chairman. Mr. Bonderman previously served on the boards of directors of the following public companies: Burger King Holdings, Inc.; Ducati Motor Holdings S.p.A.; Gemalto N.V.; Gemplus International S.A. (predecessor to Gemalto); IASIS Healthcare, LLC; Univision Communications, Inc.; and Washington Mutual, Inc. Mr. Bonderman also serves on the boards of directors of XO Jet and Kite Pharma, Inc. Prior to forming TPG in 1992, Mr. Bonderman was Chief Operating Officer of the Robert M. Bass Group, Inc. (now doing business as Keystone Group, L.P.) in Fort Worth, Texas. Prior to joining RMBG in 1983, Mr. Bonderman was a partner in the law firm of Arnold & Porter in Washington, D.C., where he specialized in corporate, securities, bankruptcy and antitrust litigation. From 1969 to 1970, Mr. Bonderman was a Fellow in Foreign and Comparative Law in conjunction with Harvard University, and from 1968 to 1969, he was Special Assistant to the U.S. Attorney General in the Civil Rights Division. From 1967 to 1968, Mr. Bonderman was Assistant Professor at Tulane University School of Law in New Orleans. Mr. Bonderman

graduated magna cum laude from Harvard Law School in 1966. He was a member of the Harvard Law Review and a Sheldon Fellow. He is a 1963 graduate of the University of Washington in Seattle. Mr. Bonderman is 69 years old.

Mr. Bonderman has had an extensive career in private equity investments and finance, and as a result brings to the Board significant business development, mergers & acquisitions and financial expertise. Mr. Bonderman has served and continues to serve on a number of public company boards, enabling the Board to benefit from his considerable public company board experience. In addition, Mr. Bonderman has served on the Company's Board for 17 years and has extensive knowledge of the commercial real estate and information services industries as well as the Company's products, services and business strategies.

Michael J. Glosserman has served as a Managing Member of The JBG Companies, a real estate investment and development firm, since 1998, and is Chairman of its Executive Committee. He began his career as a staff attorney with the U.S. Department of Justice, shortly thereafter moving into commercial real estate investment and development with the Rouse Company in 1972 and then joining JBG in 1979. His non-professional affiliations include: Chairman of the Board, National Building Museum; Executive Board Trustee, Federal City Council; and Board Member of the University of Pennsylvania Institute for Urban Research. He received a B.S. in Economics from the Wharton School at the University of Pennsylvania and received his J.D. from the University of Texas Law School. He is 66 years old.

Mr. Glosserman has over 40 years of experience investing in, developing and owning commercial real estate. As a result of his experience, Mr. Glosserman brings to the Board significant business development, financial and commercial real estate industry expertise. As a user of commercial real estate information, Mr. Glosserman also provides the Board with a client's perspective on the Company's business development and mergers & acquisitions strategies, including valuable insight into the potential 'fit' of acquisition targets and the development and marketing of products and services.

Warren H. Haber has been, for more than thirty-five years, Chairman of the Board and Chief Executive Officer of Founders Equity, Inc. and its affiliates, private investment concerns. Mr. Haber is also Managing General Partner of FEF Management Services, LLC, which manages Founders Equity SBIC I, L.P. and Founders Equity NY L.P., and a Partner of Founders Property LLC, an affiliate of FEF Management Services, LLC. Mr. Haber serves on the boards of directors of several privately-held companies, including Advantage Healthcare Systems, Inc.; Core BTS (formerly known as Core Business Solutions); Richardson Foods, Inc.; Stone Source, Inc.; and Pay-O-Matic, Inc., of which he is Chairman. Mr. Haber holds a BBA in Finance from Baruch College. He is 71 years old.

Through his more than 40 years of investment banking experience, Mr. Haber has served as an executive officer and/or director of a number of portfolio companies. As a result of his experience, he brings financial and business development expertise to the Company's Board, leadership experience, as well as public company board and management experience. The Board also draws upon Mr. Haber's mergers & acquisitions experience when developing strategies for business combinations and integrating acquired companies. Through his 17 years of service on the Board, Mr. Haber has also developed extensive knowledge of the commercial real estate and information services industries and the Company's products, services and business strategies.

Christopher J. Nassetta has been the President and Chief Executive Officer of Hilton Worldwide (fka Hilton Hotels corporation), a global hospitality company, since December 2007. Prior to joining Hilton Worldwide, Mr. Nassetta served as the President and Chief Executive Officer of Host Hotels & Resorts (fka Host Marriott Corporation), a lodging real estate investment trust and owner of luxury and upper upscale hotels, from May 2000 to December 2007. Mr. Nassetta joined Host Hotels & Resorts in 1995 as Executive Vice President and was elected the Chief Operating Officer in 1997. Prior to joining Host Hotels & Resorts, Mr. Nassetta served as President of Bailey Realty Corporation from 1991 until 1995, and he had previously served as Chief Development Officer and in various other positions with the Oliver Carr Company from 1984 through 1991. Mr. Nassetta serves on the board of directors of the Real Estate Roundtable. He is also a member of the McIntire School of Commerce Advisory Board for the University of Virginia. Mr. Nassetta previously served on the board of directors of Host Hotels & Resorts. Mr. Nassetta

received a degree in finance from the University of Virginia McIntire School of Commerce. Mr. Nassetta is 49 years old.

Through his current and previous positions, Mr. Nassetta brings to the Board significant operational and business development experience, mergers & acquisitions experience, public company board and management experience, leadership experience, as well as commercial real estate industry expertise. As a user of commercial real estate information, Mr. Nassetta also provides the Board with a client's perspective on the Company's business development and mergers & acquisitions strategies, including valuable insight into the potential "fit" of acquisition targets and the development and marketing of products and services.

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David J. Steinberg has been the Chief Executive Officer of SnappCloud, Inc., a technology company that integrates online cloud software applications for distribution by large PC and software OEMs, since September 2009. From November 2008 to September 2009, Mr. Steinberg worked with investors and the board of directors of SnappCloud (formerly known as ARPU) on funding and revising the company's operational focus. Prior to joining SnappCloud, Mr. Steinberg was the Chairman and Chief Executive Officer of SwapDrive, Inc., an online storage cloud solution from May 2001 to October 2008, during which time SwapDrive was sold to Symantec. Mr. Steinberg also founded bridge2bridge, where he helped companies at all stages with strategy in the areas of business development, channels, and capital formation. Prior to founding bridge2bridge, Mr. Steinberg was Vice President of BioNetrix Software, Inc., where he was responsible for worldwide sales and market development. Mr. Steinberg also previously served as the director of worldwide vertical channels at then start up Check Point Software, Inc. and as a founding member of SynOptics Communications, Inc. (which became Bay Networks after a merger), establishing SynOptics' U.S. Eastern and federal systems operations. Mr. Steinberg serves on the boards of directors of three privately-held companies, SingleClick Systems, MessageRadius and SolSystems. He is a member of the advisory board of the Washington, DC venture capital firm Core Capital Partners, and he serves on the boards of directors for several not-for-profit entities, including SEED School of DC, We are Family and St. John's Pre School, all located in Washington, DC. Mr. Steinberg received a B.S. in physiological psychology from the University of Cincinnati. Mr. Steinberg is 54 years old.

Mr. Steinberg has over thirty years of sales, technical and executive experience in the data communication, network security, and Internet services industries. As a result of his experience, Mr. Steinberg brings to the Board significant business development, marketing, and executive management experience, as well as significant Internet services industry, financial and growth strategies expertise.

THE BOARD RECOMMENDS A VOTE "FOR" EACH OF THESE NOMINEES.

Continued on next page.

ITEM 2
APPROVAL OF A PROPOSED CHARTER AMENDMENT
TO INCREASE THE AUTHORIZED COMMON STOCK OF THE COMPANY

Effective April 2, 2012, the Board unanimously adopted resolutions declaring advisable and recommending to the Company's stockholders for their approval an amendment to the Company's Restated Certificate of Incorporation to increase the authorized shares of common stock from 30,000,000 shares to 60,000,000 shares. The number of shares of preferred stock authorized for issuance under our Restated Certificate of Incorporation would remain unchanged, at Two Million (2,000,000) shares.

If the proposal is approved and the amendment becomes effective, the first paragraph of Article Four of our Restated Certificate of Incorporation, which sets forth our currently authorized capital stock, will be amended to read in its entirety as follows:

“The total number of shares of all classes of stock which the Corporation shall have authority to issue is Sixty-Two Million (62,000,000) shares, of which Two Million (2,000,000) shares, designated as Preferred Stock, shall have a par value of \$0.01 per share (the “Preferred Stock”), and Sixty Million (60,000,000) shares, designated as Common Stock, shall have a par value of \$0.01 per share (the “Common Stock”).”

The amendment would be reflected in an Amended and Restated Certificate of Incorporation of CoStar Group, Inc. The newly authorized shares of common stock will have all the rights and privileges of the shares of common stock presently authorized. Therefore, approval of this proposal and any subsequent issuance of additional common stock would not affect your current rights as a stockholder, except for any dilutive effects of a potential increase in the number of outstanding shares of common stock to, among other things, earnings per share, book value per share and the voting power of current holders of our common stock.

Our Board believes that it is in the best interests of our Company that we maintain the flexibility to issue additional shares of common stock in connection with stock splits, stock dividends, acquisitions and other strategic transactions, financings, grants under employee incentive compensation plans and other proper corporate purposes, should our Board deem any of those actions to be in the best interests of our Company and our stockholders. As of the April 9, 2012 record date, there were 4,194,084 authorized and unissued shares of our common stock, 1,840,934 of which have been reserved for issuance under our existing stock incentive and stock purchase plans. In addition, 2,250,000 authorized and unissued shares of our common stock have been reserved and registered under the Securities Act of 1933, as amended (the “Securities Act”) for issuance in connection with our proposed acquisition of LoopNet, Inc., as previously disclosed in the Company's filings with the Securities and Exchange Commission (the “SEC”), including our proxy statement/prospectus dated June 6, 2011. Therefore, only 103,150 authorized and unissued shares of our common stock remain available for other purposes.

If our stockholders do not approve the proposed amendment to our Restated Certificate of Incorporation, we may not be able to complete future strategic transactions, retain employees and pursue other business opportunities integral to our growth and success. Our Board believes that the proposed increase in authorized common stock will make a sufficient number of shares available to maintain the flexibility necessary to pursue these and other strategic opportunities in the foreseeable future.

The Board regularly evaluates the Company's needs and opportunities to utilize shares of the Company's common stock:

- to raise additional equity capital for funding corporate opportunities, growth opportunities (including internally generated growth and acquisitions) and/or deleveraging,

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- to acquire companies, products, technologies or businesses in exchange, in whole or in part, for common stock;
- to satisfy or fund obligations, issue stock dividends, or as substitutes for cash payments (including those with respect to compensation of directors, officers and employees);
 - for employee incentive compensation plans; or
 - for other strategic transactions and proper corporate purposes.

Except as set forth above, we have no current plans and there are currently no agreements or arrangements to issue any authorized and unissued shares of common stock. We also have no current plans and there are currently no agreements or arrangements to issue any of the additional shares of common stock that would be authorized by the proposed amendment. However, if stockholders approve the proposed amendment, the additional authorized shares would give the Board more flexibility in responding to a variety of corporate opportunities, including those listed above, which, if they become available, are likely to require prompt action on our part. The Board believes that the increase in the authorized number of shares of common stock will enable the Company to take timely advantage of market conditions and the availability of favorable opportunities without the delay and expense associated with convening a special meeting to obtain stockholder approval at that time (unless otherwise required by the rules of NASDAQ).

In the future, we may enter into or develop a plan, proposal or arrangement, written or otherwise, to issue all or a portion of the newly authorized shares of common stock. Once shares of the common stock are authorized, no additional action or authorization by our stockholders would be necessary prior to the issuance of such additional shares, unless required by applicable law or the rules of any stock exchange or national securities association trading system on which our common stock is then listed or quoted. Acquisitions involving stock issuances above certain enumerated thresholds would require stockholder approval under applicable rules of NASDAQ and in some circumstances Delaware law.

Effects of the Increase in Authorized Common Stock

The Board is required to make any determination to issue shares of common stock based on its judgment regarding the best interests of our stockholders and our Company. We have not proposed the increase in the number of authorized shares of common stock with the intent of using the additional shares to prevent or discourage any actual or threatened takeover of our Company. However, under certain circumstances, it could have an anti-takeover effect. Additional shares could be issued (within the limits imposed by applicable law) in one or more transactions that could resist, frustrate or make more difficult a third-party transaction that was favored by a majority of the independent stockholders and that might provide an above-market premium. The holders of our common stock are not entitled to preemptive rights and consequently, additional shares could be issued to dilute the stock ownership or voting rights of persons seeking to obtain control of our Company. Similarly, the issuance of additional shares to persons allied with the Board or management could have the effect of making it more difficult to remove directors or members of management by diluting the stock ownership or voting rights of persons seeking to effect such a removal. The additional shares could also be issued in private placements and without stockholder approval or further action by our stockholders, subject to applicable law or the rules of any stock exchange or national securities association trading system on which our common stock is then listed or quoted. Accordingly, if the proposed amendment is approved, the additional shares of authorized common stock may render more difficult or discourage a merger, tender offer or proxy contest, the assumption of control by a holder of a large block of our common stock, or the replacement or removal of management or our Board. Any such anti-takeover effect may be beneficial to management and our Board and could have an adverse impact on stockholders.

We are not currently aware of any specific third-party effort to accumulate shares of common stock or to obtain control of our Company by means of a merger, tender offer or solicitation in opposition to management or our Board. Moreover, we currently have no plans to issue newly authorized shares of common stock or adopt other anti-takeover proposals with the intent of discouraging third parties from attempting to take over our Company. Although our Board is motivated by business and financial considerations in proposing the increase in the number of authorized shares of common stock, and not the threat of any attempt by a third party to gain control of our Company, stockholders nevertheless should be aware that increasing the number of authorized shares of common stock could facilitate our Board's and management's ability to deter or prevent changes in control in the future, and any issuance of newly authorized shares of common stock, regardless of the intent, could have an anti-takeover effect.

The proposed increase in the number of authorized shares of our common stock will not have any immediate dilutive effect on the proportionate voting power or other rights of our existing stockholders. However, because stockholders are not entitled to preemptive rights, shares of common stock issued otherwise than for a stock split or a dividend may decrease existing stockholders' percentage equity ownership and, depending on the price at which they are issued, could be dilutive to the voting rights of existing stockholders and have a negative effect on the market price of the common stock.

Required Vote and Effective Date of Proposed Amendment

Approval of the charter amendment to increase the authorized common stock of the Company requires the affirmative “FOR” vote of a majority of the total number of shares of common stock outstanding and entitled to be voted on the proposal. Accordingly, abstentions and broker non-votes will have the same effect as a vote against the amendment. Unless marked to the contrary, proxies received will be voted “FOR” approval of the amendment to increase the authorized number of shares of common stock of the Company by 30,000,000.

If our stockholders approve the proposed amendment, it will become effective upon filing of an Amended and Restated Certificate of Incorporation with the Delaware Secretary of State, which we anticipate doing as soon as practicable following stockholder approval. However, if our stockholders approve the proposed amendment to our Restated Certificate of Incorporation, our Board retains discretion under Delaware law not to implement the proposed amendment. If our Board were to exercise such discretion, the number of authorized shares would remain at current levels.

Neither Delaware law, the Company’s Restated Certificate of Incorporation, nor the Company’s Amended and Restated Bylaws provides for appraisal or other similar rights for dissenting stockholders in connection with this proposal. Accordingly, stockholders will have no right to dissent and obtain payment for their shares.

Recommendation

We believe that approval of the amendment to our Restated Certificate of Incorporation to increase the authorized common stock of the Company by 30,000,000 shares is an important part of our continued success. For the reasons stated above, stockholders are being asked to approve this proposal. If approved, the amendment will be reflected in an Amended and Restated Certificate of Incorporation of CoStar Group, Inc.

THE BOARD RECOMMENDS THAT YOU VOTE “FOR” THE APPROVAL OF THE CHARTER AMENDMENT TO INCREASE THE AUTHORIZED COMMON STOCK OF THE COMPANY.

Continued on next page.

ITEM 3
APPROVAL OF QUALIFYING PERFORMANCE CRITERIA
UNDER THE 2007 STOCK INCENTIVE PLAN

As discussed below in Item 4, we are asking our stockholders to approve an amendment to the CoStar Group, Inc. 2007 Stock Incentive Plan (as amended, the “2007 Plan”) to increase the number of authorized shares under the plan. Separate from the approval of the amendment to the 2007 Plan, in this Item 3 we are asking stockholders to approve the qualifying performance criteria under the 2007 Plan so that performance-based awards under the 2007 Plan can be tax deductible for the Company. Stockholders are not being asked under this Item 3 to approve any amendments to the 2007 Plan or to approve the 2007 Plan itself. In particular, stockholders are not being asked to approve an increase in the number of shares available for grant under the 2007 Plan under this Item 3. This Item 3 is separate from, and not contingent upon stockholder approval of, Item 4, in which we are asking stockholders to approve an amendment to the 2007 Plan to increase the number of authorized shares available under the plan.

The Board believes that it is in the best interests of the Company and its stockholders to continue to provide for an equity incentive plan under which compensation awards made to the Company’s executive officers are eligible to qualify for deductibility by the Company for federal income tax purposes. Accordingly, the 2007 Plan is structured in a manner such that awards granted under it can satisfy the requirements for “performance-based” compensation within the meaning of Section 162(m) (“Section 162(m)”) of the Internal Revenue Code of 1986 (the “Tax Code”) and thus not be subject to Section 162(m)’s deductibility cap, however there can be no guarantee that amounts payable under the 2007 Plan will be treated as qualified “performance-based” compensation under Section 162(m). In general, under Section 162(m), in order for the Company to be able to deduct compensation in excess of \$1,000,000 paid in any one year to the Company’s chief executive officer or any of the Company’s three other most highly compensated executive officers (other than the Company’s chief financial officer), such compensation must qualify as “performance-based.” One of the requirements of “performance-based” compensation for purposes of Section 162(m) is that the material terms of the performance goals under which compensation may be paid be disclosed to and approved by the Company’s stockholders every five years. For purposes of Section 162(m), the material terms include (i) the individuals eligible to receive compensation, (ii) a description of the business criteria on which the performance goal is based, and (iii) the maximum amount of compensation that can be paid to an individual under the performance goal. Each of these aspects is discussed below, and stockholder approval of this Item 3 constitutes approval of each of these aspects of the 2007 Plan for purposes of the approval requirements of Section 162(m).

The following summary of certain material terms of the 2007 Plan is qualified in its entirety by reference to the complete text of the 2007 Plan (which also includes the changes to the 2007 Plan described below in Item 4), which is set forth in Appendix A to this Proxy Statement. Stockholders should also refer to “Item 4—Approval of an Amendment to the CoStar Group, Inc.’s 2007 Stock Incentive Plan” for the summary of other material terms of the 2007 Plan and a discussion of the 2007 Plan benefits.

Individuals Eligible to Receive Compensation

The 2007 Plan is administered by the Compensation Committee (the “Administrator”). The 2007 Plan permits awards to employees, officers, consultants and directors of the Company and its subsidiaries. There are approximately 6 non-employee directors, 15 executives and 1,500 employees who are currently eligible to receive awards under the 2007 Plan.

Description of the Business Criteria on which the Performance Goal Is Based

Awards of incentive and nonqualified stock options, stock appreciation rights, restricted stock and restricted stock units that are intended to qualify as “performance-based compensation” within the meaning of Section 162(m) of the

Tax Code will be subject to the attainment of performance goals relating to the performance criteria selected by the Administrator. Performance goals must be based solely on one or more of the following business criteria (as selected and defined by the Administrator): (i) cash flow (before or after dividends), (ii) earnings or earnings per share (including earnings before interest, taxes, depreciation and amortization), (iii) stock price, (iv) return on equity, (v) total stockholder return, (vi) return on capital or investment (including return on total capital, return on invested capital, or return on investment), (vii) return on assets or net assets, (viii) market capitalization, (ix) economic value added, (x) debt leverage (debt to capital), (xi) revenue, (xii) income or net income, (xiii) operating income, (xiv) operating profit or net operating profit, (xv) operating margin or profit margin, (xvi) return on operating revenue, (xvii) cash

from operations, (xviii) operating ratio, (xix) operating revenue, or (xx) customer service. Any of these performance criteria may be used to measure the performance of the Company as a whole or any business unit or subsidiary of the Company, either individually or in any combination. Further, the performance criteria may be measured annually or cumulatively over a period of years, on an absolute basis or relative to a pre-established target, to previous years' results or to a designated comparison group, as specified by the Administrator.

To the extent consistent with Section 162(m) of the Tax Code, the Administrator will appropriately adjust any evaluation of performance under a qualifying performance criteria to eliminate the effects of charges for restructurings, discontinued operations, extraordinary items and all items of gain, loss or expense determined to be extraordinary or unusual in nature or related to the acquisition or disposal of a segment of a business or related to a change in accounting principle all as determined in accordance with standards established by Accounting Standards Codification ("ASC") 225 Extraordinary and Unusual Items or other applicable or successor accounting provisions, as well as the cumulative effect of accounting changes, in each case as determined in accordance with generally accepted accounting principles or identified in the Company's financial statements or notes to the financial statements. In addition, to the extent consistent with Section 162(m) of the Tax Code, the Administrator may appropriately adjust any evaluation of performance under a qualifying performance criteria to exclude any of the following events that occurs during a performance period: (i) asset write-downs, (ii) litigation, claims, judgments or settlements, (iii) the effect of changes in tax law or other such laws or provisions affecting reported results, (iv) accruals for reorganization and restructuring programs, and (v) accruals of any amounts for payment under the 2007 Plan or any other compensation arrangement maintained by the Company.

Maximum Amount of Compensation that Can Be Paid to an Individual Under the Performance Goal

Subject to adjustment as provided in the 2007 Plan, the aggregate number of shares subject to awards granted under the 2007 Plan during any one year to any one participant will not exceed 400,000 shares. The Administrator shall adjust the maximum annual individual award limit in the case of a combination of shares, stock split, stock dividend, reorganization, or other equity restructuring transaction (as defined in ASC 718 Stock Compensation).

Required Vote

Approval of the qualifying performance criteria under the 2007 Plan requires the affirmative "FOR" vote of a majority of the votes cast on the proposal. Unless marked to the contrary, proxies received will be voted "FOR" approval of the qualifying performance criteria under the 2007 Plan.

Recommendation

We believe that approval of the amendment to the 2007 Plan is an important part of our continued success as it would allow performance-based awards under the 2007 Plan to continue to be tax deductible for the Company. Our employees are one of our most valuable assets. Stock options and other incentive awards, such as those available under the 2007 Plan, are critical for attracting and retaining outstanding and highly skilled individuals. These awards also are vital to our ability to motivate employees to achieve our goals. For the reasons stated above, stockholders are being asked to approve the qualifying performance criteria under the 2007 Plan.

THE BOARD RECOMMENDS THAT YOU VOTE "FOR" THE APPROVAL OF THE QUALIFYING PERFORMANCE CRITERIA UNDER THE 2007 PLAN.

ITEM 4

APPROVAL OF AN AMENDMENT TO THE COSTAR GROUP, INC. 2007 STOCK INCENTIVE PLAN

At the Annual Meeting, stockholders will be asked to approve an amendment to the 2007 Plan to increase the maximum number of shares of our common stock that may be issued under the 2007 Plan by 900,000 shares.

In April 2007, the Compensation Committee of the Board of Directors approved and recommended to the Board, and the Board of Directors adopted, subject to stockholder approval, the 2007 Plan. Stockholders approved the 2007 Plan in June 2007; an amendment to the 2007 Plan in June 2010, which increased the number of authorized shares that can be issued under the 2007 Plan (the “June 2010 Amendment”); and, an amendment to the 2007 Plan in June 2011, which increased the limit on the number of shares of common stock that may be granted under the 2007 Plan pursuant to the Tax Code, to any one participant during a calendar year. On April 2, 2012, the Board of Directors adopted, subject to stockholder approval, an amendment to the 2007 Plan to increase the maximum number of shares of our common stock that may be issued under the 2007 Plan by 900,000. Stockholders have previously authorized us to issue under the 2007 Plan up to a total of 2,300,000 shares of common stock, plus 121,875 shares that remained available under the Company’s 1998 stock incentive plan (the “1998 Plan”), shares received upon cancellation, expiration or forfeiture of awards under the 2007 Plan or the 1998 Plan and shares received by the Company as the result of the exchange of shares by a participant in the 2007 Plan as full or partial payment of the exercise price or tax withholding with respect to awards issued under the 2007 Plan, in each case subject to adjustment upon certain changes in our capital structure.

Stock incentive plans allow companies to provide equity compensation under a stockholder-approved plan in order to attract, motivate and retain key personnel, encourage equity ownership among this group, and enhance a mutuality of interest with stockholders in improving the long-term performance of the Company and the value of the Company’s common stock. There are approximately 6 non-employee directors, 15 executives and 1,500 employees who are currently eligible to receive awards under the 2007 Plan.

Since our stockholders approved the 2007 Plan in June 2007, we have acquired four companies and have made additions to our management team. One of those recent acquisitions occurred after our stockholders approved the June 2010 Amendment, and in April 2011, we entered into an agreement to acquire a fifth company, LoopNet, Inc. The Company utilizes equity compensation as an incentive for employees of acquired companies to stay with the combined entity and to work to realize the benefits of the combination. We also recently commenced granting performance-based restricted stock awards to our executive officers and currently contemplate awarding similar performance-based restricted stock awards to employees in the future, which awards generally utilize a greater number of shares than our more typical restricted stock grants which vest over time. The performance-based restricted stock awards are expected to further align employee incentives with long-term stockholder value. To permit us to continue to grow organically and through acquisitions and to continue to have the ability to grant stock options and restricted stock to our new and existing employees and directors and to incentivize those individuals by granting a continuing interest in the long-term success of the Company, the Board of Directors has amended the 2007 Plan to increase the number of shares available for issuance under the 2007 Plan by 900,000 shares.

The Compensation Committee and the Board of Directors believe that in order for us to successfully attract and retain the best possible candidates, we must continue to offer a competitive equity compensation program. This increase is important so we can continue to grant stock options and restricted stock that are vital to our ability to attract and retain outstanding and highly skilled individuals in the extremely competitive labor markets in which we operate. In addition, the increase will permit more flexibility in determining the form of future equity awards to our key employees, including performance-based stock grants and/or multi-year long-term incentive awards if the Board or Compensation Committee chooses to implement such programs. Our employees are one of our most valuable assets and attracting and retaining them is crucial to our business. In addition, we believe that stock awards generally align the interests of our employees with the interests of our stockholders.

As of March 30, 2012, 838,689 shares of common stock remained available for future grants of awards under the 2007 Plan, an amount that the Compensation Committee and the Board of Directors believe is not adequate to meet our anticipated needs. Therefore, the Compensation Committee approved and recommended to the Board, and the Board of Directors adopted, subject to stockholder approval, an amendment to the 2007 Plan to increase the maximum number of shares of our common stock that may be issued under the 2007 Plan by 900,000 shares to a total of 3,200,000 shares, plus shares that remained available under the 1998 Plan, shares received upon cancellation, expiration or forfeiture of awards under the 2007 Plan or the

1998 Plan and shares received by the Company as the result of the exchange of shares by a participant in the 2007 Plan as full or partial payment of the exercise price or tax withholding with respect to awards issued under the 2007 Plan, in each case subject to adjustment upon certain changes in our capital structure.

In addition, the increase in the number of shares available for issuance under the 2007 Plan will allow us to continue to grant stock awards to our new and existing employees and directors, as well as receive a federal income tax deduction for “qualifying performance-based” compensation paid under the 2007 Plan, although there can be no assurance that any compensation awarded or paid under the 2007 Plan will be fully deductible under all circumstances. Should the amendment not be approved, the 2007 Plan as currently in effect will remain in full force and effect. Granting stock awards under the 2007 Plan has certain benefits for both the Company and the holder. For example, in order for an option to qualify as an “incentive stock option” under the Tax Code, the option must be granted under a plan approved by the issuer's stockholders. Individuals who receive incentive stock options and comply with certain holding period requirements will receive favorable tax treatment with respect to any gains realized on the sale of shares acquired on exercise of the options. In addition, the Company may receive a federal income tax deduction for performance-based compensation in excess of \$1 million, if any, granted under the 2007 Plan to the Chief Executive Officer and the three other most highly compensated executive officers (other than the Chief Financial Officer) if, among other things, the 2007 Plan has been approved by the Company's stockholders.

Summary of the 2007 Plan

The following summary of the 2007 Plan is qualified in its entirety by the specific language of the 2007 Plan, as proposed to be amended, which is set forth in Appendix A to this Proxy Statement.

Plan Administration. The 2007 Plan is administered by the Compensation Committee, which is composed of individuals who are “non-employee directors” (as that term is defined under Rule 16b-3 of the Securities Exchange Act of 1934, as amended (the “Exchange Act”)) and “outside directors” (within the meaning of Section 162(m) of the Tax Code). All of the members of the Compensation Committee are independent as defined under Rule 5605(a)(2) of the Nasdaq listing rules. The Compensation Committee has authority to, among other things:

- Interpret and administer the 2007 Plan;
- Make rules and regulations relating to the administration of the 2007 Plan; and
- Make any other determinations and take any other action that it deems necessary or desirable for the administration of the 2007 Plan.

Decisions of the Committee or another person delegated responsibilities under the 2007 Plan shall be final, conclusive and binding on all persons.

Stock Subject to the Plan. Assuming stockholders approve this proposal, a total of 3,200,000 shares of common stock will have been reserved for issuance pursuant to the 2007 Plan, which includes shares that remained available for issuance under the 1998 Plan that were rolled into the 2007 Plan upon adoption of the 2007 Plan. Any shares that are subject to an award under the 2007 Plan or the 1998 Plan that are forfeited, cancelled, or expire without the issuance of such shares will again be available for grant under the 2007 Plan. Further, any shares that are subject to an award under the 2007 Plan that are received by the Company as the result of the exchange of shares by a participant in the 2007 Plan as full or partial payment of the exercise price or tax withholding with respect to awards issued under the 2007 Plan will be available for grant under the 2007 Plan. The shares issued under the 2007 Plan may consist, in whole or in part, of authorized but unissued shares or treasury shares or shares held in trust for issuance under the 2007 Plan. On March 30, 2012, options to purchase a total of 941,535 shares and 699,146 unvested shares of restricted

stock were outstanding under the 2007 Plan and 1998 Plan, which comprise all of the Company's stock incentive plans. The outstanding stock options had a weighted-average exercise price of \$42.02 per share and a weighted-average remaining contractual life of 5.96 years. On March 30, 2012, 838,689 shares of common stock remained available for future grants of awards under the 2007 Plan and no shares remained available for future grants under the 1998 Plan.

Limitations. Subject to adjustment as provided in the 2007 Plan, no participant shall be eligible to receive in any one calendar year awards relating to more than 400,000 shares of our common stock.

Eligibility. The 2007 Plan permits awards to employees, officers, consultants and directors of the Company and its subsidiaries.

Awards. The 2007 Plan provides for the grant of options (including nonqualified options), stock appreciation rights, restricted stock, and restricted stock units.

Options. Incentive stock options and nonqualified stock options may be granted under the 2007 Plan, either alone or in combination with other awards. The terms of any option grant generally are determined by the Compensation Committee. The price at which a share may be purchased under an option may not be less than the fair market value of a share on the date the option is granted. Fair market value generally means the closing price for the Company's common stock on the Nasdaq Global Select Market on the date of grant. The 2007 Plan provides that the Compensation Committee shall establish the term of each option, which in no case shall exceed a period of ten years from the date of grant.

Stock Appreciation Rights. Stock appreciation rights entitle a participant to receive payment from the Company in an amount determined by multiplying the difference between the fair market value of the shares on the date of exercise and the fair market value on the date of grant by the number of shares subject to the award. The terms of any grant of stock appreciation rights generally are determined by the Compensation Committee. Stock appreciation rights may be granted in tandem with an option or alone. The grant price of a tandem stock appreciation right is equal to the exercise price of the related option, and the grant price of a freestanding stock appreciation right is equal to the fair market value of the common stock on the grant date. The 2007 Plan provides that the Compensation Committee shall establish the term of each grant of stock appreciation rights, which in no case shall exceed a period of ten years from the date of grant.

Restricted Stock and Stock Units. Restricted stock and stock units reflect a right to receive shares of stock upon the satisfaction of certain terms, conditions and restrictions. Both may be issued under the 2007 Plan on such terms and conditions as the 2007 Plan permits and generally are subject to terms determined by the Compensation Committee. Stock unit awards may be paid in cash, stock or a combination of cash and stock. Except as set forth below, participants holding restricted stock or stock units may be permitted to receive dividends paid with respect to underlying shares or dividend equivalents, subject to such terms and conditions as may be established by the Compensation Committee. Participants holding restricted stock or stock units that are subject to qualifying performance criteria under the 2007 Plan are not entitled to dividends or dividend equivalents unless and until the applicable qualifying performance criteria have been met.

No Repricing. The repricing of stock options or stock appreciation rights is prohibited. The terms of outstanding stock options and stock appreciation rights may not be amended to reduce the exercise price or cancel, exchange, substitute, buyout or surrender an outstanding stock option or stock appreciation right in exchange for cash or other awards with an exercise price that is less than the exercise price of the original award without stockholder approval.

Minimum Vesting Period. Except upon a change of control of the Company, the death or disability of the participant or awards granted to employees of the Company or its subsidiaries in appreciation of past service to the Company or a subsidiary pursuant to a Company program or policy that applies to all such employees on an equal basis, no award of restricted stock or stock units payable in shares shall vest earlier than one year from the date of grant, except that an award of restricted stock or stock units that vests based solely on continued service (as opposed to attainment of performance goals) shall not vest earlier than three years from the date of grant.

Performance Goals. Awards under the 2007 Plan may be made subject to the attainment of performance goals relating to one or more of the following business criteria: (1) cash flow (before or after dividends), (2) earnings or earnings per share (including earnings before interest, taxes, depreciation and amortization), (3) stock price, (4) return on equity,

(5) total stockholder return, (6) return on capital or investment (including return on total capital, return on invested capital, or return on investment), (7) return on assets or net assets, (8) market capitalization, (9) economic value added, (10) debt leverage (debt to capital), (11) revenue, (12) income or net income, (13) operating income, (14) operating profit or net operating profit, (15) operating margin or profit margin, (16) return on operating revenue, (17) cash from operations, (18) operating ratio, (19) operating revenue, or (20) customer service (collectively, the "Performance Criteria").

The Performance Criteria may be used to measure the performance of the Company as a whole or with respect to any business unit, subsidiary or business segment of the Company, either individually, alternatively or in any combination, and may be measured either annually or cumulatively over a period of years, on an absolute basis or relative to a pre-established target, to previous period results or to a designated comparison group, in each case as specified by the Compensation Committee. To the extent consistent with Section 162(m) of the Tax Code, the Compensation Committee (A) shall appropriately adjust any evaluation of performance under a Performance Criteria to eliminate the effects of charges for restructurings, discontinued operations, extraordinary items and all items of gain, loss or expense determined to be extraordinary or unusual in nature or related to the acquisition or disposal of a segment of a business or related to a change in accounting principle all as determined in accordance with standards established by the Accounting Principles Board or other applicable or successor accounting provisions, as well as the cumulative effect of accounting changes, in each case as determined in accordance with generally accepted accounting principles or identified in the Company's financial statements or notes to the financial statements, and (B) may appropriately adjust any evaluation of performance under a Performance Criteria to exclude any of the following events that occurs during a performance period: (i) asset write-downs, (ii) litigation, claims, judgments or settlements, (iii) the effect of changes in tax law or other such laws or provisions affecting reported results, (iv) accruals for reorganization and restructuring programs and (v) accruals of any amounts for payment under this Plan or any other compensation arrangement maintained by the Company.

Tax Withholding. The Company may specify the terms and conditions on which any award recipient must satisfy any tax obligations occurring under federal, state, local or foreign law, and may withhold issuance of any shares of common stock until such terms and conditions are met.

Assignability. Awards granted under the 2007 Plan are generally not transferable or assignable, except by will or the laws of descent and distribution. However, participants may be permitted to assign or transfer an award to the extent allowed by the Compensation Committee in its discretion and subject to Section 422 of the Tax Code.

Adjustments. The number and kind of securities available for issuance under the 2007 Plan (including under any awards then outstanding), and the number and kind of securities subject to the limits set forth in Section 5 of the 2007 Plan, shall be equitably adjusted by the Compensation Committee to reflect any reorganization, reclassification, combination of shares, stock split, reverse stock split, spin-off, dividend or distribution of securities, property or cash (other than regular, quarterly cash dividends), or any other equity restructuring transaction, as that term is defined in ASC 718 Stock Compensation. Such adjustment may be designed to comply with Section 424 of the Tax Code or, except as otherwise expressly provided in Section 5(c) of the 2007 Plan, may be designed to treat the securities available under the 2007 Plan and subject to awards as if they were all outstanding on the record date for such event or transaction or to increase the number of such securities to reflect a deemed reinvestment in securities of the amount distributed to the Company's stockholders. The terms of any outstanding award under the 2007 Plan shall also be equitably adjusted by the Compensation Committee as to price, number or kind of securities subject to such award, vesting, and other terms to reflect the foregoing events, which adjustments need not be uniform as between different awards or different types of awards.

In the event there are any other changes in the Company's common stock, by reason of a change of control, other merger, consolidation or otherwise in circumstances that do not involve an equity restructuring transaction, as that term is defined in ASC 718 Stock Compensation, then the Compensation Committee shall determine the appropriate adjustment, if any, to be effected. In addition, in the event of a change described in this paragraph, the Compensation Committee may accelerate the time or times at which any award under the 2007 Plan may be exercised and may provide for cancellation of such accelerated awards that are not exercised within a time prescribed by the Compensation Committee in its sole discretion.

There is no right to purchase fractional shares that result from any adjustment in awards under the 2007 Plan. In case of any such adjustment, the shares of common stock subject to the award shall be rounded down to the nearest whole share.

Change in Control. The Compensation Committee shall have the discretion, exercisable at any time before a sale, merger, consolidation, reorganization, liquidation, dissolution or change in control of the Company, to take such action as it determines to be necessary or advisable with respect to awards under the 2007 Plan.

Amendment and Termination. The Board may amend, alter or discontinue the 2007 Plan and the Compensation Committee may amend, or alter any agreement or other document evidencing an award made under the 2007 Plan but, except as specifically provided for in the 2007 Plan, no such amendment shall, without the approval of the stockholders of the Company (a) reduce the exercise price of outstanding options or stock appreciation rights, (b) reduce the price at which options may be granted below the price provided for in the 2007 Plan or (c) otherwise amend the 2007 Plan in any manner requiring stockholder approval by law or under the Nasdaq listing rules. No amendment or alteration to the 2007 Plan or an award or award agreement shall be made which would impair the rights of the holder of an award, without such holder's consent, provided that no such consent shall be required if the Compensation Committee determines in its sole discretion and prior to the date of any change in control that such amendment or alteration either is required or advisable in order for the Company, the 2007 Plan or the award to satisfy any law or regulation or to meet the requirements of or avoid adverse financial accounting consequences under any accounting standard.

Unless sooner terminated as provided in the 2007 Plan, the 2007 Plan shall terminate ten years after approval by the stockholders. Termination would not affect grants and awards then outstanding.

Deferral. The Compensation Committee may permit or require a participant to defer receipt of the payment of any award of restricted stock or restricted stock units to the extent permitted by Section 409A of the Tax Code.

Federal Income Tax Consequences

The following discussion summarizes certain federal income tax consequences of the issuance and receipt of options and other awards under the 2007 Plan under the law as in effect on the date of this Proxy Statement. The summary does not purport to cover all federal employment tax or other federal tax consequences that may be associated with the 2007 Plan, nor does it cover state, local, or non-U.S. taxes.

Non-Qualified Options ("NSOs"). A participant will not have taxable income upon the grant of a NSO. Upon the exercise of a NSO, the participant will recognize ordinary income equal to the difference between (i) one share of stock valued at the closing price on the day the option is exercised and (ii) the exercise price of one share, times the number of shares exercised.

The participant will be subject to income tax withholding at the time when the ordinary income is recognized. The Company will be entitled to a tax deduction at the same time and in the same amount.

The subsequent sale of the shares by a participant generally will give rise to capital gain or loss equal to the difference between the sale price and the sum of the exercise price paid for the shares plus the ordinary income recognized with respect to the shares, and the capital gains will be taxable as long-term capital gains if the participant held the shares for more than one year.

Incentive Stock Options ("ISOs"). There generally are no tax consequences upon the grant or vesting of an ISO, provided that an option that is otherwise intended to be an ISO will no longer qualify for ISO tax treatment (and instead will be taxed as an NSO) if the option is not exercised while the participant is an employee of the Company or within three months following termination of employment (one year in the case of termination due to total and permanent disability as defined in the Tax Code). If a participant sells or otherwise disposes of the shares acquired upon the exercise of an ISO at any time within one year after the date shares are transferred to the participant or two years after the date the ISO is granted to the participant, then:

- if the sales price exceeds the exercise price of the ISO, the participant will recognize capital gain equal to the excess, if any, of the sales price over the fair market value of the shares on the date of exercise, and the participant

will recognize ordinary income equal to the excess, if any, of the lesser of the sales price or the fair market value of the shares on the date of exercise over the exercise price of the ISO; or

- if the participant's sales price is less than the exercise price of the ISO, the participant will recognize a capital loss equal to the excess of the exercise price of the ISO over the sales price of the shares.

In this event, the Company will generally be entitled to a tax deduction equal to the ordinary income the participant recognizes.

If the participant sells or otherwise disposes of shares acquired upon exercise of an ISO at any time after the participant has held the shares for at least one year after the date the Company transfers the shares to the participant pursuant to the participant's exercise of the ISO and at least two years after the date the Company grants the ISO to the participant, then the participant will recognize long-term capital gain or loss equal to the difference between the sales price and the exercise price of the ISO, and the Company will not be entitled to any deduction.

The amount by which the fair market value of the shares the participant acquires upon exercise of an ISO exceeds the exercise price on the date of exercise will be included as a positive adjustment in the calculation of the participant's "alternative minimum taxable income" in the year of exercise. Before exercising an ISO, a participant should determine whether and to what extent exercise of an ISO will result in alternative minimum tax in the year of exercise.

Stock Appreciation Rights ("SARs"). The grant of a SAR is generally not a taxable event for a participant. Upon exercise of the SAR, the participant will generally recognize ordinary income equal to the amount of cash and/or the fair market value of any shares received. The participant will be subject to income tax withholding at the time when the ordinary income is recognized. The Company will be entitled to a tax deduction at the same time for the same amount. If the SAR is settled in shares, the participant's subsequent sale of the shares generally will give rise to capital gain or loss equal to the difference between the sale price and the ordinary income recognized when the participant received the shares, and these capital gains will be taxable as long-term capital gains if the participant held the shares for more than one year.

Restricted Stock. The tax consequences of a grant of restricted stock depends upon whether or not a participant elects under Section 83(b) of the Tax Code to be taxed at the time of the grant.

If no election is made, the participant will not recognize taxable income at the time of the grant of the restricted stock. When the restrictions on the restricted stock lapse, the participant will recognize ordinary income equal to the value (determined on the lapse date) of the restricted stock.

If the election is made, the participant will recognize ordinary income at the time of the grant of the restricted stock equal to the value of the stock at that time, determined without regard to any of the restrictions. If the restricted stock is forfeited before the restrictions lapse, the participant will generally not be entitled to a deduction on account thereof.

The participant will be subject to income tax withholding at the time when the ordinary income (including any dividends taxed as ordinary income) is recognized. Subject to the Section 162(m) restrictions discussed below, the Company will be entitled to a tax deduction at the same time and for the same amount.

A subsequent sale of restricted stock generally will give rise to capital gain or loss equal to the difference between the sale price and the ordinary income the participant recognized with respect to the stock. The capital gains will be taxable as long-term capital gains if the participant held the stock for more than one year. The holding period to determine whether a participant has long-term or short-term capital gain or loss on a subsequent sale generally begins when the stock restrictions lapse, or on the date of grant if the participant made a valid Section 83(b) election.

Stock Units. A participant will not have taxable income upon the grant of a stock unit. Rather, taxation will be postponed until the stock becomes payable, which will be either immediately following the lapse of the restrictions on the stock units, or, if the participant has elected deferral to a later date, such later date. At that time, the participant will recognize ordinary income equal to the value of the amount then payable.

The participant will be subject to income tax withholding at the time when the ordinary income (including any dividend equivalents taxed as ordinary income) is recognized. Subject to the Section 162(m) restrictions discussed below, the Company will be entitled to a tax deduction at the same time and for the same amount.

If a stock unit is settled in shares, subsequent sale of the shares generally will give rise to capital gain or loss equal to the difference between the sale price and the ordinary income recognized when the participant received the shares, and these capital gains will be taxable as long-term capital gains if the participant held the shares for more than one year.

Other. In general, under Section 162(m), remuneration paid by a public corporation to its chief executive officer or any of its other top three named executive officers other than the chief financial officer, ranked by pay, is not deductible to the extent it exceeds one million dollars (\$1,000,000) for any year. Taxable payments or benefits under the 2007 Plan may be subject to this deduction limit. However, under Section 162(m), qualifying performance-based compensation, including income from stock options and other performance-based awards that are made under stockholder-approved plans and that meets certain other requirements, is exempt from the deduction limitation. The 2007 Plan has been designed so that the Compensation Committee in its discretion may grant qualifying exempt performance-based awards under the 2007 Plan. The rules and regulations promulgated under Section 162(m) are complicated, however, and subject to change from time to time, sometimes with retroactive effect. In addition, a number of requirements must be met in order for particular compensation to so qualify. As such, there can be no assurance that any compensation awarded or paid under the 2007 Plan will be fully deductible under all circumstances.

Under the so-called “golden parachute” provisions of the Tax Code, the accelerated vesting of stock options and benefits paid under other awards in connection with a change in control of a corporation may be required to be valued and taken into account in determining whether participants have received compensatory payments, contingent on the change in control, in excess of certain limits. If these limits are exceeded, a portion of the amounts payable to the participant may be subject to an additional twenty percent (20%) federal tax and may be nondeductible to the Company.

Plan Benefits

The amount and timing of future awards granted under the 2007 Plan are determined in the sole discretion of the Compensation Committee and therefore cannot be determined in advance. The future benefits or amounts that would be received under the 2007 Plan by executive officers, non-executive directors and non-executive officer employees are discretionary and are therefore not determinable at this time. As of March 30, 2012, the closing price of a share of the Company’s common stock on the Nasdaq Global Select Market was \$69.05. The following table shows the number of shares underlying grants of all types of awards under the 2007 Plan that have been granted since the 2007 Plan was adopted to (a) each executive officer named in the Summary Compensation Table, (b) all current executive officers as a group, (c) all employees, including all current officers who are not executive officers, as a group, (d) all current non-employee directors as a group, (e) each director nominee and (f) each person who has received 5% of the shares authorized for issuance under the 2007 Plan.

Name and Position	Total Number of Shares Underlying Awards Granted(1)
Andrew C. Florance, Chief Executive Officer & President	476,539
Brian J. Radecki, Chief Financial Officer	144,321
John L. Stanfill, Senior Vice President, Sales & Customer Service	148,737
Jennifer L. Kitchen, Senior Vice President, Research	62,139
Paul Marples, Managing Director, CoStar UK Limited	60,717
Executive Officer Group (executive officers named above)	892,453
Non-Executive Officer Employee Group	916,066
Michael R. Klein (Director Nominee)	8,008
David Bonderman (Director Nominee)	7,712
Michael J. Glosserman (Director Nominee)	7,669

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Warren H. Haber (Director Nominee)	10,926
Christopher J. Nassetta (Director Nominee)	9,319
David J. Steinberg (Director Nominee)	1,715
Non-Employee Director Group	45,349

(1) Includes stock options and restricted stock as of March 30, 2012.

Miscellaneous

The 2007 Plan is not exclusive and does not limit the authority of the Board or its committees to grant awards or authorize any other compensation, with or without reference to shares, under any other plan or authority.

Required Vote

Approval of the proposed amendment to the 2007 Plan requires the affirmative “FOR” vote of a majority of the votes cast on the proposal. Unless marked to the contrary, proxies received will be voted “FOR” approval of the amendment to increase the number of shares issuable under the 2007 Plan by 900,000 shares.

Recommendation

We strongly believe that approval of the amendment to the 2007 Plan is essential to our continued success. Our employees are one of our most valuable assets. Stock options and other incentive awards, such as those available under the 2007 Plan, are critical for attracting and retaining outstanding and highly skilled individuals. These awards also are vital to our ability to motivate employees to achieve our goals. For the reasons stated above, stockholders are being asked to approve the amendment to the 2007 Plan.

THE BOARD RECOMMENDS THAT YOU VOTE “FOR” THE APPROVAL OF AN AMENDMENT TO INCREASE THE NUMBER OF SHARES ISSUABLE UNDER THE 2007 PLAN BY 900,000 SHARES.

Continued on next page.

ITEM 5
 RATIFICATION OF THE APPOINTMENT OF INDEPENDENT REGISTERED PUBLIC
 ACCOUNTING FIRM

The Audit Committee has recommended and the Board has approved the appointment of Ernst & Young LLP as the independent registered public accounting firm for the Company for 2012. As a matter of good corporate governance, the Board is asking stockholders to ratify thint style="DISPLAY: inline; FONT-SIZE: 10pt; MARGIN-LEFT: 0px; TEXT-INDENT: 0px; MARGIN-RIGHT: 0px; FONT-FAMILY: Times New Roman">-

	-
	112,500
Impairment of loss on assets	-
	-
	9,709
Loss on disposal of equipment	-
	51,100
	30,364
Write-off of accounts receivable	-
	-
	245,065
Note payable issued for litigation	-
	-
	385,000
Changes in operating assets and liabilities	
Increase in receivables	

)	(225,000)
)	-
)	(232,529)
Increase in accounts payable	254,171
	209,939
	2,718,357
Increase in accrued interest payable	22,366
	30,672
	660,285
Net Cash Used by Operating Activities	(550,694)
)	(2,513,243)
)	(10,614,399)
)	
CASH FLOWS FROM INVESTING ACTIVITIES	
Increase in deposits	-
	-
)	(51,100)
Purchase of equipment	-
)	(78,045)

)	(221,334)
Issuance of notes receivable	
)	-
)	(313,170)
)	(313,170)
Payments received on notes receivable	
)	-
)	-
	130,000
Net Cash Used by Investing Activities	
)	-
)	(391,215)
)	(455,604)
CASH FLOWS FROM FINANCING ACTIVITIES	
Issuance of common stock, preferred stock and warrants for cash	
)	-
)	3,006,000
)	10,033,845
Contributed equity	
)	-
)	-
)	131,374
Proceeds from notes payable	
)	-

	-
	1,336,613
Payments on notes payable	
	-
)	(300,000
	(801,287
)	
Proceeds from convertible notes payable	
	-
	-
	571,702
Payments on convertible notes payable	
	-
	-
)	(98,500
Net Cash Provided by Financing Activities	
	-
	2,706,000
	11,173,747
NET INCREASE (DECREASE) IN CASH	
	(550,694
)	
	(198,458
)	
	103,744
CASH AT BEGINNING OF PERIOD	
	654,438

	1,455,397
	-
CASH AT END OF PERIOD	
\$	103,744
\$	1,256,939
\$	103,744

See notes to condensed consolidated financial statements

MEDICAL DISCOVERIES, INC. AND SUBSIDIARIES
 (A Development Stage Company)
 Condensed Consolidated Statements of Cash Flows (Continued)
 (Unaudited)

	For the Nine Months Ended September 30,	
	2006	2005
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION		
Initial valuation of financial instrument	\$ -	\$ 6,279,829
Conversion of preferred stock to common stock	\$ 8,722	\$ -

See notes to condensed consolidated financial statements

MEDICAL DISCOVERIES, INC. AND SUBSIDIARIES

(A Development Stage Company)

Notes to the Unaudited Condensed Consolidated Financial Statements

Note 1 — Basis of Presentation*Unaudited Interim Consolidated Financial Statements*

The accompanying unaudited consolidated financial statements have been prepared by the Company pursuant to the rules and regulations of the Securities and Exchange Commission. Certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted pursuant to such rules and regulations. In the opinion of management, all adjustments and disclosures necessary for a fair presentation of these financial statements have been included and are of normal, recurring nature. These financial statements should be read in conjunction with the financial statements and notes thereto included in the Company's 2005 Annual Report on Form 10-KSB for the year ended December 31, 2005, as filed with the Securities and Exchange Commission. The results of operations for the three months and nine months ended September 30, 2006 may not be indicative of the results that may be expected for the year ending December 31, 2006.

Loss Per Common Share

Loss per share is computed by dividing net loss applicable to common shareholders by the weighted-average number of shares outstanding. Potential common shares from convertible preferred stock, convertible notes payable, convertible preferred stock, warrants and stock options have not been included as they are anti-dilutive. The potential common shares as of September 30, 2006 are detailed below.

	Potential Common Shares as of	
	September 30,	
	2006	2005
Convertible notes	\$ 128,671	\$ 128,671
Convertible preferred stock	62,018,018	38,244,444
Warrants	40,923,861	40,923,861
Stock options	19,983,000	19,483,000
Total potential common shares	\$ 123,053,550	\$ 98,779,976

Stock Based Compensation

Effective January 1, 2006, the Company adopted SFAS 123R, using the modified prospective method. SFAS 123R requires the recognition of the cost of employee services received in exchange for an award of equity instruments in the financial statements and is measured based on the grant date fair value of the award. SFAS 123R also requires the stock option compensation expense to be recognized over the period during which an employee is required to provide service in exchange for the award (the vesting period). Prior to our adopting SFAS 123R, we accounted for our stock-based compensation plans under Accounting Principles Board Opinion ("APB") No. 25, "Accounting for Stock Issued to Employees" ("APB 25"). Under APB 25, generally no compensation expense is recorded when the terms of the award are fixed and the exercise price of the employee stock option equals or exceeds the fair value of the underlying stock on the date of grant. We adopted the disclosure-only provision of SFAS No. 123, "Accounting for Stock-Based Compensation" ("SFAS 123").

As a result of adopting FAS 123(R), we recognized compensation expense related to options granted during the nine months ended September 30, 2006 in the amount of \$67,350, which was the fair value of the options issued during the nine months ended September 30, 2006.

Revenue Recognition

We recognize revenue in accordance with Securities and Exchange Commission Staff Accounting Bulletin No. 104, "Revenue Recognition in Financial Statements" ("SAB 104"). We recognize revenue when all of the following criteria are met: persuasive evidence of an arrangement exists; delivery has occurred or services have been rendered; the seller's price to the buyer is fixed or determinable; collectibility is reasonably assured; and title and the risks and rewards of ownership have transferred to the buyer. At the time of the transaction we also assess whether or not collection is reasonably assured. If we determine that collection of a fee is not reasonably assured, we defer recognition of the fee as revenue and recognize revenue at the time collection becomes reasonably assured, which is generally upon receipt of cash.

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MEDICAL DISCOVERIES, INC. AND SUBSIDIARIES

(A Development Stage Company)

Notes to the Unaudited Condensed Consolidated Financial Statements

Note 2 — Going Concern Considerations

The Company's recurring losses from development-stage activities in current and prior years raise substantial doubt about the Company's ability to continue as a going concern. The financial statements do not include any adjustments to reflect the possible effects on the recoverability and classification of assets or amounts and classifications of liabilities that may result from the possible inability of the Company to continue as a going concern. The Company is attempting to raise additional capital to fund research and development costs and general and administrative expenses until it is able to consistently generate revenues and sustain profitable operations. However, there can be no assurance that these plans will be successful.

Note 3 - Stockholders' Equity

Common and preferred stock

During January 2006, the Company converted 200 shares of Series A Preferred Stock into 242,424 shares of common stock pursuant to the Subscription Agreement dated October 18, 2004. The conversion price was \$.0825 per share. The preferred stock had an assigned value of \$8,722 which was reclassified to common stock at the time of conversion. During May 2006, the Company converted 7,380 shares of Series A Preferred Stock into 10,000,000 shares of Common Stock pursuant to the Subscription Agreement dated December 4, 2004. The conversion price was \$.0738 per share. The preferred stock did not have any assigned value due to proceeds being assigned to the warrant liability.

Financial instrument

The Company adjusted to market value the outstanding warrants as of September 30, 2006. There were 40,923,861 warrants outstanding, and the fair value of the financial instrument was \$1,139,245. The Company used the Black Scholes model in calculating fair value with the following assumptions: volatility of 136%, risk-free interest rate of 4.91%, and an expected life of one and a half years. The changes in fair market value have been recorded as adjustments in the line "Unrealized gain on financial instrument" in the financial statements.

Stock options

During the nine months ended September 30, 2006, the Company granted a stock option to a former officer and director. The option is for 500,000 shares exercisable at \$0.25 per share through December 31, 2010. The Company valued these options at \$67,350 (\$0.13 per share) using the Black-Scholes option pricing model with the following assumptions: risk-free rate of 4.3%, volatility of 152%, and an expected life of five years.

Note 4 - Related Party Transactions

At September 30, 2006, the Company had accounts payable to current and former officers and directors totaling \$1,090,978 for services performed and costs incurred in behalf of the Company, including \$879,727 payable to the Company's President and CEO. Also at September 30, 2006, the Company had accounts payable to its Controller of \$73,000 and former officers of the Company of \$138,251.

Note 5 - Notes Receivable

On July 15, 2005, the Company entered into an Assignment of Patent, Participation and Research and Development Agreement (the "Agreement") with the inventor of the Company's formestane cream technology. The terms of the Agreement included the Company granting a non-interest bearing loan to the inventor. As of September 30, 2006, the amount of the loan was €250,000 (approximately \$317,175 under current exchange rates). On October 30, 2006 the Company amended the Agreement and entered into a Loan and Security Agreement for a Special Purpose Loan. This loan agreement provides for the Company to advance loan installments of €50,000 (approximately \$63,435 under current exchange rates) during the remainder of 2006, €110,000 (approximately \$139,557 under current exchange rates) during 2007 and €90,000 (approximately \$114,183 under current exchange rates) during 2008. The loans are secured by 2,301,000 warrants for the Company's Common Stock issuable to the inventor upon conclusion of certain pending transfers of patent and patent application rights to the Company (see Note 6). The Company has agreed to forgive the balance of the loan in the event the proceeds from the sale of the common stock upon conversion of the warrants are not adequate to pay in the full the balance of the loan. During the quarter ended September 30, 2006 the Company provided in the accompanying financial statements an allowance of \$165,175 related to collectibility of this note receivable.

MEDICAL DISCOVERIES, INC. AND SUBSIDIARIES

(A Development Stage Company)

Notes to the Unaudited Condensed Consolidated Financial Statements

Note 6 - Formestane Cream (formerly SaveCream) Asset Purchase

On March 16, 2005, the Company completed the purchase of the intellectual property assets (the "Assets") of Savetherapeutics AG, a German corporation in liquidation in Hamburg, Germany ("SaveT"). The Assets consist primarily of patents, patent applications, pre-clinical study data and clinical trial data concerning formestane cream (formerly called SaveCream), a developmental-stage topical aromatase inhibitor treatment for breast cancer. Formestane cream did not generate revenues for SaveT.

The purchase price of the Assets was €2,350,000 (approximately \$3 million under current exchange rates), payable as follows: €500,000 at closing, €500,000 (approximately \$665,700 on the date of transaction, \$634,350 using the September 30, 2006 exchange rates) upon conclusion of certain pending transfers of patent and patent application rights from formestane cream's inventors to the Company, and the remaining €1,350,000 (approximately \$1,712,745 at September 30, 2006) upon successful commercialization of the Assets.

The pending transfers of patent and patent application rights have not occurred as of September 30, 2006. The Company has deemed the transfers are reasonably likely to occur due to existing contractual commitments of the inventors and the reasonably likely success of the Company's action in German court proceeding to effect these transfers. Accordingly, the Company has recorded the second €500,000 payment as a research and development obligation in these financial statements.

In July, 2006 the Company entered into a co-development and license agreement with Eucodis Forschungs-und Entwicklungs GmbH (Eucodis) which provides for up-front licensing fees and milestone payments in excess of the €1,350,000 threshold for successful commercialization of the Assets. Accordingly, in the quarter ended September 30, 2006 the Company recorded the final €1,350,000 purchase price payment as research and development obligation in the accompanying financial statements. Consistent with the Company's conclusion that no business had been acquired in connection with the purchase of the Assets, the charge has been reflected as a research and development expense in the accompanying financial statements.

Note 7 - Other Significant Transactions

Debt Restructuring

On June 10, 2006, the Company entered into an agreement with a former vendor to forgive certain accrued expenses. The balance owed before the agreement was \$229,066. Per the agreement, \$3,975 was paid on the date of the agreement, another \$3,975 will be paid by November 7, 2006, and \$131,116 was forgiven. The remaining balance of \$90,000 will be due and payable immediately upon MDI's receipt of \$1 million in cumulative license revenue for MDI's drug MDI-P in any human indication and has been recorded as Note Payable in the accompanying financial statements. Additionally, the company determined \$476,645 of previously recorded payables has passed the statute of limitations for collection and are included in gain on debt restructuring in the accompanying financial statements.

Licensing Agreement

On May 8, 2006, MDI Oncology, Inc. (MDIO), a wholly-owned subsidiary of Medical Discoveries, Inc., entered into a letter of intent with Eucodis. The agreement included a \$192,825 exclusivity fee for the sixty day period ending July 8, 2006. This amount has been recorded as revenue in accompanying financial statements.

On July 29, 2006, MDIO entered into a Definitive Master Agreement (the "Agreement") with Eucodis. The agreement will give Eucodis the exclusive right and license to develop, manufacture, and commercialize the Formestane Cream in the European Union for use in breast cancer. According to the Agreement, MDIO will receive upfront license fees and milestone payments of approximately \$2.4 million (at current exchange rates), plus royalties. As of September 30, 2006, the Company had received license fees of \$382,175 in cash and recorded another \$225,000 as receivable and these amounts have been recoded as revenue in the accompanying financial statements. The receivable balance was collected subsequent to the date of these financial statements.

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MEDICAL DISCOVERIES, INC. AND SUBSIDIARIES

(A Development Stage Company)

Notes to the Unaudited Condensed Consolidated Financial Statements

Amendment and Loan Agreement with Inventor

On October 30, 2006, the Company amended its Assignment of Patent, Participation and Research and Development Agreement (the "Amendment") and entered into a Loan and Security Agreement for a Special Purpose Loan ("the Loan Agreement") with the inventor of the Company's formestane cream technology. Per the terms of the Amendment the inventor relinquished his right to receive a 6% interest in MDIO and will receive 2,301,000 warrants for the Company's Common Stock upon the completion of pending transfers of patent and patent application rights. The Amendment also terminated as of March 1, 2006 the inventor's obligation to perform certain research activities in exchange for a fee of €120,000 per annum (approximately \$152,000 using current exchange rates.) Additionally the Loan Agreement provides for the Company to advance a €250,000 non-interest bearing loan to the inventor. The loan balance is payable at the request of MDI and is secured by warrants for the Company's stock. However, if the proceeds from the conversion and sale of the warrants is insufficient to fully repay the loan, the Company has agreed to forgive any remaining unpaid balance on the loan.

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

The purpose of this section is to discuss and analyze our condensed consolidated financial condition, liquidity and capital resources, and results of operations. This analysis should be read in conjunction with the condensed consolidated financial statements and notes thereto at pages 3 through 11 and Management's Discussion and Analysis of Financial Condition and Results of Operations contained in our Annual Report on Form 10-KSB for the year ended December 31, 2005 (the "2005 10-KSB").

This section contains certain forward-looking statements that involve risks and uncertainties, including statements regarding our plans, objectives, goals, strategies and financial performance. Our actual results could differ materially from the results anticipated in these forward-looking statements as a result of factors set forth under "Cautionary Statement for Forward-Looking Information and Factors Affecting Future Results" below and elsewhere in this report.

Overview

We are a developmental-stage bio-pharmaceutical company engaged in the research, validation, development and ultimate commercialization of two drugs: MDI-P and formestane cream (formerly known as SaveCream). MDI-P is an anti-infective drug that we believe will be a useful and well-tolerated treatment for bacterial infections, viral infections and fungal infections. We further believe that MDI-P will be a useful treatment for cystic fibrosis. Formestane cream is a breast cancer medication that is applied topically to reduce breast cancer tumors. Both of these drugs are still in development and have not been approved by the U. S. Food and Drug Administration (FDA).

Our initial target indications for MDI-P are cystic fibrosis and HIV. On November 10, 2004 we filed an Investigational New Drug application (IND) with the FDA seeking permission to begin Phase I human clinical trials of MDI-P as a treatment for cystic fibrosis. The FDA placed the proposed Phase I clinical trials on clinical hold pending additional preclinical testing. We completed that preclinical testing and no significant toxicities were noted. We submitted that data to the FDA on March 16, 2006. On April 21, 2006, the FDA responded and continued the clinical hold pending the outcome of yet another battery of preclinical trials. We intend to complete those additional tests and resubmit our IND within 6 months of raising additional capital to fund those tests. If the FDA lifts the clinical hold upon receipt of the amended IND and allows us to proceed with Phase I studies, we will begin human trials at St. Luke's Regional Medical Center in Boise, Idaho using a protocol designed by Dr. Henry Thompson. If our Phase I IND for cystic fibrosis is successful, we intend to file an IND for Phase I testing of MDI-P as a treatment for HIV at the Harvard School of Medicine using a protocol designed by Dr. Bruce Dezube. We also expect to add additional indications for the use of MDI-P in the future as we further our preclinical development.

We purchased the intellectual property assets related to our topical breast cancer treatment drug, formestane cream (formerly called SaveCream) from the bankruptcy estate of a German biotechnology company. Formestane cream is an aromatase inhibitor ("AI") previously marketed as an intramuscular depot injection for adjuvant treatment of breast cancer. Formestane cream represents a novel treatment option based on the inhibition of local production of estrogen, which is a key signal of tumor growth and progression in more than 90% of breast cancer cases. Thus far, clinical evaluation has demonstrated significant reduction of tumor size and low toxicity relative to current AI treatments. There have been no overt side effects observed although further study is necessary to assure an acceptable toxicity profile. In previous studies the topical application to the breast showed significantly dose-dependent uptake. In addition, these studies have indicated stronger down-regulation of estrogen production in the local breast tissue, which is believed to be essential in effecting tumor reduction, and a significant shrinkage of tumor size.

To date, we have not generated significant revenues from operations or realized a profit. Through September 30, 2006, we had incurred cumulative net losses since inception of \$22,496,733.

Recent Events

On July 29, 2006, MDI Oncology, Inc. (“MDIO”), a subsidiary of the Company, entered into a Definitive Master Agreement (the “Agreement”) with Eucodis Forschungs - und Entwicklungs GmbH of Vienna, Austria (“Eucodis”). Pursuant to the Agreement, MDIO licensed to Eucodis the exclusive right to develop, manufacture and commercialize MDIO’s formestane cream product in the European Union and certain surrounding countries. Eucodis is obligated to develop the products through Phase II clinical trials as per U.S. Food and Drug Administration and European Medicines Agency (EMA) standards. If the product is not out-licensed by Eucodis following Phase II, then a Steering Committee created by the parties will determine whether and how to proceed to Phase III trials.

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According to the Agreement, MDIO will receive upfront license fees and milestone payments of approximately \$2.4 million (at current exchange rates), plus royalties. In addition Eucodis has agreed to incur and fund the costs to complete the remaining pre-clinical study and the Phase II trials. The Agreement specifies the data gathered during the Phase II trials will meet the requirements for submission to both the FDA and the EMEA, MDIO has retained the right to complete a global out-license of the product upon certain payments to Eucodis. Finally, Eucodis has agreed to be responsible for manufacturing all the product necessary for trials and MDIO has agreed to purchase product from Eucodis.

Cystic Fibrosis IND. We are continuing to prosecute our IND for cystic fibrosis with the FDA. We submitted an amended IND to the FDA on March 16, 2006. On April 21, 2006, the FDA responded and continued the clinical hold pending the outcome of yet another battery of preclinical trials. Specifically, the FDA has suggested we conduct two additional toxicity studies (dose response and acute toxicity) in a third mammal species, the rat. Data from those studies will help establish safe dosing in humans. In addition, the FDA has asked for additional data on the extractable components of MDI-P. As of the September 30, 2006 the Company is in the process of contacting contract research organizations and other vendors to perform these studies and current estimates to complete this work are approximately \$1,500,000 to \$2,000,000.

The additional studies and data the FDA is requesting can be completed within six to nine months time. However, we will need additional capital to conduct the studies. We estimate the cost of the studies plus overhead expenses during the period of study to require an aggregate of \$2 to \$3 million in funding.

Results of Operations

Revenues and Gross Profit — On May 8, 2006 we entered into a letter of intent with Eucodis to proceed with an evaluation, negotiation and possible execution of a definitive agreement to license and co-develop formestane cream. The agreement included a \$192,825 exclusivity fee for the sixty day period ending July 8, 2006. The fee was received and recorded as revenue in our third quarter. Additionally, we recorded revenue of \$607,175 related to the upfront payments due during the third quarter of 2006 as specified in the co-development agreement with Eucodis. As we continue to pursue preclinical and clinical testing of our pharmaceuticals, we may not book significant revenues in the near future, except for the revenue related to the Eucodis fees.

Operating Expenses and Operating Income or Loss — We incurred \$1,667,080 of research and development fees in the third quarter of 2006 as compared to \$364,335 in the same quarter of 2005. The research and development expenses in the third quarter of 2006 were incurred primarily in connection with accruing the remaining €1,350,000 (approximately \$1,712,745 at September 30, 2006) future payment obligation for the purchase of the intellectual property assets of Savetherapeutics AG, a German corporation in liquidation in Hamburg, Germany. This payment is due upon the successful commercialization of the assets, which in the purchase agreement is specified as receiving €1,350,000 of revenue related to formestane cream. In July, 2006 the Company entered into a co-development and license agreement with Eucodis Forschungs-und Entwicklungs GmbH (Eucodis) which provides for up-front licensing fees and milestone payments in excess of the €1,350,000 threshold for successful commercialization of the assets. Consistent with the Company's conclusion that no business had been acquired in connection with the purchase of the Assets, the charge has been reflected as a research and development expense in the accompanying Condensed Consolidated Statement of Operations. The balance of the expenses in third quarter of 2006 and the expenses in the third quarter of 2005 were incurred in connection with the pre-clinical testing of MDI-P.

For the nine months ended September 30, 2006 we incurred \$1,994,322 of research and development expenses as compared to \$2,034,841 in the first nine months of 2005. The expenses in 2005 were related primarily to accruing the final payment for the purchase of the intellectual property of Savetherapeutics, AG and costs incurred with the pre-clinical development of our anti-infective compound, MDI-P. In the first nine months of 2005 we incurred \$2,034,841 of research and development expenses, \$1,345,000 of which related to our acquiring the patents and patent

rights relating to formestane cream. The balance of the expenses related to preclinical testing of MDI-P.

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Our general and administrative expenses in the third quarter of 2006 were \$618,359 as compared to \$557,713 in the same quarter of 2005. The expenses in this quarter were related primarily to the salaries of our executive and administrative staff and legal expense incurred in connection with negotiating and drafting the license and co-development agreement with Eucodis. Additionally the company incurred legal expenses for the continued activities to transfer and fully assign the patent and application rights from the formestane cream inventors to our company. The increase in general and administrative expense from the third quarter of 2005 was due primarily to increase in legal expenses. In the first nine months of 2006 we incurred \$1,349,825 of general and administrative expenses as compared to \$1,446,034 of expenses for the same period of 2005. As a result of the foregoing, we sustained an operating loss of \$1,485,439 for the quarter ended September 30, 2006 and \$2,544,147 for the first nine months of 2006, as compared with an operating loss of \$922,048 and \$3,480,875 for the same periods of 2005 respectively.

Other Income/Expense and Net Loss — We recorded \$519 in interest income and incurred interest expenses of \$7,538 for the quarter ended September 30, 2006, as compared with interest income of \$2,674 and \$7,591 in interest expenses for the same period of 2005. During the quarter ended September 30, 2006, we also booked a foreign currency gain of \$2,300. We had a foreign currency loss of \$9,720 for the same period of 2005. In addition, we recorded \$840,271 as unrealized gain on financial instrument during the quarter ended September 30, 2006 to record the accounting of warrants resulting from the issuance of the Series A Convertible Preferred Stock entered into in October 2004 and March 2005. The unrealized loss on financial instrument was \$200,673 for the same period of 2005. In sum, our net loss applicable to common shareholders for the third quarter of 2006 was \$647,156 or a loss of \$0.01 per fully diluted share as compared to a loss applicable to common shareholders of \$1,137,358 or a loss of \$0.01 per fully diluted share.

We recorded \$2,295 in interest income and incurred interest expenses of \$22,382 for the nine months ended September, 30, 2006, as compared with interest income of \$17,584 and \$30,726 in interest expenses for the same period of 2005. During the nine months ended September 30, 2006, we also recorded a foreign currency loss of \$21,125. We had a foreign currency gain of \$51,080 for the same period of 2005. In addition, we recorded \$1,720,351 as unrealized gain on financial instrument during the first nine months of 2006 to record the accounting of warrants resulting from the issuance of the Series A Convertible Preferred Stock entered into in October 2004 and March 2005 as compared to a gain of \$1,790,242 for the same period of 2005. We also recorded a gain on debt restructuring of \$607,761 in the first nine months of 2006 quarter as compared to a gain of \$196,353 in the same period of 2005 as we continue to work out arrangements with vendors to settle amounts previously recoded as payables. In sum, our net loss applicable to common shareholders for the first nine months of 2006 was \$256,442 or a loss of \$0.00 per fully diluted share. For the first nine months of 2005 we incurred a net loss applicable to common shareholders of \$1,456,342, making a loss of less than \$0.01 per fully diluted share.

Future Expectations — We may incur losses from operations for several more years while we continue to research, gain regulatory approval of, and commercialize our technologies. If funding is available, we will spend more in research and development expenses for the pre-clinical test for MDI-P as we continue to implement our commercialization strategy. Similarly, if funding becomes available, we expect our general and administrative expenses to continue to increase for the remainder of 2006 as we continue to expand the scope of our operations and build out our infrastructure. As a result, we expect to continue to experience losses form operations in 2006.

Liquidity and Capital Resources - As of September 30, 2006, we had \$103,744 in cash and had a working capital deficit of \$5,832,191. Since our inception, we have financed our operations primarily through private sales of equity and the issuance of convertible and non-convertible notes and preferred stock. The company currently expects it will not be required to raise capital to advance its formestane cream technology through Phase II clinical trials as Eucodis has contractually agreed to incur these costs; however we will need to raise capital to fund some or all of the final payments related to the purchase of the intellectual property related to formestane cream and costs expected to be

incurred related to obtaining the final transfers of patent and patent application rights. We continue to require significant supplementary funding to continue to develop, research, and seek regulatory approval of our MDI-P technologies. We do not currently generate any cash from operations and have no credit facilities in place or available.

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To continue operating, we must raise additional financing or enter into appropriate collaboration agreements with third parties providing for cash payments to the Company. Given that we are still in an early development stage, raising equity financing is difficult. In addition, any additional equity financing will have a substantial dilutive effect to our current shareholders. No assurance can be given that the Company will be successful in obtaining any such financing or in securing collaborative agreements with third parties on acceptable terms, if at all, or if secured, that such financing or collaborative agreements will provide for payments to the Company sufficient to continue funding operations. In the absence of such financing or third-party collaborative agreements, we may be required to scale back or terminate operations and/or seek protection under applicable bankruptcy laws.

We estimate we will need approximately \$1.5 to \$2.0 million in capital to fund the pre-clinical testing in order to advance MDI-P to the next developmental milestone: approval of our Phase I IND. Additionally, we will need to raise funding to cover the costs of our general and administrative expenses until the next developmental milestone. If our IND application is approved, we will need additional capital to initiate Phase I clinical trials. We estimate the cost to complete Phase I and Phase II clinical trials to be several million dollars per indication and the cost to complete Phase III testing and obtain approval to market to be in the tens of millions of dollars per indication. While our ability to obtain financing may improve in the event an IND application is approved and we enter the clinic, we cannot give assurances that we will have access to the significant capital required to take a drug through regulatory approvals and to market. We may seek a partner in the global pharmaceutical industry to help us co-develop, license, or even purchase some or all of our technologies.

Off-Balance Sheet Arrangements

We have no off-balance sheet arrangements as defined in Item 303(c) of Regulation S-B.

Cautionary Statement for Forward Looking Information

Certain information set forth in this report contains “forward-looking statements” within the meaning of federal securities laws. Forward looking statements include statements concerning our plans, objectives, goals, strategies, future events, future revenues or performance, capital expenditures, and financing needs and other information that is not historical information. When used in this report, the words “estimates,” “expects,” “anticipates,” “forecasts,” “plans,” “intends,” “believes” and variations of such words or similar expressions are intended to identify forward-looking statements. Additional forward-looking statements may be made by us from time to time. All such subsequent forward-looking statements, whether written or oral and whether made by us or on our behalf, are also expressly qualified by these cautionary statements.

Our forward-looking statements are based upon our current expectations and various assumptions. Our expectations, beliefs and projections are expressed in good faith and are believed by us to have a reasonable basis, including without limitation, our examination of historical operating trends, data contained in our records and other data available from third parties, but there can be no assurance that our expectations, beliefs and projections will result or be achieved or accomplished. Our forward-looking statements apply only as of the date made. We undertake no obligation to publicly update or revise forward-looking statements which may be made to reflect events or circumstances after the date made or to reflect the occurrence of unanticipated events.

There are a number of risks and uncertainties that could cause actual results to differ materially from those set forth in, contemplated by or underlying the forward-looking statements contained in this report. Those risks and uncertainties include, but are not limited to, our lack of significant operating revenues and lack of profit to date, our need for substantial and immediate additional capital, the fact that we may dilute existing shareholders through additional stock issuances, the extensive governmental regulation to which we are subject, the fact that our technologies remain unproven, the intense competition we face from other companies and other products, and our reliance upon potentially

inadequate intellectual property. Those risks and certain other uncertainties are discussed in more detail in the 2005 10-KSB. There may also be other factors, including those discussed elsewhere in this report, that may cause our actual results to differ from the forward-looking statements. Any forward-looking statements made by us or on our behalf should be considered in light of these factors.

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ITEM 3. CONTROLS AND PROCEDURES

(a) Under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, we conducted an evaluation of our disclosure controls and procedures, as such term is defined under Rule 13a-14(c) promulgated under the Securities Exchange Act of 1934, as amended (the “Exchange Act”), as of September 30, 2006. Based on this evaluation, our principal executive officer and principal financial officer concluded that our disclosure controls and procedures were effective as of September 30, 2006.

(b) There have been no significant changes (including corrective actions with regard to significant deficiencies or material weaknesses) in our internal controls or in other factors that could significantly affect these controls subsequent to the date of the evaluation referenced in paragraph (a) above.

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PART II
OTHER INFORMATION

ITEM 6. EXHIBITS

The following documents are furnished as exhibits to this Form 10-QSB. Exhibits marked with an asterisk are filed herewith. The remainder of the exhibits previously have been filed with the Commission and are incorporated herein by reference.

Number	Exhibit
2.1	Sale and Purchase Agreement between Attorney Hinnerk-Joachim Müller as liquidator of Savetherapeutics AG i.L. and Medical Discoveries, Inc. regarding the purchase of the essential assets of Savetherapeutics AG i.L. (filed as Exhibit 2.1 to the Company's Annual Report on Form 10-KSB for the fiscal year ended December 31, 2004, and incorporated herein by reference).
3.1	Amended and Restated Articles of Incorporation of the Company (filed as Exhibit 3.1 to the Company's Annual Report on Form 10-KSB for the fiscal year ended December 31, 1994, and incorporated herein by reference).
3.2	Amended Bylaws of the Company (filed as Exhibit 3.2 to the Company's Annual Report on Form 10-KSB for the fiscal year ended December 31, 1994, and incorporated herein by reference).
4.1	Registration Rights Agreement dated October 18, 2004 among Monarch Pointe Fund, Ltd., Mercator Advisory Group, LLC and Medical Discoveries, Inc. (filed as Exhibit 4.1 to the Company's Annual Report on Form 10-KSB for the fiscal year ended December 31, 2004, and incorporated herein by reference).
4.2	Registration Rights Agreement dated December 3, 2004 among Mercator Momentum Fund, LP, Mercator Momentum Fund III, LP, Mercator Advisory Group, LLC and Medical Discoveries, Inc. (filed as Exhibit 4.2 to the Company's Annual Report on Form 10-KSB for the fiscal year ended December 31, 2004, and incorporated herein by reference).
4.3	Certificate of Designations of Preferences and Rights of Series A Convertible Preferred Stock of Medical Discoveries, Inc. (filed as Exhibit 4.1 to Registration Statement No. 333-121635 filed on Form SB-2 on December 23, 2004, and incorporated herein by reference).

4.4	Amendment to Certificate of Designations of Preferences and Rights of Series A Convertible Preferred Stock of Medical Discoveries, Inc. (filed as Exhibit 4.2 to Registration Statement No. 333-121635 filed on Form SB-2 on December 23, 2004, and incorporated herein by reference).
10.1	2002 Stock Incentive Plan adopted by the Board of Directors as of July 11, 2002 (filed as Exhibit 10.5 to the Company's Quarterly Report on Form 10-QSB for the quarter ended June 30, 2002, and incorporated herein by reference).
10.2	Subscription Agreement dated October 18, 2004 among Monarch Pointe Fund, Ltd., Mercator Advisory Group, LLC, and Medical Discoveries, Inc. (filed as Exhibit 10.2 to Amendment No. 2 to Registration Statement No. 333-121635 filed on form SB-2 on June 2, 2005, and incorporated herein by reference).
10.3	Subscription Agreement dated December 3, 2004 among Mercator Momentum Fund, LP, Mercator Momentum Fund III, LP, Mercator Advisory Group, LLC, and Medical Discoveries, Inc. (filed as Exhibit 10.3 to Amendment No. 2 to Registration Statement No. 333-121635 filed on form SB-2 on June 2, 2005, and incorporated herein by reference).
10.4	Employment Agreement dated March 1, 2005 between Medical Discoveries, Inc. and Judy M. Robinett. (filed as Exhibit 10.4 to Amendment No. 3 to Registration Statement No. 333-121635 filed on Form SB-2 on October 13, 2005, and incorporated herein by reference).
10.5	Definitive Master Agreement, dated as of July 29, 2006, by and between MDI Oncology, Inc. and Eucodis Forschungs und Entwicklungs GmbH (filed as Exhibit 10.1 to the Company's Current Report on Form 8-K filed August 3, 2006, and incorporated herein by reference).
31.1	Rule 13a-14(a) Certification, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.*
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32.1	Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.*
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* Filed herewith.

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SIGNATURES

In accordance with the requirements of the Exchange Act, the registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

MEDICAL DISCOVERIES, INC.

Date: November 14, 2006

By: /s/ JUDY M. ROBINETT

Judy M. Robinett
President and Chief Executive Officer

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