

FIRST MERCHANTS CORP
Form 10-Q
May 10, 2010

FORM 10-Q
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

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

For the quarterly period ended March 31, 2010

OR

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

For the Transition Period from _____ to _____

Commission File Number 0-17071

FIRST MERCHANTS CORPORATION
(Exact name of registrant as specified in its charter)

| | |
|-------------------------------------------------------------------|-----------------------------------------|
| Indiana | 35-1544218 |
| (State or other jurisdiction of incorporation or organization) | (I.R.S. Employer Identification No.) |

| | |
|------------------------------------------|------------|
| 200 East Jackson Street, Muncie, IN | 47305-2814 |
| (Address of principal executive offices) | (Zip code) |

(Registrant's telephone number, including area code): (765) 747-1500

Not Applicable
(Former name, former address and former fiscal year,
if changed since last report)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (Section 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes ☐ No ☐

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Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definition of “large accelerated filer,” “accelerated filer” and “smaller reporting company” in Rule 12b-2 of the Exchange Act. (Check one): Large accelerated filer ☐ Accelerated filer ☒ Non-accelerated filer ☐ (Do not check if smaller reporting company) Smaller reporting company ☐

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

As of April 30, 2010, there were 25,522,494 outstanding common shares, of the registrant.

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PART I. FINANCIAL INFORMATION
ITEM 1. FINANCIAL STATEMENTS
CONSOLIDATED CONDENSED BALANCE SHEETS
(Dollars in thousands)

CONSOLIDATED CONDENSED BALANCE SHEETS

| | March 31, 2010 | December 31, 2009 |
|------------------------------------------------------------------|--------------------|-------------------------|
| | (Unaudited) | |
| ASSETS | | |
| Cash and due from banks | \$ 52,679 | \$ 76,801 |
| Federal funds sold | 7,044 | 102,346 |
| Cash and cash equivalents | 59,723 | 179,147 |
| Interest-bearing time deposits | 157,735 | 74,025 |
| Investment securities available for sale | 475,596 | 413,607 |
| Investment securities held to maturity | 163,485 | 149,510 |
| Mortgage loans held for sale | 3,646 | 8,036 |
| Loans, net of allowance for loan losses of \$88,568 and \$92,131 | 3,045,972 | 3,177,657 |
| Premises and equipment | 54,431 | 55,804 |
| Federal Reserve and Federal Home Loan Bank stock | 36,721 | 38,576 |
| Interest receivable | 19,532 | 20,818 |
| Core deposit intangibles | 16,175 | 17,383 |
| Goodwill | 141,357 | 141,357 |
| Cash surrender value of life insurance | 95,146 | 94,636 |
| Other real estate owned | 18,268 | 14,879 |
| Tax asset, deferred and receivable | 59,190 | 64,394 |
| Other assets | 28,889 | 31,123 |
| TOTAL ASSETS | \$4,375,866 | \$4,480,952 |
| LIABILITIES | | |
| Deposits: | | |
| Noninterest-bearing | \$ 520,551 | \$ 516,487 |
| Interest-bearing | 2,877,235 | 3,020,049 |
| Total Deposits | 3,397,786 | 3,536,536 |
| Borrowings: | | |
| Securities sold under repurchase agreements | 112,826 | 125,687 |
| Federal Home Loan Bank advances | 123,261 | 129,749 |
| Subordinated debentures, revolving credit lines and term loans | 194,794 | 194,790 |
| Total Borrowings | 430,881 | 450,226 |
| Interest payable | 4,812 | 5,711 |
| Other liabilities | 53,446 | 24,694 |
| Total Liabilities | 3,886,925 | 4,017,167 |
| COMMITMENTS AND CONTINGENT LIABILITIES | | |
| STOCKHOLDERS' EQUITY | | |
| Preferred Stock, no-par value: | | |
| Authorized -- 500,000 shares | | |
| Series A, Issued and outstanding - 116,000 shares | 112,559 | 112,373 |

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| | | |
|---------------------------------------------------------------------------|--------------------|--------------------|
| Cumulative Preferred Stock, \$1,000 par value, \$1,000 liquidation value: | | |
| Authorized -- 600 shares | | |
| Issued and outstanding -- 125 shares | 125 | 125 |
| Common Stock, \$.125 stated value: | | |
| Authorized -- 50,000,000 shares | | |
| Issued and outstanding - 25,495,550 and 21,227,741 shares | 3,187 | 2,653 |
| Additional paid-in capital | 230,764 | 206,600 |
| Retained earnings | 150,595 | 150,860 |
| Accumulated other comprehensive loss | (8,289) | (8,826) |
| Total Stockholders' Equity | 488,941 | 463,785 |
| TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY | \$4,375,866 | \$4,480,952 |

See notes to consolidated condensed financial statements.

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CONSOLIDATED CONDENSED STATEMENTS OF OPERATIONS
(Dollars in thousands, except per share amounts)
(Unaudited)

CONSOLIDATED CONDENSED STATEMENTS OF OPERATIONS

| | Three Months Ended March 31, | |
|------------------------------------------------------------------------------|---------------------------------|---------------|
| | 2010 | 2009 |
| INTEREST INCOME | | |
| Loans receivable: | | |
| Taxable | \$45,448 | \$53,793 |
| Tax exempt | 277 | 215 |
| Investment securities: | | |
| Taxable | 2,891 | 3,763 |
| Tax exempt | 2,646 | 1,769 |
| Federal funds sold | 17 | 12 |
| Deposits with financial institutions | 60 | 102 |
| Federal Reserve and Federal Home Loan Bank stock | 360 | 473 |
| Total Interest Income | 51,699 | 60,127 |
| INTEREST EXPENSE | | |
| Deposits | 11,495 | 16,711 |
| Federal funds purchased | | 22 |
| Securities sold under repurchase agreements | 499 | 467 |
| Federal Home Loan Bank advances | 1,564 | 2,949 |
| Subordinated debentures, revolving credit lines and term loans | 1,926 | 1,479 |
| Total Interest Expense | 15,484 | 21,628 |
| NET INTEREST INCOME | 36,215 | 38,499 |
| Provision for loan losses | 13,869 | 12,921 |
| NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES | 22,346 | 25,578 |
| OTHER INCOME | | |
| Service charges on deposit accounts | 3,262 | 3,542 |
| Fiduciary activities | 2,060 | 2,059 |
| Other customer fees | 2,498 | 2,003 |
| Commission income | 1,989 | 2,059 |
| Earnings on cash surrender value of life insurance | 508 | 323 |
| Net gains and fees on sales of loans | 1,149 | 1,430 |
| Net realized gains on sales of available for sale securities | 1,842 | 2,792 |
| Other-than-temporary impairment on available for sale securities | (1,179) | (478) |
| Portion of loss recognized in other comprehensive income before taxes | 691 | |
| Net impairment losses recognized in earnings | (488) | (478) |
| Other income | 144 | 741 |
| Total Other Income | 12,964 | 14,471 |
| OTHER EXPENSES | | |
| Salaries and employee benefits | 17,562 | 20,015 |
| Net occupancy | 2,851 | 2,569 |
| Equipment | 1,853 | 1,876 |

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| | | |
|-----------------------------------------------------|--------|---------|
| Marketing | 429 | 549 |
| Outside data processing fees | 1,280 | 1,933 |
| Printing and office supplies | 318 | 363 |
| Core deposit amortization | 1,207 | 1,277 |
| FDIC assessments | 1,722 | 576 |
| Other expenses | 7,418 | 5,556 |
| Total Other Expenses | 34,640 | 34,714 |
| INCOME BEFORE INCOME TAX | 670 | 5,335 |
| Income tax expense (benefit) | (916) | 1,218 |
| NET INCOME | 1,586 | 4,117 |
| Preferred stock dividends and discount accretion | 1,450 | 628 |
| NET INCOME AVAILABLE TO COMMON STOCKHOLDERS | \$136 | \$3,489 |
| Per Share Data: | | |
| Basic Net Income Available to Common Stockholders | \$0.01 | \$0.17 |
| Diluted Net Income Available to Common Stockholders | \$0.01 | \$0.17 |
| Cash Dividends Paid | \$0.01 | \$0.23 |
| Average Diluted Shares Outstanding (in thousands) | 21,462 | 21,093 |

See notes to consolidated condensed financial statements.

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CONSOLIDATED CONDENSED STATEMENTS OF COMPREHENSIVE INCOME
(Dollars in thousands)
(Unaudited)

| | Three Months Ended March 31, | |
|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|---------------------------------|----------|
| | 2010 | 2009 |
| Net income | \$1,586 | \$4,117 |
| Other comprehensive income (losses) net of tax: | | |
| Unrealized holding gain on securities available for sale arising during the period, net of income tax expense of \$(994) and \$(874) | 1,846 | 1,622 |
| Unrealized loss on securities available for sale for which a portion of an other-than-temporary impairment has been recognized in income, net of tax benefit of \$243 and \$0 | (452) | |
| Unrealized losses on cash flow hedges: | | |
| Unrealized losses arising during the period, net of income tax benefit of \$0 and \$926 | | (1,388) |
| Amortization of items previously recorded in accumulated other comprehensive income (losses), net of income tax (expense) benefit of \$(15) and \$469 | 23 | (704) |
| Reclassification adjustment for gains (losses) included in net income net of income tax (expense) benefit of \$474 and \$(98) | (880) | 147 |
| | 537 | (323) |
| Comprehensive income | \$2,123 | \$3,794 |

The components of accumulated other comprehensive income (loss), included in stockholders' equity, are as follows:

| | March 31, 2010 | March 31, 2009 |
|----------------------------------------------------------------------------------------------------------------------------------------------|-------------------|-------------------|
| Net unrealized gain (loss) on securities available for sale | \$5,140 | \$(625) |
| Net unrealized loss on securities available for sale for which a portion of an other-than-temporary impairment has been recognized in income | (452) | |
| Net unrealized gain on cash flow hedges | | 229 |
| Defined Benefit Plans | (12,977) | (15,592) |
| Accumulated other comprehensive income | \$(8,289) | \$(15,988) |

See notes to consolidated condensed financial statements.

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CONSOLIDATED CONDENSED STATEMENTS OF STOCKHOLDERS' EQUITY
(Dollars in thousands)
(Unaudited)

CONSOLIDATED CONDENSED STATEMENTS OF STOCKHOLDERS' EQUITY

| | March 31, | |
|------------------------------------------------------------------|-----------|-----------|
| | 2010 | 2009 |
| Balances, January 1 | \$463,785 | \$395,903 |
| Net income | 1,586 | 4,117 |
| Cash dividends on common stock | (215) | (4,921) |
| Cash dividends on preferred stock | (1,450) | |
| Other comprehensive income (loss), net of tax | 537 | (323) |
| Stock issued under employee benefit plan | 164 | |
| Stock issued under dividend reinvestment and stock purchase plan | 16 | 228 |
| Tax benefit (expense) from stock compensation | (48) | 198 |
| Stock redeemed | (69) | (190) |
| Common stock issued | 24,150 | |
| Adjustment to Issuance of stock related to acquisition | | (3,451) |
| Warrants issued under Capital Purchase Program | | 4,169 |
| Cumulative preferred stock issued under Capital Purchase Program | | 111,831 |
| Share-based compensation | 485 | 544 |
| Balances, March 31 | \$488,941 | \$508,105 |

See notes to consolidated condensed financial statements.

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CONSOLIDATED CONDENSED STATEMENTS OF CASH FLOWS

(Dollars in thousands)

(Unaudited)

CONSOLIDATED CONDENSED STATEMENTS OF CASH FLOWS

| | March 31, 2010 | 2009 |
|-----------------------------------------------------------------------------------|-------------------|--------------|
| Cash Flow From Operating Activities: | | |
| Net income | \$1,586 | \$4,117 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Provision for loan losses | 13,869 | 12,921 |
| Depreciation and amortization | 1,447 | 1,464 |
| Share-based compensation | 485 | 544 |
| Tax expense (benefit) from stock compensation | 48 | (198) |
| Mortgage loans originated for sale | (37,492) | (59,335) |
| Proceeds from sales of mortgage loans | 41,882 | 54,971 |
| Gains on sales of securities available for sale | 1,842 | 2,791 |
| Recognized loss on other-than-temporary-impairment | (488) | (477) |
| Change in interest receivable | 1,286 | 3,193 |
| Change in interest payable | (899) | (566) |
| Other adjustments | 7,294 | (24,211) |
| Net cash provided by (used in) operating activities | \$30,860 | \$(4,786) |
| Cash Flows from Investing Activities: | | |
| Net change in interest-bearing deposits | \$(83,710) | \$(119,472) |
| Purchases of: | | |
| Securities available for sale | (95,265) | (32,190) |
| Securities held to maturity | (17,120) | (5,397) |
| Proceeds from sales of securities available for sale | 42,743 | 47,480 |
| Proceeds from maturities of: | | |
| Securities available for sale | 20,757 | 26,894 |
| Securities held to maturity | 2,825 | 8,019 |
| Change in Federal Reserve and Federal Home Loan Bank stock | 1,855 | (101) |
| Net change in loans | 107,709 | 59,347 |
| Proceeds from the sale of other real estate owned | 5,543 | 796 |
| Other adjustments | (74) | (771) |
| Net cash used in investing activities | \$(14,737) | \$(15,395) |
| Cash Flows from Financing Activities: | | |
| Net change in : | | |
| Demand and savings deposits | \$(41,836) | \$52,362 |
| Certificates of deposit and other time deposits | (96,914) | (86,208) |
| Borrowings | 4 | 78,953 |
| Repayment of borrowings | (19,349) | (100,839) |
| Cash dividends on common stock | (215) | (4,921) |
| Cash dividends on preferred stock | (1,450) | |
| Stock issued in private equity placement | 24,150 | |
| Stock issued under dividend reinvestment and stock purchase plans | 180 | 228 |
| Cumulative preferred stock issued | | 116,000 |
| Tax (expense) benefit from stock options exercised | (48) | 198 |

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| | | |
|-----------------------------------------------------------|--------------|-----------|
| Stock redeemed | (69) | (190) |
| Net cash provided by (used in) financing activities | \$(135,547) | \$55,583 |
| Net Change in Cash and Cash Equivalents | (119,424) | 35,402 |
| Cash and Cash Equivalents, January 1 | 179,147 | 150,486 |
| Cash and Cash Equivalents, March 31 | \$59,723 | \$185,888 |
| Additional cash flow information: | | |
| Interest paid | \$16,383 | \$22,194 |
| Income tax refunded | \$(6,054) | |
| Loans transferred to other real estate owned | \$10,107 | \$4,569 |
| Non-cash investing activities using trade date accounting | \$28,308 | \$6,208 |

See notes to consolidated condensed financial statements.

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NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(Table dollars in thousands)

(Unaudited)

NOTE 1. General

Financial Statement Preparation

The significant accounting policies followed by First Merchants Corporation ("Corporation") and its wholly owned subsidiaries for interim financial reporting are consistent with the accounting policies followed for annual financial reporting. All adjustments, which are of a normal recurring nature and are in the opinion of management necessary for a fair statement of the results for the periods reported, have been included in the accompanying consolidated condensed financial statements.

The consolidated condensed balance sheet of the Corporation as of December 31, 2009 has been derived from the audited consolidated balance sheet of the Corporation as of that date. Certain information and note disclosures normally included in the Corporation's annual financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted. These consolidated condensed financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in the Corporation's Form 10-K annual report filed with the Securities and Exchange Commission. The results of operations for the three months ended March 31, 2010 are not necessarily indicative of the results to be expected for the year.

NOTE 2. Share-Based Compensation

Stock options and restricted stock awards ("RSAs") have been issued to directors, officers and other management employees under the Corporation's 1999 Long-term Equity Incentive Plan and the 2009 Long-term Equity Incentive Plan. The stock options, which have a ten-year life, become 100 percent vested ranging from three months to two years and are fully exercisable when vested. Option exercise prices equal the Corporation's common stock closing price on NASDAQ on the date of grant. RSAs provide for the issuance of shares of the Corporation's common stock at no cost to the holder and generally vest after three years. The RSAs vest only if the employee is actively employed by the Corporation on the vesting date and, therefore, any unvested shares are forfeited. Deferred stock units ("DSUs") have been credited to non-employee directors who have elected to defer payment of compensation under the Corporation's 2008 Equity Compensation Plan for Non-employee Directors. DSUs credited are equal to the restricted shares that the non-employee director would have received under the plan. As of March 31, 2010, there were 4,594 DSUs credited to the non-employee directors.

The Corporation's 2009 Employee Stock Purchase Plan ("ESPP") provides eligible employees of the Corporation and its subsidiaries an opportunity to purchase shares of common stock of the Corporation through quarterly offerings financed by payroll deductions. The price of the stock to be paid by the employees shall be equal to 85 percent of the average of the closing price of the Corporation's common stock on each trading day during the offering period. However, in no event shall such purchase price be less than the lesser of an amount equal to 85 percent of the market price of the Corporation's stock on the offering date or an amount equal to 85 percent of the market value on the date of purchase. Common stock purchases are made quarterly and are paid through advance payroll deductions up to a calendar year maximum of \$25,000.

Share-based compensation guidance requires the Corporation to record compensation expense related to unvested share-based awards by recognizing the unamortized grant date fair value of these awards over the remaining service periods of those awards, with no change in historical reported fair values and earnings. Awards are valued at fair value in accordance with provisions of share-based compensation guidance and are recognized on a straight-line basis over the service periods of each award. To complete the exercise of vested stock options, RSA's and ESPP options, the Corporation generally issues new shares from its authorized but unissued share pool. Share-based compensation for the three months ended March 31, 2010 and 2009 were \$485,000 and \$544,000, respectively, and has been recognized as a component of salaries and benefits expense in the accompanying Consolidated Condensed Statements of Income.

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NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(Table dollars in thousands)

(Unaudited)

NOTE 2. Share-Based Compensation continued

The estimated fair value of the stock options granted during 2010 and in prior years was calculated using a Black Scholes option pricing model. The following summarizes the assumptions used in the 2010 Black Scholes model:

| | |
|------------------------------------------------|------------|
| Risk-free interest rate | 2.38% |
| Expected price volatility | 43.54% |
| Dividend yield | 4.02% |
| Forfeiture rate | 5.00% |
| Weighted-average expected life, until exercise | 6.68 years |

The Black Scholes model incorporates assumptions to value share-based awards. The risk-free rate of interest, for periods equal to the expected life of the option, is based on a U.S. government instrument over a similar contractual term of the equity instrument. Expected price volatility is based on historical volatility of the Corporation's common stock. In addition, the Corporation generally uses historical information to determine the dividend yield and weighted-average expected life of the options until exercise. Separate groups of employees that have similar historical exercise behavior with regard to option exercise timing and forfeiture rates are considered separately for valuation and attribution purposes.

Share-based compensation expense recognized in the Consolidated Condensed Statements of Operations is based on awards ultimately expected to vest and is reduced for estimated forfeitures. Share-based compensation guidance requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods, if actual forfeitures differ from those estimates. Pre-vesting forfeitures were estimated to be approximately 5 percent for the three months ended March 31, 2010, based on historical experience.

The following table summarizes the components of the Corporation's share-based compensation awards recorded as expense:

| | Three Months Ended March 31, | |
|------------------------------------------------------|---------------------------------|--------|
| | 2010 | 2009 |
| Stock and ESPP Options | | |
| Pre-tax compensation expense | \$ 182 | \$ 209 |
| Income tax benefit | (17) | (19) |
| Stock and ESPP option expense, net of income taxes | \$ 165 | \$ 190 |
| Restricted Stock Awards | | |
| Pre-tax compensation expense | \$ 302 | \$ 335 |
| Income tax benefit | (106) | (121) |
| Restricted stock awards expense, net of income taxes | \$ 196 | \$ 214 |
| Total Share-Based Compensation: | | |
| Pre-tax compensation expense | \$ 485 | \$ 544 |
| Income tax benefit | (123) | (140) |

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| | | |
|-------------------------------------------------------------|-------|-------|
| Total share-based compensation expense, net of income taxes | \$362 | \$404 |
|-------------------------------------------------------------|-------|-------|

As of March 31, 2010, unrecognized compensation expense related to stock options and RSAs totaling \$147,000 and \$302,000, respectively, is expected to be recognized over weighted-average periods of .98 and 2.11 years, respectively.

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NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS
(Table dollars in thousands)
(Unaudited)

NOTE 2. Share-Based Compensation continued

Stock option activity under the Corporation's stock option plans as of March 31, 2010 and changes during the three months ended March 31, 2010 were as follows:

| | Number of Shares | Weighted-Average Exercise Price | Weighted Average Remaining Contractual Term (in Years) | Aggregate Intrinsic Value |
|--------------------------------|---------------------|------------------------------------|-----------------------------------------------------------------------|---------------------------------|
| Outstanding at January 1, 2010 | 1,087,930 | \$ 23.51 | | |
| Granted | 35,000 | \$ 5.89 | | |
| Exercised | | | | |