Pendrell Corp
Form 10-Q
May 04, 2012
Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended March 31, 2012

Or

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

For the transition period from to

Commission File Number 001-33008

PENDRELL CORPORATION

(Exact name of registrant as specified in its charter)

Delaware	**98-0221142**
(State or other jurisdiction of	**(IRS Employer**
incorporation or organization)	**Identification No.)**

2300 Carillon Point, Kirkland, Washington 98033

(Address of principal executive offices including zip code)

(425) 278-7100

(Registrant s telephone number, including area code)

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 x No ¨.

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

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

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

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

As of April 30, 2012, the registrant had 207,464,324 shares of Class A common stock and 53,660,000 shares of Class B convertible common stock outstanding.

Table of Contents

PENDRELL CORPORATION

FORM 10-Q

For the three months ended March 31, 2012

INDEX

Table of Contents

PART I FINANCIAL INFORMATION

Item 1. Financial Statements

Pendrell Corporation

Condensed Consolidated Balance Sheets

(In thousands, except share data, unaudited)

	March 31, 2012	December 31, 2011
ASSETS		
Current assets:		
Cash and cash equivalents	$ 208,621	$ 230,377
Receivable from DISH Network associated with disposition of assets		10,000
Prepaid expenses and other current assets net of reserve of $2,750 in both periods	5,024	2,443
Deferred tax asset	49,570	49,570
Total current assets	263,215	292,390
Property in service net of accumulated depreciation of $1,012 and $962, respectively	259	288
Other assets	29	131
Intangible assets net of accumulated amortization of $4,700 and $1,986, respectively	144,681	120,145
Goodwill	22,093	22,093
Total	$ 430,277	$ 435,047
LIABILITIES, STOCKHOLDERS EQUITY AND NONCONTROLLING INTEREST		
Current liabilities:		
Accounts payable	$ 258	$ 282
Accrued expenses	12,903	17,489
Accrued interest	29,847	28,092
Capital lease obligations	15,092	14,896
Total current liabilities	58,100	60,759
Income tax	9,992	9,870
Other	475	479
Deferred tax liability	51,161	51,161
Total liabilities	119,728	122,269
Commitments and contingencies (Note 6)		
Stockholders equity and noncontrolling interest:		
Preferred stock, $.01 par value, 75,000,000 shares authorized, no shares issued or outstanding		
Class A common stock, $.01 par value, 900,000,000 shares authorized, 265,579,798 and 264,992,881 shares issued, and 207,194,882 and 206,696,021 shares outstanding	2,662	2,650
Class B convertible common stock, $.01 par value, 150,000,000 shares authorized, 84,663,382 shares issued and 53,660,000 shares outstanding	847	847
Additional paid-in capital	2,797,649	2,794,970
Treasury stock, 58,384,916 and 58,296,860 shares of Class A common stock and 31,003,382 shares of Class B convertible common stock	(878,052)	(877,833)
Accumulated other comprehensive loss	(13,843)	(11,660)

Accumulated deficit	(1,605,778)	(1,603,941)
Total Pendrell stockholders equity	303,485	305,033
Noncontrolling interest	7,064	7,745
Total stockholders equity and noncontrolling interest	310,549	312,778
Total	$ 430,277	$ 435,047

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

3

Table of Contents

Pendrell Corporation

Condensed Consolidated Statements of Operations

(In thousands, except share and per share data, unaudited)

	Three months ended March 31, 2012		Three months ended March 31, 2011	
Revenue	$	3,699	$	
Operating expenses:				
General and administrative (including non-cash stock compensation expense of $1,338 and $1,754, respectively)		9,921		6,485
Contract settlements				(4,735)
Amortization of intangible assets		2,714		
Total operating expenses		12,635		1,750
Operating loss		(8,936)		(1,750)
Interest income		61		7
Interest expense		(1,250)		(1,079)
Gain associated with disposition of assets		5,645		300,886
Other income		1,249		397
Income (loss) before income taxes		(3,231)		298,461
Income tax benefit		713		2,732
Net income (loss)		(2,518)		301,193
Net income (loss) attributable to noncontrolling interest		(681)		
Net income (loss) attributable to Pendrell	$	(1,837)	$	301,193
Basic income (loss) per share attributable to Pendrell	$	(0.01)	$	1.20
Diluted income (loss) per share attributable to Pendrell	$	(0.01)	$	1.18
Weighted average shares outstanding used to compute basic income (loss) per share		256,122,995		251,959,984
Weighted average shares outstanding used to compute diluted income (loss) per share		256,122,995		255,360,490

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

4

Table of Contents

Pendrell Corporation

Condensed Consolidated Statements of Comprehensive Income (Loss)

(In thousands, unaudited)

	Three months ended March 31, 2012	Three months ended March 31, 2011
Net income (loss)	$ (2,518)	$ 301,193
Other comprehensive loss:		
Cumulative translation adjustments	(2,183)	(1,224)
Comprehensive income (loss)	(4,701)	299,969
Comprehensive loss attributable to noncontrolling interest	681	
Comprehensive income (loss) attributable to Pendrell	$ (4,020)	$ 299,969

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

5

Table of Contents

Pendrell Corporation

Condensed Consolidated Statements of Cash Flows

(In thousands, except share data, unaudited)

	Three months ended March 31, 2012	Three months ended March 31, 2011
Operating activities:		
Net income (loss) including noncontrolling interest	$ (2,518)	$ 301,193
Adjustments to reconcile net income (loss) to net cash used in operating activities:		
Stock-based compensation	1,338	1,754
Amortization of prepaid compensation from Ovidian Group acquisition	754	
Amortization of intangibles	2,714	
Depreciation	52	22
Unrealized foreign exchange gains	(218)	(440)
Gain associated with contract settlements		(4,735)
Gain associated with disposition of assets	(5,645)	(300,886)
Other		(217)
Other changes in certain assets and liabilities, net of acquisitions:		
Prepaid expenses and other current/non-current assets	(2,657)	(52)
Accounts payable	(24)	175
Accrued interest payable	951	860
Other accrued expenses	(5,383)	(1,472)
Net cash used in operating activities	(10,636)	(3,798)
Investing activities:		
Purchases of property and intangible assets	(27,273)	(23)
Payments to affiliates		(270)
Proceeds associated with disposition of assets	15,645	35,000
Net cash provided by (used in) investing activities	(11,628)	34,707
Financing activities:		
Proceeds from exercise of stock options	718	48
Payment of withholding taxes from stock awards	(220)	(119)
Net cash provided by (used in) financing activities	498	(71)
Effect of foreign exchange rate changes on cash	10	251
Net increase (decrease) in cash and cash equivalents	(21,756)	31,089
Cash and cash equivalents beginning of period	230,377	20,771
Cash and cash equivalents end of period	$ 208,621	$ 51,860
Supplemental disclosures:		
Income taxes paid	$ 2,156	$
Supplemental disclosures of non-cash activities:		
Issuance of Class A common shares for advisory services		125
Issuance of Class A common shares for stock-based compensation	832●	

allows banks to establish subsidiaries to engage in certain activities which a financial holding company could engage in, if the bank meets certain management, capital and Community Reinvestment Act standards;

- allows insurers and other financial services companies to acquire banks and removes various restrictions that currently apply to bank holding company ownership of securities firms and mutual fund advisory companies; and establishes the overall regulatory structure applicable to financial holding companies that also engage in insurance and securities operations.

The Modernization Act modified other laws, including laws related to financial privacy and community reinvestment.

The Modernization Act also amended the BHCA and the Bank Merger Act to require the federal banking agencies to consider the effectiveness of a financial institution's anti-money laundering activities when reviewing an application under these acts.

Additional proposals to change the laws and regulations governing the banking and financial services industry are frequently introduced in Congress, in the state legislatures and before the various bank regulatory agencies. The likelihood and timing of any such changes and the impact such changes might have on the Company cannot be determined at this time.

The Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley Act"), which became law on July 30, 2002, added new legal requirements affecting corporate governance, accounting and corporate reporting for companies with publicly traded securities.

The Sarbanes-Oxley Act provides for, among other things:

- a prohibition on personal loans made or arranged by the issuer to its directors and executive officers (except for loans made by a bank subject to Regulation O of the Federal Reserve Board);
- independence requirements for audit committee members;
- disclosure of whether at least one member of the audit committee is a "financial expert" (as such term is defined by the Securities and Exchange Commission ("SEC") and if not, why not;
- independence requirements for outside auditors;

- a prohibition by a company's registered public accounting firm from performing statutorily mandated audit services for the company if the company's chief executive officer, chief financial officer, comptroller, chief accounting officer or any person serving in equivalent positions had been employed by such firm and participated in the audit of such company during the one-year period preceding the audit initiation date;

Table of Contents

- certification of financial statements and annual and quarterly reports by the principal executive officer and the principal financial officer;
- the forfeiture of bonuses or other incentive-based compensation and profits from the sale of an issuer's securities by directors and senior officers in the twelve month period following initial publication of any financial statements that later require restatement due to corporate misconduct;
- disclosure of off-balance sheet transactions;
- two-business day filing requirements for insiders filing Forms 4;
- disclosure of a code of ethics for financial officers and filing a Form 8-K for a change or waiver of such code;
- "real time" filing of periodic reports;
- posting of certain SEC filings and other information on the company website;
- the reporting of securities violations "up the ladder" by both in-house and outside attorneys;
- restrictions on the use of non-GAAP financial measures;
- the formation of a public accounting oversight board; and
- various increased criminal penalties for violations of securities laws.

Additionally, Section 404 of the Sarbanes-Oxley Act requires that a public company subject to the reporting requirements of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), include in its annual report (i) a management's report on internal control over financial reporting assessing the company's internal controls, and (ii) an auditor's attestation report, completed by the registered public accounting firm that prepares or issues an accountant's report which is included in the company's annual report, attesting to the effectiveness of management's internal control assessment. Because we are neither a "large accelerated filer" nor an "accelerated filer", under current rules, compliance with the auditor's attestation report requirement is not required until we file our annual report for 2010.

Each of the national stock exchanges, including the Nasdaq Global Market where the Company's common stock is listed, have implemented new corporate governance rules, including rules strengthening director independence requirements for boards, and the adoption of charters for the nominating, corporate governance, and audit committees. The rule changes are intended to, among other things, make the board of directors independent of management and allow shareholders to more easily and efficiently monitor the performance of companies and directors. These increased burdens have increased the Company's legal and accounting fees and the amount of time that the Board of Directors and management must devote to corporate governance issues.

Effective August 29, 2002, as directed by Section 302(a) of Sarbanes-Oxley, the Company's principal executive officer and principal financial officer are each required to certify that the Company's Quarterly and Annual Reports do not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of circumstances under which they were made, not misleading. The rules have several requirements, including having these officers certify that: they are responsible for establishing, maintaining and regularly evaluating the effectiveness of the Company's disclosure controls and procedures and internal control over financial reporting; they have made certain disclosures to the Company's auditors and the audit committee of the Board of Directors about the Company's internal control over financial reporting; and they have included information in the Company's Quarterly and Annual Reports about their evaluation of disclosure controls and procedures and whether there have been significant changes in the Company’s internal controls\ over financial reporting.

9

Table of Contents

As part of the USA Patriot Act, signed into law on October 26, 2001, Congress adopted the International Money Laundering Abatement and Financial Anti-Terrorism Act of 2001 (the “Act”). The Act authorizes the Secretary of the Treasury, in consultation with the heads of other government agencies, to adopt special measures applicable to financial institutions such as banks, bank holding companies, broker-dealers and insurance companies. Among its other provisions, the Act requires each financial institution: (i) to establish an anti-money laundering program; (ii) to establish due diligence policies, procedures and controls that are reasonably designed to detect and report instances of money laundering in United States private banking accounts and correspondent accounts maintained for non-United States persons or their representatives; and (iii) to avoid establishing, maintaining, administering, or managing correspondent accounts in the United States for, or on behalf of, a foreign shell bank that does not have a physical presence in any country. In addition, the Act expands the circumstances under which funds in a bank account may be forfeited and requires covered financial institutions to respond under certain circumstances to requests for information from federal banking agencies within 120 hours.

The Department of Treasury has issued regulations implementing the due diligence requirements. These regulations require minimum standards to verify customer identity and maintain accurate records, encourage cooperation among financial institutions, federal banking agencies, and law enforcement authorities regarding possible money laundering or terrorist activities, prohibit the anonymous use of “concentration accounts,” and require all covered financial institutions to have in place an anti-money laundering compliance program.

As a New Jersey-chartered commercial bank, the Bank is subject to supervision and examination by the New Jersey Department of Banking and Insurance. The Bank is also subject to regulation by the FDIC, which is its principal federal bank regulator.

The Bank must comply with various requirements and restrictions under federal and state law, including the maintenance of reserves against deposits, restrictions on the types and amounts of loans that may be granted and the interest that may be charged thereon, limitations on the types of investments that may be made and the services that may be offered, and restrictions on dividends as described in the preceding section. Consumer laws and regulations also affect the operations of the Bank. In addition to the impact of regulation, commercial banks are affected significantly by the actions of the Federal Reserve Board which influence the money supply and credit availability in the national economy.

Community Reinvestment Act

Under the Community Reinvestment Act (“CRA”), as implemented by FDIC regulations, a bank has a continuing and affirmative obligation, consistent with its safe and sound operation, to help meet the credit needs of its entire community, including low- and moderate-income neighborhoods. CRA does not establish specific lending requirements or programs for financial institutions nor does it limit an institution’s discretion to develop the types of products and services that it believes are best suited to its particular community, consistent with CRA. CRA requires the FDIC to assess an institution’s record of meeting the credit needs of its community and to take such record into account in its evaluation of certain applications by the applicable institution. The CRA requires public disclosure of an institution’s CRA rating and requires that the FDIC provide a written evaluation of an institution’s CRA performance utilizing a four-tiered descriptive rating system. An institution’s CRA rating is considered in determining whether to grant charters, branches and other deposit facilities, relocations, mergers, consolidations and acquisitions. Performance less than satisfactory may be the basis for denying an application. At its last CRA examination, the Bank was rated “satisfactory” under CRA.

FIRREA

Under the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (“FIRREA”), a depository institution insured by the FDIC can be held liable for any loss incurred by, or reasonably expected to be incurred by, the FDIC in connection with (i) the default of a commonly controlled FDIC-insured depository institution or (ii) any assistance provided by the FDIC to a commonly controlled FDIC-insured depository institution in danger of default. These provisions have commonly been referred to as FIRREA’s “cross guarantee” provisions. Further, under FIRREA, the failure to meet capital guidelines could subject a bank to a variety of enforcement remedies available to federal regulatory authorities.

FIRREA also imposes certain independent appraisal requirements upon a bank’s real estate lending activities and further imposes certain loan-to-value restrictions on a bank’s real estate lending activities. The bank regulators have promulgated regulations in these areas.

Table of Contents

Insurance of Deposits

Subject to the immediately following paragraph, the Bank's deposits are insured up to a maximum of $250,000 per depositor through December 31, 2009 under the Deposit Insurance Fund. The FDICIA is applicable to depository institutions and deposit insurance. The FDICIA requires the FDIC to establish a risk-based assessment system for all insured depository institutions. Under this legislation, the FDIC is required to establish an insurance premium assessment system based upon: (i) the probability that the insurance fund will incur a loss with respect to the institution, (ii) the likely amount of the loss, and (iii) the revenue needs of the insurance fund. In compliance with this mandate, the FDIC has developed a matrix that sets the assessment premium for a particular institution in accordance with its capital level and overall rating by the primary regulator. Under the matrix as currently in effect, the assessment rate ranges from 0 to 27 basis points of assessed deposits. Additionally, the Financing Corporation ("FICO"), a mixed-ownership government corporation established to recapitalize the Federal Savings & Loan Insurance Corporation, a predecessor to the Deposit Insurance Fund, is authorized to impose and collect, with the approval of the FDIC, assessments for anticipated interest payments, issuance costs and custodial fees on noncallable bonds historically issued by FICO in connection with such recapitalization. The bonds issued by FICO are due to mature in 2017 through 2019. The FICO assessment is a component of the FDIC assessment.

In October 2008, the FDIC announced the Temporary Liquidity Guarantee Program, under which any participating depository institution would be able to provide full deposit insurance coverage for non-interest bearing transaction accounts, regardless of the dollar amount. Under the program, effective December 5, 2008, insured depository institutions that have not opted out of the Temporary Liquidity Guaranty Program will be subject to a 0.10% surcharge applied to non-interest bearing transaction deposit account balances in excess of $250,000, which surcharge will be added to the institution's existing risk-based deposit insurance assessments. The Bank opted in the FDIC Temporary Liquidity Guaranty Program.

In February 2009, the FDIC announced that it would impose an emergency special assessment of 0.20% surcharge on all insured institutions to be collected on September 30, 2009 and that it may also impose possible additional special assessments of up to 0.10% to maintain public confidence in the Deposit Insurance Fund. The FDIC subsequently reduced the amount of the emergency special assessment to 0.10% in March 2009.

In November 2009, the FDIC announced that it would require insured institutions to prepay slightly over three years of estimated insurance assessments. The prepayment allowed the FDIC to strengthen the cash position of the Deposit Insurance Fund. Payment of the prepaid assessment of $2,918,390, along with the $198,853 payment of the regular third quarter assessment, was made by the Bank on December 30, 2009.

Item 1A. Risk Factors.

The following are some important factors that could cause the Company's actual results to differ materially from those referred to or implied in any forward-looking statement. These are in addition to the risks and uncertainties discussed elsewhere in this Annual Report on Form 10-K and the Company's other filings with the SEC.

A prolonged economic downturn or the return of negative developments in the financial services industry could negatively impact our operations.

The global and U.S. economic downturn has resulted in uncertainty in the financial markets in general with the possibility of a slow recovery or a fall back into recession. The Federal Reserve, in an attempt to help the overall economy, has kept interest rates low through its targeted federal funds rate and the purchase of mortgage- backed securities. If the Federal Reserve increases the federal funds rate, overall interest rates will likely rise which may negatively impact the housing markets and the U.S. economic recovery. A prolonged economic downturn or the return of negative developments in the financial services industry could negatively impact our operations by causing an increase in our provision for loan losses and a deterioration of our loan portfolio. Such a downturn may also adversely affect our ability to originate or sell loans. The occurrence of any of these events could have an adverse impact our financial performance.

Table of Contents

A prolonged or worsened downturn affecting the economy and/or the real estate market in our primary market area would adversely affect our loan portfolio and our growth potential.

Much of the Company's lending is in northern and central New Jersey. As a result of this geographic concentration, a further significant broad-based deterioration in economic conditions in the New Jersey metropolitan area could have a material adverse impact on the quality of the Company's loan portfolio, results of operations and future growth potential. A prolonged decline in economic conditions in our market area could restrict borrowers' ability to pay outstanding principal and interest on loans when due, and consequently, adversely affect the cash flows and results of operation of the Company's business.

The Company's loan portfolio is largely secured by real estate collateral located in the State of New Jersey. Conditions in the real estate markets in which the collateral for the Company's loans are located strongly influence the level of the Company's non-performing loans and results of operations. A continued decline in the New Jersey real estate markets could adversely affect the Company's loan portfolio. Decreases in local real estate values would adversely affect the value of property used as collateral for our loans. Adverse changes in the economy also may have a negative effect on the ability of our borrowers to make timely repayments of their loans, which would have an adverse impact on our earnings.

The Company faces significant competition.

The Company faces significant competition from many other banks, savings institutions and other financial institutions which have branch offices or otherwise operate in the Company's market area. Non-bank financial institutions, such as securities brokerage firms, insurance companies and money market funds, engage in activities which compete directly with traditional bank business, which has also led to greater competition. Many of these competitors have substantially greater financial resources than the Company, including larger capital bases that allow them to attract customers seeking larger loans than the Company is able to accommodate and the ability to aggressively advertise their products and to allocate considerable resources to locations and products perceived as profitable. There can be no assurance that the Company and the Bank will be able to successfully compete with these entities in the future.

The Company is subject to interest rate risk.

The Company's earnings are largely dependent upon its net interest income. Net interest income is the difference between interest income earned on interest-earning assets such as loans and securities and interest expense paid on interest-bearing liabilities such as deposits and borrowed funds. Interest rates are highly sensitive to many factors that are beyond the Company's control, including general economic conditions and policies of various governmental and regulatory agencies and, in particular, the Federal Reserve Board. Changes in monetary policy, including changes in interest rates, could influence not only the interest the Company receives on loans and securities and the amount of interest it pays on deposits and borrowings, but such changes could also affect (i) the Company's ability to originate loans and obtain deposits, (ii) the fair value of the Company's financial assets and liabilities, and (iii) the average duration of the Company's mortgage-backed securities portfolio. If the spread between the interest rates paid on deposits and other borrowings and the interest rates received on loans and other investments narrows, the Company's net interest income, and therefore earnings, could be adversely affected. This also includes the risk that interest-earning assets may be more responsive to changes in interest rates than interest-bearing liabilities, or vice versa (repricing risk), the risk that the individual interest rates or rate indices underlying various interest-earning assets and interest bearing liabilities may not change in the same degree over a given time period (basis risk), and the risk of changing interest rate relationships across the spectrum of interest-earning asset and interest-bearing liability maturities (yield curve risk).

Although management believes it has implemented effective asset and liability management strategies to reduce the potential effects of changes in interest rates on the Company's results of operations, any substantial, unexpected, prolonged change in market interest rates could have a material adverse effect on the Company's financial condition and results of operations.

The Company is subject to risks associated with speculative construction lending.

The risks associated with speculative construction lending include the borrower's inability to complete the construction process on time and within budget, the sale of the project within projected absorption periods, the economic risks associated with real estate collateral, and the potential of a rising interest rate environment. Such loans may include financing the development and/or construction of residential subdivisions. This activity may involve financing land purchase, infrastructure development (i.e. roads, utilities, etc.), as well as construction of residences or multi-family dwellings for subsequent sale by developer/builder. Because the sale of developed properties is integral to the success of developer business, loan repayment may be especially subject to the volatility of real estate market values. Management has established underwriting and monitoring criteria to minimize the inherent risks of speculative commercial real estate construction lending. Further, management concentrates lending efforts with developers demonstrating successful performance on marketable projects within the Bank's lending areas.

Table of Contents

Federal and state government regulation impacts the Company's operations.

The operations of the Company and the Bank are heavily regulated and will be affected by present and future legislation and by the policies established from time to time by various federal and state regulatory authorities. In particular, the monetary policies of the Federal Reserve Board have had a significant effect on the operating results of banks in the past and are expected to continue to do so in the future. Among the instruments of monetary policy used by the Federal Reserve Board to implement its objectives are changes in the discount rate charged on bank borrowings. It is not possible to predict what changes, if any, will be made to the monetary policies of the Federal Reserve Board or to existing federal and state legislation or the effect that such changes may have on the future business and earnings prospects of the Company.

The Company and the Bank are subject to examination, supervision and comprehensive regulation by various federal and state agencies. Compliance with the rules and regulations of these agencies may be costly and may limit growth and restrict certain activities, including payment of dividends, investments, loans and interest rate charges, interest rates paid on deposits, and locations of offices. The Bank is also subject to capitalization guidelines set forth in federal legislation and regulations.

The laws and regulations applicable to the banking industry could change at any time, and we cannot predict the impact of these changes on our business and profitability. Because government regulation greatly affects the business and financial results of all commercial banks and bank holding companies, the cost of compliance could adversely affect the Company's result of operations.

If our allowance for loan losses is not sufficient to cover actual loan losses, our earnings could decrease.

We make various assumptions and judgments about the collectability of our loan portfolio, including the creditworthiness of our borrowers and the value of the real estate and other assets serving as collateral for the repayment of many of our loans. In determining the amount of the allowance for loan losses, we review our loans and our loan and delinquency experience, and we evaluate economic conditions. If our assumptions are incorrect, our allowance for loan losses may not be sufficient to cover losses inherent in our loan portfolio, resulting in additions to our allowance. Material additions to our allowance would materially decrease our net income.

In addition, bank regulators periodically review our allowance for loan losses and may require us to increase our provision for loan losses or recognize further loan charge-offs. Any increase in our allowance for loan losses or loan charge-offs as required by these regulatory authorities might have a material adverse effect on our financial condition and results of operations.

Market Reform Efforts May Result in Our Businesses Becoming Subject to Extensive and Pervasive Additional Regulations.

Recent economic and market conditions have led to numerous proposals for changes in the regulation of the financial industry in an effort to prevent future crises and reform the financial regulatory system. President Obama's administration has released a comprehensive plan for regulatory reform in the financial industry. The Administration's plan contains significant proposed structural reforms, including heightened powers for the Federal Reserve to regulate risk across the financial system; a new Financial Services Oversight Council chaired by the U.S. Treasury; and two new federal agencies, a Consumer Financial Protection Agency and a new National Bank Supervisor. The plan also calls for new substantive regulation across the financial industry, including more heightened scrutiny and regulation for any financial firm whose combination of size, leverage, and interconnectedness could pose a threat to financial stability if it failed.

13

There can be no assurance as to whether or when any of the parts of the Administration's plan or other proposals will be enacted into legislation, and if adopted, what the final provisions of such legislation will be. The financial services industry is highly regulated, and the Company and the Bank are subject to regulation by several government agencies, including the Federal Reserve Board and the FDIC. Legislative and regulatory changes, as well as changes in governmental economic and monetary policy, not only can affect our ability to attract deposits and make loans, but can also affect the demand for business and personal lending and for real estate mortgages. Government regulations affect virtually all areas of our operations, including our range of permissible activities, products and services, the amount of service fees or the ability to assess such fees, the geographic locations in which our services can be offered, the amount of capital required to be maintained to support operations, the right to pay dividends and the amount which we can pay to obtain deposits. New legislation and regulatory changes could require the Company to change certain of its business practices, impose additional costs on us, or otherwise adversely affect our business, results of operations or financial condition.

The price of our common stock may fluctuate.

The price of our common stock on the NASDAQ Global Market constantly changes and recently, given the uncertainty in the financial markets, has fluctuated widely. From the beginning of fiscal year 2008 through the end of fiscal year 2009, our stock price fluctuated between a high of $16.28 per share and a low of $4.04 per share. We expect that the market price of our common stock will continue to fluctuate. Consequently, the current market price of our common stock may not be indicative of future market prices, and we may be unable to sustain or increase the value of an investment in our common stock.

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

- quarterly fluctuations in our operating and financial results;
- operating results that vary from the expectations of management, securities analysts and investors;
- changes in expectations as to our future financial performance, including financial estimates by securities analysts and investors;
- events negatively impacting the financial services industry which result in a general decline in the market valuation of our common stock;
- announcements of material developments affecting our operations or our dividend policy;
- future sales of our equity securities;
- new laws or regulations or new interpretations of existing laws or regulations applicable to our business;
- changes in accounting standards, policies, guidance, interpretations or principles; and
- general domestic economic and market conditions.

In addition, recently the stock market generally has experienced extreme price and volume fluctuations, and industry factors and general economic and political conditions and events, such as economic slowdowns or recessions, interest rate changes or credit loss trends, could also cause our stock price to decrease regardless of our operating results.

The Company is subject to liquidity risk.

Liquidity risk is the potential that the Company will be unable to meet its obligations as they become due, capitalize on growth opportunities as they arise, or pay regular dividends because of an inability to liquidate assets or obtain adequate funding in a timely basis, at a reasonable cost and within acceptable risk tolerances.

Liquidity is required to fund various obligations, including credit commitments to borrowers, mortgage and other loan originations, withdrawals by depositors, repayment of borrowings, dividends to shareholders, operating expenses and capital expenditures.

Table of Contents

Liquidity is derived primarily from retail deposit growth and retention; principal and interest payments on loans; principal and interest payments; sale, maturity and prepayment of investment securities; net cash provided from operations and access to other funding sources.

Our access to funding sources in amounts adequate to finance our activities could be impaired by factors that affect us specifically or the financial services industry in general. Factors that could detrimentally impact our access to liquidity sources include a decrease in the level of our business activity due to a market downturn or adverse regulatory action against us. Our ability to borrow could also be impaired by factors that are not specific to us, such as a severe disruption of the financial markets or negative views and expectations about the prospects for the financial services industry as a whole.

Our agreements with the Treasury impose restrictions and obligations on us that limit our ability to pay cash dividends and repurchase our common stock or trust preferred securities.

On December 23, 2008, we issued Preferred Stock Series B and a warrant to purchase our common stock to the Treasury as part of its TARP CPP. Prior to December 23, 2011, unless we have redeemed all of the Preferred Stock Series B or the Treasury has transferred all of the Preferred Stock Series B to a third party, the consent of the Treasury will be required for us to, among other things, pay cash dividends on our common stock or repurchase our common stock or other trust preferred securities (with certain exceptions, including the repurchase of our common stock in connection with an employee benefit plan in the ordinary course of business and consistent with past practice).

Higher FDIC deposit insurance premiums and assessments could adversely affect our financial condition.

FDIC insurance premiums have increased substantially in 2009 and we may have to pay significantly higher FDIC premiums in the future and prepay insurance premiums. Market developments during 2009 significantly depleted the insurance fund of the FDIC and reduced the ratio of reserves to insured deposits.

The FDIC adopted a revised risk-based deposit insurance assessment schedule during the first quarter of 2009, which raised regular deposit insurance premiums. In May 2009, the FDIC also implemented a five basis point special assessment of each insured depository institution’s total assets minus Tier 1 capital as of June 30, 2009, but no more than 10 basis points times the institution’s assessment base for the second quarter of 2009, collected by the FDIC on September 30, 2009. The amount of this special assessment for the Bank was $272,518.

In November 2009, the FDIC announced that it would require insured institutions to prepay slightly over three years of estimated insurance assessments. The prepayment allowed the FDIC to strengthen the cash position of the Deposit Insurance Fund. Payment of the prepaid assessment of $2,918,390, along with the $198,853 payment of the regular third quarter assessment, was made by the Bank on December 30, 2009.

The FDIC may impose additional special assessments for future quarters or may increase the FDIC standard assessments. We cannot provide you with any assurances that we will not be required to pay additional FDIC insurance assessments, which could have an adverse effect on our results of operations.

Our shares of Preferred Stock Series B impact net income available to our common stockholders and our earnings per share.

As long as there are shares of Preferred Stock Series B outstanding, no cash dividends may be paid on our common stock unless all dividends on the Preferred Stock Series B have been paid in full. The dividends declared on our Preferred Stock Series B reduce the net income available to common shareholders and our earnings per common share. Additionally, warrants to purchase the Company’s common stock issued to the Treasury, in conjunction with the issuance of shares of Preferred Stock Series B, may be dilutive to our earnings per share. The shares of Preferred Stock Series B will also receive preferential treatment in the event of liquidation, dissolution or winding up of the Company.

We are not required to declare cash dividends on our common stock and have never paid a cash dividend on our common stock. Until the earlier of (i) December 23, 2011 or (ii) the date the Treasury no longer owns any shares of Preferred Stock Series B, we may not pay any dividends on our common stock without obtaining the prior consent of the Treasury.

Table of Contents

Future offerings of debt or other securities may adversely affect the market price of our stock.

In the future, we may attempt to increase our capital resources or, if our or the Bank's capital ratios fall below the required minimums, we or the Bank could be forced to raise additional capital by making additional offerings of debt or preferred equity securities, including medium-term notes, trust preferred securities, senior or subordinated notes and preferred stock. Upon liquidation, holders of our debt securities and shares of preferred stock and lenders with respect to other borrowings will receive distributions of our available assets prior to the holders of our common stock. Additional equity offerings may dilute the holdings of our existing shareholders or reduce the market price of our common stock, or both. Holders of our common stock are not entitled to preemptive rights or other protections against dilution.

The Company may lose lower-cost funding sources.

Checking, savings, and money market deposit account balances and other forms of customer deposits can decrease when customers perceive alternative investments, such as the stock market, as providing a better risk/return tradeoff. If customers move money out of bank deposits and into other investments, the Company could lose a relatively low-cost source of funds, increasing its funding costs and reducing the Company's net interest income and net income.

There may be changes in accounting policies or accounting standards.

The Company's accounting policies are fundamental to understanding its financial results and condition. Some of these policies require use of estimates and assumptions that may affect the value of the Company's assets or liabilities and financial results. The Company identified its accounting policies regarding the allowance for loan losses, security impairment, goodwill and other intangible assets, and income taxes to be critical because they require management to make difficult, subjective and complex judgments about matters that are inherently uncertain. Under each of these policies, it is possible that materially different amounts would be reported under different conditions, using different assumptions, or as new information becomes available.

From time to time the Financial Accounting Standards Board and the SEC change the financial accounting and reporting standards that govern the form and content of the Company's external financial statements. In addition, accounting standard setters and those who interpret the accounting standards (such as the FASB, SEC, banking regulators and the Company's outside auditors) may change or even reverse their previous interpretations or positions on how these standards should be applied. Changes in financial accounting and reporting standards and changes in current interpretations may be beyond the Company's control, can be hard to predict and could materially impact how the Company reports its financial results and condition. In certain cases, the Company could be required to apply a new or revised standard retroactively or apply an existing standard differently (also retroactively) which may result in the Company restating prior period financial statements in material amounts.

The Company encounters continuous technological change.

The financial services industry is continually undergoing rapid technological change with frequent introductions of new technology-driven products and services. The effective use of technology increases efficiency and enables financial institutions to better serve customers and to reduce costs. The Company's future success depends, in part, upon its ability to address the needs of its customers by using technology to provide products and services that will satisfy customer demands, as well as to create additional efficiencies in the Company's operations. Many of the Company's competitors have substantially greater resources to invest in technological improvements. The Company may not be able to effectively implement new technology-driven products and services or be successful in marketing these products and services to its customers. Failure to successfully keep pace with technological change affecting the financial services industry could have a material adverse impact on the Company's business and, in turn, the Company's financial condition and results of operations.

The Company is subject to operational risk.

The Company faces the risk that the design of its controls and procedures, including those to mitigate the risk of fraud by employees or outsiders, may prove to be inadequate or are circumvented, thereby causing delays in detection of errors or inaccuracies in data and information. Management regularly reviews and updates the Company's internal controls, disclosure controls and procedures, and corporate governance policies and procedures. Any system of controls, however well designed and operated, is based in part on certain assumptions and can provide only reasonable, not absolute, assurances that the objectives of the system are met. Any failure or circumvention of the Company's controls and procedures or failure to comply with regulations related to controls and procedures could have a material adverse effect on the Company's business, results of operations and financial condition.

Table of Contents

The Company may also be subject to disruptions of its systems arising from events that are wholly or partially beyond its control (including, for example, computer viruses or electrical or telecommunications outages), which may give rise to losses in service to customers and to financial loss or liability. The Company is further exposed to the risk that its external vendors may be unable to fulfill their contractual obligations (or will be subject to the same risk of fraud or operational errors by their respective employees as is the Company) and to the risk that the Company's (or its vendors') business continuity and data security systems prove to be inadequate.

The Company's performance is largely dependent on the talents and efforts of highly skilled individuals. There is intense competition in the financial services industry for qualified employees. In addition, the Company faces increasing competition with businesses outside the financial services industry for the most highly skilled individuals. The Emergency Economic Stabilization Act and the agreements between the Company and the Treasury related to the purchase of the Company's Preferred Stock Series B and common stock warrants place restrictions on the Company's ability to pay compensation to its senior officers. The Company's business operations could be adversely affected if it were unable to attract new employees and retain and motivate its existing employees.

There may be claims and litigation.

From time to time as part of the Company's normal course of business, customers make claims and take legal action against the Company based on actions or inactions of the Company. If such claims and legal actions are not resolved in a manner favorable to the Company, they may result in financial liability and/or adversely affect the market perception of the Company and its products and services. This may also impact customer demand for the Company's products and services. Any financial liability or reputation damage could have a material adverse effect on the Company's business, which, in turn, could have a material adverse effect on its financial condition and results of operations.

Severe weather, acts of terrorism and other external events could significantly impact our business.

A significant portion of our primary markets are located near coastal waters which could generate naturally occurring severe weather, or in response to climate change, that could have a significant impact on our ability to conduct business. Additionally, surrounding areas, including New Jersey, may be central targets for potential acts of terrorism against the United States. Such events could affect the stability of our deposit base, impair the ability of borrowers to repay outstanding loans, impair the value of collateral securing loans, cause significant property damage, result in loss of revenue and/or cause us to incur additional expenses. Although we have established disaster recovery policies and procedures, the occurrence of any such event in the future could have a material adverse effect on our business, which, in turn, could have a material adverse effect on our financial condition and results of operations.

Item 1B. Unresolved Staff Comments.

Not applicable.

Table of Contents

Item 2. Properties.

The following table provides certain information with respect to our offices as of December 31, 2009:

Location	Leased or Owned	Original Year Leased or Acquired	Year of Lease Expiration
Main Office 2650 Route 130 Cranbury, New Jersey	Leased	1989	2010
Village Office 74 North Main Street Cranbury, New Jersey	Owned	2005	---
Montgomery Office 947 State Road Princeton, New Jersey	Leased	1995	2013
Plainsboro Office Plainsboro Village Center 11 Shalks Crossing Road Plainsboro, New Jersey	Leased	1998	2021
Hamilton Office 3659 Nottingham Way Hamilton, New Jersey	Leased	1999	2014
Princeton Office The Windrows at Princeton Forrestal 200 Windrow Drive Princeton, New Jersey	Leased	2001	2011
Perth Amboy Office 145 Fayette Street Perth Amboy, New Jersey	Leased	2003	2018
Jamesburg Office 1 Harrison Street Jamesburg, New Jersey	Owned	2002	---
West Windsor Office 44 Washington Road Princeton Jct, New Jersey	Leased	2004	2019
Fort Lee Office 180 Main Street Fort Lee, New Jersey	Leased	2006	2014
Hightstown Office			

140 Mercer Street Hightstown, New Jersey	Leased	2007	2014
Mortgage Warehouse Funding Office 285 Davidson Avenue Somerset, New Jersey	Leased	2009	2015
Lawrenceville Property 146 Lawrenceville-Pennington Road, Lawrenceville, New Jersey	Owned	2009	---

Management believes the foregoing facilities are suitable for the Company's and the Bank's present and projected operations.

Table of Contents

Item 3. Legal Proceedings.

The Company may, in the ordinary course of business, become a party to litigation involving collection matters, contract claims and other legal proceedings relating to the conduct of its business. Management is not aware of any present material legal proceedings or contingent liabilities and commitments that would have a material impact on the Company's financial position or results of operations.

Item 4. (Removed and Reserved).

PART II

Item 5. Market for Registrant's Common Equity, Related Shareholder Matters and Issuer Purchases of Equity Securities.

The common stock of the Company trades on the Nasdaq Global Market under the trading symbol "FCCY". The following are the high and low sales prices per share for each quarter during 2009 and 2008, as reported on the Nasdaq Global Market.

	2009(1)		2008(1)	
	High	Low	High	Low
First Quarter	$ 10.25	$ 3.85	$ 13.43	$ 9.97
Second Quarter	9.51	5.71	12.08	9.71
Third Quarter	8.67	7.00	10.79	7.38
Fourth Quarter	7.76	5.25	11.57	6.13

(1) All per share data has been retroactively adjusted for stock dividends.

As of March 25, 2010, there were approximately 318 record holders of the Company's common stock.

The Company paid 5% stock dividends on February 3, 2010 and February 2, 2009 and a 6% stock dividend on February 6, 2008.

The Company has never paid a cash dividend on its common stock and there are no plans to pay a cash dividend on its common stock at this time. In addition, please refer to the discussion above of the Preferred Stock Series B under the heading "Supervision and Regulation" for additional restrictions on cash dividends.

Table of Contents

Issuer Purchases of Equity Securities

On July 21, 2005, the Board of Directors authorized a stock repurchase program under which the Company may repurchase in open market or privately negotiated transactions up to 5% of its common shares outstanding at that date. The Company undertook this repurchase program in order to increase shareholder value. The following table provides common stock repurchases made by or on behalf of the Company during the three months ended December 31, 2009, which purchases were made under the stock repurchase program.

Issuer Purchases of Equity Securities (1)

Period Beginning	Period Ending	Total Number of Shares Purchased	Average Price Paid Per Share	Total Number of Shares Purchased As Part of Publicly Announced Plan or Program	Maximum Number of Shares That May Yet be Purchased Under the Plan or Program
October 1, 2009	October 31, 2009	1,093	$ 7.31	1,093	163,233
November 1, 2009	November 30, 2009	-	-	-	-
December 1, 2009	December 31, 2009	-	-	-	-
	Total	1,093	$ 7.31	1,093	163,233

(1) The Company's common stock repurchase program covers a maximum of 195,076 shares of common stock of the Company, representing 5% of the outstanding common stock of the Company on July 21, 2005, as adjusted for subsequent stock dividends.

As a result of the Company's issuance on December 23, 2008 of Preferred Stock Series B and a warrant to purchase common stock to the Treasury as part of its TARP CPP, the Company may not repurchase its common stock or other equity securities except under certain limited circumstances. Please refer to the discussion above of the Preferred Stock Series B under the heading "Supervision and Regulation" for restrictions on the Company's repurchase of its common stock or other equity securities.

Item 6. Selected Financial Data.

Not required.

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operation.

This discussion should be read in conjunction with the consolidated financial statements, notes and tables included elsewhere in this report. Throughout the following sections, the "Company" refers to 1st Constitution Bancorp and its wholly owned subsidiaries, 1st Constitution Bank and 1st Constitution Capital Trust II, the "Bank" refers to 1st Constitution Bank, and the "Trust II" refers to 1st Constitution Capital Trust II. The purpose of this discussion and analysis is to assist in the understanding and evaluation of the Company's financial condition, changes in financial condition and results of operations.

Critical Accounting Policies and Estimates

“Management’s Discussion and Analysis of Financial Condition and Results of Operation” is based upon the Company’s consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of these financial statements requires the Company to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses. Note 1 to the Company’s Consolidated Financial Statements for the year ended December 31, 2009 contains a summary of the Company’s significant accounting policies. Management believes the Company’s policies with respect to the methodologies for the determination of the allowance for loan losses and for determining other-than-temporary security impairment involve a higher degree of complexity and requires management to make difficult and subjective judgments which often require assumptions or estimates about highly uncertain matters. Changes in these judgments, assumptions or estimates could materially impact results of operations. These critical policies and their application are periodically reviewed with the Audit Committee and the Board of Directors. The provision for loan losses is based upon management’s evaluation of the adequacy of the allowance, including an assessment of known and inherent risks in the portfolio, giving consideration to the size and composition of the loan portfolio, actual loan loss experience, level of delinquencies, detailed analysis of individual loans for which full collectibility may not be assured, the existence and estimated net realizable value of any underlying collateral and guarantees securing the loans, and current economic and market conditions. Although management uses the best information available to it, the level of the allowance for loan losses remains an estimate which is subject to significant judgment and short-term change. Various regulatory agencies, as an integral part of their examination process, periodically review the Company’s allowance for loan losses. Such agencies may require the Company to make additional provisions for loan losses based upon information available to them at the time of their examination. Furthermore, the majority of the Company’s loans are secured by real estate in the State of New Jersey. Accordingly, the collectibility of a substantial portion of the carrying value of the Company’s loan portfolio is susceptible to changes in local market conditions and may be adversely affected should real estate values decline or the Central New Jersey area experience an adverse economic shock. Future adjustments to the allowance for loan losses may be necessary due to economic, operating, regulatory and other conditions beyond the Company’s control.

Management utilizes various inputs to determine the fair value of its investment portfolio. To the extent they exist, unadjusted quoted market prices in active markets (level 1) or quoted prices on similar assets (level 2) are utilized to determine the fair value of each investment in the portfolio. In the absence of quoted prices, valuation techniques would be used to determine fair value of any investments that require inputs that are both significant to the fair value measurement and unobservable (level 3). Valuation techniques are based on various assumptions, including, but not limited to cash flows, discount rates, rate of return, adjustments for nonperformance and liquidity, and liquidation values. A significant degree of judgment is involved in valuing investments using level 3 inputs. The use of different assumptions could have a positive or negative effect on consolidated financial condition or results of operations.

Management must periodically evaluate if unrealized losses (as determined based on the securities valuation methodologies discussed above) on individual securities classified as held to maturity or available for sale in the investment portfolio are considered to be other-than-temporary. The analysis of other-than-temporary impairment requires the use of various assumptions, including, but not limited to, the length of time an investment's book value is greater than fair value, the severity of the investment's decline, as well as any credit deterioration of the investment. If the decline in value of an investment is deemed to be other-than-temporary, the investment is written down to fair value and a non-cash impairment charge is recognized in the period of such evaluation.

Results of Operations

The Company reported net income for the year ended December 31, 2009 of $2,560,761, a decrease of 7.2% from the $2,759,458 reported for the year ended December 31, 2008. The decrease is primarily due to (i) a larger provision for loan losses, (ii) a substantial increase in the FDIC deposit insurance premiums, (iii) an other-than temporary security impairment and (iv) increases in salaries and employee benefits which was offset by (A) an increase in net interest income, (B) the increase in non-interest income, which was principally increased by gains on sale of securities available for sale and gains on sales of loans, and (C) a reduction of income taxes. Net income available to common shareholders fell from $2,759,458 for the year ended December 31, 2008 to $1,841,160 for the year ended December 31, 2009 for the reasons indicated above and the payment of dividends on the Company's Preferred Stock Series B in 2009.

Diluted net income per common share was $0.41 for the year ended December 31, 2009 compared to $0.62 reported for the year ended December 31, 2008. Basic net income per common share for the year ended December 31, 2009 was $0.41 as compared to the $0.63 reported for the year ended December 31, 2008. Net income available to common shareholders was reduced in 2009 by an aggregate of $719,601 attributable to dividends and discount accretion related to the preferred stock issued to the United States Department of the Treasury. No similar amount was recorded in 2008. All share information has been restated for the effect of a 5% stock dividend declared on December 17, 2009 and paid on February 3, 2010 to shareholders of record on January 19, 2010.

Return on average assets ("ROA") and return on average equity ("ROE") were 0.41% and 4.52%, respectively, for the year ended December 31, 2009, compared to 0.56% and 6.52%, respectively, for the year ended December 31, 2008 and 1.29% and 14.32%, respectively, for the year ended December 31, 2007. Key performance ratios declined for the 2009 fiscal year as compared to the prior year due to the lower net income for the year ended December 31, 2009 as compared to the year ended December 31, 2008.

The Bank's results of operations depend primarily on net interest income, which is primarily affected by the market interest rate environment, the shape of the U.S. Treasury yield curve, and the difference between the yield on interest-earning assets and the rate paid on interest-bearing liabilities. Other factors that may affect the Bank's operating results are general and local economic and competitive conditions, government policies and actions of regulatory authorities. The net interest margin for the year ended December 31, 2009 was 3.06% as compared to the 3.64% net interest margin recorded for the year ended December 31, 2008, a reduction of 58 basis points. The

Company will continue to closely monitor the mix of earning assets and funding sources to maximize net interest income during this challenging interest rate environment.

Net Interest Income

Net interest income, the Company's largest and most significant component of operating income, is the difference between interest and fees earned on loans and other earning assets, and interest paid on deposits and borrowed funds. This component represented 79.9% of the Company's net revenues for the year ended December 31, 2009. Net interest income also depends upon the relative amount of interest earning assets, interest-bearing liabilities, and the interest rate earned or paid on them, respectively.

Table of Contents

The following tables set forth the Company's consolidated average balances of assets and liabilities and shareholders' equity as well as interest income and expense on related items, and the Company's average yield or rate for the years ended December 31, 2009, 2008 and 2007. The average rates are derived by dividing interest income and expense by the average balance of assets and liabilities, respectively.

Average Balance Sheets with Resultant Interest and Rates

(yields on a tax-equivalent basis)		2009			2008		
	Average Balance	Interest	Average Rate	Average Balance	Interest	Average Rate	A B
Assets:							
Federal Funds Sold/Short-Term Investments	$ 39,676,869	$ 116,070	0.29%	$ 4,667,073	$ 112,427	2.41%	$ 1
Investment Securities:							
Taxable	136,588,291	5,143,123	3.77%	84,611,384	4,158,923	4.92%	80
Tax-exempt (4)	12,483,060	720,245	5.77%	14,471,144	829,249	5.73%	22
Total	149,071,351	5,863,368	3.93%	99,082,528	4,988,172	5.03%	103
Loan Portfolio:							
Construction	89,202,415	5,451,941	6.11%	115,517,676	8,090,444	7.00%	129
Residential Real Estate	10,834,490	675,464	6.23%	10,376,822	652,728	6.29%	8
Home Equity	14,722,638	869,531	5.91%	15,490,320	986,117	6.37%	14
Commercial and commercial real estate	140,449,945	9,751,822	6.94%	127,377,980	9,302,815	7.30%	117
Mortgage warehouse lines	114,749,562	5,305,911	4.62%	57,477,364	2,755,003	4.79%	
Installment	770,169	60,572	7.86%	1,204,297	96,375	8.00%	1
All Other Loans	32,843,891	2,275,030	6.93%	26,660,793	2,405,176	9.02%	21
Total (1)	403,573,110	24,390,271	6.04%	354,105,252	24,288,658	6.86%	292
Total Interest-Earning Assets	592,321,330	30,369,709	5.13%	457,854,853	29,389,257	6.42%	397
Allowance for Loan Losses	(4,155,438)			(3,612,156)			(3
Cash and Due From Banks	18,414,336			12,446,849			10
Other Assets	21,030,355			22,180,579			17
Total Assets	$ 627,610,583			$ 488,870,125			$ 422
Liabilities and Shareholders' Equity:							
Interest-Bearing Liabilities:							
Money Market and NOW Accounts	$ 105,526,965	$ 1,987,269	1.88%	$ 89,274,785	$ 2,164,369	2.42%	$ 83
Savings Accounts	154,261,417	2,907,443	1.88%	79,864,816	1,990,479	2.49%	64
Certificates of Deposit under $100,000	84,121,374	2,454,236	2.92%	76,921,495	3,096,986	4.03%	67
Certificates of Deposit of $100,000 and Over	93,913,185	2,480,084	2.64%	70,297,311	2,855,024	4.06%	54
Other Borrowed Funds	29,526,575	1,353,489	4.58%	37,111,612	1,556,238	4.19%	29
Trust Preferred Securities	18,557,000	1,072,827	5.78%	18,557,000	1,069,351	5.76%	19
Total Interest-Bearing Liabilities	485,906,516	12,255,348	2.52%	372,027,019	12,732,447	3.42%	318

Net Interest Spread (2)			2.61%			3.00%	
Non-interest Bearing Demand Deposits	78,588,727			69,907,048			60
Other Liabilities	6,480,126			4,608,108			4
Total Liabilities	570,975,369			446,542,175			384
Shareholders' Equity	56,635,214			42,327,950			38
Total Liabilities and Shareholders' Equity	$ 627,610,583			$ 488,870,125			$ 42
Net Interest Margin (3)		$ 18,114,361	3.06%		$ 16,656,810	3.64%	

22

Table of Contents

(1) Loan origination fees are considered an adjustment to interest income. For the purpose of calculating loan yields, average loan balances include nonaccrual loans with no related interest income. Please refer to Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operation under the heading "Non-Performing Assets" for a discussion of the Bank's policy with regard to non-accrual loans.
(2) The interest rate spread is the difference between the average yield on interest earning assets and the average rate paid on interest bearing liabilities.
(3) The net interest margin is equal to net interest income divided by average interest earning assets.
(4) Tax equivalent basis.

Changes in net interest income and margin result from the interaction between the volume and composition of interest earning assets, interest bearing liabilities, related yields, and associated funding costs. The Rate/Volume Table demonstrates the impact on net interest income of changes in the volume of interest earning assets and interest bearing liabilities and changes in interest rates earned and paid.

The Company's net interest income increased on a tax equivalent basis by $1,457,551, or 8.8%, to $18,114,361 for the year ended December 31, 2009, from the $16,656,810 reported for the year ended December 31, 2008. As indicated in the Rate/Volume Table, the principal factor contributing to the increase in net interest income for the year ended December 31, 2009 was an increase in the interest income of $980,451, resulting from increased volumes on the earning assets components. This was combined with a decrease in interest expense resulting from decreases in the rates of the deposit components.

The Company's net interest income decreased on a tax-equivalent basis by $1,541,529, or 8.5%, to $16,656,810 for the year ended December 31, 2008, from the $18,198,339 reported for the year ended December 31, 2007. As indicated in the Rate/Volume Table, the principal factor contributing to the decrease in net interest income for the year ended December 31, 2008 was a decrease in the interest income of $1,399,721, resulting from decreased rates on the earning assets components. This was combined with an increase in interest expense resulting from increases in the balances of the deposit components.

Table of Contents

Rate/Volume Table	Amount of Increase (Decrease)				
	Year Ended December 31, 2009 versus 2008 Due to Change in:			Year Ended Decemb 2008 versus 20 Due to Change	
(Tax-equivalent basis)	Volume	Rate	Total	Volume	Rate
Interest Income:					
Loans:					
Construction	$ (1,693,382)	$ (945,121)	$ (2,638,503)	$ (1,094,267)	$ (2,302,233
Residential Real Estate	28,874	(6,138)	22,736	94,238	(99,438
Home Equity	(47,116)	(69,469)	(116,586)	95,054	(172,050
Commercial and Commercial Real Estate	870,410	(421,403)	449,007	748,916	(586,243
Mortgage Warehouse Lines	2,695,979	(145,072)	2,550,908	2,755,003	0
Installment	(34,424)	(1,379)	(35,803)	(26,940)	(6,168
All Other Loans	492,389	(622,537)	(130,147)	600,091	(830,792
Total Loans	2,312,730	(2,221,118)	101,612	3,172,095	(3,996,924
Investment Securities :					
Taxable	2,257,248	(1,273,048)	984,200	188,735	(308,100
Tax-exempt	(114,354)	5,350	(109,004)	(483,349)	16,566
Total Investment Securities	2,142,894	(1,267,697)	875,196	(294,614)	(291,534
Federal Funds Sold / Short-Term Investments	180,375	(176,732)	3.643	128,512	(117,256
Total Interest Income	4,635,999	(3,655,548)	980,451	3,005,993	(4,405,714
Interest Expense :					
Money Market and NOW Accounts	$ 349,145	$ (526,243)	$ (177,098)	$ 130,364	$ 296,518
Savings Accounts	1,628,306	(711,343)	916,963	434,450	(461,551
Certificates of Deposit under $100,000	250,617	(893,368)	(642,751)	423,858	(497,194
Certificates of Deposit of $100,000 and Over	791,043	(1,165,984)	(374,941)	727,894	(584,337
Other Borrowed Funds	(332,648)	129,899	(202,749)	351,007	(309,676
Trust Preferred Securities	0	3,476	3,476	(84,797)	(284,728
Total Interest Expense	2,686,463	(3,163,563)	(477,100)	1,982,776	(1,840,968
Net Interest Income	$ 1,949,536	$ (491,985)	$ 1,457,551	$ 1,023,217	$ (2,564,746

Average interest earning assets increased by $134,466,477, or 29.4%, to $592,321,330 for the year ended December 31, 2009 from $457,854,853 for the year ended December 31, 2008. Led by the mortgage warehouse lines component, the average total loan portfolio increased by $49,467,858, or 14.0%, to $403,573,110 for the year ended December 31, 2009 from $354,105,252 for the year ended December 31, 2008. However, due to the low level of market interest rates during 2009, loan yields averaged 6.04% for the year ended December 31, 2009, 82 basis points lower than for the year ended December 31, 2008. The average investment securities portfolio increased 50.5%, while the yield on that portfolio decreased 110 basis points for the year ended December 31, 2009 compared to the year ended December 31, 2008. Overall, the yield on interest earning assets decreased 129 basis points to 5.13% in the year ended December 31, 2009 from 6.42% in the year ended December 31, 2008.

Average interest earning assets increased by $59,985,025, or 15.1%, to $457,854,853 for the year ended December 31, 2008 from $397,869,829 for the year ended December 31, 2007, consisting primarily of an increase of $61,733,901 in loans for 2008 as compared to 2007. Led by the mortgage warehouse lines component, the average total loan portfolio grew by 21.1%. However, due to the declining level of market interest rates during 2008, loan yields averaged 6.86% for the year ended December 31, 2008, 173 basis points lower than for the year ended December 31, 2007. The average investment securities portfolio decreased 4.6%, and the yield on that portfolio decreased 34 basis points for the year ended December 31, 2008 compared to the year ended December 31, 2007. Overall, the yield on interest earning assets decreased 132 basis points to 6.42% in the year ended December 31, 2008 from 7.74% in the year ended December 31, 2007.

Interest expense decreased by $477,100, or 3.7%, to $12,255,348 for the year ended December 31, 2009, from $12,732,447 for the year ended December 31, 2008. This decrease in interest expense is principally attributable to higher levels of interest-bearing liabilities priced at a significantly lower market interest rate level. Savings accounts, helped by higher FDIC deposit insurance limits that will remain until the end of 2013, increased on average by $74,396,601 in 2009, or 93.2%, as compared to 2008, contributing to the funding of loan portfolio growth. The cost on these deposits decreased 61 basis points in 2009 as compared to 2008. Average interest bearing liabilities rose 30.6% in 2009 from 2008. The cost of total interest-bearing liabilities decreased 90 basis points to 2.52% in 2009 from 3.42% in 2008.

Table of Contents

Interest expense increased by $141,808, or 1.1%, to $12,732,447 for the year ended December 31, 2008, from $12,590,639 for the year ended December 31, 2007. This increase in interest expense is principally attributable to higher levels of interest-bearing liabilities priced at a lower market interest rate level. Certificates of deposit of $100,000 and over increased on average by $16,045,224 in 2008, or 29.6%, as compared to 2007, contributing to the funding of loan portfolio growth. The cost on these deposits decreased 94 basis points in 2008 as compared to 2007. Average interest bearing liabilities rose 16.8% in 2008 from 2007. The cost of total interest-bearing liabilities decreased 53 basis points to 3.42% in 2008 from 3.95% in 2007.

Average non-interest bearing demand deposits increased by $8,681,679, or 12.4%, to $78,588,727 for the year ended December 31, 2009 from $69,907,048 for the year ended December 31, 2008. The primary cause of this increase for 2009 was the requirement for customers of the Warehouse Line of Credit to maintain deposit relationships with the Bank that, on average, represent 10% to 15% of the loan balances.

Non-Interest Income

Non-interest income increased by $1,225,200, or 37.4%, to $4,505,076 for the year ended December 31, 2009 from $3,279,876 for the year ended December 31, 2008.

Service charges on deposit accounts represents a consistent source of non-interest income. Service charge revenues increased by $1,820 to $885,702 for the year ended December 31, 2009 compared to $883,882 for the year ended December 31, 2008. This component of non-interest income represented 19.7% and 26.9% of the total non-interest income for the years ended December 31, 2009 and 2008, respectively.

Gains on sales of loans held for sale increased by $284,358, or 27.3%, to $1,325,274 for the year ended December 31, 2009, from $1,040,916 for the year ended December 31, 2008. The Bank sells both residential mortgage loans and Small Business Administration loans in the secondary market. The low interest rate environment that continued into 2009 has positively impacted the volume of sales transactions in the mortgage loan market and the resultant gains from these sales transactions.

Gains from the sales of available-for-sale securities totaled $1,138,655 for the year ended December 31, 2009. The gains resulted from the sales of mortgage-backed securities in the low interest rate environment that continued in 2009. There were no security sales for the year ended December 31, 2008.

During the quarter ended December 31, 2009, the Bank recognized an other-than-temporary impairment charge of $864,727 attributed to its only pooled trust preferred security. Of this amount, $363,783 was a credit loss recorded in the income statement and $500,944 was a non-credit related loss recorded as an increase to the other comprehensive loss component of shareholders' equity in the balance sheet. The Bank recognized no other charges for other-than-temporary impairment during the years ended December 31, 2009 and 2008.

Non-interest income also includes income from bank-owned life insurance ("BOLI") which amounted to $389,851 for the year ended December 31, 2009 compared to $378,852 for the year ended December 31, 2008. The Bank purchased tax-free BOLI assets to partially offset the cost of employee benefit plans and reduce the Company's overall effective tax rate.

The Bank also generates non-interest income from a variety of fee-based services. These include safe deposit rentals, wire transfer service fees and Automated Teller Machine fees for non-Bank customers. Increased customer demand for these services contributed to the increase in the other income component of non-interest income, amounting to $1,129,377 for the year ended December 31, 2009, as compared to $976,226 for the year ended December 31, 2008.

Non-Interest Expenses

Non-interest expenses increased by $2,086,860, or 13.9%, to $17,115,801 for the year ended December 31, 2009 from $15,028,941 for the year ended December 31, 2008. The following table presents the major components of non-interest expenses for the years ended December 31, 2009 and 2008.

Table of Contents

Non-interest Expenses

		2009		2008
Salaries and employee benefits	$	9,352,360	$	8,426,729
Occupancy expense		1,783,031		1,802,723
Data processing services		1,085,257		896,724
Equipment expense		631,677		626,467
Marketing		130,393		246,879
Regulatory, professional and consulting fees		1,006,830		861,006
Office expense		572,477		649,461
FDIC deposit insurance		1,193,309		196,072
Directors' fees		105,700		108,000
Other real estate owned expenses		123,795		120,688
Other expenses		1,130,972		1,094,192
Total	$	17,115,801	$	15,028,941

Salaries and employee benefits, which represent the largest portion of non-interest expenses, increased by $925,631, or 11.0%, to $9,352,360 for the year ended December 31, 2009 compared to $8,426,729 for the year ended December 31, 2008. The increase in salaries and employee benefits for the year ended December 31, 2009 was a result of an increase in the number of employees, regular merit increases and increased health care costs. Staffing levels overall increased to 121 full-time equivalent employees as of December 31, 2009, comprised of 115 full time employees and 6 full-time equivalent employees, as compared to 113 full-time equivalent employees at December 31, 2008.

Marketing expense decreased by $116,486, or 47.2%, to $130,393 for the year ended December 31, 2009 compared to $246,879 for the year ended December 31, 2008. During 2009, the Bank utilized the less costly print media in promoting products and services as opposed to the more costly radio broadcast media used in prior years.

Regulatory, professional and other fees increased by $145,824, or 16.9%, to $1,006,830 for the year ended December 31, 2009 compared to $861,006 for the year ended December 31, 2008. During 2009, the Company incurred additional legal fees primarily in connection with the recovery of non-performing asset balances. The Bank also incurred additional fees in connection with examinations performed by independent consultants during 2009 to assess the effectiveness of internal controls as required by the Sarbanes-Oxley Act.

The FDIC substantially increased its assessment rate for all insured banks and charged a special assessment in 2009 in an effort to increase its reserve ratio, resulting in an increased expense of $1,193,309 for the year ended December 31, 2009 compared with $196,072 for the year ended December 31, 2008. In addition to significantly higher assessment rates, the FDIC announced a special assessment on all insured institutions equal to the lesser of 10% of deposits or 5% of assets minus tier 1 equity. Included in the current year's expense was a one-time $272,518 payment for the special assessment.

Data processing services increased by $188,533, or 21.0%, to $1,085,257 for the year ended December 31, 2009 compared to $896,724 for the year ended December 31, 2008. The increase in expense was primarily attributable to increased costs in enhancing the Bank's data security systems.

Other real estate owned expenses increased by $3,107, or 2.6%, to $123,795 for the year ended December 31, 2009 compared to $120,688 for the year ended December 31, 2008, as the Company incurred maintenance costs on more properties held as Other Real Estate Owned than were held during 2008.

All other categories of expenses, in the aggregate, decreased by $56,986, or 1.3%, to $4,223,857 for the year ended December 31, 2009 compared to $4,280,843 for the year ended December 31, 2008. These expenses are comprised of a variety of operating expenses and fees as well as expenses associated with lending activities.

The Bank's ratio of non-interest expense to average assets has remained consistently favorable at 2.73% for the year ended December 31, 2009 compared to 3.08% for the year ended December 31, 2008.

26

Income Taxes

The Company had income tax expense of $156,282 for the year ended December 31, 2009 compared to income tax expense of $1,239,341 for year ended December 31, 2008. The reduced income tax expense for the year ended December 31, 2009 was primarily due to (1) a significantly lower level of pretax income in 2009 compared with the year ended December 31, 2008 and (2) the reversal of an over-accrual of income taxes during 2006 and 2007 that coincided with the completion of an Internal Revenue Service examination of the Company's 2006 and 2007 Federal income tax returns.

During 2009, the Internal Revenue Service completed an examination of the Company's 2006 and 2007 Federal tax returns and issued its Revenue Agent Report on June 30, 2009. The Company had deferred the annual process of adjusting the recorded Federal and State liability balances pending the completion of the examination which began in September 2008. The examination adjustments were included in this annual process of adjusting recorded liabilities with balances per the tax returns and resulted in over-accrued Federal and State liabilities being reversed by a credit to income tax expense during the year ended December 31, 2009.

Financial Condition

Cash and Cash Equivalents

At December 31, 2009, cash and cash equivalents totaled $25,854,285 compared to $14,333,119 at December 31, 2008. Cash and cash equivalents at December 31, 2009 consisted of cash and due from banks of $25,842,901 and federal funds sold/short-term investments of $11,384. The corresponding balances at December 31, 2008 were $14,321,777 and $11,342, respectively. Despite several rounds of interest rate reductions for the Bank's deposit accounts during the fourth quarter of 2009, deposits continued to increase as loan demand declined contributing to the increase in cash and cash equivalents. To the extent that the Bank did not utilize the funds for loan originations or securities purchases, the cash inflows accumulated in cash and cash equivalents.

Investment Securities

The investment securities portfolio amounted to $227,727,830, or 33.6% of total assets, at December 31, 2009, compared to $130,027,600, or 23.8% of total assets, at December 31, 2008. Due to the continued uncertain economic environment during 2009, combined with strong deposit growth, funds were used primarily to purchase investment securities at a reduced net interest spread than that generally available if the funds were utilized by lending activities. On an average balance basis, the investment securities portfolio represented 25.2% and 21.6%, respectively, of average interest-earning assets for each of the years ended December 31, 2009 and 2008. The average yield earned on the portfolio was 3.93% for the year ended December 31, 2009, a decrease of 110 basis points from 5.03% earned for the year ended December 31, 2008.

Securities available for sale are investments that may be sold in response to changing market and interest rate conditions or for other business purposes. Activity in this portfolio is undertaken primarily to manage liquidity and interest rate risk and to take advantage of market conditions that create economically more attractive returns. At December 31, 2009, available-for-sale securities amounted to $204,118,850, an increase of $110,641,827 from December 31, 2008.

Table of Contents

Amortized cost, gross unrealized gains and losses, and the estimated fair value by security type are as follows:

2009	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Available for sale-				
U. S. Treasury securities and				
obligations of U.S. Government				
sponsored corporations and agencies	$ 138,351,028	$ 291,906	$ (673,252)	$ 137,969,682
Residential collateralized mortgage obligations	34,749,123	172,698	(252,023)	34,669,798
Residential mortgage backed securities	24,182,584	1,449,071	0	25,631,655
Obligations of State and				
Political subdivisions	2,633,210	45,644	(91,212)	2,587,642
Trust preferred debt securities	2,457,262	0	(687,089)	1,770,173
Restricted Stock	1,464,900	0	0	1,464,900
Mutual Fund	25,000	0	0	25,000
	$ 203,863,107	$ 1,959,319	$ (1,703,576)	$ 204,118,850
Held to maturity-				
Residential collateralized mortgage obligations	$ 4,881,475	$ 150,055	$ 0	$ 5,031,530
Residential mortgage backed securities	6,111,131	97,782	(29,521)	6,179,392
Obligations of State and				
Political subdivisions	8,600,596	270,947	0	8,871,543
Trust preferred debt securities	133,054	0	0	133,054
Corporate debt securities	3,882,724	117,287	0	4,000,011
	$ 23,608,980	$ 636,071	$ (29,521)	$ 24,215,530

The $133,054 amortized cost of held to maturity trust preferred debt securities is net of a $500,944 noncredit-related impairment charge recorded as of December 31, 2009. The Company did not record any other noncredit-related impairment on its held to maturity securities during 2009.

At December 31, 2009, all of the Company's residential mortgage-backed securities and all but four of the Company's residential collateralized mortgage obligations were issued by Government Sponsored Enterprises ("GSE"). The four non-GSE issues had, at December 31, 2009, an aggregate amortized cost and aggregate fair value of $8,208,000 and $8,146,000, respectively.

2008	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Available for sale-				
U. S. Treasury securities and				
obligations of U.S. Government				
sponsored corporations and agencies	$ 22,802,334	$		