HYBRIDS: A CASE STUDY

HITTING IT OUT OF THE PARK: BANK OF AMERICA CORPORATION HITS

HYBRID SECURITIES are securities that have some equity characteristics and some debt characteristics. The securities are structured to obtain favorable equity treatment from ratings agencies, permit issuers to make tax-deductible payments, and qualify as Tier 1 capital for bank holding companies. The benefits of a hybrid security depend on its "equity-like" or "debt-like" characteristics. From a ratings agency perspective, the more equity-like the hybrid, generally, the more favorable the treatment for the issuer. From a tax perspective, the more debt-like the hybrid, generally, the more favorable the tax treatment for the issuer. Success lies in structuring a single security meeting these seemingly contradictory objectives. It helps if the security has a catchy name, too.

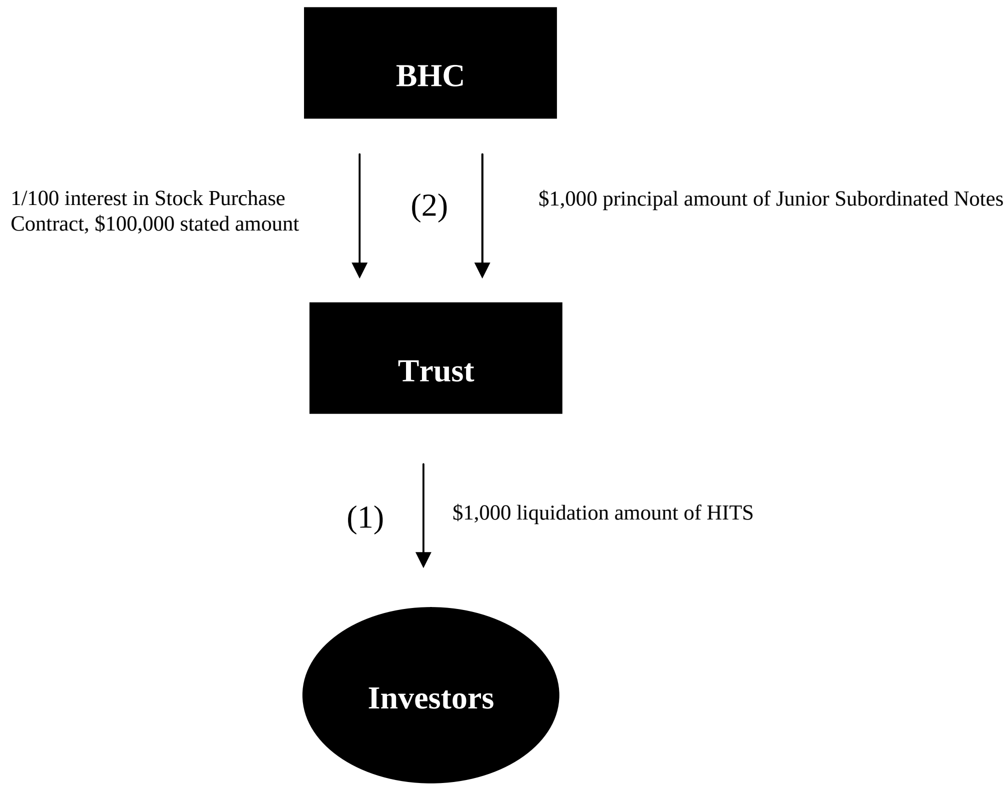
In February 2007, we worked with Bank of America Corporation and Banc of America Securities LLC in connection with the issuance of approximately $1.5 billion of hybrid securities, called Hybrid Income Term Securities, or HITS. HITS are an example of a hybrid unit transaction, which pairs two securities—a perpetual non-cumulative security and a forward stock purchase contract. The forward stock purchase contract commits the issuer to deliver, and investors to purchase, a variable number of shares of perpetual preferred stock of the issuer some time from issuance.

In this case, Bank of America Corporation, a bank holding company, issued through a trust a hybrid income term security. See Figure 1. The hybrid income term security consisted of a remarketable junior subordinated debt security paired with a five-year forward stock purchase contract on Bank of America perpetual preferred stock. The trust holds remarketable junior subordinated notes issued by Bank of America. The HITS and the perpetual preferred stock have an identical coupon. Interest on the remarketable junior subordinated notes is deferrable and is cumulative. After the offering, investors may exchange HITS, together with certain U.S. Treasury securities, for Treasury HITS and Corporate HITS by substituting pledged U.S. Treasury securities for the pledged notes. A holder of Treasury HITS and Corporate HITS may convert back into HITS at any time. See Figure 2. After five years, the subordinated notes can be remarketed, and the proceeds from the remarketing will be used to exercise the forward contract to purchase the non-cumulative perpetual preferred stock. If the notes are not remarketed, then the trust can deliver the notes to the issuer as payment for the non-cumulative perpetual preferred stock.

The HITS issuance incorporated several hybrid structuring innovations. The offering was structured in two tranches, a series of floating rate HITS and a fixed-to-floating rate HITS. The HITS also included call provisions permitting the issuer to redeem the security upon the occurrence of certain events, including an investment company event and a capital treatment event. The securities also included a call upon the occurrence of a tax event, which included a make-whole premium in the fixed-rate tranche. Consistent with the newest generation of hybrids, HITS contained an alternative payment mechanism that required that deferred distributions be paid only out of proceeds from the issuance of more junior or parity securities. HITS also incorporated a replacement capital covenant for the benefit of holders of Bank of America's more senior debt securities. The contractual replacement language requires that funds for redemption be from proceeds of the issuance of common stock, other perpetual or long-dated non-cumulative preferred stock, or certain other allowed instruments received within 180 days of redemption. Redemption is subject to regulatory approval.

Standard & Poor's views the HITS as two separate transactions. The issuer benefits from payment deferral, although Standard & Poor's notes that the term of the notes is too short to obtain equity credit. However, the non-cumulative perpetual preferred stock has strong equity-like characteristics. Moody's assigned the HITS D-basket treatment. On maturity, the securities receive a "strong" ranking. On ongoing payments, distributions are deferrable and must be settled using common stock. The forward contract obligates Bank of America to sell non-cumulative perpetual preferred stock to holders in five years. The perpetual preferred is immediately callable subject to binding replacement language. As to ongoing payments, the HITS receive a "moderate" ranking. On loss absorption, the HITS rank "strong." From a tax perspective, the components (the note and the forward contract) are treated as two separate instruments. Interest on the note is deductible for federal income tax purposes in reliance on Revenue Ruling 2003-97, addressing an investment unit comprised of a debt instrument and a forward contract to buy common stock.

ISSUANCE OF HITS

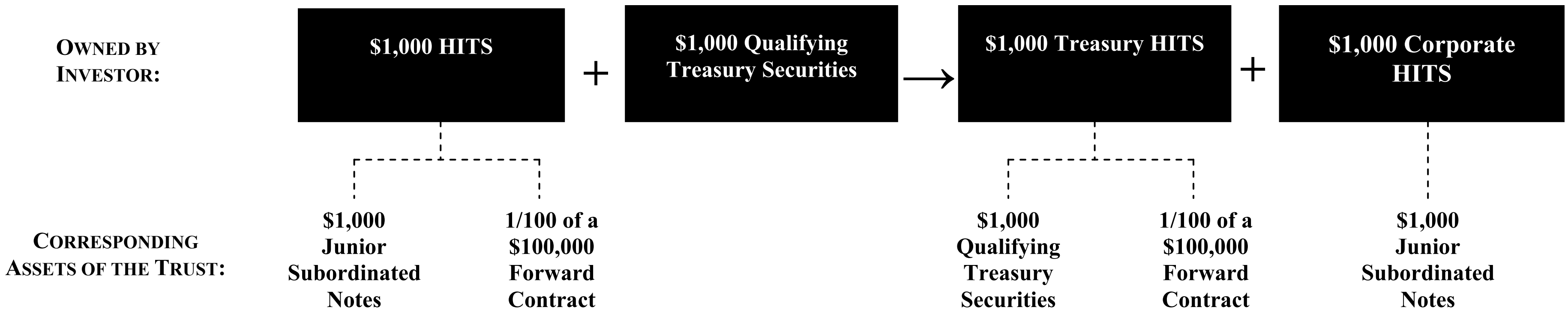


(1) Investors purchase HITS, $1,000 liquidation amount, from the Trust, initially corresponding to a $1,000 principal amount of Junior Subordinated Notes and a 1/100th interest in a Forward Contract having a stated amount of $100,000.

(2) The Trust purchases Junior Subordinated Notes from BHC and enters into the Forward Contracts with BHC. The Trust pledges the Junior Subordinated Notes to BHC to secure its obligation under the Forward Contract.

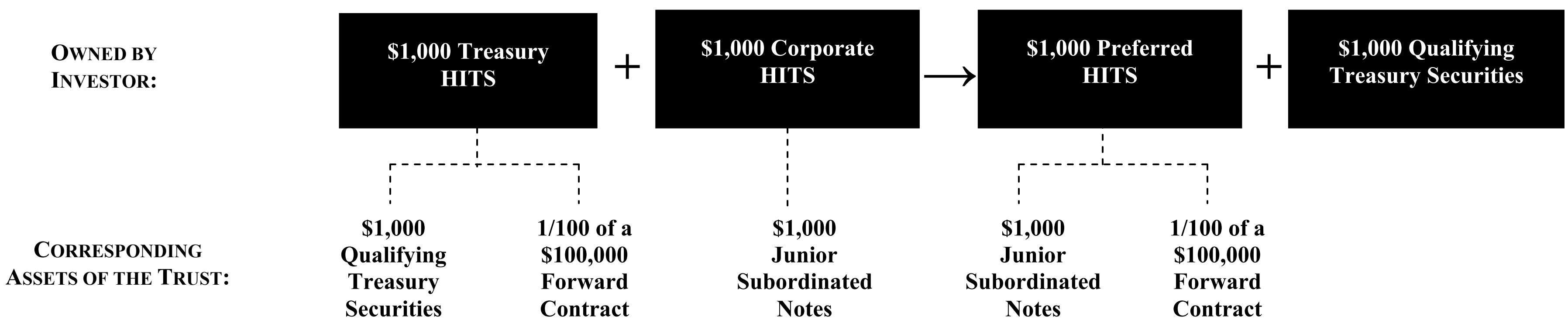
Figure 1

Exchange of HITS and Qualifying Treasury Securities for Treasury HITS and Corporate HITS



- Investor delivers $1,000 liquidation amount of HITS and $1,000 principal amount of Qualifying Treasury Securities.
- Investor receives $1,000 liquidation amount of Treasury HITS and $1,000 liquidation amount of Corporate HITS.

Exchange of Treasury hits and Corporate hits for HITS and Qualifying Treasury Securities



- Investor delivers $1,000 liquidation amount of Treasury HITS and $1,000 principal amount of Corporate HITS.
- Investor receives $1,000 liquidation amount of Preferred HITS and $1,000 liquidation amount of Qualifying Treasury Securities.

Figure 2