

HERITAGE COMMERCE CORP  
Form 10-Q  
May 11, 2010

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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

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**FORM 10-Q**

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(MARK ONE)

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

For the quarterly period ended March 31, 2010

OR

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_  
Commission file number 000-23877

**Heritage Commerce Corp**

(Exact name of Registrant as Specified in its Charter)

**California**  
(State or Other Jurisdiction of  
Incorporation or Organization)

**77-0469558**  
(I.R.S. Employer  
Identification No.)

**150 Almaden Boulevard, San Jose, California**  
(Address of Principal Executive Offices)

**95113**  
(Zip Code)

**(408) 947-6900**  
(Registrant's Telephone Number, Including Area Code)

**N/A**

(Former Name, Former Address and Former Fiscal Year, if Changed Since Last Report)

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

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

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer       Accelerated filer       Non-accelerated filer       Smaller reporting company   
(Do not check if a  
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

The Registrant had 11,820,509 shares of Common Stock outstanding on April 16, 2010.

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**Heritage Commerce Corp and Subsidiaries**

**Quarterly Report on Form 10-Q**

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Table of Contents**Part I FINANCIAL INFORMATION****ITEM 1 CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)****Heritage Commerce Corp****Consolidated Balance Sheets**

|   | March 31,<br>2010   | December 31,<br>2009 |
|---|---------------------|----------------------|
| (Dollars in thousands)  |                     |                      |
| <b>Assets</b>   |                     |                      |
| Cash and due from banks   | \$ 53,080           | \$ 45,372            |
| Federal funds sold  | 125                 | 100                  |
| Interest-bearing deposits in other financial institutions                 | 90                  | 90                   |
| <b>Total cash and cash equivalents</b>                                    | <b>53,295</b>       | <b>45,562</b>        |
| Securities available-for-sale, at fair value                              | 139,387             | 109,966              |
| Loans held-for-sale, at lower of cost or market, including deferred costs | 11,123              | 10,742               |
| Loans, including deferred costs   | 1,006,445           | 1,070,113            |
| Allowance for loan losses   | (26,527)            | (28,768)             |
| <b>Loans, net</b>   | <b>979,918</b>      | <b>1,041,345</b>     |
| Federal Home Loan Bank and Federal Reserve Bank stock, at cost            | 8,463               | 8,454                |
| Company owned life insurance  | 42,722              | 42,313               |
| Premises and equipment, net   | 8,861               | 9,006                |
| Goodwill  | 43,181              | 43,181               |
| Intangible assets   | 3,445               | 3,589                |
| Accrued interest receivable and other assets                              | 46,181              | 49,712               |
| <b>Total assets</b>   | <b>\$ 1,336,576</b> | <b>\$ 1,363,870</b>  |

**Liabilities and Shareholders' Equity****Liabilities:**

|  |                  |                  |
|--|------------------|------------------|
| <b>Deposits</b>                                |                  |                  |
| Demand, noninterest bearing                    | \$ 261,047       | \$ 260,840       |
| Demand, interest bearing                       | 150,923          | 146,828          |
| Savings and money market                       | 306,688          | 295,404          |
| Time deposits under \$100                      | 38,856           | 40,197           |
| Time deposits \$100 and over                   | 131,220          | 129,831          |
| Time deposits CDARS                            | 18,490           | 38,154           |
| Time deposits brokered                         | 174,471          | 178,031          |
| <b>Total deposits</b>                          | <b>1,081,695</b> | <b>1,089,285</b> |
| Securities sold under agreement to repurchase  | 20,000           | 25,000           |
| Subordinated debt                              | 23,702           | 23,702           |
| Short-term borrowings                          | 3,892            | 20,000           |
| Accrued interest payable and other liabilities | 39,198           | 33,578           |
| <b>Total liabilities</b>                       | <b>1,168,487</b> | <b>1,191,565</b> |

**Shareholders' equity:**

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|   |                  |                  |
|---|------------------|------------------|
| Preferred stock, no par value; 10,000,000 shares authorized; 40,000 shares outstanding (liquidation preference of \$1,000 per share plus accrued dividends) | 39,846           | 39,846           |
| Discount on preferred stock   | (1,507)          | (1,598)          |
| Common stock, no par value; 30,000,000 shares authorized; 11,820,509 shares outstanding   | 80,484           | 80,222           |
| Retained earnings   | 51,678           | 56,389           |
| Accumulated other comprehensive loss  | (2,412)          | (2,554)          |
| <br>Total shareholders' equity  | <br>168,089      | <br>172,305      |
| <br>Total liabilities and shareholders' equity  | <br>\$ 1,336,576 | <br>\$ 1,363,870 |

See notes to consolidated financial statements

Table of Contents**Heritage Commerce Corp****Consolidated Statements of Operations (Unaudited)**

|   | Three Months Ended<br>March 31,               |           |
|---|---|-----------|
|   | 2010  | 2009      |
|   | (Dollars in thousands, except per share data) |           |
| Interest income:  |   |           |
| Loans, including fees                                     | \$ 13,174                                     | \$ 15,030 |
| Securities, taxable                                       | 1,162   | 994       |
| Securities, non-taxable                                   |   | 5         |
| Interest-bearing deposits in other financial institutions | 10  | 4         |
| Total interest income                                     | 14,346  | 16,033    |
| Interest expense:   |   |           |
| Deposits  | 2,364   | 4,030     |
| Subordinated debt   | 466   | 500       |
| Repurchase agreements                                     | 131   | 243       |
| Short-term borrowings                                     | 16  | 26        |
| Note payable  |   | 82        |
| Total interest expense                                    | 2,977   | 4,881     |
| Net interest income before provision for loan losses      | 11,369  | 11,152    |
| Provision for loan losses                                 | 5,095   | 10,420    |
| Net interest income after provision for loan losses       | 6,274   | 732       |
| Noninterest income:                                       |   |           |
| Service charges and fees on deposit accounts              | 548   | 571       |
| Servicing income  | 421   | 420       |
| Increase in cash surrender value of life insurance        | 409   | 412       |
| Gain on sale of loans                                     | 114   |           |
| Other   | 192   | 220       |
| Total noninterest income                                  | 1,684   | 1,623     |
| Noninterest expense:                                      |   |           |
| Salaries and employee benefits                            | 5,881   | 6,458     |
| Professional fees   | 1,278   | 913       |
| FDIC deposit insurance premiums                           | 1,191   | 707       |
| Occupancy and equipment                                   | 959   | 916       |
| Other real estate owned expense                           | 418   | 63        |
| Insurance expense   | 256   | 59        |

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|   |               |               |
|---|---------------|---------------|
| Software subscription                               | 234           | 196           |
| Low income housing investment losses                | 225           | 214           |
| Data processing                                     | 212           | 229           |
| Other   | 1,544         | 1,607         |
| <b>Total noninterest expense</b>                    | <b>12,198</b> | <b>11,362</b> |
| Loss before income tax benefit                      | (4,240)       | (9,007)       |
| Income tax benefit                                  | (120)         | (5,052)       |
| Net loss  | (4,120)       | (3,955)       |
| Dividends and discount accretion on preferred stock | (591)         | (585)         |
| Net loss allocable to common shareholders           | \$ (4,711)    | \$ (4,540)    |
| <b>Loss per common share:</b>                       |               |               |
| Basic   | \$ (0.40)     | \$ (0.38)     |
| Diluted   | \$ (0.40)     | \$ (0.38)     |

See notes to consolidated financial statements

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## Heritage Commerce Corp

Consolidated Statements of Changes in Shareholders' Equity (Unaudited)  
Three Months Ended March 31, 2010 and 2009

|  | Preferred Stock |            | Common Stock |           | Retained Earnings | Accumulated                       | Total Shareholders' Equity | Comprehensive Income (Loss) |
|--|-----------------|------------|--------------|-----------|-------------------|-----------------------------------|----------------------------|-----------------------------|
|  | Amount          | Discount   | Shares       | Amount    |                   | Other Comprehensive Income (Loss) |                            |                             |
| (Dollars in thousands, except share data)  |                 |            |              |           |                   |                                   |                            |                             |
| <b>Balance, January 1, 2009</b>  | \$ 39,846       | \$ (1,946) | 11,820,509   | \$ 78,854 | \$ 70,986         | \$ (3,473)                        | \$ 184,267                 |                             |
| Net loss   |                 |            |              |           | (3,955)           |                                   | (3,955)                    | \$ (3,955)                  |
| Net change in unrealized gain on securities available-for-sale and interest-only strips, net of reclassification adjustment and deferred income taxes      |                 |            |              |           |                   | 374                               | 374                        | 374                         |
| Net increase in pension and other postretirement obligations, net of deferred income taxes   |                 |            |              |           |                   | 33                                | 33                         | 33                          |
| Total comprehensive loss   |                 |            |              |           |                   |                                   |                            | \$ (3,548)                  |
| Amortization of restricted stock award   |                 |            |              | 38        |                   |                                   | 38                         |                             |
| Cash dividends accrued on preferred stock  |                 |            |              |           | (500)             |                                   | (500)                      |                             |
| Accretion of discount on preferred stock   |                 | 85         |              |           | (85)              |                                   |                            |                             |
| Cash dividend declared on common stock, \$0.02 per share   |                 |            |              |           | (236)             |                                   | (236)                      |                             |
| Stock option expense   |                 |            |              | 332       |                   |                                   | 332                        |                             |
| Income tax effect of restricted stock award vesting  |                 |            |              | (72)      |                   |                                   | (72)                       |                             |
| <b>Balance, March 31, 2009</b>   | \$ 39,846       | \$ (1,861) | 11,820,509   | \$ 79,152 | \$ 66,210         | \$ (3,066)                        | \$ 180,281                 |                             |
| <b>Balance, January 1, 2010</b>  | \$ 39,846       | \$ (1,598) | 11,820,509   | \$ 80,222 | \$ 56,389         | \$ (2,554)                        | \$ 172,305                 |                             |
| Net loss   |                 |            |              |           | (4,120)           |                                   | (4,120)                    | \$ (4,120)                  |
| Net change in unrealized gain/loss on securities available-for-sale and interest-only strips, net of reclassification adjustment and deferred income taxes |                 |            |              |           |                   | 127                               | 127                        | 127                         |
| Net increase in pension and other postretirement   |                 |            |              |           |                   | 15                                | 15                         | 15                          |



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obligations, net of  
deferred income taxes

|   |           |            |            |           |           |            |            |            |
|---|-----------|------------|------------|-----------|-----------|------------|------------|------------|
| Total comprehensive loss                            |           |            |            |           |           |            |            | \$ (3,978) |
| Amortization of restricted stock award              |           |            | 38         |           |           |            |            | 38         |
| Cash dividends accrued on preferred stock           |           |            |            | (500)     |           |            |            | (500)      |
| Accretion of unearned discount on preferred stock   | 91        |            |            |           | (91)      |            |            |            |
| Stock option expense                                |           |            | 298        |           |           |            |            | 298        |
| Income tax effect of restricted stock award vesting |           |            |            | (74)      |           |            |            | (74)       |
| <b>Balance, March 31, 2010</b>                      | \$ 39,846 | \$ (1,507) | 11,820,509 | \$ 80,484 | \$ 51,678 | \$ (2,412) | \$ 168,089 |            |

Table of Contents**Heritage Commerce Corp****Consolidated Statements of Cash Flows (Unaudited)**

|   | <b>Three Months Ended<br/>March 31,</b> |             |
|---|---|-------------|
|   | <b>2010</b>                             | <b>2009</b> |
|   | <b>(Dollars in thousands)</b>           |             |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>                                |   |             |
| Net loss  | \$ (4,120)                              | \$ (3,955)  |
| Adjustments to reconcile net loss to net cash used in operating activities: |   |             |
| Depreciation and amortization   | 202                                     | 199         |
| Provision for loan losses   | 5,095                                   | 10,420      |
| Stock option expense  | 298                                     | 332         |
| Amortization of other intangible assets                                     | 144                                     | 160         |
| Amortization of restricted stock award                                      | 38                                      | 38          |
| Amortization (accretion) of discounts and premiums on securities            | (224)                                   | (40)        |
| Writedowns and losses on sale of foreclosed assets                          | 406                                     | (35)        |
| Gain on sale of loans   | (114)                                   |             |
| Proceeds from sale of loans   | 2,414                                   |             |
| Net change in loans originated held-for-sale                                | (4,354)                                 |             |
| Increase in cash surrender value of life insurance                          | (409)                                   | (412)       |
| Effect of changes in:   |   |             |
| Accrued interest receivable and other assets                                | 2,994                                   | (4,345)     |
| Accrued interest payable and other liabilities                              | (3,055)                                 | (3,428)     |
| Net cash used in operating activities                                       | (685)                                   | (1,066)     |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>                                |   |             |
| Net change in loans   | 58,274                                  | 26,056      |
| Net change in loans previously transferred to held-for-sale                 | (269)                                   |             |
| Purchases of securities available-for-sale                                  | (25,100)                                |             |
| Maturities/Paydowns/Calls of securities available-for-sale                  | 4,351                                   | 7,711       |
| Purchase of premises and equipment  | (57)                                    | (65)        |
| Purchase of restricted stock and other investments                          | (9)                                     | (460)       |
| Proceeds from sale of foreclosed assets                                     |   | 370         |
| Net cash provided by investing activities                                   | 37,190                                  | 33,612      |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>                                |   |             |
| Net change in deposits  | (7,590)                                 | 11,953      |
| Income tax effect of restricted stock award vesting                         | (74)                                    | (72)        |
| Payment of cash dividends common stock                                      |   | (236)       |
| Payment of cash dividends preferred stock                                   |   | (467)       |
| Net change in short-term borrowings   | (16,108)                                | (23,000)    |
| Net change in note payable  |   | (15,000)    |
| Net change in securities sold under agreement to repurchase                 | (5,000)                                 | (5,000)     |
| Net cash used in financing activities                                       | (28,772)                                | (31,822)    |
| Net increase in cash and cash equivalents                                   | 7,733                                   | 724         |
| Cash and cash equivalents, beginning of period                              | 45,562                                  | 30,096      |
| Cash and cash equivalents, end of period                                    | \$ 53,295                               | \$ 30,820   |

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Supplemental disclosures of cash flow information:

Cash paid during the period for:

|                   |          |          |
|-------------------|----------|----------|
| Interest paid     | \$ 2,551 | \$ 5,196 |
| Income taxes paid | \$       | \$ 450   |

Supplemental schedule of non-cash investing and financing

activities:

|   |          |        |
|---|----------|--------|
| Transfer from loans held-for-sale to the loan portfolio | \$ 1,942 | \$     |
| Loans transferred to foreclosed assets                  | \$       | \$ 477 |
| Securities acquired not yet settled                     | \$ 8,201 | \$     |

See notes to consolidated financial statements

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**HERITAGE COMMERCE CORP**

**Notes to Consolidated Financial Statements**

**March 31, 2010**

**(Unaudited)**

**1) Basis of Presentation**

The unaudited consolidated financial statements of Heritage Commerce Corp (the "Company") and its wholly owned subsidiary, Heritage Bank of Commerce ("HBC"), have been prepared pursuant to the rules and regulations for reporting on Form 10-Q. Accordingly, certain information and notes required by accounting principles generally accepted in the United States of America ("GAAP") for annual financial statements are not included herein. The interim statements should be read in conjunction with the consolidated financial statements and notes that were included in the Company's Form 10-K for the year ended December 31, 2009. The Company has also established the following unconsolidated subsidiary grantor trusts: Heritage Capital Trust I; Heritage Statutory Trust I; Heritage Statutory Trust II; and Heritage Commerce Corp Statutory Trust III which are Delaware Statutory business trusts formed for the exclusive purpose of issuing and selling trust preferred securities.

HBC is a commercial bank serving customers located in Santa Clara, Alameda, and Contra Costa counties of California. No customer accounts for more than 10 percent of revenue for HBC or the Company. Management evaluates the Company's performance as a whole and does not allocate resources based on the performance of different lending or transaction activities. Accordingly, the Company and its subsidiary operate as one business segment.

In the Company's opinion, all adjustments necessary for a fair presentation of these consolidated financial statements have been included and are of a normal and recurring nature. All intercompany transactions and balances have been eliminated.

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting periods. Actual results could differ significantly from these estimates.

The results for the three months ended March 31, 2010 are not necessarily indicative of the results expected for any subsequent period or for the entire year ending December 31, 2010.

***Adoption of New Accounting Standards***

In June 2009, the FASB amended previous guidance relating to transfers of financial assets and eliminates the concept of a qualifying special purpose entity. This guidance must be applied as of the beginning of each reporting entity's first annual reporting period that begins after November 15, 2009, for interim periods within that first annual reporting period and for interim and annual reporting periods thereafter. This guidance must be applied to transfers occurring on or after the effective date. Additionally, on and after the effective date, the concept of a qualifying special purpose entity is no longer relevant for accounting purposes. Therefore, formerly qualifying special purpose entities should be evaluated for consolidation by reporting entities on and after the effective date in accordance with the applicable consolidation guidance. The disclosure provisions were also amended and apply to transfers that occurred both before and after the effective date of this guidance. See note 3 to the consolidated financial statements for the impact of the adoption of this guidance.

In June 2009, the FASB amended guidance for consolidation of variable interest entity guidance by replacing the quantitative based risks and rewards calculation for determining which enterprise, if any,

Table of Contents**HERITAGE COMMERCE CORP****Notes to Consolidated Financial Statements (Continued)**

**March 31, 2010**  
**(Unaudited)**

**1) Basis of Presentation (Continued)**

has a controlling financial interest in a variable interest entity with an approach focused on identifying which enterprise has the power to direct the activities of a variable interest entity that most significantly impact the entity's economic performance and (1) the obligation to absorb losses of the entity or (2) the right to receive benefits from the entity. Additional disclosures about an enterprise's involvement in variable interest entities are also required. This guidance is effective as of the beginning of each reporting entity's first annual reporting period that begins after November 15, 2009, for interim periods within that first annual reporting period, and for interim and annual reporting periods thereafter. Early adoption is prohibited. The adoption of this guidance did not have a material impact on the Company's financial statements.

In January 2010, the FASB issued guidance clarifying the accounting for shareholder distributions where the shareholder has the ability to elect to have his or her distribution in the form of cash (up to a pre-determined maximum), stock or a combination of the two. The amendments of the update provide that the stock portion of a distribution where the shareholder had the ability to elect the distribution as stock or cash (up to a pre-determined maximum) should be accounted for as a share issuance and thereby eliminate diversity in practice. The provisions of this update became effective for financial statements dated on or after December 15, 2009. The adoption of this standard did not have a material impact on the Company's financial statements.

In January 2010, the FASB issued guidance requiring increased fair value disclosures. There are two components to the increased disclosure requirements set forth in the update: (1) a description of, as well as the disclosure of, the dollar amount of transfers in or out of level one or level two (2) in the reconciliation for fair value measurements using significant unobservable inputs (level 3), a reporting entity should present separately information about purchases, sales, issuances and settlements (that is, gross amounts shall be disclosed as opposed to a single net figure). Increased disclosures regarding the transfers in or out of level one and two are required for interim and annual periods beginning after December 15, 2009. The adoption of this portion of the standard did not have a material impact on the Company's financial statements. Increased disclosures regarding the level three fair value reconciliation are required for fiscal years beginning after December 15, 2010.

**2) Securities**

The amortized cost and estimated fair value of securities at March 31, 2010 and December 31, 2009 were as follows:

| March 31, 2010                                  | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Estimated<br>Fair<br>Value |
|---|-------------------|------------------------------|-------------------------------|----------------------------|
| (Dollars in thousands)                          |                   |                              |                               |                            |
| <b>Securities available-for-sale:</b>           |                   |                              |                               |                            |
| U.S. Government Sponsored Entities              | \$ 2,000          | \$                           | \$ (3)                        | \$ 1,997                   |
| Mortgage-Backed Securities Residential          | 131,013           | 1,818                        | (374)                         | 132,457                    |
| Collateralized Mortgage Obligations Residential | 4,744             | 189                          |                               | 4,933                      |
| <b>Total securities available-for-sale</b>      | <b>\$ 137,757</b> | <b>\$ 2,007</b>              | <b>\$ (377)</b>               | <b>\$ 139,387</b>          |

Table of Contents**HERITAGE COMMERCE CORP****Notes to Consolidated Financial Statements (Continued)**

**March 31, 2010**  
(Unaudited)

**2) Securities (Continued)**

| December 31, 2009                               | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Estimated<br>Fair<br>Value |
|---|-------------------|------------------------------|-------------------------------|----------------------------|
| (Dollars in thousands)                          |                   |                              |                               |                            |
| Securities available-for-sale:                  |                   |                              |                               |                            |
| U.S. Government Sponsored Entities              | \$ 2,000          | \$                           | \$ (27)                       | \$ 1,973                   |
| Mortgage-Backed Securities Residential          | 101,356           | 1,653                        | (463)                         | 102,546                    |
| Collateralized Mortgage Obligations Residential | 5,227             | 220                          |                               | 5,447                      |
| <b>Total securities available-for-sale</b>      | <b>\$ 108,583</b> | <b>\$ 1,873</b>              | <b>\$ (490)</b>               | <b>\$ 109,966</b>          |

Securities classified as U.S. Government Sponsored Entities as of March 31, 2010 and December 31, 2009 were issued by the Federal National Mortgage Association ("Fannie Mae"), Federal Home Loan Mortgage Corporation ("Freddie Mac"), and the Federal Home Loan Bank. At March 31, 2010 and December 31, 2009, all mortgage-backed securities and collateralized mortgage obligations were issued by Fannie Mae, Freddie Mac, or the Government National Mortgage Association ("Ginnie Mae").

At March 31, 2010 and December 31, 2009, there were no holdings of securities of any one issuer, other than the U.S. Government and its sponsored entities, in an amount greater than 10% of shareholders' equity.

Securities with unrealized losses at quarter end March 31, 2010 and December 31, 2009, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, are as follows:

| March 31, 2010                         | Less Than 12 Months<br>Fair<br>Value | Unrealized<br>Losses | 12 Months or More<br>Fair<br>Value | Unrealized<br>Losses | Total<br>Fair<br>Value | Total<br>Unrealized<br>Losses |
|--|--------------------------------------|----------------------|------------------------------------|----------------------|------------------------|-------------------------------|
| (Dollars in thousands)                 |                                      |                      |                                    |                      |                        |                               |
| U.S. Government Sponsored Entities     | \$ 1,997                             | \$ (3)               | \$                                 |                      | \$ 1,997               | \$ (3)                        |
| Mortgage-Backed Securities Residential | 67,459                               | (374)                |                                    |                      | 67,459                 | (374)                         |
| <b>Total</b>                           | <b>\$ 69,456</b>                     | <b>\$ (377)</b>      | <b>\$</b>                          |                      | <b>\$ 69,456</b>       | <b>\$ (377)</b>               |

| December 31, 2009                      | Less Than 12 Months<br>Fair<br>Value | Unrealized<br>Losses | 12 Months or More<br>Fair<br>Value | Unrealized<br>Losses | Total<br>Fair<br>Value | Total<br>Unrealized<br>Losses |
|--|--------------------------------------|----------------------|------------------------------------|----------------------|------------------------|-------------------------------|
| (Dollars in thousands)                 |                                      |                      |                                    |                      |                        |                               |
| U.S. Government Sponsored Entities     | \$ 1,973                             | \$ (27)              | \$                                 |                      | \$ 1,973               | \$ (27)                       |
| Mortgage-Backed Securities Residential | 43,600                               | (463)                |                                    |                      | 43,600                 | (463)                         |
| <b>Total</b>                           | <b>\$ 45,573</b>                     | <b>\$ (490)</b>      | <b>\$</b>                          |                      | <b>\$ 45,573</b>       | <b>\$ (490)</b>               |

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At March 31, 2010, the Company held 91 securities, of which 36 had a fair value below amortized cost. No security has been carried with an unrealized loss for over 12 months. Unrealized losses were primarily due to higher interest rates. The issuers are of high credit quality and all principal amounts

Table of Contents**HERITAGE COMMERCE CORP****Notes to Consolidated Financial Statements (Continued)**

**March 31, 2010**  
**(Unaudited)**

**2) Securities (Continued)**

are expected to be paid when securities mature. The fair value is expected to recover as the securities approach their maturity date and/or market rates decline. The Company does not intend to sell any securities with an unrealized loss and does not believe that it is more likely than not that the Company will be required to sell a security in an unrealized loss position prior to recovery in value. The Company does not consider these securities to be other-than-temporarily impaired at March 31, 2010.

At December 31, 2009, the Company held 75 securities, of which 23 had fair values below amortized cost. No securities have been carried with an unrealized loss for over 12 months. The Company did not consider these securities to be other-than-temporarily impaired at December 31, 2009.

The estimated fair values of securities as of March 31, 2010, by weighted average life are shown below. Expected maturities will differ from contractual maturities because borrowers may have the right to call or pre-pay obligations with or without call or pre-payment penalties:

|   | <b>Within One<br/>Year</b>    | <b>March 31, 2010 Weighted Average Life</b>    |  |                            | <b>Total</b>      |
|---|-------------------------------|--|--|----------------------------|-------------------|
|   |                               | <b>After One<br/>and Within<br/>Five Years</b> | <b>After Five<br/>and Within<br/>Ten Years</b> | <b>After Ten<br/>Years</b> |                   |
|   | <b>(Dollars in thousands)</b> |  |  |                            |                   |
| Securities available-for-sale (at fair value)   |                               |  |  |                            |                   |
| U.S. Government Sponsored Entities              | \$                            | \$ 1,997                                       | \$   | \$                         | \$ 1,997          |
| Mortgage-Backed Securities Residential          | 6                             | 39,893   | 87,783   | 4,775                      | 132,457           |
| Collateralized Mortgage Obligations Residential | 3,933                         | 1,000  |  |                            | 4,933             |
| <b>Total Securities Available-for-Sale</b>      | <b>\$ 3,939</b>               | <b>\$ 42,890</b>                               | <b>\$ 87,783</b>                               | <b>\$ 4,775</b>            | <b>\$ 139,387</b> |



Table of Contents**HERITAGE COMMERCE CORP****Notes to Consolidated Financial Statements (Continued)**

**March 31, 2010**  
**(Unaudited)**

**3) Loans**

Loans were as follows:

|   | <b>March 31,<br/>2010</b>     | <b>December 31,<br/>2009</b> |
|---|-------------------------------|------------------------------|
|   | <b>(Dollars in thousands)</b> |                              |
| Loans held for sale                           | \$ 11,123                     | \$ 10,742                    |
| Loans held for investment                     |                               |                              |
| Commercial                                    | \$ 395,399                    | \$ 427,177                   |
| Real estate mortgage                          | 393,168                       | 400,731                      |
| Real estate land and construction             | 153,811                       | 182,871                      |
| Home equity                                   | 51,369                        | 51,368                       |
| Consumer                                      | 11,943                        | 7,181                        |
| Loans   | 1,005,690                     | 1,069,328                    |
| Deferred loan origination costs and fees, net | 755                           | 785                          |
| Loans, including deferred costs               | 1,006,445                     | 1,070,113                    |
| Allowance for loan losses                     | (26,527)                      | (28,768)                     |
| Loans, net                                    | \$ 979,918                    | \$ 1,041,345                 |

At March 31, 2010, included in the balance of loans held-for-sale are \$3.9 million of SBA loans that have been transferred to third parties. However, these loans are subject to a SBA warranty for a period of 90 days, which under new accounting guidance requires the Company to treat these as secured borrowings during the warranty period. The secured borrowings are classified as "short-term borrowings" on the consolidated balance sheets. The warranty period for these loans expires in the following quarter. Provided the loans remain current through the end of the warranty period all elements necessary to record the sale will have been met. The Company has deferred gains of \$210,000 associated with these loans, which are included in other liabilities on the consolidated balance sheets.

Changes in the allowance for loan losses were as follows:

|                              | <b>Three Months Ended<br/>March 31,</b> |             | <b>For the Year Ended<br/>December 31,</b> |
|------------------------------|---|-------------|--|
|                              | <b>2010</b>                             | <b>2009</b> | <b>2009</b>                                |
|                              | <b>(Dollars in thousands)</b>           |             |  |
| Balance, beginning of period | \$ 28,768                               | \$ 25,007   | \$ 25,007                                  |
| Loans charged-off            | (7,702)                                 | (11,534)    | (31,534)                                   |
| Recoveries                   | 366                                     | 7           | 1,367                                      |
| Net charge-offs              | (7,336)                                 | (11,527)    | (30,167)                                   |
| Provision for loan losses    | 5,095                                   | 10,420      | 33,928                                     |
| Balance, end of period       | \$ 26,527                               | \$ 23,900   | \$ 28,768                                  |



Table of Contents**HERITAGE COMMERCE CORP****Notes to Consolidated Financial Statements (Continued)**

**March 31, 2010**  
**(Unaudited)**

**3) Loans (Continued)**

Impaired loans were as follows:

|  | <b>Three Months Ended</b>     |                  |                     |
|--|-------------------------------|------------------|---------------------|
|  | <b>March 31,</b>              |                  | <b>December 31,</b> |
|  | <b>2010</b>                   | <b>2009</b>      | <b>2009</b>         |
|  | <b>(Dollars in thousands)</b> |                  |                     |
| Period-end loans with no allocated allowance for loan losses | \$ 21,132                     | 20,286           | \$ 13,202           |
| Period-end loans with allocated allowance for loan losses    | 46,070                        | 35,779           | 49,173              |
| <b>Total</b>   | <b>\$ 67,202</b>              | <b>\$ 56,065</b> | <b>\$ 62,375</b>    |

Amount of the allowance for loan losses at

|            |          |          |          |
|------------|----------|----------|----------|
| period-end | \$ 9,165 | \$ 7,972 | \$ 9,103 |
|------------|----------|----------|----------|

Nonperforming loans include both smaller dollar balance homogeneous loans that are collectively evaluated for impairment and individually classified loans. Nonperforming loans were as follows:

|   | <b>Three Months Ended</b>     |                  |                     |
|---|-------------------------------|------------------|---------------------|
|   | <b>March 31,</b>              |                  | <b>December 31,</b> |
|   | <b>2010</b>                   | <b>2009</b>      | <b>2009</b>         |
|   | <b>(Dollars in thousands)</b> |                  |                     |
| Restructured and loans past due over 90 days still on accrual | \$ 2,176                      | \$ 1,774         | \$ 2,895            |
| Nonaccrual loans  | 65,026                        | 54,291           | 59,480              |
| <b>Total</b>  | <b>\$ 67,202</b>              | <b>\$ 56,065</b> | <b>\$ 62,375</b>    |

**4) Supplemental Retirement Plan**

The Company has a supplemental retirement plan covering current and former key executives and directors. The Plan is a nonqualified defined benefit plan. Benefits are unsecured as there are no Plan assets. The following table presents the amount of periodic cost recognized for the three months ended March 31, 2010 and 2009:

|  | <b>Three Months Ended</b> |             |
|--|---------------------------|-------------|
|  | <b>March 31,</b>          |             |
|  | <b>2010</b>               | <b>2009</b> |

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(Dollars in thousands)

| Components of net periodic benefits cost |    |     |        |
|--|----|-----|--------|
| Service cost                             | \$ | 244 | \$ 241 |
| Interest cost                            |    | 209 | 191    |
| Prior service cost                       |    | 9   | 9      |
| Amortization of loss                     |    | 17  | 48     |
| Net periodic cost                        | \$ | 479 | \$ 489 |

Table of Contents**HERITAGE COMMERCE CORP****Notes to Consolidated Financial Statements (Continued)****March 31, 2010****(Unaudited)****5) Comprehensive Income (Loss)**

Comprehensive income (loss) for the three months ended March 31, 2010 and 2009 consists of the following:

|                                 | <b>Three Months Ended<br/>March 31,</b> |                   |
|---------------------------------|---|-------------------|
|                                 | <b>2010</b>                             | <b>2009</b>       |
|                                 | <b>(Dollars in thousands)</b>           |                   |
| Net loss                        | \$ (4,120)                              | \$ (3,955)        |
| Other comprehensive income      | 142                                     | 407               |
| <b>Total comprehensive loss</b> | <b>\$ (3,978)</b>                       | <b>\$ (3,548)</b> |

**6) Fair Value**

Accounting guidance establishes a fair value hierarchy which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The standard describes three levels of inputs that may be used to measure fair value:

Level 1: Quoted prices (unadjusted) for identical assets or liabilities in active markets that the entity has the ability to access as of the measurement date.

Level 2: Significant other observable inputs other than Level 1 prices such as quoted prices for similar assets or liabilities in active markets; quoted prices for identical assets or liabilities in markets that are not active; or other inputs that are observable or can be corroborated by observable market data (for example, interest rates and yield curves observable at commonly quoted intervals, prepayment speeds, credit risks, and default rates).

Level 3: Significant unobservable inputs that reflect a reporting entity's own assumptions about the assumptions that market participants would use in pricing an asset or liability.

***Financial Assets and Liabilities Measured on a Recurring Basis***

The fair values of securities available for sale are determined by obtaining quoted prices on nationally recognized securities exchanges (Level 1 inputs) or matrix pricing, which is a mathematical technique widely used in the industry to value debt securities without relying exclusively on quoted prices for the specific securities, but rather by relying on the securities' relationship to other benchmark quoted securities (Level 2 inputs). The fair value of the Company's available for sale securities are primarily based on quoted market prices of comparable instruments at each period end.

The fair value of interest-only ("I/O") strip receivable assets is based on a valuation model used by a third party. The Company is able to compare the valuation model inputs and results to widely available published industry data for reasonableness (Level 2 inputs). The weighted average discount rate and constant prepayment rate ("CPR") assumptions used to estimate the I/O strip receivables were 11.3% and 14.0%, respectively, at March 31, 2010. The weighted average discount rate and constant prepayment rate ("CPR") assumptions used to estimate the I/O strip receivables were 10.7% and 15.8%, respectively, at December 31, 2009.

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## HERITAGE COMMERCE CORP

## Notes to Consolidated Financial Statements (Continued)

March 31, 2010  
(Unaudited)

**6) Fair Value (Continued)****Assets and Liabilities Measured on a Recurring Basis**

|   | Balance  | Fair Value Measurements Using   |  |  |
|---|----------|---|--|--|
|   |          | Quoted Prices in<br>Active Markets for<br>Identical Assets<br>(Level 1) | Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
| (Dollars in thousands)                          |          |   |  |  |
| <b>Assets at March 31, 2010:</b>                |          |   |  |  |
| Available-for-sale securities                   |          |   |  |  |
| U.S. Government Sponsored Entities              | \$ 1,997 | \$  | \$ 1,997                                   | \$   |
| Mortgage-Backed Securities Residential          | 132,457  |   | 132,457                                    |  |
| Collateralized Mortgage Obligations Residential | 4,933    |   | 4,933                                      |  |
| I/O strip receivables                           | 2,015    |   | 2,015                                      |  |
| <b>Assets at December 31, 2009:</b>             |          |   |  |  |
| Available-for-sale securities                   |          |   |  |  |
| U.S. Government Sponsored Entities              | \$ 1,973 | \$  | \$ 1,973                                   | \$   |
| Mortgage-Backed Securities Residential          | 102,546  |   | 102,546                                    |  |
| Collateralized Mortgage Obligations Residential | 5,447    |   | 5,447                                      |  |
| I/O strip receivables                           | 2,116    |   | 2,116                                      |  |

**Assets and Liabilities Measured on a Non-Recurring Basis**

The fair value of impaired loans with specific allocations of the allowance for loan losses is generally based on recent real estate appraisals. The appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach. Adjustments are routinely made in the appraisal process by the appraisers to adjust for differences between the comparable sales and income data available. Such adjustments are usually significant and typically result in a Level 3 classification of the inputs for determining fair value.

Nonrecurring adjustments to certain commercial and residential estate properties classified as other real estate owned are measured at the lower of carrying amount or fair value, less costs to sell. Fair values are generally based on third party appraisals of the property, resulting in a Level 3 classification. In cases where the carrying amount exceeds the fair value, less costs to sell, an impairment loss is recognized.

Table of Contents**HERITAGE COMMERCE CORP****Notes to Consolidated Financial Statements (Continued)**

**March 31, 2010**  
**(Unaudited)**

**6) Fair Value (Continued)***Assets and Liabilities Measured on a Non-recurring Basis***Assets and Liabilities Measured on a Non-recurring Basis**

|                                   | Balance   | Fair Value Measurements Using   |   |  |
|-----------------------------------|-----------|---|---|--|
|                                   |           | Quoted Prices in<br>Active Markets for<br>Identical Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
| (Dollars in thousands)            |           |   |   |  |
| Assets at March 31, 2010:         |           |   |   |  |
| Impaired Loans:                   |           |   |   |  |
| Commercial                        | \$ 12,077 | \$  | \$  | \$ 12,077  |
| Real estate mortgage              | 16,252    |   |   | 16,252   |
| Real estate land and construction | 23,930    |   |   | 23,930   |
| Home Equity                       | 274       |   |   | 274  |
| Consumer                          | 116       |   |   | 116  |
|                                   | \$ 52,649 | \$  | \$  | \$ 52,649  |
| Other real estate owned           | \$ 1,835  |   |   | \$ 1,835   |
| Assets at December 31, 2009:      |           |   |   |  |
| Impaired loans                    | \$ 48,410 | \$  | \$  | \$ 48,410  |
| Other real estate owned           | 812       |   |   | 812  |

Impaired loans which are measured primarily for impairment using the fair value of the collateral were \$67,202,000 at March 31, 2010, after partial charge-offs of \$5,137,000 in 2010. In addition, these loans had a specific valuation allowance of \$9,165,000 at March 31, 2010. Impaired loans totaling \$61,814,000 at March 31, 2010 were carried at fair value as a result of the aforementioned partial charge-offs and specific valuation allowances at period-end. The remaining \$5,388,000 of impaired loans were carried at cost at March 31, 2010, as the fair value of the collateral exceeded the cost basis of each respective loan. Partial charge-offs and changes in specific valuation allowances during 2010 on impaired loans carried at fair value at March 31, 2010 resulted in an additional provision for loan losses of \$6,608,000.

Impaired loans which are measured primarily for impairment using the fair value of the collateral were \$62,375,000 at December 31, 2009, after partial charge-offs of \$14,027,000 in 2009. In addition, these loans had a specific valuation allowance of \$9,103,000 at December 31, 2009. Impaired loans totaling \$57,513,000 at December 31, 2009 were carried at fair value as a result of the aforementioned partial charge-offs and specific valuation allowances at year-end. The remaining \$4,862,000 of impaired loans were carried at cost at December 31, 2009, as the fair value of the collateral exceeded the cost basis of each respective loan. Partial charge-offs and changes in specific valuation allowances during 2009 on impaired loans carried at fair value at December 31, 2009 resulted in an additional provision for loan losses of \$16,574,000.

Table of Contents**HERITAGE COMMERCE CORP****Notes to Consolidated Financial Statements (Continued)**

**March 31, 2010**  
**(Unaudited)**

**6) Fair Value (Continued)**

Total other real estate owned, consisting of two properties, had a fair value of \$1,835,000 at March 31, 2010. There was a write down of \$406,000 in the first quarter of 2010.

Total other real estate owned, consisting of two properties, had a carrying value of \$2,241,000 at December 31, 2009. One property is carried at fair value, less costs to sell, of \$812,000 at December 31, 2009. The other property is carried at cost as of December 31, 2009. There were no impairment write downs subsequent to acquisition in 2009.

The carrying amounts and estimated fair values of the Company's financial instruments, at March 31, 2010 and December 31, 2009 were as follows:

|  | 2010             |                      | 2009             |                      |
|--|------------------|----------------------|------------------|----------------------|
|  | Carrying Amounts | Estimated Fair Value | Carrying Amounts | Estimated Fair Value |
| (Dollars in thousands)                           |                  |                      |                  |                      |
| <b>Assets</b>                                    |                  |                      |                  |                      |
| Cash and cash equivalents                        | \$ 53,295        | \$ 53,295            | \$ 45,562        | \$ 45,562            |
| Securities available-for-sale                    | 139,387          | 139,387              | 109,966          | 109,966              |
| Loans (including loans held-for-sale), net       | 991,041          | 922,554              | 1,052,087        | 955,242              |
| FHLB and FRB stock                               | 8,463            | N/A                  | 8,454            | N/A                  |
| Accrued interest receivable                      | 3,448            | 3,448                | 3,472            | 3,472                |
| Loan servicing rights and I/O strips receivables | 3,053            | 4,948                | 3,183            | 4,972                |
| <b>Liabilities</b>                               |                  |                      |                  |                      |
| Time deposits                                    | \$ 363,037       | \$ 365,603           | \$ 386,213       | \$ 389,027           |
| Other deposits                                   | 718,658          | 718,658              | 703,072          | 703,072              |
| Securities sold under agreement to repurchase    | 20,000           | 20,250               | 25,000           | 25,341               |
| Short-term borrowings                            | 3,892            | 3,892                | 20,000           | 20,000               |
| Subordinated debt                                | 23,702           | 18,563               | 23,702           | 14,938               |
| Accrued interest payable                         | 1,612            | 1,612                | 1,194            | 1,194                |

The methods and assumptions, not previously discussed, used to estimate the fair value are described as follows:

**Cash and Cash Equivalents and Accrued Interest Receivable and Payable**

The carrying amount approximates fair value because of the short maturities of these instruments.

**Loans**

Loans with similar financial characteristics are grouped together for purposes of estimating their fair value. Loans are segregated by type such as commercial, term real estate, construction and land development, and consumer. Each loan category is further segmented into fixed and adjustable rate interest terms.

The fair value of performing, fixed rate loans is calculated by discounting scheduled future cash flows using estimated market discount rates that reflect the credit and interest rate risk inherent in the



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**HERITAGE COMMERCE CORP**

**Notes to Consolidated Financial Statements (Continued)**

**March 31, 2010**  
**(Unaudited)**

**6) Fair Value (Continued)**

loan. The fair value of variable rate loans approximates the carrying amount as these loans generally reprice within 90 days.

The fair value of loans held-for-sale is based on estimated market values from third party investors.

***FHLB and FRB Stock***

It was not practical to determine the fair value of FHLB and FRB stock due to the restrictions placed on transferability.

***Deposits***

The fair value of deposits with no stated maturity, such as demand deposits, savings, and money market accounts, approximates the amount payable on demand. The carrying amount approximates the fair value of time deposits with a remaining maturity of less than 90 days. The fair value of all other time deposits is calculated based on discounting the future cash flows using rates currently offered for time deposits with similar remaining maturities.

***Subordinated debt and Securities Sold Under Agreement to Purchase***

The fair values of subordinated debt and securities sold under agreement to repurchase were determined based on the current market value for like kind instruments of a similar maturity and structure.

***Short-term Borrowings and Note Payable***

The carrying amount approximates the fair value of short-term borrowings and the note payable that reprice frequently and fully.

***Off-Balance Sheet Items***

The fair value of off-balance sheet items, such as commitments to extend credit, is not considered material and therefore is not included in the table above.

***Limitations***

Fair value estimates are made at a specific point in time, based on relevant market information about the financial instruments. These estimates do not reflect any premium or discount that could result from offering for sale at one time the entire holdings of a particular financial instrument. Fair value estimates are based on judgments regarding future expected loss experience, current economic conditions, risk characteristics of various financial instruments, and other factors. These estimates are subjective in nature and involve uncertainties and matters of significant judgment and therefore cannot be determined with precision. Changes in assumptions could significantly affect the estimates.

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**HERITAGE COMMERCE CORP**

**Notes to Consolidated Financial Statements (Continued)**

**March 31, 2010**

**(Unaudited)**

**7) Regulatory Matters**

On February 17, 2010, the Company and HBC entered into a written agreement with the Federal Reserve Bank of San Francisco ("FRB") and the California Department of Financial Institutions ("DFI"). Under the terms of the written agreement, the Company must obtain the prior written approval of the Federal Reserve and DFI before it may (i) declare or pay any dividends, (ii) make any distributions of principal or interest on the Company's outstanding trust preferred securities and related subordinated debt, (iii) incur, increase or guarantee any debt, (iv) redeem any outstanding stock, or (v) take dividends or any other form of payment that represents a reduction in capital from HBC. The written agreement also requires the Company to (i) submit a written plan to strengthen credit risk management practices, (ii) submit a written capital plan for sufficient capitalization of both the Company and HBC, (iii) submit a written business plan for 2010 to improve the Company's earnings and overall financial condition, (iv) comply with notice and approval requirements related to the appointment of directors and senior executive officers or change in the responsibility of any current senior executive officer, (v) comply with restrictions on paying or agreeing to pay certain indemnification and severance payments without prior written approval, (vi) submit a written plan to improve management of the Company's liquidity position and funds management practices, (vii) notify the Federal Reserve and DFI no more than 30 days after the end of any quarter in which the capital ratios of the Company or HBC fall below approved capital plan's minimum ratios, together with an acceptable written plan to increase capital ratios to or above the approved capital plan's minimum levels (viii) comply with specified procedures for board (or a committee of the board) approval for the extension, renewal or restructure of any "criticized loan", (ix) submit plans to improve the Company's position on outstanding past due and other problem loans in excess of \$2 million, (x) maintain policies and procedures and submit a plan for the maintenance of an adequate allocation for loan losses, and (xi) provide quarterly progress reports to the Federal Reserve and DFI.

Prior to entering into the written agreement in February 2010, the Company had already ceased paying dividends on its common stock (in the second quarter of 2009), suspended interest payments on its trust preferred securities and related subordinated debt (in the fourth quarter of 2009), and suspended dividend payments on its preferred stock (also in the fourth quarter of 2009).

The Company is addressing the requirements of the written agreement. The Company has submitted specific plans to the FRB and DFI relating to improving asset quality and credit risk management, improving profitability, liquidity management and a capital plan. The plans are subject to review by and further discussions with the FRB and DFI.

Failure to comply with the written agreement may subject the Company and HBC to additional supervisory actions and orders.

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

The following discussion provides information about the results of operations, financial condition, liquidity, and capital resources of Heritage Commerce Corp ("the Company") and its wholly owned subsidiary, Heritage Bank of Commerce ("HBC" or "the Bank"). This information is intended to facilitate the understanding and assessment of significant changes and trends related to our financial condition and the results of operations. This discussion and analysis should be read in conjunction with our consolidated financial statements and the accompanying notes presented elsewhere in this report. Unless we state otherwise or the context indicates otherwise, references to the "Company," "Heritage," "we," "us," and "our," in this Report on Form 10-Q refer to Heritage Commerce Corp and Heritage Bank of Commerce.

This Report on Form 10-Q contains various statements that may constitute forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, or Securities Act, and Section 21E of the Securities Exchange Act of 1934, as amended, or Exchange Act, and are intended to be covered by the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. Any statements about our expectations, beliefs, plans, objectives, assumptions or future events or performance are not historical facts and may be forward-looking. These forward-looking statements often can be, but are not always, identified by the use of words such as "assume," "expect," "intend," "plan," "project," "believe," "estimate," "predict," "anticipate," "may," "might," "should," "could," "goal," "potential" and similar expressions. We base these forward-looking statements on our current expectations and projections about future events, our assumptions regarding these events and our knowledge of facts at the time the statements are made. These statements include statements relating to our projected growth, anticipated future financial performance, and management's long-term performance goals, as well as statements relating to the anticipated effects on results of operations and financial condition.

These forward-looking statements are subject to various risks and uncertainties that may be outside our control and our actual results could differ materially from our projected results. In addition, our past results of operations do not necessarily indicate our future results. Please see our most recent Annual Report on Form 10-K for the year ended December 31, 2009 and our subsequent Quarterly Reports on Form 10-Q and the other information contained in this Report on Form 10-Q for a further discussion of these and other risks and uncertainties applicable to our business. The forward-looking statements could be affected by many factors, including but not limited to:

Our ability to attract new deposits and loans;

Local, regional, and national economic conditions and events and the impact they may have on us and our customers;

Risks associated with concentrations in real estate related loans;

Increasing levels of classified assets, including nonperforming assets, which could adversely affect our earnings and liquidity;

Market interest rate volatility;

Stability of funding sources and continued availability of borrowings;

Changes in legal or regulatory requirements or the results of regulatory examinations that could restrict growth and constrain our activities, including the terms of our written agreement entered into by the Company, the Board of Governors of the Federal Reserve System and the Department of Financial Institutions;

Changes in accounting standards and interpretations;

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Significant decline in the market value of the Company that could result in an impairment of goodwill;

Our ability to raise capital or incur debt on reasonable terms;

Regulatory limits on the Heritage Bank of Commerce's ability to pay dividends to the Company;

Effectiveness of the Emergency Economic Stabilization Act of 2008, the American Recovery and Reinvestment Act of 2009 and other legislative and regulatory efforts to help stabilize the U.S. financial markets;

Future legislative or administrative changes to the U.S. Treasury Capital Purchase Program enacted under the Emergency Economic Stabilization Act of 2008;

The impact of the Emergency Economic Stabilization Act of 2008 and the American Recovery and Reinvestment Act of 2009 and related rules and regulations on our business operations and competitiveness, including the impact of executive compensation restrictions, which may affect our ability to retain and recruit executives in competition with other firms who do not operate under those restrictions; and

Our success in managing the risks involved in the foregoing items.

We are not able to predict all the factors that may affect future results. You should not place undue reliance on any forward-looking statement, which speaks only as of the date of this Report on Form 10-Q. Except as required by applicable laws or regulations, we do not undertake any obligation to update or revise any forward-looking statement, whether as a result of new information, future events or otherwise.

**EXECUTIVE SUMMARY**

This summary is intended to identify the most important matters on which management focuses when it evaluates the financial condition and performance of the Company. When evaluating financial condition and performance, management looks at certain key metrics and measures. The Company's evaluation includes comparisons with peer group financial institutions and its own performance objectives established in the internal planning process.

The primary activity of the Company is commercial banking. The Company's operations are located entirely in the southern and eastern regions of the general San Francisco Bay area of California in the counties of Santa Clara, Alameda and Contra Costa. The largest city in this area is San Jose and the Company's market includes the headquarters of a number of technology based companies in the region known commonly as Silicon Valley. The Company's customers are primarily closely held businesses and professionals.

***Performance Overview***

For the three months ended March 31, 2010, net loss was \$4.1 million. Net loss allocable to common shareholders was \$4.7 million, or \$(0.40) per diluted common share for the first quarter ended March 31, 2010, which included a \$5.1 million provision for loan losses and \$591,000 in dividends and discount accretion on preferred stock. In the quarter ended March 31, 2009, net loss was \$4.0 million. Net loss allocable to common shareholders was \$4.5 million, or \$(0.38) per diluted common share for the first quarter ended March 31, 2009, which included a \$10.4 million provision for loan losses and \$585,000 in dividends and discount accretion on preferred stock. The loss before income tax benefit was \$4.2 million in the first quarter of 2010, compared to \$9.0 million in the first quarter of 2009. The Company's return on average assets was -1.23% and return on average equity was -9.61% for the first quarter of 2010 compared to -1.08% and -8.65% a year ago.

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The following are major factors that impacted the Company's results of operations:

Net interest income increased 2% to \$11.4 million for the first quarter of 2010 from \$11.2 million for the first quarter of 2009, primarily due to expansion of the net interest margin.

The net interest margin increased 46 basis points to 3.81% for the first quarter of 2010, compared with 3.35% for the first quarter of 2009, and increased 20 basis points compared with 3.61% for the fourth quarter of 2009. The increase in the net interest margin was primarily due to lower deposits and borrowing costs.

The provision for loan losses was \$5.1 million for the first quarter of 2010, compared to \$10.4 million for the first quarter of 2009.

Noninterest income increased 4% to \$1.7 million for the first quarter of 2010 from \$1.6 million for the first quarter of 2009, primarily due to the gain on the sale of loans of \$114,000.

Noninterest expense increased 7% to \$12.2 million for the first quarter of 2010 from \$11.4 million for the first quarter of 2009. The increase in noninterest expense was primarily due to higher FDIC deposit insurance premiums, professional fees related to problem loans, and expenses related to OREO properties.

The efficiency ratio was 93.45% for the first quarter of 2010, compared to 88.94% for the first quarter of 2009, primarily due to higher noninterest expenses.

The income tax benefit for the first quarter of 2010 was \$120,000, as compared to an income tax benefit of \$5.1 million for the first quarter of 2009. The negative effective income tax rate was 3% for first quarter of 2010, compared to 56% for the first quarter of 2009. The difference in the effective tax rate compared to the combined Federal and state statutory tax rate of 42% is primarily the result of the Company's investment in life insurance policies whose earnings are not subject to taxes, tax credits related to investments in low income housing limited partnerships, and interest income from tax-free loans.

The following are important factors in understanding our current financial condition and liquidity position:

Total assets decreased by \$27.3 million, or 2%, to \$1.34 billion at March 31, 2010 from \$1.36 billion at December 31, 2009.

Total loans, excluding loans held-for-sale, decreased \$204.1 million, or 17%, to \$1.01 billion at March 31, 2010, compared to \$1.21 billion at March 31, 2009, and decreased \$63.7 million, or 6%, from December 31, 2009. Land and construction loans decreased \$90.4 million, or 37%, to \$153.8 million at March 31, 2010, compared to \$244.2 million at March 31, 2009, and decreased \$29.1 million, or 16%, from \$182.9 million at December 31, 2009.

The allowance for loan losses was \$26.5 million, or 2.64% of total loans at March 31, 2010, compared to \$23.9 million or 1.97% of total loans at March 31, 2009, and \$28.8 million, or 2.69% of total loans at December 31, 2009.

Nonperforming assets were \$69.0 million, or 5.17% of total assets at March 31, 2010, compared to \$56.9 million or 3.89% of total assets at March 31, 2009 and \$64.6 million, or 4.74% of total assets at December 31, 2009.

Total deposits were \$1.08 billion at March 31, 2010, compared to \$1.17 billion at March 31, 2009, and \$1.09 billion at December 31, 2009.

The ratio of noncore funding (which consists of time deposits \$100,000 and over, CDARS deposits, brokered deposits, securities under agreement to repurchase, notes payable and

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short-term borrowings) to total assets was 26% at March 31, 2010, compared to 30% at March 31, 2009, and 29% at December 31, 2009.

The loan to deposit ratio was 93.04% at March 31, 2010, compared to 103.82% at March 31, 2009, and 98.24% at December 31, 2009.

On a consolidated basis, the Company's capital ratios continue to exceed regulatory well-capitalized standards with a leverage ratio of 10.19%, a Tier 1 risk-based capital ratio of 11.88%, and a total risk-based capital ratio of 13.14% at March 31, 2010.

Heritage Bank of Commerce's capital ratios continue to exceed regulatory well-capitalized standards with a leverage ratio of 10.07%, a Tier 1 risk-based capital ratio of 11.73%, and a total risk-based capital ratio of 13.00% at March 31, 2010

### *Deposits*

The composition and cost of the Company's deposit base are important in analyzing the Company's net interest margin and balance sheet liquidity characteristics. Except for brokered time deposits, the Company's depositors are generally located in its primary market area. Depending on loan demand and other funding requirements, the Company also obtains deposits from wholesale sources including deposit brokers. The Company had \$174.5 million in brokered deposits at March 31, 2010, compared to \$183.5 million at March 31, 2009, and \$178.0 million at December 31, 2009. Deposits from title insurance companies, escrow accounts and real estate exchange facilitators decreased to \$21.6 million at March 31, 2010, compared to \$40.4 million at March 31, 2009, and \$23.0 million at December 31, 2009. The Company has a policy to monitor all deposits that may be sensitive to interest rate changes to help assure that liquidity risk does not become excessive due to concentrations. Deposits at March 31, 2010 were \$1.08 billion, compared to \$1.17 billion at March 31, 2009, and \$1.09 billion at December 31, 2009.

HBC is a member of the Certificate of Deposit Account Registry Service ("CDARS") program. The CDARS program allows customers with deposits in excess of FDIC insured limits to obtain coverage on time deposits through a network of banks within the CDARS program. Deposits gathered through this program are considered brokered deposits under regulatory guidelines. Deposits in the CDARS program totaled \$18.5 million at March 31, 2010, compared to \$12.3 million at March 31, 2009 and \$38.2 million at December 31, 2009.

HBC is a participant in the FDIC's Transaction Account Guarantee Program ("TAGP"), which provides HBC's depositors with unlimited FDIC insurance coverage for certain noninterest-bearing transaction accounts. Unless extended by the FDIC, the TAGP will expire on December 31, 2010, at which time the amount of coverage for each depositor will be limited to \$250,000. The impact of the TAGP expiration in December 2010 could have an adverse effect on HBC's deposit base.

### *Liquidity*

Our liquidity position refers to our ability to maintain cash flows sufficient to fund operations and to meet obligations and other commitments in a timely fashion. We believe that our liquidity position is more than sufficient to meet our operating expenses, borrowing needs and other obligations for 2010. At March 31, 2010, we had \$53.3 million in cash and cash equivalents and approximately \$176.3 million in available borrowing capacity from various sources including the Federal Home Loan Bank ("FHLB"), the Federal Reserve Bank of San Francisco ("FRB"), and Federal funds facilities with several financial institutions. The Company also had \$82.8 million in unpledged securities available at March 31, 2010. Our loan to deposit ratio decreased to 93.04% at March 31, 2010, compared to 103.82% at March 31, 2009, and 98.24% at December 31, 2009, primarily due to a reduction in the loan portfolio.

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***Lending***

Our lending business originates primarily through our branch offices located in our primary market. The Company also has SBA loan production offices in Sacramento, Oakland and Santa Rosa, California. As a result of the weakened economy in our primary service area throughout 2009 and the first quarter of 2010 and loan payoffs, we have seen a contraction in our loan portfolio during the first three months of 2010. Commercial and industrial loans accounted for 39% of the total loan portfolio, and commercial real estate loans (of which 51% are owner occupied) also account for 39% of the total loan portfolio. We have actively lowered our exposure to land and construction loans and our overall credit risk on these portfolios has been reduced. Land and construction loans decreased \$90.4 million at March 31, 2010, compared to March 31, 2009, and accounted for 15% of our total loan portfolio. Consumer and home equity loans accounted for the remaining 7% of total loans at March 31, 2010.

***Net Interest Income***

The management of interest income and expense is fundamental to the performance of the Company. Net interest income, the difference between interest income and interest expense, is the largest component of the Company's total revenue. Management closely monitors both total net interest income and the net interest margin (net interest income divided by average earning assets).

Because of our focus on commercial lending to closely held businesses, the Company will continue to have a high percentage of floating rate loans and other assets. Given the current volume, mix and repricing characteristics of our interest-bearing liabilities and interest-earning assets, we believe our interest rate spread is expected to increase in a rising rate environment, and decrease in a declining interest rate environment.

The Company, through its asset and liability policies and practices, seeks to maximize net interest income without exposing the Company to an excessive level of interest rate risk. Interest rate risk is managed by monitoring the pricing, maturity and repricing options of all classes of interest bearing assets and liabilities. This is discussed in more detail under *Liquidity and Asset/Liability Management*.

From January 22, 2008 through December 16, 2008, the Board of Governors of the Federal Reserve System reduced short-term interest rates by 325 basis points. This decrease in short-term rates immediately affected the rates applicable to the majority of the Company's loans. While the decrease in interest rates also lowered the cost of interest bearing deposits, which represents the Company's primary funding source, these deposits tend to price more slowly than floating rate loans, which resulted in compression of the Company's net interest margin. The Company's net interest margin has recently expanded in the first quarter of 2010, as the costs of deposits and borrowings have continued to decline.

The net interest margin is also impacted by the reversal of interest on nonaccrual loans, and the reinvestment of loan payoffs into lower yielding investment securities and other short-term investments.

***Management of Credit Risk***

We continue to proactively identify, quantify, and manage our problem loans. Early identification of problem loans and potential future losses helps enable us to resolve credit issues with potentially less risk and ultimate losses. We maintain an allowance for loan losses in an amount that we believe is adequate to absorb probable incurred losses in the portfolio. While we strive to carefully manage and monitor credit quality and to identify loans that may be deteriorating, circumstances can change at any time for loans included in the portfolio that may result in future losses, that as of the date of the financial statements have not yet been identified as potential problem loans. Through established credit practices, we identify deteriorating loans and adjust the allowance for loan losses accordingly. However, because future events are uncertain, there may be loans that deteriorate some of which could occur in



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an accelerated time frame. As a result, future additions to the allowance may be necessary. Because the loan portfolio contains a number of commercial loans, commercial real estate, construction and land development loans with relatively large balances, deterioration in the credit quality of one or more of these loans may require a significant increase to the allowance for loan losses. Future additions to the allowance may also be required based on changes in the financial condition of borrowers, such as have resulted due to the current, and potentially worsening, economic conditions. Additionally, Federal and state banking regulators, as an integral part of their supervisory function, periodically review our allowance for loan losses. These regulatory agencies may require us to recognize further loan loss provisions or charge-offs based upon their judgments, which may be different from ours. Any increase in the allowance for loan losses would have an adverse effect, which may be material, on our financial condition and results of operation.

Further discussion of the management of credit risk appears under "*Provision for Loan Losses*" and "*Allowance for Loan Losses*."

***Noninterest Income***

While net interest income remains the largest single component of total revenues, noninterest income is an important component. Prior to the third quarter of 2007, a significant percentage of the Company's noninterest income was associated with its SBA lending activity, consisting of gains on the sale of loans sold in the secondary market and servicing income from loans sold with servicing retained. From the third quarter of 2007 through the second quarter of 2009, the Company retained its SBA production. In the third quarter of 2009, the Company began to again sell loans in the secondary market. During the first quarter of 2010, \$2.4 million of loans were sold resulting in a net gain on sale of loans of \$114,000. Additionally, \$3.9 million of SBA loans have been transferred to third parties during the first quarter of 2010. However, these loans are subject to a SBA warranty for a period of 90 days, which under new accounting guidance requires the Company to treat these as secured borrowings during the warranty period. The warranty period for these loans expires in the following quarter. Provided the loans remain current through the end of the warranty period all elements necessary to record the sale will have been met. The Company has deferred gains of \$210,000 associated with these loans, which are included in other liabilities on the consolidated balance sheets. We expect to continue to sell loans in the secondary market in 2010 to enhance liquidity and improve noninterest income. Other sources of noninterest income include loan servicing fees, service charges and fees, and cash surrender value from company owned life insurance policies.

***Noninterest Expense***

Management considers the control of operating expenses to be a critical element of the Company's performance. Over the last several quarters the Company has undertaken several initiatives to reduce its noninterest expense and improve its efficiency. Nonetheless, noninterest expense increased in the first quarter of 2010 compared to the first quarter of 2009, due to a substantial increase in FDIC deposit insurance premiums, professional fees related to problem loans, and expenses related to other real estate owned ("OREO"). The Company's efficiency ratio was 93.45% in the first quarter of 2010 compared to 88.94% in the first quarter of 2009. The efficiency ratio increased in 2010 primarily due to higher noninterest expense.

***Capital Management***

As part of its asset and liability process, the Company continually assesses its capital position to take into consideration growth, expected earnings, risk profile and potential corporate activities that it may choose to pursue.

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At March 31, 2010, HBC's total risk-based capital ratio was 13.0%, compared to the 10% regulatory requirement for well-capitalized banks under the regulatory framework for prompt corrective actions. HBC's Tier 1 risk-based capital ratio of 11.7% and our leverage ratio of 10.1% at March 31, 2010 also exceeded regulatory guidelines for well-capitalized banks under the prompt corrective actions framework. On a consolidated basis, the Company has a leverage ratio of 10.2%, a Tier 1 risk-based capital ratio of 11.9%, and a total risk-based capital ratio of 13.1% at March 31, 2010.

In April 2009, the Board of Directors suspended the quarterly dividend on our common stock, commencing with the second quarter of 2009, to build capital and further strengthen our balance sheet. In November 2009, we exercised our right to defer interest payments on our outstanding trust preferred subordinated debt and our right to suspend payment of dividends on our Series A Preferred Stock. We do not expect to resume paying cash dividends on our common stock or Series A Preferred Stock or interest on our trust preferred subordinated debt for the near term, and future dividends and interest payments will depend on sufficient earnings to support them and prior approval of the Federal Reserve. We believe these actions will further enhance our capital levels during the current economic challenges.

**RESULTS OF OPERATIONS**

The Company earns income from two primary sources. The first is net interest income, which is interest income generated by earning assets less interest expense on interest-bearing liabilities. The second is noninterest income, which primarily consists of gains on the sale of loans, loan servicing fees, customer service charges and fees, the increase in cash surrender value of life insurance, and gains on the sale of securities. The majority of the Company's noninterest expenses are operating costs that relate to providing a full range of banking services to our customers.

***Net Interest Income and Net Interest Margin***

The level of net interest income depends on several factors in combination, including yields on earning assets, the cost of interest-bearing liabilities, the relative volumes of earning assets and interest-bearing liabilities, and the mix of products which comprise the Company's earning assets, deposits, and other interest-bearing liabilities. To maintain its net interest margin, the Company must manage the relationship between interest earned and paid.

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The following Distribution, Rate and Yield table presents the average amounts outstanding for the major categories of the Company's balance sheet, the average interest rates earned or paid thereon, and the resulting net interest margin on average interest earning assets for the periods indicated. Average balances are based on daily averages.

**Distribution, Rate and Yield**

| NET INTEREST INCOME AND<br>NET INTEREST MARGIN               | For the Three Months Ended<br>March 31, 2010 |                                |                           | For the Three Months Ended<br>March 31, 2009 |                                |                           |
|--|--|--------------------------------|---------------------------|--|--------------------------------|---------------------------|
|  | Average<br>Balance                           | Interest<br>Income/<br>Expense | Average<br>Yield/<br>Rate | Average<br>Balance                           | Interest<br>Income/<br>Expense | Average<br>Yield/<br>Rate |
| (Dollars in thousands)                                       |  |                                |                           |  |                                |                           |
| <b>Assets:</b>   |  |                                |                           |  |                                |                           |
| Loans, gross   | \$ 1,063,928                                 | \$ 13,174                      | 5.02%                     | \$ 1,236,361                                 | \$ 15,030                      | 4.93%                     |
| Securities   | 127,004                                      | 1,162                          | 3.71%                     | 110,169                                      | 999                            | 3.68%                     |
| Federal funds sold   | 102  |                                | 0.00%                     | 176  |                                | 0.00%                     |
| Interest bearing deposits in other<br>financial institutions | 17,601                                       | 10                             | 0.23%                     | 5,215  | 4                              | 0.31%                     |
| Total interest earning assets                                | 1,208,635                                    | 14,346                         | 4.81%                     | 1,351,921                                    | 16,033                         | 4.81%                     |
| Cash and due from banks                                      | 21,132                                       |                                |                           | 24,481                                       |                                |                           |
| Premises and equipment, net                                  | 8,957  |                                |                           | 9,468  |                                |                           |
| Goodwill and other intangible assets                         | 46,714                                       |                                |                           | 47,349                                       |                                |                           |
| Other assets   | 68,593                                       |                                |                           | 51,325                                       |                                |                           |
| Total assets   | \$ 1,354,031                                 |                                |                           | \$ 1,484,544                                 |                                |                           |
| <b>Liabilities and shareholders' equity:</b>                 |  |                                |                           |  |                                |                           |
| <b>Deposits:</b>   |  |                                |                           |  |                                |                           |
| Demand, interest bearing                                     | \$ 149,360                                   | 86                             | 0.23%                     | \$ 136,317                                   | 99                             | 0.29%                     |
| Savings and money market                                     | 301,634                                      | 398                            | 0.54%                     | 346,857                                      | 792                            | 0.93%                     |
| Time deposits under \$100                                    | 39,564                                       | 148                            | 1.52%                     | 46,108                                       | 296                            | 2.60%                     |
| Time deposits \$100 and over                                 | 132,371                                      | 499                            | 1.53%                     | 176,837                                      | 874                            | 2.00%                     |
| Time deposits CDARS  | 19,373                                       | 53                             | 1.11%                     | 10,829                                       | 47                             | 1.76%                     |
| Time deposits brokered                                       | 177,420                                      | 1,180                          | 2.70%                     | 193,123                                      | 1,922                          | 4.04%                     |
| Subordinated debt  | 23,702                                       | 466                            | 7.97%                     | 23,702                                       | 500                            | 8.56%                     |
| Securities sold under agreement to<br>repurchase             | 22,722                                       | 131                            | 2.34%                     | 32,722                                       | 243                            | 3.01%                     |
| Note payable   |  |                                | N/A                       | 10,278                                       | 82                             | 3.24%                     |
| Short-term borrowings  | 20,860                                       | 16                             | 0.31%                     | 39,622                                       | 26                             | 0.27%                     |
| Total interest bearing liabilities                           | 887,006                                      | 2,977                          | 1.36%                     | 1,016,395                                    | 4,881                          | 1.95%                     |
| Demand, noninterest bearing                                  | 254,415                                      |                                |                           | 253,481                                      |                                |                           |
| Other liabilities  | 38,821                                       |                                |                           | 29,244                                       |                                |                           |
| Total liabilities  | 1,180,242                                    |                                |                           | 1,299,120                                    |                                |                           |
| Shareholders' equity   | 173,789                                      |                                |                           | 185,424                                      |                                |                           |
| Total liabilities and shareholders'<br>equity                | \$ 1,354,031                                 |                                |                           | \$ 1,484,544                                 |                                |                           |
| Net interest income / margin                                 |  | \$ 11,369                      | 3.81%                     |  | \$ 11,152                      | 3.35%                     |

Note: Yields and amounts earned on loans include loan fees and costs. Nonaccrual loans are included in the average balance calculation above.

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The Volume and Rate Variances table below sets forth the dollar difference in interest earned and paid for each major category of interest-earning assets and interest-bearing liabilities for the noted periods, and the amount of such change attributable to changes in average balances (volume) or

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changes in average interest rates. Volume variances are equal to the increase or decrease in the average balance times the prior period rate, and rate variances are equal to the increase or decrease in the average rate times the prior period average balance. Variances attributable to both rate and volume changes are equal to the change in rate times the change in average balance and are included below in the average volume column.

**Volume and Rate Variances**

|   | <b>Three Months Ended March 31,<br/>2010 vs. 2009</b> |                         |                       |
|---|---|-------------------------|-----------------------|
|   | <b>Increase (Decrease)</b>                            |                         |                       |
|   | <b>Due to Change In:</b>                              |                         |                       |
|   | <b>Average<br/>Volume</b>                             | <b>Average<br/>Rate</b> | <b>Net<br/>Change</b> |
| <b>(Dollars in thousands)</b>                                 |   |                         |                       |
| <b>Income from interest earning assets:</b>                   |   |                         |                       |
| Loans, gross  | \$ (2,130)  | \$ 274                  | \$ (1,856)            |
| Securities  | 154   | 9                       | 163                   |
| Federal funds sold  |   |                         |                       |
| Interest bearing deposits in other financial institutions     | 7   | (1)                     | 6                     |
| <b>Total interest income from interest earnings assets</b>    | <b>\$ (1,969)</b>                                     | <b>\$ 282</b>           | <b>\$ (1,687)</b>     |
| <b>Expense on interest bearing liabilities:</b>               |   |                         |                       |
| Demand, interest bearing                                      | \$ 9  | \$ (22)                 | \$ (13)               |
| Savings and money market                                      | (64)  | (330)                   | (394)                 |
| Time deposits under \$100                                     | (25)  | (123)                   | (148)                 |
| Time deposits \$100 and over                                  | (168)   | (207)                   | (375)                 |
| Time deposits CDARS   | 23  | (17)                    | 6                     |
| Time deposits brokered  | (106)   | (636)                   | (742)                 |
| Subordinated debt   |   | (34)                    | (34)                  |
| Securities sold under agreement to repurchase                 | (58)  | (54)                    | (112)                 |
| Note payable  |   | (82)                    | (82)                  |
| Short-term borrowings   | (14)  | 4                       | (10)                  |
| <b>Total interest expense on interest bearing liabilities</b> | <b>\$ (403)</b>                                       | <b>\$ (1,501)</b>       | <b>\$ (1,904)</b>     |
| <b>Net interest income</b>                                    | <b>\$ (1,566)</b>                                     | <b>\$ 1,783</b>         | <b>\$ 217</b>         |

Net interest income for the first quarter of 2010 increased \$217,000, or 2% from first quarter of 2009. The increase in 2010 was primarily due to a 46 basis point increase in the net interest margin, offset by a \$143.3 million reduction in earning assets. The Company's net interest margin, expressed as a percentage of average earning assets, expanded to 3.81% in the first quarter of 2010 compared to 3.35% in the first quarter of 2009, which was primarily due to a 59 basis point decline in the average cost of funds.

A substantial portion of the Company's earning assets are variable-rate loans that re-price when the Company's prime lending rate is changed, versus a large base of core deposits that are generally slower to re-price. This causes the Company's balance sheet to be asset-sensitive, which means that all else being equal, the Company's net interest margin will be lower during periods when short-term interest rates are falling and higher when rates are rising.

***Provision for Loan Losses***

Credit risk is inherent in the business of making loans. The Company establishes an allowance for loan losses through charges to earnings, which are shown in the statements of operations as the

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provision for loan losses. Specifically identifiable and quantifiable known losses are promptly charged off against the allowance. The provision for loan losses is determined by conducting a quarterly evaluation of the adequacy of the Company's allowance for loan losses and charging the shortfall, if any, to the current quarter's expense. This has the effect of creating variability in the amount and frequency of charges to the Company's earnings. The provision for loan losses and level of allowance for each period are dependent upon many factors, including loan growth, net charge-offs, changes in the composition of the loan portfolio, delinquencies, management's assessment of the quality of the loan portfolio, the valuation of problem loans and the general economic conditions in the Company's market area.

In the first quarter of 2010, the Company had a provision for loan losses of \$5.1 million compared to \$10.4 million in the first quarter of 2009. The decrease in provision for loan losses in the first quarter of 2010 compared to the same period in 2009 reflects lower charge-offs and reduced exposure and overall credit risk on land and construction loans for the period ended March 31, 2010. Improvement in charge-offs from period to period was offset by an increase in the volume of classified and nonperforming loans caused by continued challenging conditions in commercial lending and the residential housing market, and the prolonged downturn in the overall economy. We believe credit challenges could continue until the current economic cycle improves, particularly for our residential and commercial land and construction loan portfolios. We continue to aggressively monitor delinquencies and proactively review the credit exposure of our loan portfolio to minimize and mitigate potential losses.

Provisions for loan losses are charged to operations to bring the allowance for loan losses to a level deemed appropriate by the Company based on the factors discussed under "Allowance for Loan Losses".

**Noninterest Income**

The following table sets forth the various components of the Company's noninterest income for the periods indicated:

|  | For the Three<br>Months Ended<br>March 31, |          | Increase<br>(decrease)<br>2010 versus 2009 |         |
|--|--|----------|--|---------|
|  | 2010                                       | 2009     | Amount                                     | Percent |
|  | (Dollars in thousands)                     |          |  |         |
| Service charges and fees on deposit accounts       | \$ 548                                     | \$ 571   | \$ (23)                                    | -4%     |
| Servicing income                                   | 421  | 420      | 1  | 0%      |
| Increase in cash surrender value of life insurance | 409  | 412      | (3)  | -1%     |
| Gain on sale of loans                              | 114  |          | 114  | N/A     |
| Other  | 192  | 220      | (28)                                       | -13%    |
| Total noninterest income                           | \$ 1,684                                   | \$ 1,623 | \$ 61                                      | 4%      |

The increase in noninterest income in the first quarter of 2010 compared to the first quarter of 2009 was primarily attributable to a gain on sale of loans of \$114,000. Other sources of noninterest income include loan servicing fees, service charges and fees, and the cash surrender value from company owned life insurance policies.

Historically, a significant percentage of the Company's noninterest income has been associated with its SBA lending activity, as gains on the sale of loans sold in the secondary market and servicing income from loans sold with servicing rights retained. From the third quarter of 2007 through the second quarter of 2009, the Company changed its strategy regarding its SBA loan business by retaining new SBA production in lieu of selling the loans. Reflecting the strategic shift to retain SBA loan production, there were no gains from sales of loans during 2008 and for the first six months of 2009.

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During the first quarter of 2010, loans were sold resulting in a gain on sale of \$114,000, compared to no gain on loan sales in the first quarter of 2009. We expect to continue to sell loans in the secondary market in 2010 to enhance liquidity and improve noninterest income.

The servicing assets that result from the sale of SBA loans, with servicing retained, are amortized over the expected term of the loans using a method approximating the interest method. Servicing income generally declines as the respective loans are repaid.

The increase in cash surrender value of life insurance approximates a 3.92% after tax yield on the policies. To realize this tax advantaged yield, the policies must be held until death of the insured individuals, who are current and former officers and directors of the Company.

### *Noninterest Expense*

The following table sets forth the various components of the Company's noninterest expense for the periods indicated:

|                                      | <b>For the Three<br/>Months Ended<br/>March 31,</b> |                  | <b>Increase<br/>(decrease)<br/>2010 versus 2009</b> |                |
|--------------------------------------|---|------------------|---|----------------|
|                                      | <b>2010</b>   | <b>2009</b>      | <b>Amount</b>                                       | <b>Percent</b> |
| <b>(Dollars in thousands)</b>        |   |                  |   |                |
| Salaries and employee benefits       | \$ 5,881  | \$ 6,458         | \$ (577)  | -9%            |
| Professional fees                    | 1,278   | 913              | 365   | 40%            |
| FDIC deposit insurance premiums      | 1,191   | 707              | 484   | 68%            |
| Occupancy and equipment              | 959   | 916              | 43  | 5%             |
| Other real estate owned expense      | 418   | 63               | 355   | 563%           |
| Insurance expense                    | 256   | 59               | 197   | 334%           |
| Software subscription                | 234   | 196              | 38  | 19%            |
| Low income housing investment losses | 225   | 214              | 11  | 5%             |
| Data processing                      | 212   | 229              | (17)  | -7%            |
| Other                                | 1,544   | 1,607            | (63)  | -4%            |
| <b>Total noninterest expense</b>     | <b>\$ 12,198</b>                                    | <b>\$ 11,362</b> | <b>\$ 836</b>                                       | <b>7%</b>      |

The following table indicates the percentage of noninterest expense in each category:

|                                      | <b>For The Three Months Ended March 31,</b> |                             |                  |                             |
|--------------------------------------|---|-----------------------------|------------------|-----------------------------|
|                                      | <b>2010</b>                                 | <b>Percent<br/>of Total</b> | <b>2009</b>      | <b>Percent<br/>of Total</b> |
| <b>(Dollars in thousands)</b>        |   |                             |                  |                             |
| Salaries and employee benefits       | \$ 5,881                                    | 48%                         | \$ 6,458         | 57%                         |
| Professional fees                    | 1,278                                       | 10%                         | 913              | 8%                          |
| FDIC deposit insurance premiums      | 1,191                                       | 10%                         | 707              | 6%                          |
| Occupancy and equipment              | 959   | 8%                          | 916              | 8%                          |
| Other real estate owned expense      | 418   | 3%                          | 63               | 1%                          |
| Insurance expense                    | 256   | 2%                          | 59               | 1%                          |
| Software subscription                | 234   | 2%                          | 196              | 2%                          |
| Low income housing investment losses | 225   | 2%                          | 214              | 2%                          |
| Data processing                      | 212   | 2%                          | 229              | 2%                          |
| Other                                | 1,544                                       | 13%                         | 1,607            | 14%                         |
| <b>Total noninterest expense</b>     | <b>\$ 12,198</b>                            | <b>100%</b>                 | <b>\$ 11,362</b> | <b>100%</b>                 |

Salaries and employee benefits, the single largest component of noninterest expense, decreased 9%, or \$577,000 for the first quarter of 2010 from the same period in 2009, primarily due to a





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reduction in force implemented in the fourth quarter of 2009. Full-time equivalent employees were 201 and 220 at March 31, 2010 and 2009, respectively.

Professional fees increased 40% or \$365,000 for the first quarter of 2010 from the same period in 2009. The increase in professional fees was primarily due to legal fees related to loan workouts and litigation and increased expenses for bank regulatory compliance.

FDIC deposit insurance premiums increased 68% or \$484,000 for the first quarter of 2010 compared to the same period in 2009, due to an increase in the FDIC deposit assessment rate.

OREO expense increased 563%, or \$355,000 in the first quarter of 2010, compared to the same period in 2009 due to the write-down of an OREO property.

Insurance expense increased 334% or \$197,000 for 2010 compared to the same period in 2009, primarily due to an increase in the directors and officers insurance premiums.

***Income Tax Expense***

The Company computes its provision for income taxes on a monthly basis. The effective tax rate is determined by applying the Company's statutory income tax rates to pre-tax book income as adjusted for permanent differences between pre-tax book income and actual taxable income. These permanent differences include, but are not limited to, tax-exempt interest income, increases in the cash surrender value of life insurance policies, California Enterprise Zone deductions, certain expenses that are not allowed as tax deductions, and tax credits.

The Company's Federal and state income tax benefit in the first quarter of 2010 was \$120,000, as compared to \$5.1 million in the first quarter of 2009. The following table shows the Company's effective income tax rates for the periods indicated:

|                           | <b>For the Three<br/>Months Ended<br/>March 31,</b> |             |
|---------------------------|---|-------------|
|                           | <b>2010</b>   | <b>2009</b> |
| Effective income tax rate | -2.8%   | -56.1%      |

The difference in the effective tax rate compared to the combined federal and state statutory tax rate of 42% is primarily the result of the Company's investment in life insurance policies whose earnings are not subject to taxes, tax credits related to investments in low income housing limited partnerships and investments in tax-free municipal loans.

Tax-exempt interest income is generated primarily by the Company's investments in state, county and municipal loans and securities, which provided \$77,000 and \$78,000 in federal tax-exempt income in the first quarter of 2010 and 2009, respectively. Although not reflected in the investment portfolio, the Company also has total investments of \$5.2 million in low-income housing limited partnerships as of March 31, 2010. These investments have generated annual tax credits of approximately \$1.1 million in each of the years ended December 31, 2008 and 2009. The investments are expected to generate an additional \$4.1 million in aggregate tax credits from 2010 through 2016; however, the amount of the credits are dependent upon the occupancy level of the housing projects and income of the tenants and cannot be projected with certainty.

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Some items of income and expense are recognized in different years for tax purposes than when applying generally accepted accounting principles, leading to timing differences between the Company's actual tax liability and the amount accrued for this liability based on book income. These temporary differences comprise the "deferred" portion of the Company's tax expense or benefit, which is accumulated on the Company's books as a deferred tax asset or deferred tax liability until such time as they reverse. At March 31, 2010, the Company had a net deferred tax asset of approximately \$22.1 million, compared to \$17.8 million at March 31, 2009, and \$22.4 million at December 31, 2009.

Realization of the Company's deferred tax assets is primarily dependent upon the Company generating sufficient taxable income to obtain benefit from the reversal of net deductible temporary differences and utilization of tax credit carryforwards and the net operating loss carryforwards for California state income tax purposes. The amount of deferred tax assets considered realizable is subject to adjustment in future periods based on estimates of future taxable income. In assessing the realization of deferred tax assets, the Company considers whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income, including tax planning strategies, during the periods in which those temporary differences become deductible. The Company estimates that it has sufficient forecasted future taxable income, as well as various tax planning strategies which could be implemented to generate taxable income in future taxable periods, to support the balance of deferred tax assets. Based on these factors, the Company believes it is more likely than not that the Company will realize the benefits of these deductible differences and, therefore, no valuation allowance for deferred tax assets was recorded at March 31, 2010 and December 31, 2009.

**FINANCIAL CONDITION**

As of March 31, 2010, total assets were \$1.34 billion, compared to \$1.46 billion as of March 31, 2009, and \$1.36 billion at December 31, 2009. Total securities available-for-sale (at fair value) were \$139.4 million, an increase of 43% from \$97.3 million at March 31, 2009, and an increase of 27% from \$110.0 million at December 31, 2009. The total loan portfolio, excluding loans held-for-sale, was \$1.01 billion, a decrease of 17% from \$1.21 billion at March 31, 2009, and a decrease of 6% from \$1.07 billion at December 31, 2009. Total deposits decreased 7% to \$1.08 billion at March 31, 2010, from \$1.17 billion at March 31, 2009, and decreased 1% from \$1.09 billion at December 31, 2009. Securities sold under agreement to repurchase decreased 33% to \$20.0 million at March 31, 2010, from \$30.0 million at March 31, 2009, and decreased 20% from \$25.0 million at December 31, 2009.

**Securities Portfolio**

The following table reflects the estimated fair values for each category of securities at the dates indicated:

|  | March 31,              |                  | December 31,      |  |
|--|------------------------|------------------|-------------------|--|
|  | 2010                   | 2009             | 2009              |  |
|  | (Dollars in thousands) |                  |                   |  |
| <b>Securities available-for-sale (at fair value)</b> |                        |                  |                   |  |
| U.S. Treasury  | \$                     | \$ 15,491        | \$                |  |
| U.S. Government Sponsored Entities                   | 1,997                  | 8,638            | 1,973             |  |
| Mortgage-Backed Securities Residential               | 132,457                | 66,027           | 102,546           |  |
| Municipals Tax Exempt                                |                        | 698              |                   |  |
| Collateralized Mortgage Obligations Residential      | 4,933                  | 6,486            | 5,447             |  |
| <b>Total</b>   | <b>\$ 139,387</b>      | <b>\$ 97,340</b> | <b>\$ 109,966</b> |  |

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The following table summarizes the weighted average life and weighted average yields of securities at March 31, 2010:

|                         | March 31, 2010        |              |                                       |              |                                       |              |                    |              |                   |              |
|-------------------------|-----------------------|--------------|---------------------------------------|--------------|---------------------------------------|--------------|--------------------|--------------|-------------------|--------------|
|                         | Weighted Average Life |              |                                       |              |                                       |              |                    |              |                   |              |
|                         | Within<br>One Year    |              | After One and<br>Within<br>Five Years |              | After Five and<br>Within<br>Ten Years |              | After<br>Ten Years |              | Total             |              |
|                         | Amount                | Yield        | Amount                                | Yield        | Amount                                | Yield        | Amount             | Yield        | Amount            | Yield        |
| (Dollars in thousands)  |                       |              |                                       |              |                                       |              |                    |              |                   |              |
| Securities              |                       |              |                                       |              |                                       |              |                    |              |                   |              |
| available-for-sale      |                       |              |                                       |              |                                       |              |                    |              |                   |              |
| (at fair value)         |                       |              |                                       |              |                                       |              |                    |              |                   |              |
| U.S.                    |                       |              |                                       |              |                                       |              |                    |              |                   |              |
| Government              |                       |              |                                       |              |                                       |              |                    |              |                   |              |
| Sponsored               |                       |              |                                       |              |                                       |              |                    |              |                   |              |
| Entities                | \$                    |              | \$                                    | 1,997        | 2.20%                                 | \$           |                    | \$           | 1,997             | 2.20%        |
| Mortgage-Backed         |                       |              |                                       |              |                                       |              |                    |              |                   |              |
| Securities Residential  | 6                     | 5.96%        | 39,893                                | 4.38%        | 87,783                                | 3.69%        | 4,775              | 5.23%        | 132,457           | 3.95%        |
| Collateralized          |                       |              |                                       |              |                                       |              |                    |              |                   |              |
| Mortgage                |                       |              |                                       |              |                                       |              |                    |              |                   |              |
| Obligations Residential | 4,933                 | 4.80%        | 1,000                                 | 6.68%        |                                       | 0.00%        |                    |              | 4,933             | 5.18%        |
| <b>Total</b>            | <b>\$ 3,939</b>       | <b>4.80%</b> | <b>\$ 42,890</b>                      | <b>4.33%</b> | <b>\$ 87,783</b>                      | <b>3.69%</b> | <b>\$ 4,775</b>    | <b>5.23%</b> | <b>\$ 139,387</b> | <b>3.97%</b> |

The securities portfolio is the second largest component of the Company's interest-earning assets, and the structure and composition of this portfolio is important to any analysis of the financial condition of the Company. The portfolio serves the following purposes: (i) it provides a source of pledged assets for securing certain deposits and borrowed funds, as may be required by law or by specific agreement with a depositor or lender; (ii) it can be used as an interest rate risk management tool, since it provides a large base of assets, the maturity and interest rate characteristics of which can be changed more readily than the loan portfolio to better match changes in the deposit base and other funding sources of the Company; (iii) it is an alternative interest-earning use of funds when loan demand is weak or when deposits grow more rapidly than loans; and (iv) it can enhance the Company's tax position by providing partially tax exempt income.

The Company's securities are all currently classified under existing accounting rules as "available-for-sale" to allow flexibility for the management of the portfolio. Accounting guidance requires available-for-sale securities to be marked to fair value with an offset to accumulated other comprehensive income (loss), a component of shareholders' equity. Monthly adjustments are made to reflect changes in the fair value of the Company's available-for-sale securities.

The Company's portfolio is historically comprised primarily of: (i) U.S. Treasury securities and U.S. Government sponsored entities' debt securities for liquidity and pledging; (ii) mortgage-backed securities, which in many instances can also be used for pledging, and which generally enhance the yield of the portfolio; (iii) municipal obligations, which provide tax free income and limited pledging potential; and (iv) collateralized mortgage obligations, which generally enhance the yield of the portfolio.

U.S. Treasury and U.S. Government sponsored entities securities decreased \$22.1 million from \$24.1 million at March 31, 2009 to \$2.0 million at March 31, 2010 and December 31, 2009. The Company increased its holding of mortgage-back securities \$66.4 million to \$132.5 million at March 31, 2010, from \$66.0 million at March 31, 2009, and increased \$29.9 million from \$102.5 million at December 31, 2009 to take advantage of higher yields and offset some of the contraction in the loan portfolio. No securities of a single issuer exceeded 10% of shareholders' equity at March 31, 2010. The Company has no direct exposure to so-called subprime loans or securities, nor does it own any Fannie Mae or Freddie Mac equity securities. The Company has not used interest rate swaps or other derivative instruments to hedge fixed rate loans or securities to otherwise mitigate interest rate risk.

**Loans**

The Company's loans represent the largest portion of invested assets, substantially greater than the securities portfolio or any other asset category, and the quality and diversification of the loan portfolio is an important consideration when reviewing the Company's financial condition.

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Gross loans, excluding loans held-for-sale, represented 75% of total assets at March 31, 2010, as compared to 83% at March 31, 2009. The ratio of loans to deposits decreased to 93.04% at March 31, 2010 from 103.82% at March 31, 2009.

The Loan Distribution table that follows sets forth the Company's gross loans, excluding loans held-for-sale, outstanding and the percentage distribution in each category at the dates indicated.

### **Loan Distribution**

|                                     | March 31, 2010    |             | March 31, 2009      |             | December 31, 2009   |             |
|-------------------------------------|-------------------|-------------|---------------------|-------------|---------------------|-------------|
|                                     | Balance           | % to Total  | Balance             | % to Total  | Balance             | % to Total  |
| (Dollars in thousands)              |                   |             |                     |             |                     |             |
| Commercial                          | \$ 395,399        | 39%         | \$ 500,616          | 41%         | \$ 427,177          | 40%         |
| Real estate mortgage                | 393,168           | 39%         | 406,182             | 34%         | 400,731             | 37%         |
| Real estate land and construction   | 153,811           | 15%         | 244,181             | 20%         | 182,871             | 17%         |
| Home equity                         | 51,369            | 6%          | 54,011              | 5%          | 51,368              | 5%          |
| Consumer                            | 11,943            | 1%          | 4,025               | 0%          | 7,181               | 1%          |
| <b>Total loans</b>                  | <b>1,005,690</b>  | <b>100%</b> | <b>1,209,015</b>    | <b>100%</b> | <b>1,069,328</b>    | <b>100%</b> |
| Deferred loan costs                 | 755               |             | 1,556               |             | 785                 |             |
| <b>Loans, net of deferred costs</b> | <b>1,006,445</b>  | <b>100%</b> | <b>1,210,571</b>    | <b>100%</b> | <b>1,070,113</b>    | <b>100%</b> |
| Allowance for loan losses           | (26,527)          |             | (23,900)            |             | (28,768)            |             |
| <b>Loans, net</b>                   | <b>\$ 979,918</b> |             | <b>\$ 1,186,671</b> |             | <b>\$ 1,041,345</b> |             |

The Company's loan portfolio is concentrated in commercial loans, primarily manufacturing, wholesale, and services, and commercial real estate, with the balance in land development and construction and home equity and consumer loans. The decrease in the Company's loan portfolio in the first quarter of 2010 from the first and fourth quarters of 2009 is due to diminished loan demand, and loan payoffs exceeding draw downs of loan commitments. Outstanding loan balances to total loan commitments were 75% at March 31, 2010, and March 31, 2009, and 77% at December 31, 2009. The Company does not have any concentrations by industry or group of industries in its loan portfolio, however, 59% of its gross loans were secured by real property at March 31, 2010 and December 31, 2009, compared to 58% at March 31, 2009. While no specific industry concentration is considered significant, the Company's lending operations are located in areas that are dependent on the technology and real estate industries and their supporting companies.

The Company's commercial loans are made for working capital, financing the purchase of equipment or for other business purposes. Commercial loans include loans with maturities ranging from thirty days to one year and "term loans" with maturities normally ranging from one to five years. Short-term business loans are generally intended to finance current transactions and typically provide for periodic principal payments, with interest payable monthly. Term loans normally provide for floating interest rates, with monthly payments of both principal and interest.

The Company is an active participant in the SBA and U.S. Department of Agriculture guaranteed lending programs, and has been approved by the SBA as a lender under the Preferred Lender Program. The Company regularly makes such guaranteed loans (collectively referred to as "SBA loans"). Prior to the third quarter of 2007, the guaranteed portion of these loans were sold in the secondary market depending on market conditions. When the guaranteed portion of an SBA loan was sold, the Company retained the servicing rights for the sold portion. From the third quarter of 2007 through the first quarter of 2009, the Company changed its strategy regarding its SBA loan business by retaining new SBA production in lieu of selling the loans. During the second quarter of 2009, the Company transferred \$20.5 million of SBA loans to loans held-for-sale to enhance its liquidity and

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improve noninterest income in future periods. During the first quarter of 2010, loans were sold resulting in a gain on sale of \$114,000.

As of March 31, 2010, real estate mortgage loans of \$393 million consist primarily of adjustable and fixed rate loans secured by deeds of trust on commercial property. The real estate mortgage loans at March 31, 2010 consist of \$199 million, or 51%, of owner occupied properties, \$148 million, or 38%, of investment properties, and \$46 million, or 11% in other properties. Properties securing the commercial real estate mortgage loans are primarily located in the Company's primary market, which is the Greater San Francisco Bay Area.

The Company's real estate mortgage loans consist primarily of loans based on the borrower's cash flow and are secured by deeds of trust on commercial and residential property to provide a secondary source of repayment. The Company generally restricts real estate term loans to no more than 80% of the property's appraised value or the purchase price of the property during the initial underwriting of the credit, depending on the type of property and its utilization. The Company offers both fixed and floating rate loans. Maturities on real estate mortgage loans are generally between five and ten years (with amortization ranging from fifteen to twenty-five years and a balloon payment due at maturity); however, SBA and certain other real estate loans that can be sold in the secondary market may be granted for longer maturities.

The Company's land and construction loans are primarily to finance the development/construction of commercial and single family residential properties. The Company utilizes underwriting guidelines to assess the likelihood of repayment from sources such as sale of the property or availability of permanent mortgage financing prior to making the construction loan.

The Company makes consumer loans for the purpose of financing automobiles, various types of consumer goods, and other personal purposes. Consumer loans generally provide for the monthly payment of principal and interest. Most of the Company's consumer loans are secured by the personal property being purchased or, in the instances of home equity loans or lines, real property.

Additionally, the Company makes home equity lines of credit available to its existing customers. Home equity lines of credit are underwritten with a maximum 70% loan to value ratio. Home equity lines are reviewed at least semiannually, with specific emphasis on loans with a loan to value ratio greater than 70% and loans that were underwritten from mid-2005 through 2008, when real estate values were at the peak in the cycle. The Company takes measures to work with customers to reduce line commitments and minimize potential losses.

With certain exceptions, state chartered banks are permitted to make extensions of credit to any one borrowing entity up to 15% of the bank's capital and reserves for unsecured loans and up to 25% of the bank's capital and reserves for secured loans. For HBC, these lending limits were \$31.9 million and \$53.2 million at March 31, 2010, respectively.

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The following table presents the maturity distribution of the Company's loans as of March 31, 2010. The table shows the distribution of such loans between those loans with predetermined (fixed) interest rates and those with variable (floating) interest rates. Floating rates generally fluctuate with changes in the prime rate as reflected in the Western Edition of The Wall Street Journal. As of March 31, 2010, approximately 67% of the Company's loan portfolio consisted of floating interest rate loans.

|                                    | Due in<br>One Year<br>or Less | Over One<br>Year But<br>Less than<br>Five Years | Over<br>Five Years | Total        |
|------------------------------------|-------------------------------|---|--------------------|--------------|
| (Dollars in thousands)             |                               |   |                    |              |
| Commercial                         | \$ 268,054                    | \$ 41,635                                       | \$ 85,710          | \$ 395,399   |
| Real estate mortgage               | 127,480                       | 217,860   | 47,828             | 393,168      |
| Real estate land and construction  | 132,672                       | 21,139  |                    | 153,811      |
| Home equity                        | 49,228                        | 74  | 2,067              | 51,369       |
| Consumer                           | 11,581                        | 362   |                    | 11,943       |
| <br>                               |                               |   |                    |              |
| Loans                              | \$ 589,015                    | \$ 281,070                                      | \$ 135,605         | \$ 1,005,690 |
| <br>                               |                               |   |                    |              |
| Loans with variable interest rates | \$ 515,200                    | \$ 70,780                                       | \$ 88,688          | \$ 674,668   |
| Loans with fixed interest rates    | 73,815                        | 210,290   | 46,917             | 331,022      |
| <br>                               |                               |   |                    |              |
| Loans                              | \$ 589,015                    | \$ 281,070                                      | \$ 135,605         | \$ 1,005,690 |

**Loan Servicing**

As of March 31, 2010 and 2009, \$164 million and \$144 million, respectively, in SBA loans were serviced by the Company for others. Activity for loan servicing rights was as follows:

|                             | For the Three Months<br>Ended March 31, |          |
|-----------------------------|---|----------|
|                             | 2010                                    | 2009     |
| (Dollars in thousands)      |   |          |
| Beginning of period balance | \$ 1,067                                | \$ 1,013 |
| Additions                   | 93                                      |          |
| Amortization                | (123)                                   | (145)    |
| <br>                        |   |          |
| End of period balance       | \$ 1,037                                | \$ 868   |

Loan servicing rights are included in Accrued Interest and Other Assets on the balance sheet and reported net of amortization. There was no valuation allowance as of March 31, 2010 and 2009, as the fair market value of the assets was greater than the carrying value.

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Activity for the I/O strip receivable was as follows:

|                             | <b>For the Three Months<br/>Ended March 31,</b> |             |
|-----------------------------|---|-------------|
|                             | <b>2010</b>                                     | <b>2009</b> |
|                             | <b>(Dollars in thousands)</b>                   |             |
| Beginning of period balance | \$ 2,466  | \$ 2,248    |
| Additions                   |   |             |
| Amortization                | (72)  | (103)       |
| Unrealized holding gain     | (379)   | 108         |
| End of period balance       | \$ 2,015  | \$ 2,253    |

***Nonperforming Assets***

Financial institutions generally have a certain level of exposure to credit quality risk, and could potentially receive less than a full return of principal and interest if a debtor becomes unable or unwilling to repay. Since loans are the most significant assets of the Company and generate the largest portion of its revenues, the Company's management of credit quality risk is focused primarily on loan quality. Banks have generally suffered their most severe earnings declines as a result of customers' inability to generate sufficient cash flow to service their debts and/or downturns in national and regional economies and declines in overall asset values including real estate. In addition, certain debt securities that the Company may purchase have the potential of declining in value if the obligor's financial capacity to repay deteriorates.

To help minimize credit quality concerns, we have established a sound approach to credit that includes well-defined goals and objectives and well-documented credit policies and procedures. The policies and procedures identify market segments, set goals for portfolio growth or contraction, and establish limits on industry and geographic credit concentrations. In addition, these policies establish the Company's underwriting standards and the methods of monitoring ongoing credit quality. The Company's internal credit risk controls are centered in underwriting practices, credit granting procedures, training, risk management techniques, and familiarity with loan customers as well as the relative diversity and geographic concentration of our loan portfolio.

The Company's credit risk may also be affected by external factors such as the level of interest rates, employment, general economic conditions, real estate values, and trends in particular industries or geographic markets. As an independent community bank serving a specific geographic area, the Company must contend with the unpredictable changes in the general California market and, particularly, primary local markets. The Company's asset quality has suffered in the past from the impact of national and regional economic recessions, consumer bankruptcies, and depressed real estate values.

Nonperforming assets are comprised of the following: loans for which the Company is no longer accruing interest; restructured loans; loans 90 days or more past due and still accruing interest (although they are generally placed on nonaccrual when they become 90 days past due, unless they are both well-secured and in the process of collection); and OREO from foreclosures. Management's classification of a loan as "nonaccrual" is an indication that there is reasonable doubt as to the full recovery of principal or interest on the loan. At that point, the Company stops accruing interest income, reverses any uncollected interest that had been accrued as income, and begins recognizing interest income only as cash interest payments are received as long as the collection of all outstanding principal is not in doubt. The loans may or may not be collateralized, and collection efforts are pursued. Loans may be restructured by management when a borrower has experienced some change in financial status causing an inability to meet the original repayment terms and where the Company believes the borrower will eventually overcome those circumstances and make full restitution. OREO

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consists of properties acquired by foreclosure or similar means that management is offering or will offer for sale. Total OREO was \$1.8 million at March 31, 2010, compared to \$802,000 at March 31, 2009.

The following table summarizes the Company's nonperforming assets at the dates indicated:

|  | March 31,        |                  | December 31,     |
|--|------------------|------------------|------------------|
|  | 2010             | 2009             | 2009             |
| (Dollars in thousands)                                     |                  |                  |                  |
| Nonaccrual loans   | \$ 65,026        | \$ 54,291        | \$ 59,480        |
| Restructured and loans 90 days past due and still accruing | 2,176            | 1,774            | 2,895            |
| <b>Total nonperforming loans</b>                           | <b>67,202</b>    | <b>56,065</b>    | <b>62,375</b>    |
| Other real estate owned                                    | 1,835            | 802              | 2,241            |
| <b>Total nonperforming assets</b>                          | <b>\$ 69,037</b> | <b>\$ 56,867</b> | <b>\$ 64,616</b> |

Nonperforming assets as a percentage of total loans plus other real estate owned

6.85%      4.69%      6.03%

Primarily due to the general economic slowdown and a softening of the real estate market, nonperforming assets at March 31, 2010 increased \$12.2 million, or 21%, from March 31, 2009, and increased by \$4.4 million or 7%, compared to December 31, 2009. Both the general economic slowdown and soft real estate markets are expected to continue at least into the first half of 2010 in some geographic sub-markets and price points. Real estate assets within the revised federal mortgage guidelines have become available to refinance and investors are coming to the market to purchase commercial real estate assets, but at higher investor returns than have been in the market historically.

The following table provides nonperforming loans by loan type as of March 31, 2010:

|                                   | Nonaccrual       | Restructured and Loans Over 90 Days Past Due and Still Accruing | Total            |
|-----------------------------------|------------------|---|------------------|
| (Dollars in thousands)            |                  |   |                  |
| Commercial                        | \$ 14,933        | \$ 1,876  | \$ 16,809        |
| Real estate mortgage              | 21,499           |   | 21,499           |
| Real estate land and construction | 28,279           |   | 28,279           |
| Home equity                       |                  | 300   | 300              |
| Consumer                          | 315              |   | 315              |
| <b>Total</b>                      | <b>\$ 65,026</b> | <b>\$ 2,176</b>   | <b>\$ 67,202</b> |

***Allowance for Loan Losses***

The allowance for loan losses is an estimate of probable incurred losses in the loan portfolio. Loans are charged off against the allowance when management believes the uncollectibility of a loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance. Management's methodology for estimating the allowance balance consists of several key elements, which include specific allowances on individual impaired loans and the formula driven allowances on pools of loans with similar risk characteristics. Allocations of the allowance may be made for specific loans, but the entire allowance is available for any loan that, in management's judgment, should be charged off.

Specific allowances are established for impaired loans. Management considers a loan to be impaired when it is probable that the Company will be unable to collect all amounts due according to the original contractual terms of the loan agreement, including scheduled interest payments. Loans for which the terms have been modified with a concession granted, and for which the borrower is





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experiencing financial difficulties, are considered troubled debt restructurings and classified as impaired. When a loan is considered to be impaired, the amount of impairment is measured based on the fair value of the collateral, less costs to sell, if the loan is collateral dependent or on the present value of expected future cash flows or values that are observable in the secondary market. If the measure of the impaired loans is less than the investment in the loan, the deficiency will be charged off against the allowance for loan losses if the amount is a confirmed loss, or, alternatively, a specific allocation within the allowance will be established. Loans that are considered impaired are specifically excluded from the formula portion of the allowance for loan losses analysis.

The estimated loss factors for pools of loans that are not impaired are based on determining the probability of default and loss given default for loans within each segment of the portfolio, adjusted for significant factors that, in management's judgment, affect collectibility as of the evaluation date. The Company's historical delinquency experience and loss experience are utilized to determine the probability of default and loss given default for segments of the portfolio where the Company has experienced losses in the past. For segments of the portfolio where the Company has no significant prior loss experience, the Company uses quantifiable observable industry data to determine the probability of default and loss given default.

Loans that demonstrate a weakness, for which there is a possibility of loss if the weakness is not corrected, are categorized as "classified." Classified loans include all loans considered as substandard, substandard-nonaccrual, and doubtful and may result from problems specific to a borrower's business or from economic downturns that affect the borrower's ability to repay or that cause a decline in the value of the underlying collateral (particularly real estate). The principal balance of classified loans, net of SBA guarantees, was \$169.4 million at March 31, 2010, \$152.2 million at March 31, 2009, and \$164.1 million, at December 31, 2009. Management of the level of classified loans will continue to be a focus for executive management, the lending staff and the Company's Special Assets Department.

It is the policy of management to maintain the allowance for loan losses at a level adequate for risks inherent in the loan portfolio. On an ongoing basis, we have engaged an outside firm to independently assess our methodology and perform independent credit reviews of our loan portfolio. The Federal Reserve and DFI also review the allowance for loan losses as an integral part of the examination process. Based on information currently available, management believes that the allowance for loan losses is adequate. However, the loan portfolio can be adversely affected if California economic conditions and the real estate market in the Company's market area were to further weaken. Also, any weakness of a prolonged nature in the technology industry would have a negative impact on the local market. The effect of such events, although uncertain at this time, could result in an increase in the level of nonperforming loans and increased loan losses, which could adversely affect the Company's future growth and profitability. No assurance of the ultimate level of credit losses can be given with any certainty.

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The following table summarizes the Company's loan loss experience, as well as provisions and charges to the allowance for loan losses and certain pertinent ratios for the periods indicated:

|                                     | For the Three Months<br>Ended March 31, |           | For the Year Ended<br>December 31, |
|-------------------------------------|---|-----------|------------------------------------|
|                                     | 2010                                    | 2009      | 2009                               |
| (Dollars in thousands)              |   |           |                                    |
| Balance, beginning of period / year | \$ 28,768                               | \$ 25,007 | \$ 25,007                          |
| Net (charge-offs) recoveries        | (7,336)                                 | (11,527)  | (30,167)                           |
| Provision for loan losses           | 5,095                                   | 10,420    | 33,928                             |
| Balance, end of period / year       | \$ 26,527                               | \$ 23,900 | \$ 28,768                          |

**RATIOS:**

|  |        |        |        |
|--|--------|--------|--------|
| Net (charge-offs) recoveries to average loans    | -2.83% | -3.78% | -2.59% |
| Allowance for loan losses to total loans         | 2.64%  | 1.97%  | 2.69%  |
| Allowance for loan losses to nonperforming loans | 39.47% | 42.63% | 46.12% |

Net loans charged-off reflects the realization of losses in the portfolio that were partially recognized previously through provisions for loan losses. Net charge-offs were \$7.3 million in the first quarter of 2010, as compared to net charge-offs of \$11.5 million in the first quarter of 2009. Historical net loan charge-offs are not necessarily indicative of the amount of net charge-offs that the Company will realize in the future.

**Goodwill**

Goodwill resulted from the acquisition of Diablo Valley Bank and represents the excess of the purchase price over the fair value of acquired tangible assets and liabilities and identifiable intangible assets. Goodwill is assessed at least annually, as of November 30, for impairment with the assistance of an independent valuation firm. Goodwill impairment exists when a reporting unit's carrying value exceeds its fair value, which is determined through a two-step impairment test. Step 1 includes the determination of the carrying value of the Company's single reporting unit, including the existing goodwill and intangible assets, and estimating the fair value of the reporting unit. If the carrying amount of a reporting unit exceeds its fair value, the Company is required to perform a second step to the impairment test.

The Step 1 valuation of the Company was based on a weighted blend of the income approach and market approach. The income approach estimates the fair value of the Company based on the present value of discounted cash flows from future operations. The market approach considers key pricing multiples of similar companies. The Step 1 valuation indicated that the Step 2 analysis was necessary.

Step 2 requires that the implied fair value of the reporting unit goodwill be compared to the carrying amount of that goodwill. If the carrying amount of the reporting unit goodwill exceeds the implied fair value of that goodwill, an impairment loss will be recognized in an amount equal to that excess. After performing Step 2, with the assistance of the same independent valuation firm, the Company determined that the implied fair value of goodwill was greater than the carrying value, resulting in no impairment charge in 2009. Because of concerns about the Company's stock price and banking industry in general, goodwill was tested for impairment as of March 31, 2010 with the assistance of an independent valuation firm. Based on the assessment, management concluded that there was no impairment of goodwill at March 31, 2010.

**Deposits**

The composition and cost of the Company's deposit base are important components in analyzing the Company's net interest margin and balance sheet liquidity characteristics, both of which are

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discussed in greater detail in other sections herein. The Company's liquidity is impacted by the volatility of deposits or other funding instruments or, in other words, by the propensity of that money to leave the institution for rate-related or other reasons. Deposits can be adversely affected if economic conditions in California, and the Company's market area in particular, continue to weaken. Potentially, the most volatile deposits in a financial institution are jumbo certificates of deposit, meaning time deposits with balances that equal or exceed \$100,000, as customers with balances of that magnitude are typically more rate-sensitive than customers with smaller balances.

The following table summarizes the distribution of deposits and the percentage of distribution in each category of deposits for the periods indicated:

|                                     | March 31, 2010 |            | March 31, 2009 |            | December 31, 2009 |            |
|-------------------------------------|----------------|------------|----------------|------------|-------------------|------------|
|                                     | Balance        | % to Total | Balance        | % to Total | Balance           | % to Total |
| (Dollars in thousands)              |                |            |                |            |                   |            |
| Demand Deposits Noninterest Bearing | \$ 261,047     | 24%        | \$ 254,823     | 22%        | \$ 260,840        | 24%        |
| Demand Deposits Interest Bearing    | 150,923        | 14%        | 133,183        | 11%        | 146,828           | 13%        |
| Savings and Money Market            | 306,688        | 28%        | 358,848        | 31%        | 295,404           | 27%        |
| Time Deposits under \$100           | 38,856         | 4%         | 46,078         | 4%         | 40,197            | 4%         |
| Time Deposits \$100 and over        | 131,220        | 12%        | 177,308        | 15%        | 129,831           | 12%        |
| Time Deposits CDARS                 | 18,490         | 2%         | 12,272         | 1%         | 38,154            | 4%         |
| Time Deposits brokered              | 174,471        | 16%        | 183,491        | 16%        | 178,031           | 16%        |
| Total deposits                      | \$ 1,081,695   | 100%       | \$ 1,166,003   | 100%       | \$ 1,089,285      | 100%       |

The Company obtains deposits from a cross-section of the communities it serves. The Company's business is not generally seasonal in nature. The Company is not dependent upon funds from sources outside the United States. At March 31, 2010 and 2009, less than 1% and 4% of deposits were from public sources, respectively.

The decrease in deposits was primarily due to decreases in savings and money market deposits as a result of lower balances in title insurance company, escrow, and real estate exchange facilitators' accounts and lower time deposits, \$100,000 and over. At March 31, 2010, title insurance company, escrow, and real estate exchange facilitators' accounts decreased \$18.8 million, or 47% compared to March 31, 2009. Time deposits \$100,000 and over decreased \$46.1 million, or 26% from March 31, 2009, primarily due to the withdrawal of public deposits.

The following table indicates the contractual maturity schedule of the Company's time deposits of \$100,000 and over, including CDARS and brokered deposits of \$100,000 and over, as of March 31, 2010:

|                                      | March 31, 2010 |            |
|--------------------------------------|----------------|------------|
|                                      | Balance        | % of Total |
| (Dollars in thousands)               |                |            |
| Three months or less                 | \$ 100,899     | 31%        |
| Over three months through six months | 63,915         | 20%        |
| Over six months through twelve       | 104,354        | 32%        |

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|                    |            |      |
|--------------------|------------|------|
| months             |            |      |
| Over twelve months | 53,972     | 17%  |
| Total              | \$ 323,140 | 100% |

The Company focuses primarily on providing and servicing business deposit accounts that are frequently over \$100,000 in average balance per account. As a result, certain types of business clients

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that the Company serves typically carry average deposits in excess of \$100,000. The account activity for some account types and client types necessitates appropriate liquidity management practices by the Company to help ensure its ability to fund deposit withdrawals.

**Return on Equity and Assets**

The following table indicates the ratios for return on average assets and average equity, dividend payout, and average equity to average assets for the first quarter of 2010 and 2009:

|  | Three Months Ended<br>March 31, |         |
|--|---------------------------------|---------|
|  | 2010                            | 2009    |
| Return on average assets               | -1.23%                          | -1.08%  |
| Return on average tangible assets      | -1.28%                          | -1.12%  |
| Return on average equity               | -9.61%                          | -8.65%  |
| Return on average tangible equity      | -13.15%                         | -11.62% |
| Dividend payout ratio(1)               | N/A                             | -5.20%  |
| Average equity to average assets ratio | 12.83%                          | 11.49%  |

- (1) Percentage is calculated based on dividends paid on common stock divided by net income (loss) available to common shareholders.

**Off-Balance Sheet Arrangements**

In the normal course of business, the Company makes commitments to extend credit to its customers as long as there are no violations of any conditions established in the contractual arrangements. These commitments are obligations that represent a potential credit risk to the Company, yet are not reflected on the Company's consolidated balance sheets. Total unused commitments to extend credit were \$327.9 million at March 31, 2010, as compared to \$407.2 million at March 31, 2009. Unused commitments represented 33% and 34% of outstanding gross loans at March 31, 2010 and 2009, respectively.

The effect on the Company's revenues, expenses, cash flows and liquidity from the unused portion of the commitments to provide credit cannot be reasonably predicted, because there is no certainty that lines of credit and letters of credit will ever be fully utilized. The following table presents the Company's commitments to extend credit for the periods indicated:

|  | March 31,              |               |            |               |                   |               |
|--|------------------------|---------------|------------|---------------|-------------------|---------------|
|  | 2010                   |               | 2009       |               | December 31, 2009 |               |
|  | (Dollars in thousands) |               |            |               |                   |               |
|  | Fixed Rate             | Variable Rate | Fixed Rate | Variable Rate | Fixed Rate        | Variable Rate |
| Unused lines of credit and commitments to make loans | \$ 9,752               | \$ 298,031    | \$ 16,603  | \$ 371,407    | \$ 10,540         | \$ 297,900    |
| Standby letters of credit                            | 457                    | 19,671        | 2,690      | 16,460        | 557               | 19,218        |
|  | \$ 10,209              | \$ 317,702    | \$ 19,293  | \$ 387,867    | \$ 11,097         | \$ 317,118    |

**Liquidity and Asset/Liability Management**

Liquidity refers to the Company's ability to maintain cash flows sufficient to fund operations and to meet obligations and other commitments in a timely and cost effective fashion. At various times the Company requires funds to meet short-term cash requirements brought about by loan growth or

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deposit outflows, the purchase of assets, or liability repayments. An integral part of the Company's ability to manage its liquidity position appropriately is the Company's large base of core deposits, which are generated by offering traditional banking services in its service area and which have, historically, been a stable source of funds. To manage liquidity needs properly, cash inflows must be timed to coincide with anticipated outflows or sufficient liquidity resources must be available to meet varying demands. The Company manages liquidity to be able to meet unexpected sudden changes in levels of its assets or deposit liabilities without maintaining excessive amounts of balance sheet liquidity. Excess balance sheet liquidity can negatively impact the Company's interest margin. In order to meet short-term liquidity needs, the Company utilizes overnight Federal funds purchase arrangements and other borrowing arrangements with correspondent banks, solicits brokered deposits if cost effective deposits are not available from local sources and maintains collateralized lines of credit with the FHLB and FRB. In addition, the Company can raise cash for temporary needs by selling securities under agreements to repurchase and selling securities available-for-sale.

Since March 31, 2009, the Company had loan contraction of \$193.0 million, including loans held-for-sale, and it has experienced an improvement in its liquidity position. One of the more important measures of liquidity is our loan to deposit ratio. Our loan to deposit ratio improved to 93.04% at March 31, 2010 compared to 103.82% at March 31, 2009.

***FHLB and FRB Borrowings & Available Lines of Credit***

The Company has off-balance sheet liquidity in the form of Federal funds purchase arrangements with correspondent banks, including the FHLB and FRB. The Company can borrow from the FHLB on a short-term (typically overnight) or long-term (over one year) basis. At March 31, 2010, the Company had no overnight borrowings from the FHLB. At March 31, 2009, the Company had \$32.0 million of overnight borrowings from the FHLB, bearing interest at 0.21%. At December 31, 2009, the Company had \$20.0 million of overnight borrowings from the FHLB, bearing interest at 0.04%. The Company had \$167.8 million of loans pledged to the FHLB as collateral on an available line of credit of \$115.7 million at March 31, 2010.

The Company can also borrow from FRB's discount window. The Company had \$59.1 million of loans pledged to the FRB as collateral on an available line of credit of \$30.6 million at March 31, 2010, none of which was outstanding.

At March 31, 2010, the Company had Federal funds purchase arrangements available of \$30.0 million. There were no Federal funds purchased outstanding at March 31, 2010, March 31, 2009, or December 31, 2009.

The Company also had a \$3.9 million unsecured borrowing at March 31, 2010. Secured borrowings represent the guaranteed portions of SBA 7a loans transferred to third parties subject to a SBA warranty for a period of 90 days. This requires the Company to treat these as secured borrowings during the warranty period. The warranty period for these loans expires in the following quarter. Provided the loans remain current through the end of the warranty period all elements necessary to record the sale will have been met.

The Company also utilizes securities sold under repurchase agreements to manage our liquidity position. Repurchase agreements are accounted for as collateralized financial transactions and are secured by mortgage-backed securities carried at an amortized cost of approximately \$25.4 million at March 31, 2010, and approximately \$33.7 million at March 31, 2009. Securities sold under agreements to repurchase totaled \$20.0 million at March 31, 2010, compared to \$30.0 million at March 31, 2009, and \$25.0 million at December 31, 2009.

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The following table summarizes the Company's borrowings under its Federal funds purchased, security repurchase arrangements and lines of credit for the periods indicated:

|   | March 31,              |            | December 31, |
|---|------------------------|------------|--------------|
|   | 2010                   | 2009       | 2009         |
|   | (Dollars in thousands) |            |              |
| Average balance year-to-date                | \$ 43,582              | \$ 82,622  | \$ 56,269    |
| Average interest rate year-to-date          | 1.37%                  | 1.73%      | 1.65%        |
| Maximum month-end balance during the period | \$ 73,000              | \$ 101,000 | \$ 122,000   |
| Average rate at period-end                  | 2.30%                  | 1.42%      | 1.32%        |

### **Capital Resources**

At March 31, 2010, the Company had total shareholders' equity of \$168.1 million, including \$38.3 million in preferred stock, and \$2.4 million of accumulated other comprehensive loss.

The Company uses a variety of measures to evaluate capital adequacy. Management reviews various capital measurements on a regular basis and takes appropriate action to ensure that such measurements are within established internal and external guidelines. The external guidelines, which are issued by the Federal Reserve Board and the FDIC, establish a risk-adjusted ratio relating capital to different categories of assets and off-balance sheet exposures. There are two categories of capital under the Federal Reserve Board and FDIC guidelines: Tier 1 and Tier 2 Capital. Our Tier 1 Capital currently consists of total shareholders' equity (excluding accumulated other comprehensive income or loss) and the proceeds from the issuance of trust preferred securities (trust preferred securities are counted only up to a maximum of 25% of Tier 1 capital), less goodwill and other intangible assets and disallowed deferred tax assets. Our Tier 2 Capital includes the allowances for loan losses and off balance sheet credit losses.

The following table summarizes risk-based capital, risk-weighted assets, and risk-based capital ratios of the consolidated Company:

|                                      | March 31,              |                  | December 31,     |
|--------------------------------------|------------------------|------------------|------------------|
|                                      | 2010                   | 2009             | 2009             |
|                                      | (Dollars in thousands) |                  |                  |
| <b>Capital components:</b>           |                        |                  |                  |
| Tier 1 Capital                       | \$ 131,507             | \$ 151,970       | \$ 134,833       |
| Tier 2 Capital                       | 13,999                 | 16,359           | 14,720           |
| <br>Total risk-based capital         | <br>\$ 145,506         | <br>\$ 168,329   | <br>\$ 149,553   |
| <br>Risk-weighted assets             | <br>\$ 1,107,092       | <br>\$ 1,300,876 | <br>\$ 1,163,125 |
| Average assets (regulatory purposes) | \$ 1,290,135           | \$ 1,428,747     | \$ 1,341,670     |

|                           | Minimum<br>Regulatory<br>Requirements |       |       |       |
|---------------------------|---------------------------------------|-------|-------|-------|
| <b>Capital ratios:</b>    |                                       |       |       |       |
| Total risk-based capital  | 13.1%                                 | 12.9% | 12.9% | 8.00% |
| Tier 1 risk-based capital | 11.9%                                 | 11.7% | 11.6% | 4.00% |
| Leverage(1)               | 10.2%                                 | 10.6% | 10.1% | 4.00% |

(1) Tier 1 capital divided by quarterly average assets (excluding goodwill, other intangible assets and disallowed deferred tax assets).



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The table above presents the capital ratios of the consolidated Company computed in accordance with applicable regulatory guidelines and compared to the standards for minimum capital adequacy requirements for bank holding companies.

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The following table summarizes risk-based capital, risk-weighted assets, and risk-based capital ratios of HBC:

|                                      | March 31,    |              | December 31, |   |  |
|--------------------------------------|--------------|--------------|--------------|---|--|
|                                      | 2010         | 2009         | 2009         |   |  |
| (Dollars in thousands)               |              |              |              |   |  |
| <b>Capital components:</b>           |              |              |              |   |  |
| Tier 1 Capital                       | \$ 129,936   | \$ 147,629   | \$ 133,216   |   |  |
| Tier 2 Capital                       | 14,005       | 16,409       | 14,743       |   |  |
| Total risk-based capital             | \$ 143,941   | \$ 164,038   | \$ 147,959   |   |  |
| Risk-weighted assets                 | \$ 1,107,571 | \$ 1,304,914 | \$ 1,165,014 |   |  |
| Average assets (regulatory purposes) | \$ 1,290,438 | \$ 1,432,872 | \$ 1,344,407 |   |  |
|                                      |              |              |              | <b>Well-Capitalized<br/>Regulatory<br/>Requirements</b> | <b>Minimum<br/>Regulatory<br/>Requirements</b> |
| <b>Capital ratios:</b>               |              |              |              |   |  |
| Total risk-based capital             | 13.0%        | 12.6%        | 12.7%        | 10.00%  | 8.00%  |
| Tier 1 risk-based capital            | 11.7%        | 11.3%        | 11.4%        | 6.00%   | 4.00%  |
| Leverage(1)                          | 10.1%        | 10.3%        | 9.9%         | 5.00%   | 4.00%  |

(1)

Tier 1 capital divided by quarterly average assets (excluding goodwill, other intangible assets and disallowed deferred tax assets).

The table above presents the capital ratios of HBC computed in accordance with applicable regulatory guidelines and compared to the standards for minimum capital adequacy requirements under the FDIC's prompt corrective action authority. In April 2010, we submitted a written plan for sufficient capitalization of both HBC and the Company (on a consolidated basis), based on their respective risk profiles to the Federal Reserve and DFI.

At March 31, 2010 and 2009, and December 31, 2009, the Company's and HBC's capital met all minimum regulatory requirements. As of March 31, 2010, HBC was considered "Well-Capitalized" under the prompt corrective action provisions.

***Mandatory Redeemable Cumulative Trust Preferred Securities.***

To enhance regulatory capital and to provide liquidity, the Company, through unconsolidated subsidiary grantor trusts, issued the following mandatory redeemable cumulative trust preferred securities of subsidiary grantor trusts: In the first quarter of 2000, the Company issued \$7.2 million aggregate principal amount of 10.875% subordinated debt due on March 8, 2030 to a subsidiary trust, which in turn issued a similar amount of trust preferred securities. In the third quarter of 2000, the Company issued \$7.2 million aggregate principal amount of 10.60% subordinated debt due on September 7, 2030 to a subsidiary trust, which in turn issued a similar amount of trust preferred securities. In the third quarter of 2001, the Company issued \$5.2 million aggregate principal amount of Floating Rate Junior Subordinated Deferrable Interest Debentures due on July 31, 2031 to a subsidiary trust, which in turn issued a similar amount of trust preferred securities. In the third quarter of 2002, the Company issued \$4.1 million of aggregate principal amount of Floating Rate Junior Subordinated Deferrable Interest Debentures due on September 26, 2032 to a subsidiary trust, which in turn issued a similar amount of trust preferred securities. Under applicable regulatory guidelines, the trust preferred securities currently qualify as Tier I capital. The subsidiary trusts are not consolidated in the Company's consolidated financial statements. The subordinated debt is recorded as a component of long-term debt



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and includes the value of the common stock issued by the trusts to the Company. The common stock is recorded as other assets for the amount issued.

In November 2009, the Company announced that it was exercising its right to defer interest payments on its outstanding trust preferred subordinated debt securities. The Company will continue to accrue the cost and recognize the expense of the interest at the normal rate on a compounded basis until such time as the deferred arrearage has been paid current.

***U.S. Treasury Capital Purchase Program***

The Company received \$40 million in November 2008 through the issuance of its Series A Preferred Stock and a warrant to purchase 462,963 shares of its common stock to the Treasury through the U.S. Treasury Capital Purchase Program. The Series A Preferred qualifies as a component of Tier 1 capital. In November 2009, the Company announced that it was exercising its right to suspend payment of dividends on its Series A Preferred Stock. The Company accrues the cumulative unpaid dividends at the compounded dividend rate.

**Market Risk**

Market risk is the risk of loss of future earnings, fair values, or future cash flows that may result from changes in the price of a financial instrument. The value of a financial instrument may change as a result of changes in interest rates, foreign currency exchange rates, commodity prices, equity prices and other market changes that affect market risk sensitive instruments. Market risk is attributed to all market risk sensitive financial instruments, including securities, loans, deposits and borrowings, as well as the Company's role as a financial intermediary in customer-related transactions. The objective of market risk management is to avoid excessive exposure of the Company's earnings and equity to loss and to reduce the volatility inherent in certain financial instruments.

**Interest Rate Management**

Market risk arises from changes in interest rates, exchange rates, commodity prices and equity prices. The Company's market risk exposure is primarily that of interest rate risk, and it has established policies and procedures to monitor and limit earnings and balance sheet exposure to changes in interest rates. The Company does not engage in the trading of financial instruments, nor does the Company have exposure to currency exchange rates.

The principal objective of interest rate risk management (often referred to as "asset/liability management") is to manage the financial components of the Company in a manner that will optimize the risk/reward equation for earnings and capital in relation to changing interest rates. The Company's exposure to market risk is reviewed on a regular basis by the Asset/Liability Committee. Interest rate risk is the potential of economic losses due to future interest rate changes. These economic losses can be reflected as a loss of future net interest income and/or a loss of current fair market values. The objective is to measure the effect on net interest income and to adjust the balance sheet to minimize the inherent risk while at the same time maximizing income. Management realizes certain risks are inherent, and that the goal is to identify and manage the risks. Management uses two methodologies to manage interest rate risk: (i) a standard GAP analysis; and (ii) an interest rate shock simulation model.

The planning of asset and liability maturities is an integral part of the management of an institution's net interest margin. To the extent maturities of assets and liabilities do not match in a changing interest rate environment, the net interest margin may change over time. Even with perfectly matched repricing of assets and liabilities, risks remain in the form of prepayment of loans or securities or in the form of delays in the adjustment of rates of interest applying to either earning assets with floating rates or to interest bearing liabilities. The Company has generally been able to control its

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exposure to changing interest rates by maintaining primarily floating interest rate loans and a majority of its time certificates with relatively short maturities.

Interest rate changes do not affect all categories of assets and liabilities equally or at the same time. Varying interest rate environments can create unexpected changes in prepayment levels of assets and liabilities, which may have a significant effect on the net interest margin and are not reflected in the interest sensitivity analysis table. Because of these factors, an interest sensitivity gap report may not provide a complete assessment of the exposure to changes in interest rates.

The Company uses modeling software for asset/liability management in order to simulate the effects of potential interest rate changes on the Company's net interest margin, and to calculate the estimated fair values of the Company's financial instruments under different interest rate scenarios. The program imports current balances, interest rates, maturity dates and repricing information for individual financial instruments, and incorporates assumptions on the characteristics of embedded options along with pricing and duration for new volumes to project the effects of a given interest rate change on the Company's interest income and interest expense. Rate scenarios consisting of key rate and yield curve projections are run against the Company's investment, loan, deposit and borrowed funds portfolios. These rate projections can be shocked (an immediate and parallel change in all base rates, up or down) and ramped (an incremental increase or decrease in rates over a specified time period), based on current trends and econometric models or stable economic conditions (unchanged from current actual levels).

The Company applies a market value ("MV") methodology to gauge its interest rate risk exposure as derived from its simulation model. Generally, MV is the discounted present value of the difference between incoming cash flows on interest-earning assets and other investments and outgoing cash flows on interest-bearing liabilities and other liabilities. The application of the methodology attempts to quantify interest rate risk as the change in the MV which would result from a theoretical 100 and 200 basis point (1 basis point equals 0.01%) change in market interest rates. Both a 100 and 200 basis point increase and a 100 and 200 basis point decrease in market rates are considered.

At March 31, 2010, it was estimated that the Company's MV would increase 11.20% in the event of a 200 basis point increase in market interest rates. In the event of a 100 point increase in market interest rate, the Company's MV would increase 6.12% at the same date. The Company's MV at the same date would decrease 19.44% in the event of a 200 basis point decrease in applicable interest rates. In the event of a 100 point decrease in market interest rate, the Company's MV would decrease 9.16% at the same date

Presented below, as of March 31, 2010 and 2009, is an analysis of the Company's interest rate risk as measured by changes in MV for instantaneous and sustained parallel shifts of 100 and 200 basis points in applicable interest rates:

| Change in rates | March 31, 2010            |                          |  |             | March 31, 2009            |                          |  |             |
|-----------------|---------------------------|--------------------------|--|-------------|---------------------------|--------------------------|--|-------------|
|                 | \$ Change in Market Value | % Change in Market Value | Market Value as a % of Present Value of Assets | Change (bp) | \$ Change in Market Value | % Change in Market Value | Market Value as a % of Present Value of Assets | Change (bp) |
| +200 bp         | \$ 22,577                 | 11.20%                   | 16.8%  | 169         | \$ 26,074                 | 12.82%                   | 15.7%  | 179         |
| +100 bp         | \$ 12,347                 | 6.12%                    | 16.0%  | 93          | \$ 13,967                 | 6.87%                    | 14.9%  | 96          |
| 0 bp            | \$                        | 0.00%                    | 15.1%  |             | \$                        | 0.00%                    | 14.0%  |             |
| -100 bp         | \$ (18,469)               | 9.16%                    | 13.7%  | (138)       | \$ (22,562)               | -11.10%                  | 12.4%  | (155)       |
| -200 bp         | \$ (39,196)               | -19.44%                  | 12.3%  | (279)       | \$ (46,649)               | -22.94%                  | 10.8%  | (320)       |

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Management believes that the MV methodology overcomes three shortcomings of the typical maturity gap methodology. First, it does not use arbitrary repricing intervals and accounts for all expected future cash flows. Second, because the MV method projects cash flows of each financial instrument under different interest rate environments, it can incorporate the effect of embedded options on an institution's interest rate risk exposure. Third, it allows interest rates on different instruments to change by varying amounts in response to a change in market interest rates, resulting in more accurate estimates of cash flows.

However, as with any method of gauging interest rate risk, there are certain shortcomings inherent to the MV methodology. The model assumes interest rate changes are instantaneous parallel shifts in the yield curve. In reality, rate changes are rarely instantaneous. The use of the simplifying assumption that short-term and long-term rates change by the same degree may also misstate historic rate patterns, which rarely show parallel yield curve shifts. Further, the model assumes that certain assets and liabilities of similar maturity or period to repricing will react in the same way to changes in rates. In reality, certain types of financial instruments may react in advance of changes in market rates, while the reaction of other types of financial instruments may lag behind the change in general market rates. Additionally, the MV methodology does not reflect the full impact of annual and lifetime restrictions on changes in rates for certain assets, such as adjustable rate loans. When interest rates change, actual loan prepayments and actual early withdrawals from certificates may deviate significantly from the assumptions used in the model. Finally, this methodology does not measure or reflect the impact that higher rates may have on adjustable-rate loan clients' ability to service their debt. All of these factors are considered in monitoring the Company's exposure to interest rate risk.

**CRITICAL ACCOUNTING POLICIES**

Critical accounting policies are discussed in our Form 10-K for the year ended December 31, 2009. There are no changes to these policies as of March 31, 2010.

**ITEM 3 QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

The information concerning quantitative and qualitative disclosure or market risk called for by Item 305 of Regulation S-K is included as part of Item 2 above.

**ITEM 4 CONTROLS AND PROCEDURES**

**Disclosure Control and Procedures**

The Company has carried out an evaluation, under the supervision and with the participation of the Company's management, including the Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures as of March 31, 2010. As defined in Rule 13a-15(e) under the Securities Exchange Act of 1934, as amended (the "Exchange Act"), disclosure controls and procedures are controls and procedures designed to reasonably assure that information required to be disclosed in our reports filed or submitted under the Exchange Act are recorded, processed, summarized and reported on a timely basis. Disclosure controls are also designed to reasonably assure that such information is accumulated and communicated to our management, including the Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure. Based upon their evaluation, our Chief Executive Officer and Chief Financial Officer concluded the Company's disclosure controls were effective as of March 31, 2010, the period covered by this report on Form 10-Q.

During the three months ended March 31, 2010, there were no changes in our internal controls over financial reporting that materially affected, or are reasonably likely to affect, our internal controls over financial reporting.

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**Part II OTHER INFORMATION**

**ITEM 1 LEGAL PROCEEDINGS**

The Company is involved in certain legal actions arising from normal business activities. Management, based upon the advice of legal counsel, believes the ultimate resolution of all pending legal actions will not have a material effect on the financial statements of the Company.

**ITEM 1A RISK FACTORS**

A description of the risk factors associated with our business is contained in Part I, Item 1A, "Risk Factors," of our Annual Report on Form 10-K for the fiscal year ended December 31, 2009 filed with the Securities and Exchange Commission. These cautionary statements are to be used as a reference in connection with any forward-looking statements. The factors, risks and uncertainties identified in these cautionary statements are in addition to those contained in any other cautionary statements, written or oral, which may be made or otherwise addressed in connection with a forward-looking statement or contained in any of our subsequent filings with the Securities and Exchange Commission. There are no material changes in the "Risk Factors" previously disclosed in the Annual Report on Form 10-K for the year ended December 31, 2009.

**ITEM 2 UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS**

None

**ITEM 3 DEFAULTS UPON SENIOR SECURITIES**

None

**ITEM 4 SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS**

There was no submission of matters to a vote of security holders during the three months ended March 31, 2010.

**ITEM 5 OTHER INFORMATION**

None

**ITEM 6 EXHIBITS**

| <b>Exhibit</b> | <b>Description</b>   |
|----------------|--|
| 3.1            | Heritage Commerce Corp Restated Articles of Incorporation, as amended (incorporated by reference to Exhibit 3.1 to the Registrant's Annual Report on Form 10-K filed on March 16, 2009)    |
| 3.2            | Heritage Commerce Corp Bylaws, as amended (incorporated by reference to Exhibit 3.2 to the Registrant's Annual Report or Form 10-K filed on March 17, 2010)                                |
| 4.1            | Certificate of Determination for Fixed Rate Cumulative Perpetual Preferred Stock, Series A (incorporated by reference to Exhibit 3.1 to the Registrant's Form 8-K filed November 26, 2008) |
| 4.2            | Warrant to Purchase Common Stock dated November 21, 2008 (incorporated by reference to Exhibit 4.2 to the Registrant's Form 8-K filed on November 26, 2008)                                |
| 12.1           | Calculation of Ratio of Earnings to Fixed Charges and Ratio of Earnings to Fixed Charges and Preferred Stock Dividends   |

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| <b>Exhibit</b> | <b>Description</b>  |
|----------------|---|
| 31.1           | Certification of Registrant's Chief Executive Officer Pursuant To Section 302 of the Sarbanes-Oxley Act of 2002 |
| 31.2           | Certification of Registrant's Chief Financial Officer Pursuant To Section 302 of the Sarbanes-Oxley Act of 2002 |
| 32.1           | Certification of Registrant's Chief Executive Officer Pursuant To 18 U.S.C. Section 1350                        |
| 32.2           | Certification of Registrant's Chief Financial Officer Pursuant To 18 U.S.C. Section 1350                        |



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**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Heritage Commerce Corp

(Registrant)

May 11, 2010

/s/ WALTER T. KACZMAREK

Date

Walter T. Kaczmarek  
*Chief Executive Officer*

May 11, 2010

/s/ LAWRENCE D. MCGOVERN

Date

Lawrence D. McGovern  
*Chief Financial Officer*

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