

HERITAGE COMMERCE CORP

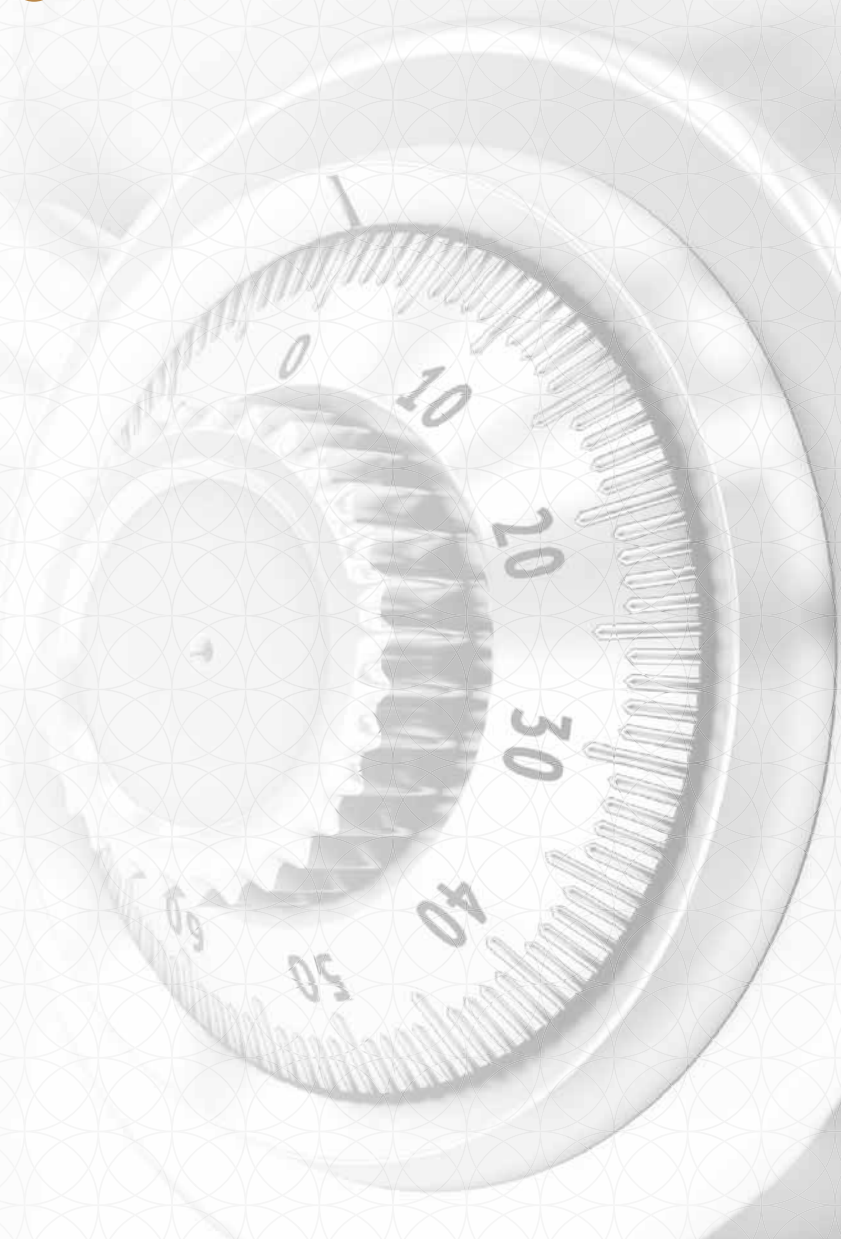
ANNUAL REPORT



2012



ON FORM 10-K



To Our Shareholders

April 17, 2013

Dear Fellow Shareholders:

Heritage Commerce Corp maintained its momentum from 2011 into 2012. With an increase in profitability and a solid capital base, we were positioned to repurchase the \$40 million TARP Series A Preferred Stock in the first quarter of 2012. We continued to build our franchise throughout 2012 with a disciplined business strategy. We saw steady growth in our deposits and loans on a year-over-year basis, and continued to improve our credit quality. As we move into 2013, we are a stronger company than we were just one year ago. Our 2012 highlights include:

- In the first quarter of 2012, we improved profitability by repaying \$40 million of Series A Preferred Stock issued to the U.S. Treasury Department under the TARP Capital Purchase Program. The redemption of those preferred shares will save more than \$2.0 million in annual preferred dividends.
- In the third quarter of 2012, we redeemed \$7 million of 10.875% fixed-rate subordinated debentures and \$7 million of 10.600% fixed-rate subordinated debentures. As a consequence, we eliminated \$1.5 million of annual interest expense.
- We ended the year with a total risk-based capital ratio of 16.2%, a Tier 1 risk-based ratio of 15.0% and a leverage ratio of 11.5%; all capital levels exceeded regulatory requirements for “well-capitalized” financial institutions.
- Nonperforming assets as a percentage of total assets declined to 1.15% at year-end 2012, compared to 1.47% at year-end 2011. Classified assets, net of Small Business Administration (SBA) guarantees, decreased by 38% to \$36.8 million at December 31, 2012, compared to \$59.5 million at December 31, 2011. In addition, net charge-offs declined to \$4.5 million in 2012, from \$9.0 million in 2011. At year-end 2012, our allowance for loan losses remained strong at \$19.0 million.
- Pre-tax income for the year ended December 31, 2012, increased 35% to \$14.2 million, compared to \$10.5 million for the year ended December 31, 2011.
- For the year ended December 31, 2012, net income available to shareholders was \$8.7 million, or \$0.27 per average common share.

During the latter part of 2012 and into 2013, we revitalized our lending efforts by adding a number of experienced bankers to help us increase market share and produce loan growth for 2013. Our goal is to continue growing our commercial & industrial, commercial real estate and SBA loan portfolios. At the same time, we will focus on managing our operating costs, continuing to improve credit quality and increasing noninterest income.

We have an exceptional Board of Directors and 190 highly engaged employees who have been resilient throughout this historic economic cycle. With our sound business strategy and solid financial position, we are in an excellent position to build for the future and create additional shareholder value. We thank you for your ongoing support and loyalty to Heritage Commerce Corp. We look forward to seeing you at our annual meeting on Thursday, May 23, 2013, at 1:00 p.m. Pacific Time.

Sincerely,



Jack W. Conner
Chairman of the Board



Walter T. Kaczmarek
President and Chief Executive Officer

HERITAGE COMMERCE CORP

**Notice of 2013 Annual Meeting
and Proxy Statement**

HERITAGE COMMERCE CORP

April 17, 2013

Dear Shareholder:

You are cordially invited to attend the 2013 Annual Meeting of Shareholders, which will be held at 1:00 p.m., Pacific Daylight Time (PDT) on Thursday, May 23, 2013, at Heritage Commerce Corp's offices, located at 150 Almaden Boulevard, San Jose, California, 95113.

The accompanying Notice of Annual Meeting and proxy statement describe the business that will be conducted at the meeting and provide information about Heritage Commerce Corp. We have also enclosed our 2012 Annual Report on Form 10-K.

Your continued support is appreciated and we hope you will attend the Annual Meeting. Whether or not you are personally present, it is very important that your shares be represented at the meeting. Accordingly, please sign, date, and mail the enclosed proxy card promptly. You may also vote electronically over the Internet or by telephone by following the instructions on the proxy card. If you attend the meeting and prefer to vote in person, you may do so.

Sincerely,



Jack W. Conner
Chairman of the Board



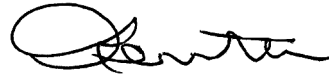
Walter T. Kaczmarek
President and Chief Executive Officer

HERITAGE COMMERCE CORP
150 Almaden Boulevard
San Jose, California 95113

Notice of Annual Meeting of Shareholders

- Date and Time:** Thursday, May 23, 2013, at 1:00 p.m., Pacific Daylight Time (PDT).
- Place:** Company's offices located at 150 Almaden Boulevard, San Jose, California 95113.
- Items of Business:**
1. To elect 12 members of the Board of Directors, each for a term of one year;
 2. To approve the 2013 Equity Incentive Plan;
 3. Ratification of the selection of Crowe Horwath LLP as the Company's independent registered public accounting firm for the year ending December 31, 2013; and
 4. To transact such other business as may properly come before the meeting, and any adjournment or postponement.
- Record Date:** You can vote if you are a shareholder of record on April 3, 2013.
- Mailing Date:** The proxy materials are being distributed to our shareholders on or about April 17, 2013, and include our Annual Report on Form 10-K, Notice of Annual Meeting, this proxy statement, and proxy or voting instruction card.
- Important Notice Regarding the Internet Availability of Proxy Materials:** The proxy statement and Annual Report on Form 10-K are available at www.heritagecommercecorp.com. **Your Vote is Important.** Please vote as promptly as possible by using the Internet or telephone or by signing, dating and returning the enclosed proxy card.

By Order of the Board of Directors,



Debbie Reuter
Corporate Secretary

April 17, 2013
San Jose, California

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**PROXY STATEMENT FOR HERITAGE COMMERCE CORP
2013 ANNUAL MEETING OF SHAREHOLDERS
INFORMATION ABOUT THE ANNUAL MEETING AND VOTING**

Why did you send me this proxy statement?

We sent you this proxy statement and the enclosed proxy card because our Board of Directors is soliciting your proxy to vote at the 2013 Annual Meeting of Shareholders. This proxy statement summarizes the information you need to know to cast an informed vote at the Annual Meeting. However, you do not need to attend the Annual Meeting to vote your shares. Instead, you may simply complete, sign and return the enclosed proxy card. You may also vote electronically by telephone or the Internet by following the instructions on the proxy card.

Along with this proxy statement, we are also sending you the Heritage Commerce Corp 2012 Annual Report on Form 10-K, which includes our consolidated financial statements. Heritage Commerce Corp is also referred to in this proxy statement as the “Company.”

Who is entitled to vote?

We will begin sending this proxy statement, the attached Notice of Annual Meeting and the enclosed proxy card on or about April 17, 2013, to all shareholders entitled to vote. Shareholders who were the record owners of the Company’s common stock at the close of business on April 3, 2013, are entitled to vote. On this record date, there were 26,333,368 shares of common stock outstanding.

What constitutes a quorum?

A majority of the outstanding shares of the common stock entitled to vote at the Annual Meeting must be present, in person or by proxy, in order to constitute a quorum. We can only conduct the business of the Annual Meeting if a quorum has been established. We will include proxies marked as abstentions and broker non-votes in determining the number of shares present at the Annual Meeting.

How many votes do I have?

Each share of common stock entitles you to one vote in person or by proxy, for each share of common stock outstanding in your name on the books of the Company as of April 3, 2013, the record date for the Annual Meeting, on any matter submitted to a vote of the shareholders, except that in connection with the election of directors (Proposal 1), you may cumulate your shares (*see “What is cumulative voting and how do I cumulate my shares?” below*). The proxy card indicates the number of votes that you have as of the record date.

Is voting confidential?

We have a confidential voting policy to protect the privacy of our shareholders’ votes. Under this policy, ballots, proxy cards and voting instructions returned to banks, brokers and other nominees are kept confidential. Only the proxy tabulator and the Inspector of Election have access to the ballots, proxy cards and voting instructions.

How do I vote by proxy?

You may vote by granting a proxy or, for shares held in street name, by submitting voting instructions to your broker or other nominee. If your shares are held by a broker or other nominee, you will receive instructions that you must follow to have your shares voted. If you hold your shares as a shareholder of record, you may vote by completing, signing and dating the enclosed proxy card and returning it promptly in the envelope provided. You may also vote electronically by telephone or over the Internet (see below). Returning the proxy card will not affect your right to attend the Annual Meeting and vote.

If you properly fill in your proxy card and send it to us in time to vote, your “proxy” (one of the individuals named on your proxy card) will vote your shares as you have directed. If you sign the proxy card but do not make specific choices, your proxy will vote your shares as recommended by the Board of Directors as follows:

- “**FOR**” the election of all 12 nominees for director;
- “**FOR**” the approval of the proposed 2013 Equity Incentive Plan; and
- “**FOR**” the ratification of the selection of Crowe Horwath LLP as our independent registered public accounting firm for 2013.

For the election of directors (Proposal 1), a shareholder may withhold authority for the proxy holders to vote for any one or more of the nominees by marking the enclosed proxy card in the manner instructed on the proxy card. Unless authority to vote for the nominees is so withheld, the proxy holders will vote the proxies received by them for the election of the nominees listed on the proxy card as directors of the Company. Your proxy does not have an obligation to vote for nominees not identified on the preprinted proxy card (that is, write-in candidates). Should any shareholder attempt to “write in” a vote for a nominee not identified on the preprinted card (and described in these proxy materials), your proxy will NOT vote the shares represented by your proxy card for any such write-in candidate, but will instead vote the shares for any and all other indicated candidates. If any of the nominees should be unable or decline to serve, which is not now anticipated, your proxy will have discretionary authority to vote for a substitute who shall be designated by the present Board of Directors to fill the vacancy. In the event that additional persons are nominated for election as directors, your proxy intends to vote all of the proxies in such a manner, in accordance with the cumulative voting, as will assure the election of as many of the nominees identified on the proxy card as possible. In such event, the specific nominees to be voted for will be determined by the proxy holders, in their sole discretion.

What do I have to do to vote my shares if they are held in the name of my broker?

If your shares are held by your broker, sometimes called “street name” shares, you must vote your shares through your broker. You should receive a form from your broker asking how you want to vote your shares. Follow the instructions on that form to give voting instructions to your broker. Under the rules that govern brokers who are voting with respect to shares held in street name, brokers have the discretion to vote such shares on routine, but not on non-routine matters. A “broker non-vote” occurs when your broker does not vote on a particular proposal because the broker does not receive instructions from the beneficial owner and does not have discretionary authority. Proposal 3 (ratification of independent registered public accounting firm) is a routine item. Proposal 1 (election of directors) and Proposal 2 (approval of the 2013 equity incentive plan), are non-routine items on which a broker may vote only if the beneficial owner has provided voting instructions.

What are the procedures for attending the Annual Meeting?

Only shareholders owning the Company’s common stock at the close of business on April 3, 2013, or their legal proxy holders, are entitled to attend the Annual Meeting. You must present photo identification for admittance. If you are a shareholder of record, your name will be verified against the list of shareholders of record on the Record Date prior to your admission to the Annual Meeting. If you are not a shareholder of record but hold shares through a bank, broker or other nominee, you must provide proof of beneficial ownership on the Record Date, such as your most recent account statement prior to April 3, 2013, or other similar evidence of ownership. If you do not provide photo identification or comply with the other procedures outlined above, you will not be admitted to the Annual Meeting.

How do I vote in person?

If you plan to attend the Annual Meeting and desire to vote in person, we will give you a ballot form when you arrive. However, if your shares are held in the name of your broker, bank or other nominee, you must bring a power of attorney from your nominee in order to vote at the Annual Meeting.

May I vote electronically over the Internet or by telephone?

Shareholders whose shares are registered in their own names may vote either over the Internet or by telephone. Special instructions for voting over the Internet or by telephone are set forth on the enclosed proxy card. The Internet and telephone voting procedures are designed to authenticate the shareholder's identity and to allow shareholders to vote their shares and confirm that their voting instructions have been properly recorded.

If your shares are registered in the name of a bank or brokerage firm, you may be eligible to vote your shares electronically by telephone or over the Internet. Most U.S. banks and brokerage firms are clients of Broadridge Financial Solutions ("Broadridge"). As such, shareholders who receive either a paper copy of their proxy statement or electronic delivery notification have the opportunity to vote by telephone or over the Internet. If your bank or brokerage firm is a Broadridge client, your proxy card or Voting Instruction Form ("VIF") will provide the instructions. If your proxy card or VIF does not provide instructions for Internet and telephone voting, please complete and return the proxy card in the self-addressed, postage-paid envelope provided.

What is cumulative voting and how do I cumulate my shares?

For the election of directors (Proposal 1), California law provides that a shareholder of a California corporation, or his/her proxy, may cumulate votes in the election of directors. That is, each shareholder may cast that number of votes equal to the number of shares owned by him/her, multiplied by the number of directors to be elected, and he/she may cumulate such votes for a single candidate or distribute such votes among as many candidates as he/she deems appropriate.

Certain affirmative steps must be taken by you in order to be entitled to vote your shares cumulatively for the election of directors. At the shareholders' meeting at which directors are to be elected, no shareholder is entitled to cumulate votes (i.e., cast for any one or more candidates a number of votes greater than the number of the shareholder's shares) unless the candidates' names have been placed in nomination at the meeting and prior to the commencement of the voting and at least one shareholder has given notice at the meeting and prior to commencement of the voting of the shareholder's intention to cumulate votes. If any shareholder has given such notice, then every shareholder entitled to vote may cumulate votes for candidates in nomination and give one candidate a number of votes equal to the number of directors to be elected multiplied by the number of votes to which that shareholder's shares are entitled, or distribute the shareholder's votes on the same principle among any or all of the candidates, as the shareholder thinks appropriate. The candidates receiving the highest number of votes, up to the number of directors to be elected, will be elected.

The proxies designated on your proxy card do not, at this time, intend to cumulate votes, to the extent they have the shareholder's discretionary authority to do so, pursuant to the proxies solicited in this proxy statement unless another shareholder gives notice to cumulate, in which case your proxy may cumulate votes in accordance with the recommendations of the Board of Directors. Therefore, discretionary authority to cumulate votes in such an event is solicited in this proxy statement.

May I change my vote after I return my proxy?

If you fill out and return the enclosed proxy card, or vote by telephone or over the Internet, you may change your vote at any time before the vote is conducted at the Annual Meeting. You may change your vote in any one of four ways:

- You may send to the Company's Corporate Secretary another completed proxy card with a later date.
- You may notify the Company's Corporate Secretary in writing before the Annual Meeting that you have revoked your proxy.
- You may attend the Annual Meeting and vote in person.
- If you have voted your shares by telephone or over the Internet, you can revoke your prior telephone or Internet vote by recording a different vote, or by signing and returning a proxy card dated as of a date that is later than your last telephone or Internet vote.

What if I receive multiple proxy cards?

If you receive multiple proxy cards, your shares are probably registered differently or are in more than one account. Vote all proxy cards received to ensure that all your shares are voted. Unless you need multiple accounts for specific purposes, we recommend that you consolidate as many of your accounts as possible under the same name and address. If the shares are registered in your name, contact our transfer agent, Wells Fargo Shareowner Services, 1-800-468-9716; otherwise, contact your bank, broker or other nominee.

What vote is required to approve each proposal?

Approval of Proposal 1 (election of directors) requires a plurality of votes cast for each nominee. This means that the 12 nominees who receive the most votes will be elected. So, if you do not vote for a particular nominee, or you indicate "WITHHOLD AUTHORITY" to vote for a particular nominee on your proxy card, your vote will not count either "for" or "against" the nominee. Abstentions will not have any effect on the outcome of the vote. You may cumulate your votes in the election of directors as described under "*What is cumulative voting and how do I cumulate my shares?*" on page 3. Broker non-votes will not count as a vote on the proposal and will not affect the outcome of the vote.

Approval of Proposal 2 (approval of the 2013 equity incentive plan) and Proposal 3 (ratification of independent registered public accounting firm) require a vote that satisfies two criteria: (i) the affirmative vote for the proposal must constitute a majority of the common shares present or represented or by proxy and voting on the proposal at the Annual Meeting and (ii) the affirmative vote for the proposal must constitute a majority of the common shares required to constitute the quorum. For purposes of Proposal 2 and Proposal 3, abstentions and broker non-votes will not affect the outcome under clause (i), which recognizes only actual votes cast. However, abstentions and broker non-votes will affect the outcome under clause (ii) if the number of affirmative votes, though a majority of the votes represented and cast, does not constitute a majority of the voting power required to constitute a quorum. The ratification of the appointment of the independent registered public accounting firm for 2013 is a matter on which a broker or other nominee is generally empowered to vote and therefore no broker non-votes are expected to exist with respect to Proposal 3.

How will voting on any other business be conducted?

Your proxy card confers discretionary authority to your proxy to vote your shares on the matters which may properly be presented for action at the Annual Meeting, and may include action with respect to procedural matters pertaining to the conduct of the Annual Meeting.

What are the costs of soliciting these proxies?

We will pay all the costs of soliciting these proxies. In addition to mailing proxy soliciting material, our directors, officers and employees also may solicit proxies in person, by telephone or by other electronic means of communication for which they will receive no compensation. We will ask banks, brokers and other institutions, nominees and fiduciaries to forward the proxy materials to their principals and to obtain authority to execute proxies. We will then reimburse them for their reasonable expenses. We have hired Advantage Proxy to seek the proxies of custodians, such as brokers, which hold shares which belong to other people. This service will cost the Company approximately \$5,000.

How do I obtain an Annual Report on Form 10-K?

A copy of our 2012 Annual Report on Form 10-K accompanies this proxy statement. If you would like another copy of this report, we will send you one without charge. The Annual Report on Form 10-K includes a list of exhibits filed with the Securities and Exchange Commission (“SEC”), but does not include the exhibits. If you wish to receive copies of the exhibits, we will send them to you; however, expenses for copying and mailing them to you will be your responsibility. Please write to:

**Heritage Commerce Corp
150 Almaden Boulevard
San Jose, California 95113
Attention: Corporate Secretary**

You can also find out more information about us at our website www.heritagecommercecorp.com. Our website is available for information purposes only and should not be relied upon for investment purposes, nor is it incorporated by reference into this proxy statement. On our website you can access electronically filed copies of our annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, Section 16 filings, and amendments to those reports and filings, free of charge. The SEC also maintains a website at www.sec.gov that contains reports, proxy statements and other information regarding SEC registrants, including the Company.

BENEFICIAL OWNERSHIP OF COMMON STOCK

The following table sets forth information as of February 15, 2013, pertaining to beneficial ownership of the Company's common stock by persons known to the Company to own five percent or more of the Company's common stock, nominees to be elected to the Board of Directors, the executive officers named in the Summary Compensation Table presented in this proxy statement, and all directors and executive officers of the Company, as a group. This information has been obtained from the Company's records, or from information furnished directly by the individual or entity to the Company.

For purposes of the following table, shares issuable pursuant to stock options which may be exercised within 60 days of February 15, 2013, are deemed to be issued and outstanding and have been treated as outstanding in determining the amount and nature of beneficial ownership and in calculating the percentage of ownership of those individuals possessing such interest, but not for any other individuals.

Name of Beneficial Owner(1)	Position	Shares Beneficially Owned(2)(3)	Exercisable Options	Percent of Class(3)
Michael E. Benito	Executive Vice President/ Banking Division	72,825(4)	56,507	0.28%
Frank G. Bisceglia	Director	123,514(5)	19,277	0.47%
Jack W. Conner	Director and Chairman of the Board	103,130(6)	30,633	0.39%
John M. Eggemeyer	Director	1,286,790(7)	2,790	4.89%
Celeste V. Ford	Director	21,808(8)	11,808	0.08%
Steven L. Hallgrimson	Director	114,758(9)	958	0.44%
Walter T. Kaczmarek	Chief Executive Officer, President and Director	203,808(10)(21)	95,000	0.77%
Dan T. Kawamoto	Executive Vice President and Chief Administrative Officer	56,152(11)(21)	23,253	0.21%
Lawrence D. McGovern	Executive Vice President and Chief Financial Officer	82,751(12)(21)	40,500	0.31%
Robert T. Moles	Director	116,581(13)	26,277	0.44%
Humphrey P. Polanen	Director	25,765(14)	19,277	0.10%
David E. Porter	Executive Vice President and Chief Credit Officer	30,000(15)	—	0.11%
Laura Roden	Director	10,958	958	0.04%
Charles J. Toeniskoetter	Director	31,677(16)	19,277	0.12%
Ranson W. Webster	Director	629,355	26,777	2.39%
W. Kirk Wycoff	Director	2,597,790(17)	2,790	9.86%
All directors, and executive officers (16 individuals)		5,507,662		20.62%
The Banc Funds Company		1,533,346(18)		5.82%
Patriot Financial Partners, L.P.		2,595,000(19)		9.85%
Wellington Management Company, LLP		2,228,946(20)		8.46%

1. Except as otherwise noted, the address for all persons is c/o Heritage Commerce Corp, 150 Almaden Boulevard, San Jose, California, 95113.

2. Subject to applicable community property laws and shared voting and investment power with a spouse, the persons listed have sole voting and investment power with respect to such shares unless otherwise noted. Listed amounts reflect all previous stock splits and stock dividends.
3. Includes shares beneficially owned (including options exercisable within 60 days of February 15, 2013, as shown in the “Exercisable Options” column).
4. Includes 9,000 shares of restricted stock that have not vested and which Mr. Benito has the right to vote. Also, includes 540 shares held by his spouse.
5. Includes 93,237 shares as one of two trustees of the Bisceglia Family Trust, and 11,000 shares held by Mr. Bisceglia in a personal Individual Retirement Account.
6. Includes 300 shares held in a trust account, and 6,700 shares held by Mr. Conner’s spouse.
7. Includes 1,284,000 shares of common stock held by Castle Creek Capital Partners IV LLC (“CC Fund IV”). CC Fund IV also owns 12,960 shares of Series C Preferred Stock which are convertible into 3,456,000 shares of common stock following transfer to third parties in a widely dispersed offering. Since CC Fund IV does not have the right to acquire the shares of common stock underlying the Series C Preferred Stock and will not have voting or dispositive power of such shares of common stock, the shares of common stock underlying the Series C Preferred Stock are not included in the table. Mr. Eggemeyer is a managing principal of Castle Creek Capital IV LLC which is the sole general partner of CC Fund IV and may be deemed to have voting and/or investment control of the securities held by CC Fund IV. Mr. Eggemeyer disclaims beneficial ownership of the securities held by CC Fund IV, except to the extent of his pecuniary interest therein.
8. Includes 10,000 shares in a trust account held by Ms. Ford.
9. Includes 71,700 shares held directly, 3,500 shares held in a personal Individual Retirement Account, and 8,000 shares held by charitable foundations, in which Mr. Hallgrimson has voting and investment power. Also includes 15,450 shares that Mr. Hallgrimson holds as trustee of various trusts, and 15,150 shares held in the accounts of others over which Mr. Hallgrimson has voting and investment power.
10. Includes 41,000 shares held in a personal Individual Retirement Account. Also includes 15,000 shares of restricted stock that have not vested and which Mr. Kaczmarek has the right to vote.
11. Includes 14,388 shares held by Mr. Kawamoto in a personal Individual Retirement Account. Also includes 14,500 shares of restricted stock that have not vested and which Mr. Kawamoto has the right to vote.
12. Includes 4,980 shares held by Mr. McGovern in a personal Individual Retirement Account. Also includes 14,500 shares of restricted stock that have not vested and which Mr. McGovern has the right to vote.
13. Includes 18,295 shares held by Mr. Moles’ spouse.
14. Includes 4,865 shares held by Mr. Polanen in a personal Individual Retirement Account and 1,623 shares held by his spouse.
15. Includes 30,000 shares of restricted stock that have not vested and which Mr. Porter has the right to vote. Mr. Porter joined the Company in June 2012.
16. Includes 150 shares held by Mr. Toeniskoetter’s spouse, and 11,000 shares held by the Toeniskoetter & Breeding, Inc. Profit Sharing Plan.
17. Mr. Wycoff is one of the general partners of Patriot Financial Partners GP, L.P. (“Patriot GP”). Patriot GP is the general partner of Patriot Financial Partners, L.P. and Patriot Financial Partners Parallel, L.P. (together, the “Funds”). Patriot Financial Partners GP, LLC (“Patriot LLC”) is the general partner of Patriot GP. Mr. Wycoff is a member of Patriot LLC. Accordingly, securities owned by the Funds may be regarded as being beneficially owned by Mr. Wycoff. Mr. Wycoff disclaims beneficial ownership of the securities owned by the Funds, except to the extent of his pecuniary interest therein.

18. Includes 418,834 shares held by Banc Fund VI L.P. (“BF VI”), 489,933 shares held by Banc Fund VII L.P. (“BF VII”) and 624,579 shares held by Banc Fund VIII L.P. (“BF VIII”). BF VI, BF VII and BF VIII are each Illinois limited partnerships. MidBanc VI L.P. is the general partner of BF VI. MidBanc VII is the general partner of BF VII. MidBanc VIII is the general partner of BF VIII. Each of the general partners are Illinois limited partnerships and the general partner for each of these entities is The Banc Funds Company, L.L.C., an Illinois corporation whose principal shareholder is Charles J. Moore. Mr. Moore as sole shareholder of the Banc Funds Company and as the manager of BF VI, BF VII and BF VIII has voting and dispositive power over the shares held by each of these entities. The address for The Banc Funds Company is 20 North Wacker Drive, Suite 3300, Chicago, Illinois 60606. All of the foregoing information has been obtained by Schedule 13G filed with the SEC on February 4, 2013.
19. Includes 2,213,000 shares of common stock held by Patriot Financial Partners, L.P. and 382,000 shares of common stock held by Patriot Financial Partners Parallel, L.P. Patriot Financial Partners GP, L.P. (“Patriot GP”) is a general partner of each Patriot Financial Partners, L.P. and Patriot Financial Partners Parallel, L.P. (together, the “Funds”) and Patriot Financial Partners GP, LLC (“Patriot LLC”) is a general partner of Patriot GP. In addition, each of W. Kirk Wycoff, Ira M. Lubert and James J. Lynch are general partners of the Funds and Patriot GP and members of Patriot LLC. Accordingly, securities owned by the Funds may be regarded as being beneficially owned by Patriot GP, Patriot LLC and each of W. Kirk Wycoff, Ira M. Lubert and James J. Lynch. Mr. Wycoff, Mr. Lubert and Mr. Lynch each disclaim beneficial ownership of the securities owned by the Funds, except to the extent of their respective pecuniary interest therein. The Funds also own 8,043 shares of Series C Preferred Stock which is convertible into 2,145,000 shares of common stock following transfer to third parties in a widely dispersed offering. Since the Funds do not have the right to acquire these shares of common stock underlying the Series C Preferred Stock and will not have voting or dispositive power of such shares of common stock, the shares of common stock underlying the Series C Preferred Stock are not included in the table. The address for Patriot Financial Group is Cira Centre, 2929 Arch Street, 27th Floor, Philadelphia, PA 19104-2868. All of the foregoing information has been obtained from Schedule 13D filed with the SEC on June 25, 2010.
20. Wellington Management Company, LLP (“Wellington Management”) is an investment adviser and may be deemed to beneficially own 2,228,946 shares of the Company which are held of record by clients of Wellington Management. The address for Wellington Management is 280 Congress Street, Boston, MA 02210. All the foregoing information has been obtained by Schedule 13G filed with the SEC on February 14, 2013.
21. The Company’s Employee Stock Ownership Plan owns 137,983 shares of our common stock, all of which have been allocated. These include shares held for the account of the following named executive officers and included in the table for: Mr. Kaczmarek 1,808 shares, Mr. McGovern 5,251 shares, Mr. Benito 2,178 shares, Mr. Kawamoto 11 shares, and zero shares for Mr. Porter. Mr. Kaczmarek and Mr. McGovern are two of the three trustees of the Employee Stock Ownership Plan. As trustees, they have the power to vote any unallocated shares of Employee Stock Ownership Plan (currently no shares are unallocated) and allocated shares for which voting instructions are not otherwise provided.

CORPORATE GOVERNANCE AND BOARD MATTERS

The Board of Directors is committed to good business practices, transparency in financial reporting and the highest level of corporate governance. To that end, the Board continually reviews its governance policies and practices, as well as the requirements of the Sarbanes-Oxley Act of 2002 and the listing standards of The NASDAQ Stock Market, to help ensure that such policies and practices are compliant and up to date.

Board of Directors

Board Independence

Eleven (11) out of twelve (12) members of the Board of Directors are independent directors, as defined by the applicable rules and regulations of The NASDAQ Stock Market, as follows:

Frank G. Bisceglia
Jack W. Conner, Chairman of the Board
John M. Eggemeyer
Celeste V. Ford
Steven L. Hallgrimson
Robert T. Moles
Humphrey P. Polanen
Laura Roden
Charles J. Toeniskoetter
Ranson W. Webster
W. Kirk Wycoff

Board and Committee Meeting Attendance

During the fiscal year ended December 31, 2012, our Board of Directors held a total of 16 meetings. Each incumbent director who was a director during 2012 attended at least 75% of the aggregate of (a) the total number of such meetings and (b) the total number of meetings held by the standing committees of the Board on which such director served.

Director Attendance at Annual Meetings of Shareholders

The Board believes it is important for all directors to attend the Annual Meeting of Shareholders in order to show their support for the Company and to provide an opportunity for shareholders to communicate any concerns to them. The Company's policy is to encourage, but not require, attendance by each director at the Company's Annual Meeting of Shareholders. All of our directors at the time of our Annual Meeting of Shareholders in 2012 were in attendance.

Communications with the Board

Shareholders may communicate with the Board of Directors, including a committee of the Board or individual directors, by writing to the Corporate Secretary, Heritage Commerce Corp, 150 Almaden Boulevard, San Jose, California 95113. Each communication from a shareholder should include the following information in order to permit shareholder status to be confirmed and to provide an address to forward a response if deemed appropriate:

- The name, mailing address and telephone number of the shareholder sending the communication; and
- If the shareholder is not a record holder of our common stock, the name of the record holder of our common stock beneficially owned must be identified along with the shareholder.

Our Corporate Secretary will forward all appropriate communications to the Board or individual members of the Board specified in the communication. Our Corporate Secretary may (but is not required to) review all correspondence addressed to the Board or any individual member of the Board, for any inappropriate correspondence more suitably directed to management. Communications may be deemed inappropriate for this purpose if it is reasonably apparent from the face of the correspondence that it relates principally to a customer dispute. Our policies regarding the handling of security holder communications were approved by a majority of our independent directors.

Nomination of Directors

The Company has a Corporate Governance and Nominating Committee. The duties of the Corporate Governance and Nominating Committee include the recommendation of candidates for election to the Company's Board of Directors.

The Corporate Governance and Nominating Committee's minimum qualifications for a director are persons of high ethical character who have both personal and professional integrity, which is consistent with the image and values of the Company. The Corporate Governance and Nominating Committee considers some or all of the following criteria in considering candidates to serve as directors:

- commitment to ethical conduct and personal and professional integrity as evidenced through the person's business associations, diversity, service as a director or executive officer or other commitment to ethical conduct and personal and professional integrity as evidenced in organizations and/or education;
- objective perspective and mature judgment developed through business experiences and/or educational endeavors;
- the candidate's ability to work with other members of the Board of Directors and management to further our goals and increase shareholder value;
- the ability and commitment to devote sufficient time to carry out the duties and responsibilities as a director;
- demonstrated experience at policy making levels in various organizations and in areas that are relevant to our activities;
- the skills and experience of the potential nominee in relation to the capabilities already present on the Board of Directors; and
- such other attributes, including independence, relevant in constituting a board that also satisfies the requirements imposed by the SEC and The NASDAQ Stock Market.

The Corporate Governance and Nominating Committee does not have a separate policy for consideration of any director candidates recommended by shareholders. Instead, the Corporate Governance and Nominating Committee considers any candidate meeting the requirements for nomination by a shareholder set forth in the Company's Bylaws (as well as applicable laws and regulations) in the same manner as any other director candidate. The Corporate Governance and Nominating Committee believes that requiring shareholder recommendations for director candidates to comply with the requirements for nominations in accordance with the Company's Bylaws ensures that the Corporate Governance and Nominating Committee receives at least the minimum information necessary for it to begin an appropriate evaluation of any such director nominee.

The Corporate Governance and Nominating Committee will consider director nominees recommended by shareholders who adhere to the following procedure. The Company's Bylaws provide that any shareholder must give written notice to the President of the Company of an intention to nominate a director at a shareholder meeting. Notice of intention to make any nominations shall be made in writing

and shall be delivered or mailed to the President of the Company not less than 21 days, nor more than 60 days, prior to any meeting of shareholders called for the election of directors; provided, however, that if less than 21 days' notice is given to shareholders, such notice of intention to nominate shall be mailed or delivered to the President of the Company no later than the close of business on the tenth day following the day on which the notice of such meeting is sent by third class mail (if permitted by law), and no notice of intention to make nominations shall be required. The notification must contain the following information to the extent known to the notifying shareholder: (i) the name and address of each proposed nominee; (ii) the principal occupation of each proposed nominee; (iii) the number of shares of capital stock of the corporation owned by each proposed nominee; (iv) the name and residence address of the notifying shareholder; (v) the number of shares of capital stock of the corporation owned by the notifying shareholder; (vi) the number of shares of capital stock of any bank, bank holding company, savings and loan association or other depository institution owned beneficially by the nominee or by the notifying shareholder and the identities and locations of any such institutions; (vii) whether the proposed nominee has ever been convicted of or pleaded nolo contendere to any criminal offense involving dishonesty or breach of trust, filed a petition in bankruptcy or been adjudicated bankrupt; and (viii) a statement regarding the nominee's compliance with Section 2.3 of the Bylaws (see below).

Nominees for the Board of Directors must also meet certain qualifications set forth in Section 2.3 of our Bylaws, which prohibit the election as a director of any person who is a director, executive officer, branch manager or trustee for any unaffiliated commercial bank, savings bank, trust company, savings and loan association, building and loan association, industrial bank or credit union that is engaged in business in (i) any city, town or village in which the Company or any affiliate or subsidiary thereof has offices; or (ii) any city, town or village adjacent to a city, town or village in which the Company or any affiliate or subsidiary thereof has offices.

In connection with the Company's June 2010 private placement, Patriot Financial Partners, L.P. and Patriot Financial Partners Parallel, L.P. (collectively referred to herein as "Patriot") and Castle Creek Capital Partners IV, L.P. ("Castle Creek") obtained the right to representation on our Board of Directors (one for Patriot, collectively, and one for Castle Creek). Patriot and Castle Creek are each entitled to nominate one person to be elected or appointed to our Board (and the Board of Directors of Heritage Bank of Commerce) subject to receipt of applicable regulatory approvals, satisfaction of all legal and governance requirements regarding service as a director of the Company and Heritage Bank of Commerce and the reasonable approval of the Governance and Nominating Committee of our Board. So long as each of Patriot and Castle Creek (along with their affiliate funds) holds at least 4.9% of all outstanding shares of our common stock (counting for such purposes all shares of common stock into which shares of Series C Preferred Stock convertible or exercisable and excluding as shares owned and outstanding shares of common stock issued by the Company after June 2010), the Company will be required to recommend to its shareholders the election of Patriot's and Castle Creek's Board representative at the Company's Annual Meeting, subject to satisfaction of all legal and governance requirements regarding service as a director of the Company and to the reasonable approval of the Governance and Nominating Committee and the Board. Each of the Board representatives may serve on any of the Board committees, except the Audit Committee, so long as the Board representative qualifies to serve on such committees under applicable rules of The NASDAQ Stock Market, bank regulatory guidelines, and the Company's corporate governance guidelines. For so long as Castle Creek and Patriot are entitled to a Board representative but do not have a Board representative serving on the Board, these investors will be entitled to designate one Board observer subject to applicable legal requirements. The rights to a Board representative and Board observer privileges are personal to Patriot and Castle Creek, respectively, and such rights are not transferable. The Patriot Board representative is W. Kirk Wycoff and the Castle Creek Board representative is John M. Eggemeyer. The Corporate Governance and Nominating Committee has recommended the election of Mr. Wycoff and Mr. Eggemeyer as directors at the 2013 Annual Meeting.

Diversity of the Board of Directors

In considering diversity of the Board (in all aspects of that term) as a criteria for selecting nominees in accordance with its charter, the Corporate Governance and Nominating Committee takes into account various factors and perspectives, including differences of viewpoint, high quality business and professional experience, education, skills and other individual qualities and attributes that contribute to Board heterogeneity, as well as race, gender and national origin. The Committee does not assign specific weights to particular criteria and no particular criterion is necessarily applicable to all prospective nominees. The Committee seeks persons with leadership experience in a variety of contexts and industries. The Committee believes that this expansive conceptualization of diversity is the most effective means to implement Board diversity. The Corporate Governance and Nominating Committee will assess the effectiveness of this approach as part of its annual review of its charter.

Term of Office

Directors serve for a one-year term or until their successors are elected. The Board does not have term limits, instead preferring to rely upon the evaluation procedures described herein as the primary methods of ensuring that each director continues to act in a manner consistent with the best interests of the shareholders and the Company. The Board may delegate portions of its responsibilities to committees of its members. These standing committees of the Board meet at regular intervals to attend to their particular areas of responsibility. Our Board has five standing committees: Audit Committee, Corporate Governance and Nominating Committee, Compensation Committee, Finance and Investment Committee, and Strategic Issues Committee. In addition, Heritage Bank of Commerce maintains a Loan Committee. An independent director, as defined by the applicable rules and regulations of The NASDAQ Stock Market, chairs the Board and its other standing committees (including the bank's Loan Committee). The Chair determines the agenda, the frequency and the length of the meetings and receives input from Board members.

Executive Sessions

Independent directors meet in executive sessions throughout the year including meeting annually to consider and act upon the recommendation of the Compensation Committee regarding the compensation and performance of the Chief Executive Officer.

Evaluation of Board Performance

A Board assessment and director self-evaluations are conducted annually in accordance with an established evaluation process and includes performance of committees. The Corporate Governance and Nominating Committee oversees this process and reviews the assessment and self-evaluation with the full Board.

Management Performance and Compensation

The Compensation Committee reviews and approves the Chief Executive Officer's evaluation of the top management team on an annual basis. The Board (largely through the Compensation Committee) evaluates the compensation plans for senior management and other employees to ensure they are appropriate, competitive and properly reflect objectives and performance.

Director Stock Ownership Guidelines

The Board has adopted a policy that each member of the Board is expected to hold, at a minimum, 10,000 shares of the Company's common stock. Any director not meeting the minimum level as of the effective date of their election to the Board has three years to bring his or her holdings up to this minimum level.

Code of Ethics

The Board expects all directors, as well as officers and employees, to display the highest standard of ethics, consistent with the principles that have guided the Company over the years.

The Board has adopted an Executive and Principal Financial Officer's Code of Ethics that applies to the Chief Executive Officer, Chief Financial Officer and the senior financial officers of the Company to help ensure that the financial affairs of the Company are conducted honestly, ethically, accurately, objectively, consistent with generally accepted accounting principles and in compliance with all applicable governmental law, rules and regulations. We will disclose any amendment to, or a waiver from a provision of our Code of Ethics on our website. The Executive and Principal Financial Officer's Code of Ethics is available on our website at www.heritagecommercecorp.com.

Reporting of Complaints/Concerns Regarding Accounting or Auditing Matters

The Company's Board of Directors has adopted procedures for receiving and responding to complaints or concerns regarding accounting and auditing matters. These procedures were designed to provide a channel of communication for employees and others who have complaints or concerns regarding accounting or auditing matters involving the Company.

Employee concerns may be communicated in a confidential or anonymous manner to the Audit Committee of the Board. The Audit Committee Chairman will make a determination on the level of inquiry, investigation or disposal of the complaint. All complaints are discussed with the Company's senior management and monitored by the Audit Committee for handling, investigation and final disposition. The Chairman of the Audit Committee will report the status and disposition of all complaints to the Board of Directors.

INFORMATION ABOUT DIRECTORS AND EXECUTIVE OFFICERS

The Board of Directors

The Board of Directors oversees our business and monitors the performance of management. In accordance with corporate governance principles, the Board does not involve itself in day-to-day operations. The directors keep themselves informed through, among other things, discussions with the Chief Executive Officer, other key executives and our principal outside advisors (legal counsel, outside auditors, and other consultants), by reading reports and other materials that we send them and by participating in Board and committee meetings.

The Company's Bylaws currently permit the number of Board members to range from 9 to 15, leaving the Board authority to fix the exact number of directors within that range. The Board has currently fixed the number of directors at 12.

Board Leadership Structure

The Board of Directors is committed to maintaining an independent Board, and a majority of the Board has been comprised of independent directors. It has further for many years been the practice of the Company to separate the roles of Chief Executive Officer and Chairman of the Board in recognition of the differences between the two roles. The Chief Executive Officer is responsible for setting the strategic direction for the Company and the day-to-day leadership and performance of the Company. The Chairman of the Board provides guidance to the Chief Executive Officer, sets the agenda for Board meetings, presides over meetings of the full Board (including executive sessions), and facilitates communication among the independent directors and between the independent directors and the Chief Executive Officer. The Board further believes that the separation of the duties of the Chief Executive Officer and the Chairman of the Board eliminates any inherent conflict of interest that may arise when the roles are combined, and that an independent director who has not served as an executive of the Company can best provide the necessary leadership and objectivity required as Chairman of the Board.

Board Authority for Risk Oversight

The Board has ultimate authority and responsibility for overseeing risk management of the Company. The Board monitors, reviews and reacts to material enterprise risks identified by management. The Board receives specific oral and written reports from officers with oversight responsibility for particular risks within the Company. Reports cover executive management on financial, credit, liquidity, interest rate, capital, operational, legal and regulatory compliance and reputation risks and the Company's degree of exposure to those risks. The Board helps ensure that management is properly focused on risk by, among other things, reviewing and discussing the performance of senior management and business line leaders.

Board committees also have responsibility for risk oversight in specific areas. The Audit Committee oversees financial, accounting and internal control risk management policies. The Company's internal Risk Management Steering Committee reports directly to the Audit Committee. The Risk Management Steering Committee is responsible for monitoring the Company's overall risk program. The Audit Committee receives quarterly reports from the Risk Management Steering Committee and the Company's internal audit department. The Audit Committee reports periodically to the Board on the effectiveness of risk management processes in place, risk trends, and the overall risk assessment of the Company's activities. The Compensation Committee assesses and monitors risks in the Company's compensation program. The Corporate Governance and Nominating Committee recommends director candidates with appropriate experience and skills who will set the proper tone for the Company's risk profile and provide competent oversight over our material risks.

The Committees of the Board

The Board may delegate portions of its responsibilities to committees of its members. These standing committees of the Board meet at regular intervals to attend to their particular areas of responsibility. Our Board has five standing committees: the Audit Committee, Corporate Governance and Nominating Committee, Compensation Committee, Finance and Investment Committee, and Strategic Issues Committee. Heritage Bank of Commerce also maintains a Loan Committee.

Audit Committee. The Company has a separately designated standing Audit Committee established in accordance with Section 3(a)(58)(A) of the Securities Exchange Act of 1934, as amended. The Audit Committee charter adopted by the Board sets out the responsibilities, authority and specific duties of the Audit Committee. The Audit Committee charter is available on the Company's website at www.heritagecommercecorp.com.

The responsibilities of the Audit Committee include the following:

- oversight of our financial, accounting and reporting process, our system of internal accounting and financial controls, and our compliance with related legal and regulatory requirements;
- the appointment, compensation, retention and oversight of our independent auditors, including conducting a review of their independence, reviewing and approving the planned scope of our annual audit, overseeing the independent auditors' work, and reviewing and pre-approving any audit and non-audit services that may be performed by them;
- review with management and our independent auditors the effectiveness of our internal controls over financial reporting;
- approve the scope and engagement of external audit services and review significant accounting policies and adjustments recommended by the independent auditors and address any significant, unresolved disagreements between the independent auditors and management;
- review and discuss the annual audited financial statements with management and the independent auditors prior to publishing the annual report and filing the Annual Report on Form 10-K with the SEC;
- review and discuss with management and the independent auditors any significant changes, significant deficiencies and material weaknesses regarding internal controls over financial reporting required by the Sarbanes-Oxley Act of 2002, and oversee the corrective action taken to mitigate any significant deficiencies and material weaknesses identified;
- review with management and the independent auditors the effect of significant regulatory and accounting initiatives, changes, and pronouncements as well as significant and unique transactions and financial relationships;
- review with the independent auditors the matters required to be discussed by Statement on Auditing Standards No. 61, and receive and discuss with the independent auditors disclosures regarding the auditors' independence;
- oversee the internal audit function and the audits directed under its auspices;
- establish policies to ensure all non-audit services provided by the independent auditors are approved prior to work being performed; and
- oversee and report to the full Board on the effectiveness of the Company's risk management processes and overall risk assessment of the Company's activities.

Each member of the Audit Committee meets the independence criteria as defined by applicable rules and regulations of the SEC for audit committee membership and is independent and is "financially

sophisticated” as defined by the applicable rules and regulations of The NASDAQ Stock Market. The members of the Audit Committee are Celeste V. Ford, Steven L. Hallgrimson, Humphrey P. Polanen (Committee Chair) and Laura Roden. The Audit Committee met 10 times during 2012.

During 2012, the Board of Directors determined that Mr. Steven L. Hallgrimson has: (i) an understanding of generally accepted accounting principles and financial statements; (ii) an ability to assess the general application of such principles in connection with the accounting for estimates, accruals and reserves; (iii) an experience preparing, auditing, analyzing or evaluating financial statements that present a breadth and level of complexity of accounting issues that are generally comparable to the breadth and complexity of issues that can reasonably be expected to be raised by our financial statements, or experience actively supervising one or more persons engaged in such activities; (iv) an understanding of internal control over financial reporting; and (v) an understanding of audit committee functions.

Therefore, in 2012 the Board determined that Mr. Hallgrimson meets the definition of “audit committee financial expert” under the applicable rules and regulations of the SEC and is “financially sophisticated” as defined by the applicable rules and regulations of The NASDAQ Stock Market. The designation of a person as an audit committee financial expert does not result in the person being deemed an expert for any purpose, including under Section 11 of the Securities Act of 1933. The designation does not impose on the person any duties, obligations or liability greater than those imposed on any other audit committee member or any other director and does not affect the duties, obligations or liability of any other member of the Audit Committee or Board of Directors.

The Audit Committee Report for 2012 appears on page 63 of this proxy statement.

Compensation Committee. The Company has a separately designated Compensation Committee, which consists entirely of independent directors as defined by the applicable rules and regulations of The NASDAQ Stock Market. The Compensation Committee has adopted a charter, which is available on the Company’s website at www.heritagecommercecorp.com. The Compensation Committee has the following responsibilities:

- review and approve our compensation philosophy;
- review industry compensation practices and our relative compensation positioning;
- approve compensation paid to our Chief Executive Officer and other executive officers;
- review and approve the Compensation Discussion and Analysis appearing in our proxy statement;
- review director compensation programs, plans and awards;
- administer our short-term and long-term executive incentive plans and stock or stock-based plans;
- review and approve general employee welfare benefit plans and other plans on an as needed basis;
- and
- retain advisors in its sole discretion to assist the Compensation Committee in the performance of its directors.

The members of the Compensation Committee are Frank G. Bisceglia, Celeste V. Ford, Robert T. Moles (Committee Chair), Ranson W. Webster and W. Kirk Wycoff. The Committee met 7 times in 2012.

Corporate Governance and Nominating Committee. The Company has a separately designated Corporate Governance and Nominating Committee, which consists of entirely independent directors as defined by the applicable rules and regulations of The NASDAQ Stock Market. The Corporate Governance and Nominating Committee has adopted a charter, which is available on the Company’s website at www.heritagecommercecorp.com.

The purposes of the Corporate Governance and Nominating Committee include the following responsibilities:

- identifying individuals qualified to become Board members and making recommendations to the full Board of candidates for election to the Board;
- recommending to the Board corporate governance guidelines;
- leading the Board in an annual review of its performance; and
- recommending director appointments to Board committees.

The members of the Corporate Governance and Nominating Committee are Robert T. Moles, Humphrey P. Polanen, Charles J. Toeniskoetter, and Ranson W. Webster (Committee Chair). The Committee met 4 times in 2012.

Finance and Investment Committee. The Finance and Investment Committee is responsible for the development of policies and procedures related to liquidity and asset-liability management, supervision of the Company’s investments and preparation of the Company’s annual budget. The members of the Finance and Investment Committee are Frank G. Bisceglia, Jack W. Conner (Committee Chair), John M. Eggemeyer, Walter T. Kaczmarek, Laura Roden, and W. Kirk Wycoff. The Finance and Investment Committee met 9 times during 2012.

Strategic Issues Committee. The principal duties of the Strategic Issues Committee are to provide oversight and guidance to senior management regarding the strategic direction of the Company, including development of an overall strategic business plan. The members of the Strategic Issues Committee are Jack W. Conner, John M. Eggemeyer, Walter T. Kaczmarek, Charles J. Toeniskoetter (Committee Chair), and Ranson W. Webster. The Strategic Issues Committee met 4 times during 2012.

Heritage Bank of Commerce Loan Committee. The Heritage Bank of Commerce Loan Committee is responsible for the approval and supervision of loans and the development of the Company’s loan policies and procedures. The members of the Loan Committee are Frank G. Bisceglia (Committee Chair), Steven L. Hallgrimson, Walter T. Kaczmarek, Robert T. Moles, and Charles J. Toeniskoetter. The Loan Committee met 35 times during 2012.

Executive Officers of the Company

Set forth below is certain information with respect to the executive officers of the Company:

<u>Name</u>	<u>Position</u>
Michael E. Benito	Executive Vice President/Banking Division
Walter T. Kaczmarek	President and Chief Executive Officer
Dan T. Kawamoto	Executive Vice President and Chief Administrative Officer
Lawrence D. McGovern	Executive Vice President and Chief Financial Officer
David E. Porter	Executive Vice President and Chief Credit Officer

Michael E. Benito, age 52, was promoted to Executive Vice President/Banking Division in January 2012. Mr. Benito joined Heritage Bank of Commerce in 2003 as Senior Vice President/Director of Sales & Business Development. From 1998 through 2003, Mr. Benito served as a Managing Director for Greater Bay Bank and from December 1986 through 1998, he served as Regional Vice President with Imperial Bancorp. Mr. Benito began his banking career more than 27 years ago at Union Bank.

Biographical information for Walter T. Kaczmarek is found under “Proposal 1—Election of Directors.”

Dan T. Kawamoto, age 62, has served as Executive Vice President and Chief Administrative Officer of the Company since July, 2009. He was the Executive Vice President and Chief Financial Officer of 1st Century Bancshares, Inc. from February, 2007 to July, 2009. Prior thereto, he served at Comerica Bank—Western Market as its Executive Vice President—Personal Financial Services from 1997 to 2007, and as its Chief Financial Officer from 1991 to 2003. Mr. Kawamoto was an audit partner for six years with Ernst & Young LLP prior to joining Comerica Bank in 1991.

Lawrence D. McGovern, age 58, has served as Executive Vice President and Chief Financial Officer of the Company since July, 1998.

David E. Porter, age 63, joined the Company as Executive Vice President and Chief Credit Officer in June 2012. Prior to joining the Company, Mr. Porter was with Pacific Capital Bancorp from August 2003 through May 2012, where his last position was Executive Vice President/ Regional Credit Manager (following the company's recapitalization in August 2010), after serving four years as Chief Credit Officer. Prior to joining Pacific Capital Bancorp, Mr. Porter had over 30 years of prior banking experience holding positions of increasing responsibility primarily with community banks.

Compliance with Section 16(a) of the Securities Exchange Act of 1934

Section 16(a) of the Securities Exchange Act of 1934, as amended, requires the Company's directors, executive officers and persons who own more than ten percent of a registered class of the Company's equity securities, to file with the SEC initial reports of ownership and reports of changes in ownership of common stock and other equity securities. They are required by SEC rules and regulations to furnish the Company with copies of all Section 16(a) forms they file.

To the Company's knowledge, based solely on review of the copies of such reports furnished to the Company and written representations that no other reports were required, all Section 16(a) filing requirements applicable to our executive officers and directors were complied with during the year ended December 31, 2012.

Transactions with Management

Some of the Company's directors and executive officers, as well as other related persons (as defined under "Policies and Procedures for Approving Related Party Transactions" below), are customers of, and have banking transactions with, the Company's subsidiary, Heritage Bank of Commerce, in the ordinary course of business, and Heritage Bank of Commerce expects to have such ordinary banking transactions with these persons in the future. In the opinion of the management of the Company and Heritage Bank of Commerce, all loans and commitments to lend included in such transactions were made in the ordinary course of business, on substantially the same terms, including interest rates and collateral, as those prevailing for comparable transactions with other persons of similar creditworthiness, and do not involve more than the normal risk of collectability or present other unfavorable features. Loans to individual directors, officers and related persons must comply with Heritage Bank of Commerce's lending policies and statutory lending limits. In addition, prior approval of Heritage Bank of Commerce's Board of Directors is required for all loans advanced to directors and executive officers. These loans are exempt from the loan prohibitions of the Sarbanes-Oxley Act.

Policies and Procedures for Approving Related Party Transactions

The Board of Directors has adopted a written Statement of Policy with Respect to Related Party Transactions. Under this policy, any "related party transaction" may be consummated or may continue only if the Audit Committee approves or ratifies the transaction in accordance with the guidelines in the policy and if the transaction is on terms comparable to those that could be obtained in arm's length dealings with an unrelated third party. For purposes of this policy, a "related person" means: (i) any person who is, or at any time since the beginning of the Company's last fiscal year was, a director or executive

officer of the Company or a nominee to become a director of the Company; (ii) any person who is known to be the beneficial owner of more than 5% of any class of the Company's voting securities; (iii) any immediate family member of any of the foregoing persons, which means any child, stepchild, parent, stepparent, spouse, sibling, mother-in-law, father-in-law, son-in-law, daughter-in-law, brother-in-law, or sister-in-law of the director, executive officer, nominee or more than 5% beneficial owner, and any person (other than a tenant or employee) sharing the household of such director, executive officer, nominee or more than 5% beneficial owner; and (iv) any firm, corporation or other entity in which any of the foregoing persons is employed or is a partner, principal or in a similar position, or in which such person has a 10% or greater beneficial ownership interest.

A "related party transaction" is a transaction between the Company and any related person (including any transaction requiring disclosure under Item 404 of Regulation S-K under the Securities Exchange Act of 1934).

The Board of Directors has determined that the Audit Committee is best suited to review and approve related party transactions. The Committee considers all of the relevant facts and circumstances available to the Committee, including (if applicable) but not limited to: the benefits to the Company; the impact on a director's independence in the event the related person is a director, an immediate family member of a director or an entity in which a director is a partner, shareholder or executive officer; the availability of other sources for comparable products or services; the terms of the transaction; and the terms available to unrelated third parties or to employees generally. No member of the Audit Committee may participate in any review, consideration or approval of any related person transaction with respect to which such member or any of his or her immediate family members is the related person. The Committee will approve only those related person transactions that are in, or are not inconsistent with, the best interests of the Company and its shareholders, as the Committee determines in good faith. The Audit Committee conveys its decision to the Chief Executive Officer, who conveys the decision to the appropriate persons within the Company.

Compensation Discussion and Analysis

The Compensation Committee of the Board of Directors has responsibility for establishing, implementing and continually monitoring the compensation structure, policies and programs of the Company. The Compensation Committee is responsible for assessing and approving the total compensation structure paid to the Chief Executive Officer and the other executive officers. Thus, the Compensation Committee is responsible for determining whether the compensation paid to each of these executive officers is fair, reasonable and competitive, and whether it serves the interests of the Company's shareholders.

The individuals who served as the Company's Chief Executive Officer and Chief Financial Officer during 2012, as well as, the other individuals included in the Summary Compensation Table, are referred to as the "named executive officers." This Compensation Discussion and Analysis identifies the Company's current compensation philosophy and objectives and describes the various methodologies, policies and practices for establishing and administering the compensation programs for our executives including the named executive officers.

The Company and the Compensation Committee believe our compensation philosophy, policies and objectives outlined within this Compensation Discussion and Analysis are appropriately designed to allow us to effectively compensate our employees both during times of positive performance and in times of weak performance.

Implications of Participation in the Troubled Asset Relief Program Capital Purchase Program on Executive Compensation Arrangements.

In November, 2008, we sold \$40 million of our Series A Preferred Stock and a warrant to purchase common stock to the U.S. Department of the Treasury (“U.S. Treasury”) under the Troubled Asset Relief Program (“TARP”) Capital Purchase Program. We completed the repurchase all of our Series A Preferred Stock on March 7, 2012.

Until we completed the repurchase all of our Series A Preferred Stock, we were subject to certain restrictions (for the period between January 1, 2012, and March 7, 2012) on and requirements regarding executive compensation set forth in Section 111 of the Emergency Economic Stabilization Act of 2008 (“EESA”), the American Recovery and Reinvestment Act of 2009 (the “ARRA”), Treasury’s Interim Final Rule on TARP Standards for Compensation and Corporate Governance, and the Securities Purchase Agreement that we entered into with Treasury in November, 2008. These standards generally applied to our senior executive officers (“SEOs”). For these purposes our SEOs are the same individuals who are our named executive officers and included the following:

- *Bonuses and Incentive Compensation.* Prohibition of the payment of any bonus, retention award, or incentive compensation to the five most highly compensated employees.
- *Stock Options.* Prohibition on stock option grants to the five most highly compensated employees.
- *Incentive Compensation Paid in Stock.* A prohibition on incentive compensation paid in stock to the five highly compensated employees except for “long-term” restricted stock, but only to the extent the value of the stock does not exceed one-third of the total amount of annual compensation of the employee receiving the stock.
- *Golden Parachutes.* Prohibition on making any severance/golden parachute payments (defined as any payment without regard to the amount of such payment) to any SEO or any of the next five most highly compensated employees upon termination of employment for any reason (except death or disability) or any payment due to a change in control.
- *Clawback.* Recovery of any bonus or other incentive payments paid to any SEO or the next 20 most highly compensated employees that were made based on financial statements or other criteria that are later found to be materially inaccurate.
- *Tax Gross-Ups.* Prohibition on the payment of any “gross-up” to any SEO or the next twenty most highly compensated employees.
- *SEO Compensation Plans that Encourage Unnecessary Risk-Taking.* Prohibition on executive compensation plans that encourage SEOs to take unnecessary and excessive risks that threaten the Company’s value.
- *Perquisites.* Annual disclosure to the U.S. Treasury and Federal Reserve Board of any perquisites whose total value exceeds \$25,000 for the fiscal year paid to any of the five highest compensated employees.
- *Earnings Manipulation.* Prohibition on compensation plans that encourage earnings manipulation.
- *Limit on Tax Deduction.* Limitation on our tax deduction for compensation paid to any SEO to \$500,000 annually.
- *Certifications of CEO and CFO.* A requirement that the Company’s Chief Executive Officer and Chief Financial Officer provide a written certification of compliance with the executive compensation restrictions in ARRA in the Company’s annual report on Form 10-K filed with the SEC.

- *Excessive Expenditures.* Implementation of a company-wide policy regarding excessive or luxury expenditures.

Consideration of Say-On-Pay Vote Results

At our 2012 Annual Shareholders Meeting, pursuant to the requirements of the Dodd-Frank Act we held a non-binding shareholder advisory vote on executive compensation (“say-on-pay”). We had also held similar say-on-pay advisory votes each prior year we were subject to the TARP requirements. At the 2012 Annual Meeting our shareholders approved our 2012 executive compensation (as they had in each prior year where we had a say-on-pay vote), with approximately 82% of voting shareholders casting their vote in favor of the say-on-pay resolution. The Compensation Committee has been mindful of the strong support our shareholders expressed for our compensation program when making executive compensation decisions, including base salary adjustments and long-term incentive awards. In making these executive compensation decisions, which are discussed more fully below, the Compensation Committee’s main considerations included our shareholders’ support for our 2011 (and prior years’) executive compensation program, and the peer and market information provided by the Compensation Committee’s compensation consultant. The Compensation Committee will continue to consider our shareholders’ views when making executive compensation decisions in the future. Also at our 2012 Annual Shareholders Meeting the shareholders approved a non-binding shareholder advisory proposal to hold say-on-pay proposals every 3 years. The Company’s Board of Directors agreed that holding say-on-pay proposals every 3 years was in the best interest of shareholders. Three years provides shareholders with sufficient time to evaluate the effectiveness of our overall compensation philosophy, policies and practices in the context of our long-term business results for the corresponding period, while avoiding over emphasis on short term variations in compensation and business results.

Overview of Compensation Philosophy

The Compensation Committee believes executive compensation packages provided by the Company to its executives, including the named executive officers, should include base salary, variable performance based cash awards and stock based compensation in order to achieve three primary goals.

The Compensation Committee believes that the first goal of our compensation program is that a reasonable percentage of executive compensation program should be linked to the financial performance of the Company. The Compensation Committee believes that a properly structured compensation program will focus on performance to motivate and support individuals to achieve specific short-term and long-term objectives while taking into consideration potential risk implications. We achieve this goal by providing our named executive officers the opportunity to significantly increase their annual cash compensation through our variable performance based cash awards incentive program by improving the Company’s performance in specified financial metrics on an annual basis. We also expect that as those improvements are maintained and built upon, the Company’s stock price will reflect these improvements.

The second goal of our compensation program is to align the interests of our executive officers with the interests of our shareholders. We use stock awards (stock options and/or restricted stock) to reward the long-term efforts of management and to retain management. These equity awards serve to increase the ownership stake of our management in the Company, further aligning the interests of the executives with those of our shareholders.

The third goal of our compensation program is to attract and retain highly competent executives. Our executives, and particularly our named executive officers, are talented managers and they are often presented with opportunities at other institutions, including opportunities at potentially higher compensation levels. We seek to attract and retain our executives by setting base compensation and incentives at competitive levels and awarding stock-based awards. We also consider other forms of executive pay, including our supplemental executive retirement plan and severance arrangements

(including change of control provisions) as a means to attract and retain our executive officers including the named executive officers.

We believe we should balance each of these goals. The Compensation Committee reviews our Compensation Peer Group (as described below) and other comparative survey data as provided and analyzed by an independent consultant to determine an appropriate mix of each element of compensation. We use our Compensation Peer Group and other comparative survey data to assess appropriate compensation levels as discussed in more detail later in this report.

Compensation Program Objectives and Rewards

The components of Company's compensation and benefits programs are driven by our business environment and are designed to enable us to achieve the goals of our compensation program within a framework that adheres to the Company's mission and values. The programs' objectives are to:

- Reflect our position as a leading community bank in our service areas;
- Attract, engage and retain the workforce that helps ensure our future success;
- Motivate and inspire employee behavior that fosters a high performance culture;
- Support a one company culture;
- Support overall business objectives;
- Provide shareholders with a superior rate of return over the long term; and
- Create shareholder value through the continuous provision of quality service to our customers.

Consequently, the guiding principles of our programs are to:

- Promote and maintain a high performance banking organization;
- Remain competitive in our marketplace for talent; and
- Balance our compensation costs with our desire to provide value to employees and shareholders.

To this end, we will measure success of our programs by:

- Overall business performance and employee engagement;
- Ability to attract and retain key talent;
- Costs and business risks that are limited to levels that optimize risk and return; and
- Employee understanding and perceptions that ensure program value equals or exceeds program cost.

All of our compensation and benefits for our named executive officers described below have as a primary purpose our need to attract, retain and motivate the highly talented individuals who will engage in the behaviors necessary to enable us to succeed in creating shareholder value in a highly competitive marketplace. Beyond that, different elements have specific purposes designed to reward different behaviors.

- *Base salary and benefits* are designed to:
 - Reward core competence in the executive role relative to skills, position and contributions to the Company; and
 - Provide fixed cash compensation with merit increases competitive with the market place.

- *Annual incentive variable cash awards* are designed to:
 - Focus employees on annual financial objectives derived from the business plan that lead to long-term success;
 - Provide annual variable performance based cash awards to reward and motivate achievement of critical annual performance metrics selected by the Compensation Committee; and
 - Foster a pay for performance culture that aligns our compensation programs with our overall business strategy.
- *Equity based compensation awards* are designed to:
 - Link compensation rewards to the creation of shareholder wealth;
 - Promote teamwork by tying compensation significantly to the value of our common stock;
 - Attract the next generation of management by providing significant capital accumulation opportunities; and
 - Retain executives by providing a long-term-oriented program whose value could only be achieved by remaining with and performing for the Company.
- *A supplemental executive retirement plan* facilitates our ability to attract and retain executives as we compete for talented employees in a marketplace where these plans are commonly offered.
- *Change of control and separation benefits* with certain officers:
 - Individual employment contracts with certain executives provide for change of control and separation benefits;
 - Separation benefits provide benefits to ease an employee's transition due to an unexpected employment termination by the Company due to ongoing changes in the Company's employment needs; and
 - Change in control benefits encourage key executives to remain focused on the Company's business in the event of rumored or actual fundamental corporate changes which will enhance shareholder value.

The use of these compensation programs and benefits enables us to reinforce our pay-for-performance philosophy, align our executives' interests with shareholders, and strengthen our ability to attract, retain and motivate highly qualified executives. We believe that this combination of programs provides an appropriate mix of fixed and variable pay, balances short-term operational performance with long-term shareholder value, and encourages executive recruitment and retention.

The use of the identified elements of compensation was restricted by the executive compensation rules for TARP recipients.

Total direct compensation is generally targeted at the 75th percentile of our Compensation Peer Group. We target above the median because of the competition in our market for talented executives and our desire to attract and, more importantly, retain and motivate talented individuals we believe are necessary to achieve the goals and objectives of our Board of Directors.

Role of Compensation Committee in Determining Compensation

The Compensation Committee of the Board of Directors has strategic and oversight responsibility for the overall compensation and benefits programs for executives of the Company. These responsibilities include establishing, implementing, and continually monitoring the compensation structure, policies, and programs of the Company, including an assessment of the risk profile of each compensation policy and

practice. The Compensation Committee is responsible for assessing and approving the total compensation paid to the Chief Executive Officer and all executive officers. The Compensation Committee is responsible for determining whether the compensation paid to each of these executives is fair, reasonable and competitive, and whether the compensation program serves the interests of the Company's shareholders. The Compensation Committee is comprised of four independent directors who satisfy The NASDAQ Stock Market listing requirements and relevant Internal Revenue Service and SEC regulations on independence. The Compensation Committee's Chair regularly reports to the Board of Directors on the Compensation Committee actions and recommendations. To evaluate and administer the compensation practices of the Chief Executive Officer and other executive officers, the Compensation Committee meets a minimum of 4 times a year. The Compensation Committee also holds special meetings and meets telephonically to discuss extraordinary items, such as the hiring or dismissal of executive officers. For fiscal year 2012, the Compensation Committee met a total of 7 times (includes regularly scheduled Compensation Committee meetings, special meetings and telephonic meetings).

When making individual compensation decisions for executive officers, the Compensation Committee takes many factors into account, including the executive's experience, responsibilities, management abilities and job performance, overall performance of the Company, current market conditions and competitive pay for similar positions at comparable companies. In addition, the Compensation Committee reviews the relationship of various positions between departments, the affordability of desired pay levels and the importance of each position within the Company. These factors are considered by the Compensation Committee in a subjective manner without any specific formula or weighting.

The Compensation Committee relies significantly on the input and recommendations of our Chief Executive Officer when evaluating these factors relative to the compensation of executive officers, excluding his own compensation, which is set according to the terms of his employment agreement and annual review by the Board of Directors. Because the Chief Executive Officer works closely with and supervises our executive team, the Compensation Committee believes that the Chief Executive Officer provides valuable insight in evaluating their performance. Our Chief Executive Officer provides the Compensation Committee with his assessment of the performance of each named executive officer and his perspective on the factors described above in developing his recommendations for the executive's compensation, including salary adjustments, incentive bonuses, annual equity grants and equity grants awarded in conjunction with promotions. The Chief Executive Officer also provides the Compensation Committee with additional information regarding the effect, if any, of market competition and changes in business strategy or priorities. The Compensation Committee discusses our Chief Executive Officer's recommendations and then approves or modifies the recommendations in collaboration with the Chief Executive Officer.

Role of Compensation Consultants

Generally, at least every two years the Compensation Committee retains the services of an executive compensation consultant to assess the competitiveness of our compensation programs, conduct other research as directed by the Compensation Committee, and support the Compensation Committee in the design and implementation of executive and Board of Director compensation. In the first quarter of 2011, the Compensation Committee retained Carl D. Jacobs Group LLC ("Jacobs Group") to assist the Compensation Committee and management in the review and assessment of multiple aspects of our compensation programs, including: (i) equity compensation practices, and short-term and long-term incentive design; (ii) total compensation analysis for the Chief Executive officer; and (iii) total compensation analysis for other named executive officers. Jacobs Group did not perform any other services for the Company and there are no known conflicts of interest between the Jacobs Group and its affiliates and the Company and its affiliates. The Jacobs Group reported directly to the Compensation Committee and did not provide services to, or on behalf of, any other part of the Company's business. In June, 2011 the Jacobs Group provided its independent analysis of the Company's executive compensation

policies and practices and provided analyses on the pay practices of the Compensation Peer Group and other comparable market data (“2011 Report”).

Market Positioning and Pay Benchmarking

The Compensation Committee generally aims to position compensation relative to market for the Chief Executive Officer and the other named executive officers at the 60th percentile for base salary, 70th percentile for total cash compensation and 75th percentile for total direct compensation. The actual positioning of each executive officer’s compensation is dependent on considerations of the executive’s performance, the performance of the Company and the individual business or corporate function for which the executive is responsible, the nature and importance of the position and role within the Company, the scope of the executive’s responsibility (including risk management and corporate strategic initiatives), and the individual’s success in promoting our core values and demonstrating leadership.

In the first quarter of 2011, the Compensation Committee undertook a review of the Company’s compensation programs for executive officers, other elected officers, selected staff and the Board of Directors. The Jacobs Group, in consultation with the Compensation Committee, selected a peer group of financial institutions to establish a Compensation Peer Group for the 2011 report. The companies included in the Compensation Peer Group were selected from publicly traded banks in California and several from neighboring states based on: (i) compatibility of the Company based on size as measured through total assets between one and four billion dollars; (ii) similarity of their product lines and business focus; (iii) participation and non-participation in the U.S. Treasury Capital Purchase Program; and (iv) the competitive market for executive talent. In addition to the Compensation Peer Group, the Jacobs Group also assembled, reviewed and compiled data from five recognized published compensation surveys. Published surveys included California banks located in our service areas as well as local area data drawn from national surveys. The Comparative Peer Group and the comparative survey data were used to benchmark executive compensation levels against banks that have executive positions with responsibilities similar in breadth and scope to ours and that compete with us for executive talent. The 2011 Report provided data relative to market for median, 65th percentile and 75th percentile of compensation. With such information and recognition that the proxy data reflected compensation levels for 2010, the Compensation Committee reviewed and analyzed compensation for the Chief Executive Officer and the other named executive officers.

The Compensation Peer Group component companies used in the evaluation of the Company’s compensation programs in the 2011 Report for executive officers and the Board of Directors were as follows:

Bank of Marin Bancorp	PacWest Bancorp
Bridge Capital Holdings	Preferred Bank
Center Financial Corporation	Premier West Bancorp
Farmers & Merchants Bancorp	Provident Financial Holdings
First California Financial Group	Sierra Bancorp
Heritage Oaks Bancorp	TriCo Bancshares
Nara Bancorp	WestAmerica Bancorp
North Valley Bancorp	West Coast Bancorp
Pacific Mercantile Bancorp	Wilshire Bancorp

Chief Executive Officer Compensation

The Compensation Committee meets with the other independent directors each year in an executive session without management present to evaluate the performance of the Chief Executive Officer. The Compensation Committee also confers with the Chief Executive Officer when setting his base salary. The Compensation Committee typically considers corporate financial performance, the Company’s

achievement of its short and long-term goals versus its strategic objectives and financial targets. Emphasis was also placed on performance factors of the Company's business units, along with the results of the independent consultant's analysis of the pay practices of the 2011 Compensation Peer Group, and personal performance goals established by the Compensation Committee. Based on the 2011 Report, the Compensation Committee determined that the Chief Executive Officer's base salary was below the target 65th percentile and his total compensation fell below target 75th percentile.

The Compensation Committee accepted the Chief Executive Officer's recommendation in 2010 and 2011, that his salary should not be increased in response to the current economic conditions adversely affecting the financial services industry, and the financial challenges facing the Company at that time. Consequently, the Chief Executive Officer's base salary remained at \$333,700 until October 2011. However, in October 2011, the Compensation Committee approved a salary increase for the Chief Executive Officer's base salary of 8.0% to \$360,400 in recognition of his efforts that contributed to the termination of the Company's regulatory written agreement with its regulators in June 2011, which remained his salary for 2012.

Base Salary Decisions for the Other Named Executive Officers

In accordance with our compensation objectives, salaries are set and administered to reflect the value of the position in the marketplace, the career experience of the individual, and the contribution and performance of the individual. Base salary is generally targeted at close to the 60th percentile of our Compensation Peer Group.

Although each of the named executive officers has an employment agreement with the Company, the initial base salary in each of the agreements may be increased (and has been in the past) in accordance with the Chief Executive Officer's evaluation of the executive's performance and the Compensation Committee's evaluation of the Company's overall compensation programs and policies.

For 2012, the Compensation Committee considered the pay practices of the Compensation Peer Group and the analyses and recommendations provided by its independent consultant in the 2011 Report. In evaluation of the base salaries in 2012 for the named executive officers, the Compensation Committee also considered the minimum, mid-range and maximum salaries paid to similarly situated positions at companies in the Compensation Peer Group as well as the performance levels of the named executive officers.

In response to the economic conditions adversely affecting the financial services industry and the financial challenges facing the Company in 2011, the Chief Executive Officer had recommended that as of March 2011 his base salary and the salaries of the other named executive officers for 2011 should not be increased. The Compensation Committee accepted the recommendation at that time and did not increase the salaries for the Chief Executive Officer or the other named executive officers. In October 2011, the Compensation Committee approved salary increases for the Chief Executive Officer and each of the other named executive officers. The Compensation Committee took this action in recognition of the efforts that the Chief Executive Officer and each of the other named executive officers contributed to the termination of the Company's regulatory written agreement with its regulators in June 2011. Salaries were increased as follows:

<u>Name</u>	<u>Prior Salary</u>	<u>New Salary</u>	<u>Percentage Increase</u>
Walter T. Kaczmarek	\$333,700	\$360,400	8.0%
Lawrence D. McGovern	\$232,000	\$242,400	4.5%
Dan T. Kawamoto	\$240,000	\$247,200	3.0%

In view of the increases in the base salaries of Walter T. Kaczmarek, Lawrence D. McGovern and Dan T. Kawamoto in October, 2011, no further increases were made in 2012.

In January 2012, the Compensation Committee approved an employment agreement for Michael E. Benito when he was promoted to Executive Vice President/Banking Division. Under the agreement Mr. Benito receives a salary of \$230,000. In June 2012, the Compensation Committee approved an employment agreement for David E. Porter when he joined the Company as its Chief Credit Officer. Under the agreement Mr. Porter receives a salary of \$250,000. The terms of both agreements are similar to the terms of the other named executive officers of the Company, and the Compensation Committee considered the salary levels to also be similar to the levels paid by the Company to the most immediate predecessors to those positions.

Base salary drives the formula used in the Management Incentive Plan as discussed below under “Management Incentive Plan.” Base salary is the only element of compensation that is used in determining the amount of contributions permitted under the Company’s 401(k) plan.

Management Incentive Plan

We believe that a portion of the annual incentive compensation for named executive officers should be based on performance against pre-defined financial metrics and performance objectives. The Company’s Management Incentive Plan (“Incentive Plan”) plays a key role in fulfilling the objective. In 2012, each of our named executive officers was eligible to receive a bonus under the Incentive Plan. Annual performance bonuses are designed to focus participants on, and reward them for, the achievement of specific annual financial, strategic and/or operational objectives of the Company.

The incentive levels (as a percent of salary) are designed to provide for the achievement of threshold and target performance objectives. The financial metrics, performance objectives, and the formula for computing the performance bonus are established by the Compensation Committee early in each fiscal year.

The award opportunities under the Incentive Plan were derived in part from our Compensation Peer Group and other comparative data provided by our independent consultant, and in part by the Compensation Committee’s judgment on internal equity of the positions, their relative value to the Company and the desire to maintain a consistent annual incentive target for the Chief Executive Officer and the other named executive officers.

The payouts for executives under the Incentive Plan are targeted to provide aggregate cash compensation together with base salary at the 70th percentile of our Compensation Peer Group when we reach our target annual financial performance (“Target”). Smaller payouts can be awarded if we reach 90% to 95% of our target annual financial performance (“Threshold”).

The incentive levels assigned as a percentage of base salary for 2012 were as follows:

<u>Named Executive</u>	<u>As a percent of base salary</u>	
	<u>Threshold</u>	<u>Target</u>
Walter T. Kaczmarek	15%	33%
Lawrence D. McGovern	15%	33%
Michael E. Benito	15%	33%
Dan T. Kawamoto	15%	33%
David E. Porter	15%	33%

Management recommends, and the Compensation Committee reviews and approves, the financial metrics for each plan year that must be met in order for awards to be paid. These financial metrics are weighted and are intended to motivate and reward eligible executives to strive for continued financial improvement of the Company, consistent with performance based compensation and increasing shareholder value. The Compensation Committee typically identifies from three to five financial metrics which may be revised from year to year to reflect current business situations.

The financial metrics selected for 2012 were net income, reduction in nonperforming assets, loan growth and deposit growth. The Compensation Committee believes net income is a valid measurement in assessing how the Company is performing from a financial standpoint. Net income is an accepted accounting measure that drives earnings per share and shareholder returns over the long term. In addition, the Compensation Committee, in consultation with the Chief Executive Officer, concluded that, in view of the economic conditions expected to occur in 2012, management should focus on credit quality and loan and deposit growth. The Compensation Committee believes that nonperforming assets are an effective measure to monitor the Company's progress in improving its credit quality. Further, in view of the Company's plans to refocus on growth, the Compensation Committee sought to incentivize and measure growth by increases in loans and deposits.

The Compensation Committee determines the weighting of financial metrics each year based upon recommendations from the senior management. For 2012, the Compensation Committee weighted the financial metrics as follow:

- Net Income 25%
- Reduction of Nonperforming Assets 25%
- Loan Growth 25%
- Deposit Growth 25%

For 2012 compared to 2011, the Compensation Committee did not significantly realign the mix of the financial metrics. Because the Compensation Committee believed that the Incentive Plan should also balance risk-taking with performance, the Compensation Committee maintained a risk-based capital element to the plan. If the total risk-based capital ratio was between 12% and 14% at year-end 2012, bonus payments would be reduced by 50%, and if the ratio was below 12%, then bonuses would be reduced to zero.

Performance objectives were generally identified through our annual financial planning and budget process. Senior management developed a financial plan for 2012, and the financial plan was reviewed and approved by the Board of Directors. The Compensation Committee received recommendations from senior management for financial performance objective ranges. In making the determination of the Threshold and Target levels, the Compensation Committee considered specific circumstances anticipated to be encountered by the Company during the coming year. The Compensation Committee believed that the Threshold and Target levels established for the Incentive Plan in 2012 were sufficiently challenging given the economic climate and the level of growth and improvement in the various financial metrics that would have to occur to meet the various performance objectives.

For 2012, performance was assessed relative to performances for the year ended December 31, 2012, as shown below and compared to actual results:

	<u>Threshold</u>	<u>Target</u>	<u>2012 Actual</u>
Net Income(1)	\$ 10,041,000(2)	\$ 11,157,000	\$ 9,909,000
Nonperforming Assets	\$ 17,800,000(2)	\$ 16,000,000	\$ 19,464,000
Loans Outstanding	\$837,000,000(3)	\$881,000,000	\$ 812,313,000
Deposits(4)	\$897,000,000(3)	\$944,000,000	\$1,014,412,000

- (1) Before dividends and discount accretion on the Company's preferred stock.
- (2) 90% of Target.
- (3) 95% of Target.
- (4) Excludes brokered deposits, CDARS, state deposits and a short-term demand deposit from one customer.

Upon completion of the fiscal year, the Compensation Committee assesses the performance of the Company for each financial metric comparing the actual fiscal year results to the pre-determined performance objectives for each financial metric calculated with reference to the pre-determined weight accorded the financial metric, and an overall percentage amount for the award is calculated. In addition, the Compensation Committee has discretionary authority to include qualitative subjective measures which may increase or decrease an award up or down by an additional 15% of base salary. The positive discretion may be utilized to address completion of special projects, department initiatives, or favorable achievements reflected in regulatory exam results. The Compensation Committee may also use its discretion in adjusting financial metrics and performance objectives for unexpected economic conditions or changes in the business of the Company.

In 2012, the Company reached the Target for “deposits.” The calculated bonus under the Incentive Plan for 2012 performance was 8.25% of base salary. However, since the Company was subject to the TARP limitations on bonuses up through most of the first quarter of 2012, the Compensation Committee approved a pro rata portion of three-fourths of the calculated amount payable. Therefore, bonuses were awarded, as follows:

<u>Name</u>	<u>Bonus Award</u>
Walter T. Kaczmarek	\$22,300
Lawrence D. McGovern	\$15,005
Michael E. Benito	\$14,158
Dan T. Kawamoto	\$15,302
David E. Porter	\$ 8,035

Impact of Capital Purchase Program. The Incentive Plan was established as a cash award performance based plan. Under the executive compensation rules applicable to TARP recipients, bonuses were not permitted to the top five most highly compensated employees. Many of the named executive officers were among the top five most highly compensated employees, and the named executive officers who were not in the top five also did not receive bonuses. The Compensation Committee’s policy during the period the Company was subject to the TARP compensation rules had been that each of the named executive officers be treated equally under the Incentive Plan with regard to whether or not bonuses were paid out. For example, in 2011, the Company reached all but one of the Targets, but, nonetheless, no bonuses were paid for 2011 performance to the named executive officers.

Equity Based Compensation

We believe that equity based compensation should be a significant component of total executive compensation to align executive compensation with the long-term performance of the Company and to encourage executives to make value enhancing decisions for the benefit of our shareholders. Each of the named executive officers is eligible to receive equity compensation.

The Compensation Committee is responsible for determining equity grants to all staff members, including named executive officers, and in doing so considers past grants, corporate and individual performance, and recommendations of our Chief Executive Officer for staff members other than himself. Stock award levels with the established ranges were determined based on market data.

The Company’s Amended and Restated 2004 Equity Plan (the “2004 Plan”) provides for the grant of non-qualified and incentive stock options, and restricted stock. The Compensation Committee approves all awards under the Plan and acts as the administrator of the 2004 Plan.

Stock options provide for financial gain derived from the potential appreciation in stock price from the date that the option is granted until the date that the option is exercised. The exercise price of stock option grants is set at fair market value on the grant date. Under the 2004 Plan, we may not grant stock options at a discount to fair market value or reduce the exercise price of outstanding stock options except

in the case of a stock split or other similar event. We do not grant stock options with a so-called “reload” feature, nor do we loan funds to employees to enable them to exercise stock options. Stock options granted to date generally vest pro rata on a daily basis over four years and expire ten years from the grant date. Our long-term performance ultimately determines the value of stock options, because gains from stock option exercises are entirely dependent on the long-term appreciation of our stock price.

The Compensation Committee approved the 2013 Equity Incentive Plan (the “2013 Plan”) subject to approval by the shareholders at the 2013 Annual Meeting. See Proposal 2—Approval of 2013 Equity Incentive Plan.

Under the U.S. Treasury executive compensation restrictions for U.S. Treasury Capital Purchase Program participants, the issuance of stock options was prohibited under the general prohibitions on bonuses for the five highest paid employees of the Company. As such, the utilized long-term restricted stock, as necessary and where appropriate, to comply with the restrictions. The Compensation Committee will continue to consider the use of restricted stock where appropriate going forward.

An award of restricted stock involves the immediate transfer by the Company to a participant of ownership of a specific number of shares of common stock. The restricted stock is valued at its fair market value on the date of grant. Restricted stock is subject to a “substantial risk of forfeiture” within the meaning of Section 83 of the Internal Revenue Code of 1986, as amended. Restricted stock awarded by the Compensation Committee will generally vest the later of two years from the date of grant or at such time as the Company has redeemed all its Series A Preferred Stock held by the U.S. Treasury.

The Compensation Committee has established a stock option and restricted stock policy which recognizes that stock options and restricted stock have an impact on the profits of the Company under current accounting rules and also have a dilutive effect on the Company’s shareholders. Accordingly, they are recognized as a scarce resource and option grants and awards of restricted stock are given the same consideration as any other form of compensation.

The Compensation Committee has established ranges for the amount of options that may be granted that depend on the individual’s position with the Company and whether the option is awarded as an incentive to attract an individual, to retain an individual or to reward performance. The Compensation Committee approves primarily nonstatutory stock options instead of incentive stock options because of the tax advantages available to the Company for nonstatutory options and because employees generally do not take full advantage of the tax benefits available to them from incentive stock options.

We do not backdate options or grant options or award restricted stock retroactively. In addition, we do not plan to coordinate grants of options or awards of restricted stock so that they are made before announcement of favorable information, or after announcement of unfavorable information. The Company’s options and restricted stock are granted at fair market value on a fixed date or event (the first day of service for new hires and the date of Compensation Committee approval for existing employees), with all required approvals obtained in advance of or on the actual grant date. All grants to executive officers require the approval of the Compensation Committee and the Board of Directors. Fair market value has been consistently determined as the closing price on The Nasdaq Global Select Market on the grant date. In order to ensure that an option exercise price or restricted stock date of grant valuation fairly reflects all material information, without regard to whether the information seems positive or negative, every grant of options and restricted stock is contingent upon an assurance by management and legal counsel that the Company is not in possession of material undisclosed information. If the Company is in a “black-out” period for trading under its trading policy or otherwise in possession of inside information, the date of grant is suspended until the second business day after public dissemination of the information.

The Company’s general practice has been to grant options and restricted stock only on the annual grant date at the Compensation Committee and Board of Directors’ regular March meeting for the named executive officer as well as current staff, and at any other Compensation Committee meeting (whether a

regular meeting or otherwise) held on the same date as a regularly scheduled Board meeting (which are held monthly) as required to attract new staff, retain staff or recognize key specific achievements.

In June 2012, because the Company had satisfactorily completed its obligations under a written agreement with its regulators, the Company awarded Lawrence D. McGovern and Dan T. Kawamoto each 6,000 shares of restricted stock. Also in June 2012, David E. Porter was awarded 30,000 shares of restricted stock when he joined the Company. Walter T. Kaczmarek was not granted any stock awards in 2012.

Retirement Plans

Our Amended and Restated Supplemental Retirement Plan (“SERP”) is an important element of our compensation program. We compete for executive talent in our market area where many of our competitors offer supplemental retirement plans. These types of plans have been commonly offered in the community bank industry for some time. The SERP is a nonqualified defined benefit plan and is unsecured and unfunded and there are no plan assets. When the Company offers key executives participation in the SERP, including some but not all of the named executive officers, the supplemental retirement benefit awarded is based on the individual’s position within the Company and a vesting schedule determined by the desirability of incenting the retention element of the program. The participant is 100% vested in his or her benefit at retirement. A participant whose employment terminates after the normal retirement date will receive 100% of his or her supplemental retirement benefit, payable monthly, commencing on the first of the month following retirement (unless selected otherwise by the participant) and continuing until the death of the participant. For information on the plan, see “Supplemental Retirement Plan for Executive Officers.”

Prohibition on Speculation in Company Stock

Our stock trading guidelines prohibit executives from speculating in our stock, which includes, but is not limited to, short selling (profiting if the market price of the securities decreases), buying or selling publicly traded options, including writing covered calls, and hedging or any other type of derivative arrangement that has a similar economic effect.

Termination of Employment and Change in Control Provisions

The Compensation Committee believes that a change in control transaction, or potential change in control transaction, would create uncertainty regarding the continued employment of our executives. This is because many change in control transactions result in significant organizational changes, particularly at the senior executive level. In order to encourage our executives to remain employed with us during an important time when their continued employment in connection with or following a transaction is often uncertain and to help keep our executives focused on our business rather than on their personal financial security, we believe that providing certain of our executives with severance benefits upon certain terminations of employment is in the best interests of our Company and our shareholders.

The Company does not have company-wide separate change of control agreements with its executive officers. Instead, the Chief Executive Officer and the other named executive officers have specific change of control and severance provisions in their respective employment agreements. The Compensation Committee considers the use of change of control provisions and severance provisions on a case by case basis depending on the individual’s position with the Company and the need to attract and/or retain the individuals.

The severance benefits provided for our named executive officers were determined by the Compensation Committee based on its judgment of prevailing market practices at the time each agreement was entered into. At present, we have employment agreements with the Chief Executive Officer and the other named executive officers, which detail their eligibility for payments under various termination scenarios. In addition, certain equity grants made to the named executive officers provide for vesting of stock options and restricted stock upon a change of control. We have disclosed the severance and/or change in control payouts that would be payable to each named executive officer if the triggering event occurred on December 31, 2012, in the “Change in Control Arrangements and Termination of Employment” section in this proxy statement.

Tax Considerations

Section 162(m) (“Section 162(m)”) of the Internal Revenue Code of 1986, as amended, limits the allowable deduction for compensation paid or accrued with respect to the Chief Executive Officer and each of the four other most highly compensated executive officers of a publicly held corporation to no more than \$1 million per year. Certain compensation is exempt from this deduction limitation, including performance based compensation paid under a plan administered by a committee of outside directors, which has been approved by shareholders. The 2013 Equity Incentive Plan being proposed at the Annual Meeting will provide the Company the authorization to issue performance based compensation awards.

In light of Section 162(m), it is the policy of the Compensation Committee to modify, where necessary, our executive compensation program to maximize the tax deductibility of compensation paid to our executive officers when and if the \$1 million threshold becomes an issue. At the same time, the Compensation Committee also believes that the overall performance of our executives cannot in all cases be reduced to a fixed formula and that the prudent use of discretion in determining pay levels is in our best interests and those of our shareholders. Under some circumstances, the Compensation Committee’s use of discretion in determining appropriate amounts of compensation may be essential. In those situations where discretion is or can be used by the Compensation Committee, compensation may not be fully deductible.

Section 409A (“Section 409A”) of the Internal Revenue Code of 1986, as amended, among other things, limits flexibility with respect to the time and form of payment of deferred compensation. If a payment or award is subject to Section 409A, but does not meet the requirements that exempt such amounts from taxation under such section, the recipient is subject to: (i) income tax at the time the payment or award is not subject to a substantial risk of forfeiture; (ii) an additional 20% tax at that time; and (iii) an additional tax equal to the amount of interest (at the underpayment rate under the Internal Revenue Code plus one percentage point) on the underpayment that would have occurred had the award been includable in the recipient’s income when first deferred or, if later, when not subject to a substantial risk of forfeiture. We have made modifications to our plans and arrangements such that payments or awards under those arrangements either are intended to not constitute “deferred compensation” for Section 409A purposes (and will thereby be exempt from Section 409A’s requirements) or, if they constitute “deferred compensation,” are intended to comply with the Section 409A statutory provisions and final regulations.

Accounting Considerations

Accounting considerations play an important role in the design of our executive compensation program. Accounting rules require us to expense the fair value of restricted stock awards and the estimated fair value of our stock option grants which reduces the amount of our reported profits. The Compensation Committee considers the amount of this expense in determining the amount of equity compensation awards.

Compensation Committee Report

Compensation Discussion and Analysis. The Compensation Committee has reviewed and discussed the Compensation Discussion and Analysis required by Item 401(b) of Regulation S-K with management and, based on such review and discussions, the Compensation Committee recommended to the Board that the Compensation Discussion and Analysis be included in this proxy statement.

Risk Assessment of Incentive Compensation Arrangements. In connection with its participation in the U.S. Treasury Capital Purchase Program, the Compensation Committee was required to meet at least every six months during 2012 with the Company's senior risk officers to discuss and review the relationship between the Company's risk management policies and practices and its SEOs incentive compensation arrangements, identifying and making reasonable efforts to limit any features in such compensation arrangements that might lead to the SEOs taking unnecessary or excessive risks that could threaten the value of the Company. The Compensation Committee, on behalf of the Company, must certify that it has completed the review and taken any necessary actions.

In response to this requirement, the Compensation Committee met with the senior risk managers of the Company (including its internal auditor, Chief Financial Officer, Chief Credit Officer, Senior Vice President-Human Resources, and Senior Vice President-Compliance). The Compensation Committee discussed the overall risk structure and the significant risks identified within the Company, and discussed the process by which those present at the meeting analyze the risks associated with the executive compensation program. This process included, among other things, a review of the Company's programs. This review included the compensation potential under the Company's incentive plans, the long-term view encouraged by the design and vesting features of the Company's long-term incentive arrangements, and the extent to which the Compensation Committee and the Company's management monitor the program. The Compensation Committee also identified areas of enterprise risk of the Company and evaluated the degree to which participants in a plan perform functions that have the potential to significantly affect overall enterprise risk. The Compensation Committee then analyzed the extent to which design features have the potential to encourage behaviors that could significantly contribute to enterprise risk.

Our SEOs participate in the following two incentive compensation plans:

- Management Incentive Plan; and
- Amended and Restated 2004 Equity Plan.

Based on its review (the most recent in September 2012), the Compensation Committee determined that the Company's executive compensation program did not encourage the SEOs to take unnecessary and excessive risks that threaten the value of the Company, and that no changes to these plans were required for this purpose.

- Among the factors the Compensation Committee considered were the following:
 - Our Management Incentive Plan in 2012 imposed a specific dollar maximum amount for each participant, did not rely on a single financial measure in awarding bonuses, and imposed minimum capital ratios that must be satisfied before any bonuses may be paid. To the extent bonuses are earned, they are subject to "clawback" provisions;
 - Our 2004 Equity Plan imposes specific ranges of stock option grant limits that apply on an individual basis, and each option grant vests over four years. Vesting has historically been tied to tenure of employment and not tied to Company or individual performance. Stock options are subject to "clawback" provisions;
 - Restricted Stock Awards are subject to a two (2) year "cliff vesting" requirement; and
 - The Compensation Committee generally targets the 75th percentile of peer practice to limit total direct compensation.

In addition to the incentive plans in which the SEO's participate, the Company has incentive plans for other officers and branch employees which reward performance. The Compensation Committee reviewed all non-SEO plans, and concluded that none of them, considered individually or as a group, presented any material threat to our capital or earnings, encouraged taking undue or excessive risks, or encouraged manipulation of financial data in order to increase the size of an award.

2012 Production Plan. This bonus plan is based on meeting production goals. Bonus awards are subject to meeting several categories of growth. The amount of bonus is capped for each category. A portion of the bonus is put into a pool and distributed based on subjective criteria. Bank earnings are not a factor in the bonus calculation. All awards are subject to a "claw back" provision based on credit quality.

Business Development Commission Plan. This bonus plan is based on customer relationship profitability not Company earnings. Employees eligible for awards do not have loan approval authority, and loans and underwriting standards are subject to regular review by the Heritage Bank of Commerce Loan Committee. Internal controls with different levels of review and approvals are designed to prevent manipulation to increase an award.

SBA Commission Plan. Awards based on loan production. Employees eligible for awards do not have loan approval authority, and loans and underwriting standards are subject to regular review by the Heritage Bank of Commerce Loan Committee. Internal controls with different levels of review and approvals are designed to prevent manipulation to increase an award.

Certification. As required by the U.S. Treasury Capital Purchase Program, the Compensation Committee certifies that with respect to the period beginning January 1, 2012 and through the year ended December 31, 2012, it has (i) reviewed with senior risk officers the SEO compensation plans and has made all reasonable efforts to ensure that these plans do not encourage SEOs to take unnecessary and excessive risks that threaten the value of the Company; (ii) reviewed with senior risk officers the Company's employee compensation plans and has made all reasonable efforts to limit any unnecessary risks these plans pose to the Company; and (iii) reviewed the Company's employee compensation plans to eliminate any features of these plans that would encourage the manipulation of reported earnings of the Company to enhance the compensation of any employee.

Compensation Committee of the Board

Robert T. Moles, Chairman

Frank G. Bisceglia

Celeste V. Ford

Ranson W. Webster

W. Kirk Wycoff

Executive Compensation Tables

The following table provides for the periods shown, information as to compensation for services of the Company's principal executive officer, principal financial officer, and the three other executive officers of the Company who had the highest total compensation (as defined in accordance with applicable regulations) with respect to the year ended 2012 (collectively referred to as the "named executive officers"):

Summary Compensation Table

Name and Principal Position (a)	Year (b)	Salary (\$)(c)(1)	Bonus (\$)(d)	Stock Awards (\$)(e)	Option Awards (\$)(f)(2)	Non-Equity Incentive Plan Compensation (\$)(g)(3)	Change in Pension Value and Nonqualified Deferred Compensation Earnings (\$)(h)(4)	All Other Compensation (\$)(i)(5)	Total (\$)(j)
Walter T. Kaczmarek President & Chief Executive Officer	2012	\$360,400	—	—	—	\$22,300	\$733,000	\$21,761	\$1,137,461
	2011	\$338,150	—	\$ 77,400	—	—	\$857,300	\$20,167	\$1,293,017
	2010	\$333,700	—	—	—	—	\$572,000	\$33,065	\$ 938,765
Lawrence D. McGovern Executive Vice President & Chief Financial Officer	2012	\$242,400	—	\$ 38,340	—	\$15,005	\$121,400	\$15,408	\$ 432,553
	2011	\$233,733	—	\$ 43,860	—	—	\$173,000	\$15,228	\$ 465,821
	2010	\$227,000	—	—	—	—	\$109,100	\$14,272	\$ 350,372
Michael E. Benito Executive Vice President/ Banking Division	2012	\$228,725	—	\$ 38,340	—	\$14,158	\$ 70,900	\$16,357	\$ 368,480
Dan T. Kawamoto Executive Vice President & Chief Administrative Officer	2012	\$247,200	—	\$ 38,340	—	\$15,302	—	\$12,920	\$ 313,762
	2011	\$241,200	—	\$ 43,860	—	—	—	\$12,825	\$ 297,885
	2010	\$240,000	—	—	—	—	—	\$12,948	\$ 252,948
David E. Porter Executive Vice President & Chief Credit Officer(6)	2012	\$129,808	\$50,000	\$183,900	—	\$ 8,035	—	\$18,297	\$ 390,040

- (1) The amounts in column (c) include amounts voluntarily deferred by each of the named executive officers into their 401(k) plan accounts. For 2012, Mr. Kaczmarek deferred \$22,500, Mr. McGovern deferred \$22,500, Mr. Benito deferred \$22,500, Mr. Kawamoto deferred \$22,500 and Mr. Porter deferred \$7,500.
- (2) The amounts shown in columns (e) and (f) reflect the applicable full grant date fair values for stock options and stock awards issued under the Company's 2004 Equity Plan in accordance with ASC 718 (excluding the effect of forfeitures), and are reported for the fiscal year during which the stock options and stock awards were issued. The assumptions used in calculating the valuation for stock option awards may be found in Note 10 to the Company's consolidated financial statements for the year ended December 31, 2012, included in the Company's Annual Report on Form 10-K, filed with the SEC on March 8, 2013.
- (3) The amounts shown in column (g) for 2012 reflect payments made under the terms of the Management Incentive Plan for 2012 performance. No payments under the plan were made to the named executive officers for 2010 or 2011 performance.
- (4) The amounts shown in column (h) for 2012 represent only the aggregate change in the actuarial present value of the accumulated benefit under the Company's Supplemental Executive Retirement Plan from December 31, 2011 to December 31, 2012. The amounts in column (h) were determined using interest rate and mortality rate assumptions consistent with those used in the Company's consolidated financial statements and include amounts which the named executive officer may not

currently be entitled to receive because such amounts are not vested. Assumptions used in the calculation of these amounts are included in Note 11 to the Company's consolidated financial statements for the year ended December 31, 2012 included in the Company's Annual Report on Form 10-K filed with the SEC on March 8, 2013.

- (5) The amounts shown in column (i) include the following for each named executive:

	Economic Value of Death Benefit of Life Insurance for Beneficiaries ^(b)	401(k) Plan Company Matching Contributions	Other Insurance Benefit	Employee Stock Ownership Plan Company Contributions	Vacation	Auto Compensation	Other	Total
Walter T. Kaczmarek . . .	\$5,197	\$1,000	\$3,564	—	—	\$12,000	—	\$21,761
Lawrence D. McGovern .	\$1,410	\$1,000	\$2,337	—	\$4,661	\$ 6,000	—	\$15,408
Dan T. Kawamoto	—	\$1,000	\$3,520	—	—	\$ 8,400	—	\$12,920
Michael E. Benito	\$1,488	\$1,000	\$1,171	—	\$4,423	\$ 8,200	\$ 75	\$16,357
David E. Porter ^(a)	—	\$1,000	\$1,930	—	—	\$ 4,317	\$11,050	\$18,297

- (a) The amounts in column (i) for Mr. Porter also include \$11,050 for temporary residence and moving expenses.

- (b) The economic value of the death benefit amounts shown above reflects the annual income imputed to each executive in connection with Company owned split-dollar life insurance policies for which the Company has fully paid the applicable premiums. These policies are discussed under "Supplemental Retirement Plan for Executive Officers."

- (6) Mr. Porter joined the Company in June 2012, and received a \$50,000 signing bonus.

Executive Contracts

Walter T. Kaczmarek—On October 17, 2007, the Company entered into an Amended and Restated Employment Agreement with Walter T. Kaczmarek. The employment contract is for three years and is automatically renewed each month for three additional years. Under the agreement, Mr. Kaczmarek receives an annual salary of \$360,400 with annual increases, if any (last increased in October 2011), as determined by the Board of Directors' annual review of executive salaries. In addition to his salary, he is eligible to participate in the Management Incentive Plan. Mr. Kaczmarek participates in the Company's 401(k) plan, under which he may receive matching contributions up to \$1,000. He also participates in the Company's Employee Stock Ownership Plan. The Company provides Mr. Kaczmarek, at no cost to him, group life, health, accident and disability insurance coverage for himself and his dependents. Mr. Kaczmarek is provided with life insurance coverage in the amount of two times his then current salary but no more than \$700,000. He is provided with long-term care insurance, with a lifetime benefit of up to \$432,000. The Company reimburses Mr. Kaczmarek for up to \$1,200 of expenses incurred by him for tax consultation and preparation of tax returns and any excess of insurance coverage for an annual physical examination. Mr. Kaczmarek is reimbursed for monthly dues for one country club and one business club membership. He receives an automobile allowance in the amount of \$1,000 per month, together with reimbursements for gasoline and maintenance expenditures.

Under his employment agreement, Mr. Kaczmarek is entitled to certain severance benefits on termination of his employment, including a change of control. See "Change of Control Arrangements and Termination of Employment."

Lawrence D. McGovern—On July 21, 2011, the Company entered into an Employment Agreement with Lawrence D. McGovern. The employment contract is for one year and is automatically renewed for one year terms. Under the agreement, Mr. McGovern receives an annual salary of \$254,762 with annual increases, if any (last increased in April 2013), as determined by the Company's Chief Executive Officer and Board of Directors' Compensation Committee annual review of executive salaries. In addition to his salary, he is eligible to participate in the Management Incentive Plan. Mr. McGovern participates in the

Company's 401(k) plan, under which he may receive matching contributions up to \$1,000. He also participates in the Company's Employee Stock Ownership Plan. The Company provides to Mr. McGovern, at no cost to him, group life, health, accident and disability insurance coverage for himself and his dependents. Mr. McGovern receives an automobile allowance in the amount of \$500 per month, together with reimbursements for gasoline expenditures. Mr. McGovern is provided with life insurance coverage in the amount of two times his salary but not to exceed \$700,000. He is also provided with long-term care insurance, with a lifetime benefit of up to \$72,000.

Under his employment agreement, Mr. McGovern is entitled to certain severance benefits on termination of his employment, including a change of control. See "Change of Control Arrangements and Termination of Employment."

Michael E. Benito—On February 1, 2012, the Company entered into an employment agreement with Michael E. Benito when he was promoted to Executive Vice President/Banking Division. The employment contract is for one year and is automatically renewed for one year terms. Under the Agreement, Mr. Benito receives an annual salary of \$237,705 with annual increases, if any (last increased in April 2013), as determined by the Company's Chief Executive Officer and Board of Directors' Compensation Committee annual review of executive salaries. In addition to his salary, he is eligible to participate in the Management Incentive Plan. Mr. Benito participates in the Company's 401(k) plan, under which he may receive matching contributions up to \$1,000. Mr. Benito also participates in the Company's Employee Stock Ownership Plan. The Company provides to Mr. Benito, at no cost to him, group life, health, accident and disability insurance coverage for himself and his dependents. Mr. Benito receives an automobile allowance in the amount of \$700 per month, together with reimbursements for gasoline expenditures. Mr. Benito is provided with life insurance coverage in the amount of two times his salary not to exceed \$700,000. He is also provided with long-term care insurance, with a lifetime benefit of up to \$72,000.

Under his employment agreement, Mr. Benito is entitled to certain severance benefits on termination of his employment, including a change of control. See "Change of Control Arrangements and Termination of Employment."

Dan T. Kawamoto—On June 11, 2009, the Company entered into an Employment Agreement with Dan Kawamoto which became effective July 13, 2009, when Mr. Kawamoto commenced his employment. The employment contract is for one year and is automatically renewed for one year terms. Under the agreement, Mr. Kawamoto receives an annual salary of \$254,616 with annual increases, if any, (last increased in April 2013) as determined by the Company's Chief Executive Officer and Board of Directors' Compensation Committee annual review of executive salaries. In addition to his salary, he is eligible to participate in the Management Incentive Plan. Mr. Kawamoto participates in the Company's 401(k) plan, under which he may receive matching contributions up to \$1,000. He also participates in the Company's Employee Stock Ownership Plan. The Company provides to Mr. Kawamoto, at no cost to him, group life, health, accident and disability insurance coverage for himself and his dependents. He also receives an automobile allowance in the amount of \$700 per month, together with reimbursements for gasoline expenditures and up to \$2,400 per year for automobile repairs and maintenance. Mr. Kawamoto is provided with life insurance coverage in the amount of two times his salary not to exceed \$700,000. He is also provided with long-term care insurance, with a lifetime benefit of up to \$72,000.

Under his employment agreement, Mr. Kawamoto is entitled to certain severance benefits on termination of his employment, including a change of control. See "Change of Control Arrangements and Termination of Employment."

David E. Porter—On June 25, 2012, the Company entered into an employment agreement with David Porter when he joined the Company as Executive Vice President and Chief Credit Officer. The employment contract is for one year and is automatically renewed for one year terms. Under the agreement, Mr. Porter receives an annual salary of \$255,000 with annual increases, if any (last increased in

April 2013), as determined by the Company's Chief Executive Officer and Board of Directors' Compensation Committee annual review of executive salaries. In addition to his salary, he is eligible to participate in the Management Incentive Plan. Mr. Porter participates in the Company's 401(k) plan, under which he could receive matching contributions up to \$1,000. Mr. Porter also participates in the Company's Employee Stock Ownership Plan. The Company provides to Mr. Porter, at no cost to him, group life, health, accident and disability insurance coverage for himself and his dependents. Mr. Porter also receives an automobile allowance in the amount of \$700 per month. Mr. Porter is provided with life insurance coverage in the amount of two times his salary not to exceed \$700,000. He is also provided with long-term care insurance, with a lifetime benefit of up to \$72,000. Under his employment agreement Mr. Porter received a \$50,000 signing bonus, \$18,000 for three (3) months temporary residence, and up to \$10,000 for moving expenses.

Under his employment agreement, Mr. Porter is entitled to certain severance benefits on termination of his employment, including a change of control. See "Change of Control Arrangements and Termination of Employment."

Plan Based Awards

Stock Based Plans. In 1994, the Board of Directors adopted the Heritage Bank of Commerce 1994 Tandem Stock Option Plan (the "1994 Stock Option Plan") in order to promote the long-term success of the Company and the creation of shareholder value. The 1994 Stock Option Plan expired on June 8, 2004. In 2004, the Board of Directors adopted the Heritage Commerce Corp 2004 Stock Option Plan (the "2004 Plan"), which was approved by the Company's shareholders at the 2004 Annual Meeting. The 1994 Stock Option Plan and the 2004 Plan authorized the Company to grant stock options to officers, employees and directors of the Company and its affiliates. In 2009, the 2004 Plan was amended and restated as the 2004 Equity Plan to authorize the issuance of restricted stock in addition to stock options. The 2004 Equity Plan was approved by the Company's shareholders at the 2009 Annual Meeting.

Management Incentive Plan. The Company maintains a Management Incentive Plan adopted by the Board of Directors in 2005. Executive officers are eligible for target bonuses which are expressed as a percentage of their respective base salaries which increase as the level of performance of established goals increases. The bonuses are tied directly to the satisfaction of overall Company performance for the year. No bonuses were paid to the named executive officers for 2010 or 2011 performance. See "Compensation Discussion and Analysis" for information about the Management Incentive Plan.

The following table provides information on the potential performance-based awards available if defined performance objectives were achieved in 2012 for each of the Company’s named executive officers under the Company’s Management Incentive Plan, and stock options or other stock awards granted to the named executive officers in 2012.

Grants of Plan-Based Awards

Name (a)	Grant Date (b)	Estimated Future Payouts Under Non-Equity			Estimated Future Payouts Under Equity			All Other Stock Awards: Number of Shares of Stock or Units (#) (i)(2)	All Other Option Awards: Number of Securities Underlying Options (#) (j)	Exercise or Base Price of Option Awards (\$/Sh) (k)	Grant Date Fair Value of Stock And Options Awards (l)(3)
		Incentive Plan Awards(1)			Incentive Plan Awards						
		Threshold (\$) (c)	Target (\$) (d)	Maximum (\$) (e)	Threshold (#) (f)	Target (#) (g)	Maximum (#) (h)				
Walter T. Kaczmarek	3/22/2012	\$54,060	\$118,932	—	—	—	—	—	—	—	
Lawrence D. McGovern . . .	5/1/2012	—	—	—	—	—	—	6,000	—	—	\$ 38,340
	3/22/2012	\$36,360	\$ 79,992	—	—	—	—	—	—	—	—
Michael E. Benito	5/1/2012	—	—	—	—	—	—	6,000	—	—	\$ 38,340
	3/22/2012	\$34,500	\$ 75,900	—	—	—	—	—	—	—	—
Dan T. Kawamoto	5/1/2012	—	—	—	—	—	—	6,000	—	—	\$ 38,340
	3/22/2012	\$37,080	\$ 81,576	—	—	—	—	—	—	—	—
David E. Porter	7/31/2012	—	—	—	—	—	—	30,000	—	—	\$183,900
	3/22/2012	\$37,500	\$ 82,500	—	—	—	—	—	—	—	—

- (1) These potential performance-based awards were established under the Management Incentive Plan if the indicated level of performance was achieved in 2012 as described further in the “Compensation and Discussion Analysis” and in the discussion under “Plan Based Awards—Management Incentive Plan.” They do not represent the actual payments made to the named executive officers. The payments made for actual performance in 2012 are reflected in column (g) in the Summary Compensation Table.
- (2) This column reflects restricted stock awards granted pursuant to the 2004 Equity Plan. The shares vest on the second anniversary of the grant date; provided, however, the vesting will be accelerated on a change of control, death or disability.
- (3) The amounts in column (l) reflect the grant date fair market value of restricted stock on the date of grant. The grant date price of restricted stock made to each of the listed persons on May 1, 2012 was \$6.39 per share and on July 31, 2012 was \$6.13 per share.

Equity Compensation Plan Information

The following table shows the number and weighted-average exercise price of securities to be issued upon exercise of outstanding options, warrants and rights, and the number of securities remaining available for future issuance under equity compensation plans at December 31, 2012:

	Number of securities to be issued upon exercise of outstanding options, warrants and rights (a)	Weighted average exercise price of outstanding options, warrants and rights (b)	Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a)) (c)
Equity compensation plans approved by security holders	1,314,347(1)	\$12.90	369,912(2)
Equity compensation plans not approved by security holders	N/A	N/A	N/A

(1) Consists of 75,810 options to acquire shares of common stock issued under the Company's 1994 Stock Option Plan, and 1,238,537 options to acquire shares under the Company's Amended and Restated 2004 Equity Plan.

(2) Available under the Company's Amended and Restated 2004 Equity Plan.

Outstanding Equity Awards

The following table shows the number of Company shares of common stock covered by exercisable and unexercisable stock options and the number of Company unvested shares of restricted common stock held by the Company's named executive officers as of December 31, 2012.

Outstanding Equity Awards at Year End

Name (a)	Option Awards					Stock Awards			
	Number of Securities Underlying Unexercised Options (#) Exercisable (b)	Number of Securities Underlying Unexercised Options (#) Unexercisable (c)	Equity Incentive Plan Awards: Number of Securities Underlying Unexercised Options (#) (d)	Options Exercise Price (\$) (e)	Options Expiration Date (f)	Number of Shares or Units of Stock That Have Not Vested (#) (g)(1)	Market Value of Shares or Units of Stock That Have Not Vested (\$) (h)(2)	Equity Incentive Plan Awards: Number of Unearned Shares, Units or Rights That Have Not Vested (#) (i)	Equity Incentive Plan Awards: Market or Payout Value of Unearned Shares, Units or Rights That Have Not Vested (\$) (j)
Walter T. Kaczmarek	—	—	—	—	—	15,000	\$104,700	—	—
	50,000	—	—	\$18.15	03/17/2015	—	—	—	—
	20,000	—	—	\$23.85	08/03/2016	—	—	—	—
	25,000	—	—	\$23.89	05/04/2017	—	—	—	—
Lawrence D. McGovern	—	—	—	—	—	6,000	\$ 41,880	—	—
	—	—	—	—	—	8,500	\$ 59,330	—	—
	7,500	—	—	\$14.11	05/27/2014	—	—	—	—
	8,000	—	—	\$20.00	08/11/2015	—	—	—	—
	10,000	—	—	\$23.85	08/03/2016	—	—	—	—
	15,000	—	—	\$23.89	05/04/2017	—	—	—	—
Michael E. Benito	—	—	—	—	—	6,000	\$ 41,880	—	—
	—	—	—	—	—	3,000	\$ 20,940	—	—
	25,000	—	—	\$12.50	11/28/2013	—	—	—	—
	5,000	—	—	\$22.78	02/16/2016	—	—	—	—
	5,000	—	—	\$23.85	08/03/2016	—	—	—	—
	7,000	—	—	\$23.89	05/04/2017	—	—	—	—
	7,000	—	—	\$16.00	05/22/2018	—	—	—	—
	4,117	383(3)	—	\$ 7.43	05/04/2019	—	—	—	—
	2,736	1,764(4)	—	\$ 3.57	07/26/2020	—	—	—	—
Dan T. Kawamoto	—	—	—	—	—	6,000	\$ 41,880	—	—
	—	—	—	—	—	8,500	\$ 59,330	—	—
	21,438	3,562(5)	—	\$ 3.22	07/27/2019	—	—	—	—
David E. Porter	—	—	—	—	—	30,000	\$209,400	—	—

- (1) This column represents the unvested shares for restricted stock awards granted.
- (2) The market value of the shares of restricted stock that have not vested is calculated by multiplying the number of shares of stock that have not vested by the closing price of our common stock at December 31, 2012, as reported on The NASDAQ Global Select Market, which was \$6.98.
- (3) The options vest daily over 4 years beginning May 4, 2009, and have a term of 10 years.
- (4) The options vest daily over 4 years beginning July 26, 2010, and have a term of 10 years.
- (5) The options vest daily over 4 years beginning July 27, 2009, and have a term of 10 years.

Option Exercises and Vested Stock Awards

The following table sets forth information with regard to the exercise and vesting of stock options and vesting of shares of restricted stock for the year ended December 31, 2012, for each of the named executive officers.

Option Exercises and Stock Vested

Name (a)	Option Awards		Stock Awards	
	Number of Shares Acquired on Exercise (#) (b)	Value Realized upon Exercise (\$) (c)	Number of Shares Acquired on Vesting (#) (d)	Value Realized on Vesting (\$) (e)(1)
	Walter T. Kaczmarek	—	—	—
Lawrence D. McGovern	—	—	—	—
Dan T. Kawamoto	—	—	—	—
Michael E. Benito	—	—	4,500	\$27,360
David E. Porter	—	—	—	—

(1) The number of vested shares reflects the gross amount of shares, without netting any shares surrendered to pay taxes. The aggregate dollar amount realized upon vesting was calculated by multiplying the number of shares by the fair market value on the vesting date.

401(k) Plan

The Company has established a broad-based employee benefit plan under Section 401(k) of the Internal Revenue Code of 1986 (“401(k) Plan”). The purpose of the 401(k) Plan is to encourage employees to save for retirement. Eligible employees may make contributions to the plan subject to the limitations of Section 401(k). The 401(k) Plan trustees administer the Plan. The Company may match up to \$1,000 of each employee’s contributions. The 401(k) Plan allows highly compensated employees to contribute up to a maximum percentage of their base salary, up to the limits imposed by the Internal Revenue Code, on a pre-tax basis. Participants choose to invest their account balances from an array of investment options as selected by plan fiduciaries. The 401(k) Plan is designed to provide for distributions in a lump sum after termination of service. However, loans and in-service distributions under certain circumstances such as hardship, attainment of age 59-1/2, or a disability are permitted. For named executive officers, these amounts are included in the Summary Compensation Table under “All Other Compensation.”

Employee Stock Ownership Plan

In 1997, Heritage Bank of Commerce initiated a broad-based employee stock ownership plan (“Stock Ownership Plan”). The Stock Ownership Plan was subsequently adopted by the Company as the successor corporation to Heritage Bank of Commerce. The Stock Ownership Plan allows the Company, at its option, to purchase shares of the Company common stock on the open market. To be eligible to receive an award of shares under the Stock Ownership Plan, an employee must have worked at least 1,000 hours during the year and must be employed by the Company on December 31. The executive officers have the same eligibility to receive awards as other employees of the Company. Awards under the Stock Ownership Plan generally vest over four years. In addition, the value of a participant’s account becomes fully vested upon reaching the age of 65 or termination of employment by death or disability. The Company may discontinue its contributions at any time. The amounts of contributions to the Stock Ownership Plan for named executive officers are included in the Summary Compensation Table in the column entitled “All Other Compensation.”

Supplemental Retirement Plan for Executive Officers

The Company has established the 2005 Amended and Restated Supplemental Executive Retirement Plan (the “SERP” or the “Plan”) covering key executives, including several of the named executive officers. The SERP is a nonqualified defined benefit plan and is unsecured and unfunded and there are no plan assets. When the Company offers key executives participation in the SERP, the supplemental retirement benefit awarded is based on the individual’s position within the Company and a vesting schedule determined by the desirability of incentivizing the retention element of the program. The participant is 100% vested in his or her benefit at normal retirement, upon termination within two years from a change in control, or upon disability. However, the participant’s vested benefit is reduced for payment prior to normal retirement age in accordance with the Plan terms.

Normal Retirement. A participant whose employment terminates after normal retirement (as defined in the Plan) will receive 100% of his or her supplemental retirement benefit, payable monthly, commencing on the first of the month following retirement (unless selected otherwise by the participant) and continuing until the death of the participant.

Early Retirement. In order to be eligible for early retirement benefits, the plan requires the participant to terminate employment (for reasons other than for cause or within two years from a change of control) after the date that the participant is at least 55 years old but prior to normal retirement as defined in the participant’s participation agreement. The participant will then receive the portion of the supplemental retirement benefit that has vested as of the actual early retirement date. However, for each year (or partial year) before normal retirement age the participant receives an early retirement benefit, the vested benefit is reduced by five percent. Unless otherwise selected by the participant, the early retirement benefit will be paid monthly, with payments to commence on the first day of the month following the participant’s separation from service and continuing until the death of the participant.

Termination Before Early Retirement. If a participant’s employment is terminated without cause or the participant resigns, the participant shall be eligible to receive the portion of the supplemental retirement benefit that has vested as of the effective date of termination reduced by five percent for each year (or partial year) that the participant’s benefits are paid prior to the participant’s normal retirement age. Benefits are payable monthly commencing on the first of the month elected by the participant but not before the participant’s early retirement age, and continuing until the death of the participant.

Disability. In the event a participant becomes disabled, the participant will receive the actuarial equivalent of his or her supplemental retirement benefit, payable monthly, commencing on the first of the month following determination that the participant is disabled and continuing until the death of the participant.

Cause. If a participant’s employment is terminated for cause, the participant forfeits any rights the participant may have under the SERP.

Change of Control. If a participant’s employment is terminated for any reason (except cause or after qualifying for normal retirement) within two years following a change of control, the participant will receive 100% of his or her supplemental retirement benefit commencing at the later of the first month following the age selected by the participant or the first month following the participant’s separation from service, and continuing until the death of the participant (unless an election has been made for successor benefit). In the event payments commence prior to the participant’s normal retirement age, then the benefit due to the participant will be reduced by five percent for each year (or partial year) that the participant’s benefit is paid prior to the participant’s normal retirement age.

Company-owned split-dollar life insurance policies support the Company’s obligations under the SERP. The premiums on the policies are paid by the Company. The cash value accrued on the policies supports the payment of the supplemental benefits for each participant. In the case of death of the

participant, the participant's designated beneficiaries will receive 80% of the net-at-risk insurance (which means the amount of the death benefit in excess of the cash value of the policy).

The following table shows the present value of the accumulated benefit payable to each of the named executive officers that participate in the SERP, including the number of service years credited to each named executive officer at December 31, 2012:

Name (a)	Plan Name (b)	Number of Years Credited Service (#) (c)	Present Value of Accumulated Benefit(1)(2) (\$) (d)	Payments During Last Fiscal Year (\$) (e)
Walter T. Kaczmarek	Heritage Commerce Corp SERP	8	\$3,455,000	—
Lawrence D. McGovern	Heritage Commerce Corp SERP	14	\$ 804,700	—
Michael E. Benito(3)	Heritage Commerce Corp SERP	9	\$ 253,000	—

(1) The amounts in column (d) were determined using interest rate and mortality rate assumptions consistent with those used in the Company's consolidated financial statements and include amounts which the named executive officer may not currently be entitled to receive because such amounts are not vested. Assumptions used in the calculation of these amounts are included in Note 11 to the Company's consolidated financial statements for the fiscal year ended December 31, 2012, included in the Company's Annual Report on Form 10-K filed with the SEC on March 8, 2013.

(2) The following vesting percentages apply to the named executive officers who participate in the SERP:

End of the year prior to termination	Walter T. Kaczmarek	Lawrence D. McGovern	Michael E. Benito(3)	
12/31/2012	84%	100%	64%	10%
12/31/2013	100%	100%	72%	20%
12/31/2014	100%	100%	80%	30%
12/31/2015	100%	100%	88%	40%
12/31/2016	100%	100%	96%	50%

(3) Mr. Benito has two separate SERP agreements.

Management Deferral Plan

In January 2004, the Company adopted the Heritage Commerce Corp Nonqualified Deferred Compensation Plan for certain executive officers. The purpose of the plan is to offer those employees an opportunity to elect to defer the receipt of compensation in order to provide termination of employment and related benefits taxable pursuant to Section 451 of the Internal Revenue Code of 1986, as amended. The plan is intended to be a "top-hat" plan (i.e., an unfunded deferred compensation plan maintained for a select group of management or highly-compensated employees) under Sections 201(2), 301(a)(3) and 401(a)(1) of the Employee Retirement Income Security Act of 1974. The executive may elect to defer up to 100% of any bonus and 50% of any regular salary into the Management Deferral Plan. Amounts deferred are invested in a portfolio of approved investment choices as directed by the executive. Under the Management Deferral Plan, the Company may make discretionary contributions for the executive, but has not done so. Amounts deferred by executives to the plan will be distributed at a future date they have selected or upon termination of employment. The executive can select a distribution schedule of up to fifteen years. None of the Company current executive officers have elected to participate in the plan.

Change of Control Arrangements and Termination of Employment

In connection with the Company's participation in the U.S. Treasury's Capital Purchase Program, the Company agreed that, until such time as the U.S. Treasury ceased to own the Series A Preferred Stock acquired under the program, the Company would take all necessary action to ensure that its benefit plans with respect to its senior executive officers comply with Section 111(b) of EESA and agreed to not adopt any benefit plans with respect to, or which cover, its senior executive officers that do not comply with EESA. The subsequent enactment of ARRA, and issuance of rules and regulations issued by the U.S. Treasury in June, 2009, has amended, and in some cases expanded upon, provisions of Section 111(b) of EESA. These provisions prohibited any payment of golden parachutes (as defined by the U.S. Treasury regulation) to the named executive officers or the five next highly-compensated employees for departure from our Company for any reason, except for death, disability or payments for services performed or benefits accrued. On March 7, 2012, the Company repurchased the \$40 million Series A Preferred Stock from the U.S. Treasury, and therefore these restrictions are no longer applicable.

Stock Option Plans. Each of the named executive officers holds options granted under the 2004 Equity Plan and/or the 1994 Stock Option Plan. Under these plans, option holders will be given 30 days' advance notice of the consummation of a change of control transaction during which time the option holders will have the right to exercise their options, and all outstanding options become immediately vested. The options terminate on the consummation of the change of control. In the event the option holder dies or becomes disabled, the option holder or his or her estate will have 12 months to exercise those options that have vested as of the date of termination of employment from a disability or death.

Restricted Stock. Each of the named executive officers holds shares of restricted stock subject to vesting requirement. Under the terms of the restricted stock awards the vesting of the shares will be accelerated upon a change of control, or the holder's death or disability.

Supplemental Executive Retirement Plan. Several of the named executives are participants in the 2005 Amended and Restated Supplemental Executive Plan. If a participant's employment is terminated without cause or the participant resigns, the participant shall be eligible to receive the portion of the supplemental retirement benefit that has vested as of the effective date of termination reduced by five percent for each year (or partial year) that the participant's benefits are paid prior to the participant's normal retirement age. Benefits are payable monthly commencing on the first of the month elected by the participant, but not before the participant's early retirement age, and continuing until the death of the participant. In the event a participant becomes disabled, the participant will receive the actuarial equivalent of his or her supplemental retirement benefit, payable monthly, commencing on the first of the month following determination that the participant is disabled and continuing until the death of the participant. If a participant's employment is terminated for cause, the participant forfeits any rights the participant may have under the plan. If a participant's employment is terminated for any reason (except cause or after qualifying for normal retirement) within two years following a change of control, the participant will receive 100% of his or her supplemental retirement benefits commencing at the later of the first month following the age selected by the participant, or the first month following the participant's separation from service, and continuing until the death of the participant. In the event payments commence prior to the participant's normal retirement age, then the benefit due to the participant will be reduced by five percent for each year (or partial year) that the participant's benefit is paid prior to the participant's normal retirement age.

Mr. Kaczmarek's Employment Agreement. If Mr. Kaczmarek's employment is terminated without cause or he resigns for good reason, he will be entitled to a lump sum payment equal to two times his base salary and his highest annual bonus in the last three years. If Mr. Kaczmarek's employment is terminated or he resigns for good reason 120 days before, or within two years after, a change of control, he will be paid a lump sum of 2.75 times his base salary and highest annual bonus in the last three years. If his employment is terminated by the Company without cause, or he resigns for good reason, or as a result of a

change of control the Company terminates his employment or he resigns for good reason, his participation in group insurance coverages will continue on at least the same level as at the time of termination for a period of 36 months from the date of termination. In the event that the amounts payable to Mr. Kaczmarek under the agreement constitute “excess parachute payments” under the Internal Revenue Code of 1986, as amended, that are subject to an excise or similar tax, the amounts payable to Mr. Kaczmarek will be increased so that he receives substantially the same economic benefit under the agreement had there been no such tax imposed. Additionally, following the termination of his employment, Mr. Kaczmarek has agreed to refrain from certain activities that would be competitive with the Company within the counties in California in which the Company has located its headquarters or branch offices, including refraining for 12 months from the date of termination from soliciting Company employees and customers.

Mr. McGovern’s Employment Agreement. If Mr. McGovern’s employment is terminated without cause, he will be entitled to a lump sum payment equal to one times his base salary, his highest annual bonus in the last three years and his annual automobile allowance. If Mr. McGovern’s employment is terminated by the Company or he resigns for good reason 120 days before, or within two years after, a change in control, he will be entitled to a lump sum payment of two times his base salary, his highest annual bonus in the last three years and his annual automobile allowance. If the employment agreement is terminated by the Company without cause, his participation in group insurance coverage will continue on at least the same level as at the time of termination for a period of 12 months from the date of termination. If Mr. McGovern’s employment is terminated as a result of a change in control during the change of control period, or he resigns for a good reason as a result of a change in control, these benefits will continue for an additional 24 months from the date of termination. In the event that the amounts payable to Mr. McGovern under the agreement constitute “excess parachute payments” under the Internal Revenue Code of 1986, as amended, that are subject to an excise or similar tax, the amounts payable to Mr. McGovern will be increased so that he receives substantially the same economic benefit under the agreement had there been no such tax imposed. Additionally, following the termination of his employment, Mr. McGovern has agreed to refrain from certain activities that would be competitive with the Company within the counties in California in which the Company has located its headquarters or branch offices, including refraining for 12 months from the date of termination from soliciting Company employees or customers.

Mr. Benito’s Employment Agreement. If Mr. Benito’s employment agreement is terminated without cause, he will be entitled to a lump sum payment equal to one times his base salary and his average annual bonus during the last three years. If Mr. Benito’s employment is terminated by the Company or he resigns for good reason 120 days before or within two years after a change in control, he will be entitled to a lump sum payment of two times his base salary and his average annual bonus during the last three years. If Mr. Benito’s employment is terminated by the Company without cause, his participation in group insurance coverage will continue on at least the same level as at the time of termination for a period of 12 months from the date of termination. If Mr. Benito’s employment is terminated by the Company as a result of a change in control, or he resigns for a good reason as a result of a change in control, these benefits will continue for an additional 24 months from the date of termination. In the event that the amounts payable to Mr. Benito under the agreement constituted “excess parachute payments” under the Internal Revenue Code of 1986, as amended, that are subject to an excise or similar tax, the amounts payable to Mr. Benito will be increased so that he receives substantially the same economic benefit under the agreement had there been no such tax imposed. Additionally, following the termination of his employment, Mr. Benito has agreed to refrain from certain activities that would be competitive with the Company within the counties in California in which the Company has located its headquarters or branch offices, including refraining for 12 months from the date of termination from soliciting Company employees or customers.

Mr. Kawamoto's Employment Agreement. If Mr. Kawamoto's employment is terminated without cause, he will be entitled to a lump sum payment equal to one times his base salary and his highest annual bonus in the last three years. If Mr. Kawamoto's employment is terminated by the Company or he resigns for good reason 120 days before or within two years after a change in control, he will be entitled to a lump sum payment of two times his base salary and his highest annual bonus in the last three years. If his employment is terminated by the Company without cause, his participation in group insurance coverage will continue on at least the same level as at the time of termination for a period of 12 months from the date of termination. If Mr. Kawamoto's employment is terminated by the Company as a result of a change in control, or he resigns for a good reason as a result of a change in control, these benefits will continue for an additional 24 months from the date of termination. In the event that the amounts payable to Mr. Kawamoto under the agreement constitute "excess parachute payments" under the Internal Revenue Code of 1986, as amended, that are subject to an excise or similar tax, the amounts payable to Mr. Kawamoto will be increased so that he receives substantially the same economic benefit under the agreement had there been no such tax imposed. Additionally, following the termination of his employment, Mr. Kawamoto has agreed to refrain from certain activities that would be competitive with the Company within the counties in California in which the Company has located its headquarters or branch offices, including refraining for 12 months from the date of termination from soliciting Company employees or customers.

Mr. Porter's Employment Agreement. If Mr. Porter's employment agreement is terminated without cause, he will be entitled to a lump sum payment equal to one times his base salary and his average annual bonus during the last three years. If Mr. Porter's employment is terminated by the Company or he resigns for good reason 120 days before or within two years after a change in control, he will be entitled to a lump sum payment of two times his base salary and his average annual bonus during the last three years. If Mr. Porter's employment is terminated by the Company without cause, his participation in group insurance coverage will continue on at least the same level as at the time of termination for a period of 12 months from the date of termination. If Mr. Porter's employment is terminated by the Company as a result of a change in control, or he resigns for a good reason as a result of a change in control, these benefits will continue for an additional 24 months from the date of termination. Additionally, following the termination of his employment, Mr. Porter has agreed to refrain from certain activities that would be competitive with the Company within the counties in California in which the Company has located its headquarters or branch offices, including refraining for 12 months from the date of termination from soliciting Company employees or customers.

The following tables summarize the payments which would be payable to our named executive officers in the event of various termination scenarios as of December 31, 2012. This information is for illustrative purposes only. Regardless of the manner in which a named executive's employment terminates, the officer would be entitled to (i) the vested portion of any stock option or restricted stock; and (ii) the vested portion of the officer's benefit under the Supplemental Executive Retirement Plan.

	<u>Change in Control</u>	<u>Involuntary Termination Without Cause</u>	<u>Termination for Good Reason</u>	<u>Death</u>	<u>Disability</u>
Walter T. Kaczmarek					
Cash severance under employment agreement	\$1,052,425	\$ 765,400	\$ 765,400	\$ —	\$ —
Health and life insurance premiums	80,661	80,661	80,661	—	—
Health and life insurance benefits	—	—	—	700,000	180,000(4)
Long-term care insurance benefits	—	—	—	—	72,000
Supplemental executive retirement plan(1)(2)(3)	604,190	604,190	604,190	—	565,523
Unvested restricted stock awards (accelerated)	104,700	104,700	104,700	104,700	104,700
Split-dollar death benefits (upon death) . .	—	—	—	2,936,432	—
Outplacement services (layoff)	5,000	—	—	—	—
IRC 280(G) excise tax gross-up	741,764	—	—	—	—
Total:	<u>\$2,588,740</u>	<u>\$1,554,951</u>	<u>\$1,554,951</u>	<u>\$3,741,132</u>	<u>\$922,223</u>
Lawrence D. McGovern					
Cash severance under employment agreement	\$ 526,810	\$ 263,405	\$ —	\$ —	\$ —
Health and life insurance premiums	66,061	33,031	—	—	—
Health and life insurance benefits	—	—	—	484,800	161,584(4)
Long-term care insurance benefits	—	—	—	—	72,000
Unvested restricted stock awards (accelerated)	101,210	101,210	101,210	101,210	101,210
Split-dollar death benefits (upon death) . .	—	—	—	1,007,785	—
Total:	<u>\$ 694,081</u>	<u>\$ 397,646</u>	<u>\$ 101,210</u>	<u>\$1,599,795</u>	<u>\$334,794</u>
Michael E. Benito					
Cash severance under employment agreement	\$ 509,158	\$ 254,579	\$ —	\$ —	\$ —
Supplemental executive retirement plan(1)(3)	306,244	114,383	—	—	136,223
Health and life insurance premiums	27,618	13,809	—	—	—
Health and life insurance benefits	—	—	—	460,000	153,318(4)
Long-term care insurance benefits	—	—	—	—	72,000
Unvested stock options (accelerated)	6,015	—	—	—	—
Unvested restricted stock awards (accelerated)	62,820	62,820	62,820	62,820	62,820
Split-dollar death benefits (upon death) . .	—	—	—	849,614	—
IRC 280(G) excise tax gross-up	360,817	—	—	—	—
Total:	<u>\$1,272,672</u>	<u>\$ 445,591</u>	<u>\$ 62,820</u>	<u>\$1,372,434</u>	<u>\$424,361</u>

	<u>Change in Control</u>	<u>Involuntary Termination Without Cause</u>	<u>Termination for Good Reason</u>	<u>Death</u>	<u>Disability</u>
Dan T. Kawamoto					
Cash severance under employment agreement	\$ 525,004	\$ 262,502	\$ —	\$ —	\$ —
Health and life insurance premiums	66,350	33,175	—	—	—
Health and life insurance benefits	—	—	—	494,400	164,784(4)
Long-term care insurance benefits	—	—	—	—	72,000
Unvested stock options (accelerated)	13,393	—	—	—	—
Unvested restricted stock awards (accelerated)	101,210	101,210	101,210	101,210	101,210
Total:	<u>\$ 705,957</u>	<u>\$ 396,887</u>	<u>\$ 101,210</u>	<u>\$ 595,610</u>	<u>\$337,994</u>
David E. Porter					
Cash severance under employment agreement	\$ 516,070	\$ 258,035	\$ —	\$ —	\$ —
Health and life insurance premiums	70,137	35,068	—	—	—
Health and life insurance benefits	—	—	—	500,000	166,650(4)
Long-term care insurance benefits	—	—	—	—	72,000
Unvested stock options (accelerated)	209,400	209,400	209,400	209,400	209,400
Total:	<u>\$ 795,607</u>	<u>\$ 502,503</u>	<u>\$ 209,400</u>	<u>\$ 709,400</u>	<u>\$448,050</u>

- (1) Assumes executive selected age 62 for commencement of the payment of this benefit.
- (2) If Mr. Kaczmarek terminates his employment for good reason or he is terminated without cause, he is entitled to be credited with two additional years of service.
- (3) The amount reflected in the table is the incremental increase in the benefit payable to the named executive officer in addition to the benefit payable under the terms of the Supplemental Executive Retirement Plan. See “Supplemental Retirement Plan for Executive Officers” and the tables included therein for information about the value of the accumulated benefit payable to each named executive officer.
- (4) This balance represents the annual payment of long-term disability for the named executive officers. This long-term payment would begin after an elimination period and a twenty-five week short term disability period. This long-term disability payment will increase by 3% (cost of living adjustment) over the first ten years of payments and cease at age 65.

Director Compensation

This section provides information regarding the compensation policies for non-employee directors and amounts paid to these directors in 2012. Mr. Kaczmarek does not receive any separate compensation for his service as a director.

The Company has a policy of compensating non-employee directors for their service on the Board and Board committees of the Company. On an annual basis, the Compensation Committee reviews director compensation, including the individual fees and retainers, the components of compensation, as well as the total amount of director compensation appropriate for the Company.

In 2012, each director received an annual retainer fee of \$45,000 (increased to \$50,000 in November 2012). The chairman of each standing committee of the Board receives an additional \$3,000 per year, and

the Chairman of the Board receives an additional \$5,000 per year. Board Members are not paid separate fees for attending Board or committee meetings.

In addition to providing cash compensation, the Compensation Committee also believes in granting equity compensation to non-employee directors in order to further align their interests with those of shareholders and has adopted a policy of granting stock options to directors.

Directors are entitled to annual grants of stock options as follows:

Board Chairman	4,500 - 5,500
Committee Chairman	3,500 - 4,500
Board members (non-chairman)	3,000 - 4,000

In 2012, each of the directors received stock options in accordance with the above schedule.

The following table summarizes the compensation of non-employee directors for the year ended December 31, 2012.

Director Compensation Table

Name (a)	Fees Earned or Paid in Cash (\$) (b)	Stock Awards (\$) (c)	Options Awards (\$) (d)(1)	Non-Equity Incentive Plan Compensation (\$) (e)	Change in Pension Value and Nonqualified Deferred Compensation Earnings (\$) (f)(2)	All Other Compensation (\$) (g)	Total (\$) (h)
Frank G. Bisceglia	\$48,833	—	\$16,470	—	\$ 3,200	\$425(3)	\$ 68,928
Jack W. Conner	\$53,837	—	\$20,130	—	\$ 7,300	\$894(3)	\$ 82,161
John M. Eggemeyer	\$45,833	—	\$14,640	—	—	—	\$ 60,473
Celeste V. Ford	\$45,833	—	\$14,640	—	—	—	\$ 60,473
Steven L. Hallgrimson	\$45,833	—	\$14,640	—	—	—	\$ 60,473
Robert T. Moles	\$48,833	—	\$16,470	—	\$22,900	—	\$ 88,203
Humphrey P. Polanen	\$48,833	—	\$16,470	—	\$ 8,800	\$411(3)	\$ 74,514
Laura Roden	\$45,833	—	\$14,640	—	—	—	\$ 60,473
Charles J. Toeniskoetter	\$48,833	—	\$16,470	—	\$ 5,500	\$871(3)	\$ 71,674
Ranson W. Webster	\$49,083	—	\$16,470	—	\$14,500	\$398(3)	\$ 80,451
W. Kirk Wycoff	\$45,833	—	\$14,640	—	—	—	\$ 60,473

- (1) The amounts shown in column (d) reflect the applicable full grant date fair value for stock options issued under the Company's 2004 Equity Plan in 2012 in accordance with ASC 718 (excluding the effect of forfeitures). See Note 10 to the Company's consolidated financial statements for the year ended December 31, 2012, included in the Company's Annual Report on Form 10-K, filed with the SEC on March 8, 2013.
- (2) The amounts shown in column (f) represent only the aggregate change in the actuarial present value of the accumulated benefit measured from December 31, 2011, to December 31, 2012, under the respective director compensation benefits agreements. The amounts in column (f) were determined using interest rate and mortality rate assumptions, consistent with those used in the Company's consolidated financial statements, and include amounts which the named director may not currently be entitled to receive because such amounts are not vested. Assumptions used in the calculation of these amounts are included in Note 11 to the Company's consolidated financial statements for the year ended December 31, 2012, included in the Company's Annual Report on Form 10-K filed with the SEC on March 8, 2013.

- (3) The amounts shown reflect the annual income imputed to each director in connection with Company owned split-dollar life insurance policies for which the Company has fully paid the applicable premiums.

Director Outstanding Stock Options

Each of the non-employee directors owned the following stock options granted under the 1994 Stock Option Plan and/or 2004 Equity Plan as of December 31, 2012:

<u>Director</u>	<u>Stock Options</u>
Frank G. Bisceglia	26,300
Jack W. Conner	39,300
John M. Eggemeyer	8,000
Celeste V. Ford	18,500
Steven L. Hallgrimson	4,000
Robert T. Moles	33,300
Humphrey P. Polanen	26,300
Laura Roden	4,000
Charles J. Toeniskoetter	26,300
Ranson W. Webster	33,800
W. Kirk Wycoff	8,000

Director Compensation Benefits Agreement

Prior to 2007, the Company entered into individual director compensation benefits agreements with each of its then directors. These agreements were amended and restated in December, 2008 (“Benefit Agreements”). The Benefit Agreements provide an annual benefit equal to a designated applicable percentage of \$1,000 times each year served as a director, subject to a 2% increase each year from the date of the commencement of payments. The applicable percentage increases over time and equals 100% after nine years of service. In the event of a disability, or a resignation or termination pursuant to a change of control, the director’s applicable percentage will be accelerated to 100%. Payments of benefits will be made in equal monthly payments on the first day of each month, commencing on the later of the director’s attaining the age of 62 or the month following the month in which the director separates from service on the Board and continuing until the director’s death. If a director is removed from the Board for cause he or she will forfeit any benefits under the Benefit Agreement.

Company-owned split-dollar life insurance policies support the Company’s obligations under the Benefit Agreements. The premiums on the policies are paid by the Company. The cash value accrued on the policies supports the payment of the supplemental benefits for each participant. In the case of death of the participant, the participant’s designated beneficiaries will receive 80% of the net-at-risk insurance (which means the amount of the death benefit in excess of the cash value of the policy).

The following table shows the present value of the accumulated benefit payable to each director who has a director compensation benefit agreement, including the number of service years credited to each director under the Benefit Agreements.

Name (a)	Plan Name (b)	Number of Years Credited Service (#) (c)	Present Value of Accumulated Benefit(1)(2) (\$) (d)	Payments During Last Fiscal Year (\$) (e)
Frank G. Bisceglia	Heritage Commerce Corp SERP	19	\$214,000	—
Jack W. Conner	Heritage Commerce Corp SERP	8	\$ 60,700	—
Robert T. Moles	Heritage Commerce Corp SERP	8	\$120,500	—
Humphrey P. Polanen . . .	Heritage Commerce Corp SERP	19	\$259,900	—
Charles J. Toeniskoetter .	Heritage Commerce Corp SERP	11	\$114,500	—
Ranson W. Webster	Heritage Commerce Corp SERP	9	\$ 90,600	—

(1) The amounts in column (d) were determined using interest rate and mortality rate assumptions consistent with those used in the Company's consolidated financial statements and include amounts which the named executive officer may not currently be entitled to receive because such amounts are not vested. Assumptions used in the calculation of these amounts are included in Note 11 to the Company's consolidated financial statements for the year ended December 31, 2012 included in the Company's Annual Report on Form 10-K filed with the SEC on March 8, 2013.

(2) The following vesting percentages apply to the directors:

End of the year prior to termination	Frank G. Bisceglia	Jack W. Conner	Robert T. Moles	Humphrey P. Polanen	Charles T. Toeniskoetter	Ranson W. Webster
12/31/2012	100%	90%	90%	100%	100%	90%
12/31/2013	100%	100%	100%	100%	100%	100%
12/31/2014	100%	100%	100%	100%	100%	100%
12/31/2015	100%	100%	100%	100%	100%	100%
12/31/2016	100%	100%	100%	100%	100%	100%

PROPOSAL 1—ELECTION OF DIRECTORS

The Bylaws of the Company provide that the number of directors shall not be less than 9 nor more than 15. By resolution, the Board of Directors has fixed the number of directors at 12. All of our directors serve one year terms that expire at the next following annual meeting. The Bylaws of the Company provide the procedure for nominations and election of the Board of Directors. For information on these procedures see “Corporate Governance and Board Matters—Nomination of Directors.” Nominations not made in accordance with the procedures may be disregarded by the Chairman of the Annual Meeting and upon his instructions, the inspector of election will disregard all votes cast for such nominees.

The Board of Directors, upon the recommendation of the Corporate Governance and Nominating Committee, has recommended the nomination of the 12 current members of the Board of Directors for one year terms that will expire at the Annual Meeting to be held in 2014. If any nominee should become unable or unwilling to serve as a director, the proxies will be voted at the Annual Meeting for substitute nominees designated by the Board. The Board presently has no knowledge that any of the nominees will be unable or unwilling to serve.

The following provides information with respect to each person nominated and recommended to be elected to the Board of Directors:

FRANK G. BISCEGLIA, age 67, became a director of the Company in 1994. Mr. Bisceglia is a Senior Vice President—Investments, Advisory and Brokerage Services, Senior Portfolio Manager, Portfolio Management Program at UBS Financial Services, Inc., a full-service securities firm. Mr. Bisceglia has a Bachelor of Science degree in Industrial Management from San Jose State University. Mr. Bisceglia contributes to the Board a substantial understanding of finance and investments from over 31 years of experience as a financial advisor to corporate and high-wealth individuals. As a long-term member of the Board and its Loan Committee, he has a broad based understanding of the Company’s business and he has developed a general knowledge of the Company’s credit administration and loan underwriting process.

JACK W. CONNER, age 73, became a director of the Company in 2004. Mr. Conner was elected Chairman of the Board in July, 2006. Mr. Conner was Chairman and Chief Executive Officer of Comerica California from 1991 until his retirement in 1998, and remained a director until 2002. He was President and a director of Plaza Bank of Commerce from 1979 to 1991. Prior to joining Plaza Bank of Commerce, he held various positions with Union Bank of California where he began his banking career in 1964. Mr. Conner has a Bachelor of Arts degree from San Jose State University. Mr. Conner contributes to the Board over 20 years of executive leadership and substantial experience in the community banking industry. Having served as a Chief Executive Officer and President at several successful community banks in the Company’s primary market, he brings a wide-ranging understanding of bank management, finance, operations and strategic planning. His demonstrated leadership ability, judgment and executive experience led the Board to elect him as Chairman of the Board.

JOHN M. EGGEMEYER, age 67, is a co-founder and Chief Executive of Castle Creek Capital LLC, a merchant banking firm specializing in the financial services industry, and Castle Creek Financial LLC, a licensed broker/dealer. Mr. Eggemeyer is Chairman of the Board of PacWest Bancorp, and Chairman and Chief Executive Officer of White River Capital, Inc. Mr. Eggemeyer also serves as a director of Guaranty Bancorp and, from 2004 to May, 2006, Mr. Eggemeyer also served as Chief Executive Officer of Guaranty Bancorp. He has previously served as a director of TCF Financial Corporation, American Financial Realty Trust, Western Bancorp and Intrawest Financial Corporation. In 2006, Mr. Eggemeyer was named Community Banker of the Year by the American Banker. Mr. Eggemeyer currently serves as a trustee of Northwestern University and is a member of the Parent Advisory Board of Stanford University. Mr. Eggemeyer brings extensive leadership and banking experience to our Board, including specific community banking expertise and management experience, as well as public company expertise and consensus-building skills. His knowledge of and experience in capital markets is an invaluable resource as

the Company regularly assesses its capital and liquidity needs. Mr. Eggemeyer provides perspective to the Board as a key investor in the Company.

CELESTE V. FORD, age 56, became a director of the Company in 2009. Since 1995, Ms. Ford has served as the Chief Executive Officer of Stellar Solutions, Inc., a professional aerospace engineering services firm she formed. In 2000, she founded Stellar Ventures, a venture investment company for investment in early-stage technology development and market applications. Ms. Ford also co-founded QuakeFinder, a humanitarian research and development company, to enable global forecasts of earthquake activity. In 2004, she organized Stellar Solutions Aerospace Ltd., based in London, to serve overseas markets. Ms. Ford has received wide recognition in her field, having served on congressional commissions in the aerospace industry as well as on business panels focusing on entrepreneurship and women in business. She was recently inducted into the Silicon Valley Engineering Hall of Fame. Ms. Ford is a member of the Council on Foreign Relations and services on the engineering council of the University of Notre Dame and serves on the Board of Trustees of the University of Notre Dame. She is a member of the Board of Directors of Bay Microsystems and American Conservatory. Ms. Ford has a Bachelor of Science degree from the University of Notre Dame, and a Masters of Science degree from Stanford University. Ms. Ford contributes to the Board her demonstrated executive leadership and general business knowledge developed from her substantial success as an entrepreneur. Her engineering background, industry standing and government service bring a unique perspective to the Board.

STEVEN L. HALLGRIMSON, age 70, had been practicing law in the San Jose, California area since 1969 in the areas of real estate, taxation and general business planning and is a certified public accountant. He is currently of counsel with the law firm of Berliner Cohen located in San Jose, California. Mr. Hallgrimson has founded and served as a board member for several private business entities engaged in automobile lending, commercial real estate brokerage and telecommunications. He has been an instructor at San Jose State University Business School and University of California, Santa Cruz teaching a variety of business, real estate and tax courses. Mr. Hallgrimson is a member of the California State Bar and California Society of Certified Public Accountants. He serves as a trustee and president of the Santa Clara County Law Library and is a former board member of the San Jose Art Museum. Mr. Hallgrimson has a Bachelor of Arts degree from Claremont McKenna College and a Juris Doctor degree from the University of California at Berkeley, Boalt Hall School of Law. Mr. Hallgrimson brings legal, accounting and tax knowledge and experience to the Board and provides a valuable perspective to the Board as a result of his involvement and extensive relationships in the community in which the Company serves. His background is particularly suited to serve as a member of the Audit Committee and as the committee's "financial expert."

WALTER T. KACZMAREK, age 61, became President, Chief Executive Officer and a director of the Company in 2005. Mr. Kaczmarek was Executive Vice President of Comerica Bank and of Plaza Bank of Commerce from 1990 to 2005. Prior to joining Plaza Bank of Commerce he served in various positions with Union Bank of California and also The Martin Group, a real estate investment development company. Mr. Kaczmarek contributes to the Board his breadth of knowledge of the Company's business, industry and strategy. Mr. Kaczmarek has a Bachelor of Science in Commerce degree from Santa Clara University, and a Masters in Business Administration degree from San Jose State University. He brings to the Board a full understanding of the Company's banking business, markets, community and culture. He provides the Board with an overall perspective of all facets of the Company's business, financial condition and its strategic direction. Mr. Kaczmarek's leadership, communication, and decision-making skills are of particular value to the Board.

ROBERT T. MOLES, age 58, became a director of the Company in 2004. Mr. Moles has been the Chairman of the Board of Intero Real Estate Services, Inc., a full-service real estate firm since 2002. Prior to joining Intero, he served as President and Chief Executive Officer of the Real Estate Franchise Group of Cendant Corporation, the largest franchiser of residential and commercial real estate brokerage offices in the world. Prior to joining Cendant, he served as President and Chief Executive Officer of Contempo

Realty, Inc. in Santa Clara, California. Mr. Moles contributes to the Board a substantial expertise in the real estate industry in the Company's primary market. With over 33 years of experience in executive and managerial positions, he brings to the Board his skills in dealing with business and financial planning and personnel management. With his background, the Board elected him as Chairman of the Compensation Committee.

HUMPHREY P. POLANEN, age 63, became a director of the Company in 1994. Mr. Polanen is the managing member of Sand Hill Management Partners LLC, a private equity investment fund. Since 1999, Mr. Polanen has been actively involved as an investor and director in various venture capital-backed companies in the technology industry, and has served as a director of various private equity funds. He was the Managing Director of Internet Venture Partners BV, an investment firm, from 2000 to 2004. Prior to joining Internet Ventures, he served in various executive positions with Sun Microsystems and Tandem Computers. Mr. Polanen is a director (and former Chairman of the Board) of St. Bernard Software, a publicly traded Internet security company. Mr. Polanen practiced corporate law for over 10 years at the beginning of his career. He has a Bachelor of Arts degree from Hamilton College and a Juris Doctor degree from Harvard University. Mr. Polanen contributes to the Board a sophisticated knowledge and effective leadership perspective of general business, finance, investments and financial reporting developed over 30 years of experience as an executive, investor, director and business manager with advanced technology companies and private equity firms. He provides the Board with an important perspective on the technology industry. With his background, the Board elected him as Chairman of the Audit Committee.

LAURA RODEN, age 54, is the founder and managing director of VC Prive LLC, a boutique investment bank for alternative asset funds including venture capital, private equity, hedge and debt and affiliated with Aurus Advisors, a member of FINRA. Prior to founding VC Prive in 2007, she was the managing director for The Angels' Forum (Palo Alto, CA), an early stage angel and venture capital investing group for high net worth individuals. Most of her prior career was spent as chief financial officer at both established and emerging corporations, including most notably Chronicle Broadcasting Company (San Francisco, CA) and PowerTV, Inc (acquired by Cisco Corporation, San Jose, CA). Ms. Roden has expertise in general management, finance, fundraising and marketing. Ms. Roden has taught courses on finance at San Jose State University, and is a frequent speaker for angel investment and venture capital groups and associations. Ms. Roden has a Bachelor of Arts degree from Harvard College and Masters in Business Administration degree from Harvard Business School. Ms. Roden has extensive management experience in a full range of business operations, strategic planning, marketing strategies and capital formation for entrepreneurial companies in the technology industry. In addition, with her prior experience as a chief financial officer, she is particularly suited to serve as a member of the Board's Audit Committee.

CHARLES J. TOENISKOETTER, age 68, became a director of the Company in 2002. Mr. Toeniskoetter is Chairman of the Board of Toeniskoetter Development Inc. (formerly Toeniskoetter & Breeding, Inc., Development), a Silicon Valley real estate development and investment company. He is a member of the Board of Directors of Redwood Trust, Inc. and from 1991 to 2012 served on the Board of Directors of SJW Corp. (both New York Stock Exchange companies). Mr. Toeniskoetter has a Bachelor of Science degree from the University of Notre Dame and a Master of Business Administration degree from Stanford University. Mr. Toeniskoetter contributes to the Board his entrepreneurial skills and substantial experience as a successful real estate owner, developer and investor, and his executive and financial experience as an owner of several businesses in the Company's primary market. Mr. Toeniskoetter's involvement in local and community affairs, and his service on the boards of two other publicly traded companies provide valuable insight and perspective to the Board.

RANSON W. WEBSTER, age 68, became a director of the Company in 2004. Mr. Webster founded Computing Resources, Inc. ("CRI") in 1978, a privately-held general purpose service bureau specializing in automating accounting functions. He served as CRI's Chief Executive Officer and Chief Financial Officer. In 1999, CRI merged with Intuit, Inc., the maker of QuickBooks and Quicken financial software.

In 1998, Mr. Webster founded Evergreen Capital, LLC, an early stage investment company focused on Internet and biotech companies. Mr. Webster contributes to the Board substantial business acumen, executive strategic planning and financial experience developed through years of proven entrepreneurial success. Mr. Webster has a unique perspective of the Company and from his long-standing service on the Board. He has a general understanding of corporate governance principles as Chairman of the Board's Nominating and Corporate Governance Committee.

W. KIRK WYCOFF, age 54, is a managing partner of Patriot Financial Partners, a private equity fund focused on investing in community banks and thrifts throughout the United States. He has more than 30 years of entrepreneurial banking experience. Mr. Wycoff serves as a director of Guaranty Bancorp and its subsidiary, Guaranty Bank and Trust Company. He also serves as Chairman of Continental Bank Holdings, Inc. and its subsidiary, Continental Bank. In addition, Mr. Wycoff serves as a director of Porter Bancorp, Inc. and its subsidiary, PBI Bank. From 2005 to 2007, Mr. Wycoff served as President and Chief Executive Officer of Continental. From 1991 to 2004, Mr. Wycoff was Chairman and Chief Executive Officer of Progress Financial Corp., which was acquired by FleetBoston Financial Corp. in 2004. As an active member of the community, Mr. Wycoff serves on the Board of Directors of non-profit corporations including the Continental Foundation, which raises money for less privileged children, and the Lincoln Center, which helps to provide alternative education programs for troubled youth and also helps families with life transitions. Mr. Wycoff brings extensive leadership and community banking experience to our Board, including executive management experience, as well as public company expertise and risk assessment skills. He provides perspective to the Board as a key investor in the Company.

Recommendation of the Board of Directors

The Board of Directors recommends the election of each nominee. The proxy holders intend to vote all proxies they hold in favor of the election of each of the nominees. If no instruction is given, the proxy holders intend to vote FOR each nominee listed.

PROPOSAL 2—APPROVAL OF THE 2013 EQUITY INCENTIVE PLAN

In 2009 the Board of Directors amended the Company's existing 2004 Stock Option Plan and adopted the Heritage Commerce Corp Amended and Restated 2004 Equity Plan ("2004 Amended Plan") to among other things authorize the issuance of restricted stock. The shareholders approved the 2004 Amended Plan at the 2009 Annual Shareholders Meeting. The 2004 Amended Plan was not amended at that time to increase the number of shares of common stock for issuance pursuant to stock awards. The 2004 Amended Plan authorized the issuance of 1,750,000 shares of common stock for equity awards, including stock options and restricted stock. As of March 31, 2013, there were 1,323,967 of unexercised stock options issued under the 2004 Amended Plan and the Company's expired 1994 Stock Option Plan ("1994 Plan") outstanding, and 369,912 shares remained available for future issuances of stock awards under the 2004 Amended Plan. The 2004 Amended Plan expires in 2014.

The Board upon recommendation of the Compensation Committee is proposing for approval the 2013 Equity Incentive Plan ("Equity Plan"). The Equity Plan will authorize 1,750,000 shares of common stock for future issuance of stock awards granted under the Equity Plan. If the Equity Plan is approved by the shareholders, the Board of Directors will terminate the 2004 Plan, and no more stock awards will be issued under the 2004 Amended Plan.

The purpose of the Equity Plan is to promote the long-term success of the Company and the creation of shareholder value. The Board of Directors believes that the availability of stock awards is a key factor in the ability of the Company to attract and retain qualified individuals to serve as directors, officers and employees. We may provide these incentives through the grant of stock options, stock appreciation rights, restricted stock awards, restricted stock units, performance shares, and performance units (individually, an "Award"). The Equity Plan is also intended to permit us to grant Awards that qualify as performance-based compensation under Section 162(m) of the Internal Revenue Code (the "Code"). The shares available under the Equity Plan and shares currently subject to outstanding options issued under the 2004 Amended Plan and 1994 Plan represent approximately 9.6% percent of our issued and outstanding shares (assuming conversion of the Series C Preferred Stock). The Board believes the ratio of authorized shares under the Equity Plan to outstanding shares is at or below the ratio of other financial institutions in the Company's peer group.

Description of the 2013 Equity Incentive Plan

The following is a summary description of the Equity Plan. A copy of the 2013 Plan is attached as Exhibit A. The following summary is qualified in its entirety by reference to the full text of the Equity Plan.

Shares Subject to Equity Plan.

A total of 1,750,000 shares of our common stock is authorized and reserved for issuance under the Equity Plan.

Appropriate adjustments will be made in the number of authorized shares and in outstanding Awards to prevent dilution or enlargement of participants' rights in the event of a merger, consolidation, reorganization, reincorporation, recapitalization, reclassification, stock dividend, stock split, reverse stock split, split-up, split-off, spin-off, combination of shares, exchange of shares or other change in our capital structure that is effected without receipt of consideration by the Company. Shares subject to Awards which expire or are cancelled or forfeited will again become available for issuance under the Equity Plan. The shares available will not be reduced by Awards settled in cash or by shares withheld to satisfy tax withholding obligations. Only the net number of shares issued upon the exercise of stock appreciation rights or options exercised by tender of previously owned shares will be deducted from the shares available under the Equity Plan.

Administration. The administrator of our Equity Plan will be the Compensation Committee. Subject to the provisions of the Equity Plan, the Compensation Committee determines in its discretion the persons to whom and the times at which Awards are granted, the types and sizes of such Awards, and all of their terms and conditions. All Awards must be evidenced by a written agreement between us and the participant. The Compensation Committee may amend, cancel or renew any Award, waive any restrictions or conditions applicable to any Award, and accelerate, continue, extend or defer the vesting of any Award. The Committee will not have the authority to reprice, adjust or amend the exercise price of options or the grant price of stock appreciation rights previously awarded to any Participant, whether through amendment, cancellation and replacement grant, or any other means. The Compensation Committee has the authority to construe and interpret the terms of the Equity Plan and Awards granted under it.

Eligibility. Awards may be granted under the Equity Plan to our employees, officers, directors, or consultants or those of any present or future parent or subsidiary corporation or other affiliated entity. While we grant incentive stock options only to employees, we may grant nonstatutory stock options, stock appreciation rights, restricted stock awards, restricted stock units, performance shares and performance units to any eligible participant. The actual number of individuals who will receive an Award under the Equity Plan cannot be determined in advance because the Compensation Committee has the discretion to select the participants. The maximum number of shares of stock with respect to an Award or Awards may be granted to any participant may not exceed five percent (5%) of the total outstanding shares of common stock issued and outstanding.

Stock Options. The Compensation Committee may grant nonstatutory stock options, “incentive stock options,” within the meaning of Section 422 of the Code, or any combination of these. The number of shares of our common stock covered by each option will be determined by the Compensation Committee.

The exercise price of each option may not be less than the fair market value of a share of our common stock on the date of grant. Any incentive stock option granted to a person who owns stock possessing more than 10 percent of the total combined voting power of all classes of our stock or of any parent or subsidiary corporation must have an exercise price equal to at least 110 percent of the fair market value of a share of our common stock on the date of grant and a term not exceeding five years. In addition, the aggregate fair market value of the shares (determined on the grant date) covered by incentive stock options which first become exercisable by any participant during any calendar year may not exceed \$100,000. The term of all options other than any incentive stock option granted to a person who owns stock possessing more than 10 percent of the total combined voting power of all classes of our stock or of any parent or subsidiary corporation may not exceed ten years.

Options vest and become exercisable at such times or upon such events and subject to such terms, conditions, performance criteria or restrictions as specified by the Compensation Committee. Unless a longer period is provided by the Compensation Committee, an option generally will remain exercisable for ninety days following the participant’s termination of service, except that if service terminates as a result of the participant’s death or disability, the option generally will remain exercisable for one year, but in any event not beyond the expiration of its term.

The exercise price of each option must be paid in full in cash (or cash equivalent) at the time of exercise. The Compensation Committee also may permit payment through the tender of shares of our common stock that are already owned by the participant, through cashless exercise, by such other consideration as may be approved by the Compensation Committee from time to time to the extent permitted by applicable law, or by any combination thereof. At the time of exercise, a participant must pay any taxes that the Company is required to withhold.

Stock Appreciation Rights. A stock appreciation right gives a participant the right to receive the appreciation in the fair market value of our common stock between the date of grant of the Award and the

date of its exercise. We may pay the appreciation either in cash or in shares of our common stock. We may make this payment in a lump sum, or payment may be deferred in accordance with the terms of the participant's Award agreement. The Compensation Committee may grant stock appreciation rights under the Equity Plan in tandem with a related stock option or as a freestanding Award. A tandem stock appreciation right is exercisable only at the time and to the same extent that the related option is exercisable, and its exercise causes the related option to be canceled. Freestanding stock appreciation rights vest and become exercisable at the times and on the terms established by the Compensation Committee. The maximum term of any stock appreciation right granted under the Equity Plan is five years.

Restricted Stock Awards. The Compensation Committee may grant Awards of restricted stock under the Equity Plan. Awards of restricted stock may vest subject to the attainment of performance goals similar to those described below or satisfaction of certain service-based or other vesting conditions as the Compensation Committee specifies, and the shares acquired may not be transferred by the participant until vested. Unless otherwise determined by the Compensation Committee, a participant will forfeit any unvested shares upon voluntary or involuntary termination of service with us for any reason, including death or disability. Except as otherwise provided in the Equity Plan or Award agreement, participants holding restricted stock will have the right to vote the shares and to receive any dividends paid, except that dividends or other distributions paid in shares will be subject to the same restrictions as the original Award.

Restricted Stock Units. Restricted stock units granted under the Equity Plan represent a right to receive shares of our common stock at a future date determined in accordance with the participant's Award agreement. The Compensation Committee may grant restricted stock units subject to the attainment of performance goals similar to those described below, or may make the Awards subject to service-based and other vesting conditions.

Performance Shares and Performance Units. The Compensation Committee may grant performance shares and performance units under the Equity Plan, which are Awards that will result in a payment to a participant only if specified performance goals are achieved during a specified performance period. Awards of performance shares are denominated in shares of our common stock, while Awards of performance units are denominated in dollars. In granting an Award of performance shares or units, the Compensation Committee establishes the applicable performance goals based on one or more measures of business performance enumerated in the Equity Plan and described in the performance goal section below.

To the extent earned, Awards of performance shares and units may be settled in cash, shares of our common stock or any combination thereof. Unless otherwise determined by the Compensation Committee, if a participant's service terminates due to death or disability prior to completion of the applicable performance period, the final Award value is determined at the end of the period on the basis of the performance goals attained during the entire period, but payment is prorated for the portion of the period during which the participant remained in service. Except as otherwise provided by the Equity Plan, if a participant's service terminates for any other reason, the participant's performance shares or units are forfeited.

Performance Goals. The Compensation Committee (in its discretion) may make performance goals applicable to a participant with respect to an Award, including but not limited to performance shares and performance units. If the Compensation Committee desires that an Award qualify as performance-based compensation under Section 162(m), then, at the Compensation Committee's discretion, one or more of the following performance goals may apply: revenue, costs, expenses (including expense efficiency ratios and other expense measures), earnings (including one or more of net profit after tax, gross profit, operating profit, earnings before interest and taxes, earnings before interest, taxes, depreciation and amortization and net earnings), earnings per share, earnings per share from continuing operations, operating income, pre-tax income, operating income margin, net income, margins (including one or more of gross, operating and net income margins), returns (including one or more of return on actual assets, net assets, equity, investment, capital and net capital employed), shareholder return (including total

shareholder return relative to an index or peer group), stock price, growth of loans and deposits, economic value added, cash generation, cash flow, unit volume, working capital, market share, cost reductions and strategic plan development and implementation. Such goals may reflect absolute entity or business unit performance or a relative comparison to the performance of a peer group of entities or other external measure of the selected performance criteria. Unless otherwise determined by the Compensation Committee at the time of establishment of the performance goals applicable to an Award, the performance measures shall be calculated in accordance with generally accepted accounting principles, but prior to the accrual or payment of any Award subject to performance goals and excluding the effect (whether positive or negative) of any change in accounting standards or any extraordinary, unusual or nonrecurring item, as determined by the Compensation Committee, occurring after the establishment of the performance goals applicable to the Award.

Change in Control. Upon a change of control (as defined in the Equity Plan) the Company will notify each participant in writing, no less than thirty (30) days prior to the change of control of participant's right to exercise all outstanding options, whether or not vested, and (ii) all outstanding options will vest and become immediately exercisable immediately prior to such change of control. All then outstanding options will terminate upon the Change of Control; provided, however, that any outstanding options not exercised as of the occurrence of the change of control will not terminate if there is a successor entity which assumes the outstanding options or substitutes for such options, new options covering the stock of the successor entity with appropriate adjustments as to the number and kind of shares and prices. Each restricted stock award will provide in the event of a change in control for the lapse of the restriction period applicable to restricted stock effective immediately prior to and conditioned upon the change in control. Each restricted stock unit award will provide that the settlement of the restricted stock unit effective immediately prior to and conditioned upon the Change in Control. The Committee, in its sole discretion, may provide in any stock appreciation right or performance award for the acceleration of the exercisability and vesting of the stock appreciation right or performance award in connection with a change in control.

Transferability. Awards granted under the Equity Plan shall not be subject in any manner to anticipation, alienation, sale, exchange, transfer, assignment, pledge, encumbrance, or garnishment by creditors of the participant or the participant's beneficiary, except transfer by will or by the laws of descent and distribution.

Amendment and Termination. The Equity Plan shall continue in effect until the earlier of its termination by the Board of Directors or the date on which all of the shares of our common stock available for issuance under the Equity Plan have been issued and all restrictions on such shares under the terms of the Equity Plan and the agreements evidencing Awards granted under the Equity Plan have lapsed. However, no Awards will be granted under the Equity Plan after the tenth anniversary of the Equity Plan's effective date.

In addition, the Compensation Committee may amend, suspend or terminate the Equity Plan at any time, provided that without shareholder approval, the Equity Plan cannot be amended to increase the number of shares authorized, change the class of persons eligible to receive incentive stock options or effect any other change that would require shareholder approval under any applicable law or listing rule. Amendment, suspension or termination of the Equity Plan may not adversely affect any outstanding Award without the consent of the participant, unless such amendment, suspension or termination is necessary to comply with applicable law.

Certain United States Federal Income Tax Information

The following paragraphs are a summary of the general federal income tax consequences to U.S. taxpayers and the Company of Awards granted under the Equity Plan. Tax consequences for any particular individual may be different.

The following discussion assumes that the fair market value of our common stock on the date of exercise is greater than the per share exercise price.

Nonstatutory Stock Options. No taxable income is reportable when a nonstatutory stock option with an exercise price equal to the fair market value of the underlying stock on the date of grant is granted to a participant. Upon exercise, the participant will recognize ordinary income in an amount equal to the excess of the fair market value (on the exercise date) of the shares purchased over the exercise price of the option. Any taxable income recognized in connection with an option exercise by an employee of the Company is subject to tax withholding by the Company. Any additional gain or loss recognized upon any later disposition of the shares would be capital gain or loss.

Incentive Stock Options. No taxable income is reportable when an incentive stock option is granted or exercised (except for purposes of the alternative minimum tax, in which case taxation is the same as for nonstatutory stock options). If the participant exercises the option and then later sells or otherwise disposes of the shares more than two years after the grant date and more than one year after the exercise date, the difference between the sale price and the exercise price will be taxed as capital gain or loss. If the participant exercises the option and then later sells or otherwise disposes of the shares before the end of the two- or one-year holding periods described above, he or she generally will have ordinary income at the time of the sale equal to the fair market value of the shares on the exercise date (or the sale price, if less) minus the exercise price of the option. Subject to certain exceptions for death or disability, if an option holder exercises an incentive stock option more than three months after termination of employment, the exercise of the option will be taxed as the exercise of a nonqualified stock option. In addition, the exercise of an incentive stock option will be treated essentially the same as the exercise of a nonqualified stock option for purposes of the federal alternative minimum tax (“AMT”), which exercise may subject the option holder to AMT.

Stock Appreciation Rights. No taxable income is reportable when a stock appreciation right with an exercise price equal to the fair market value of the underlying stock on the date of grant is granted to a participant. Upon exercise, the participant will recognize ordinary income in an amount equal to the amount of cash received and the fair market value of any shares received. Any additional gain or loss recognized upon any later disposition of the shares would be capital gain or loss.

Restricted Stock Awards, Restricted Stock Units, Performance Shares and Performance Units. A participant generally will not have taxable income at the time an Award of restricted stock, restricted stock units, performance shares, or performance units are granted. Instead, he or she will recognize ordinary income in the first taxable year in which his or her interest in the shares underlying the Award becomes either (i) freely transferable, or (ii) no longer subject to a substantial risk of forfeiture. However, the recipient of an Award of restricted stock may elect to recognize income at the time he or she receives the Award in an amount equal to the fair market value of the shares underlying the Award (less any cash paid for the shares on the date the Award is granted). A participant who makes an election under Section 83(b) of the Code within thirty days of the date of grant of the restricted stock, will recognize ordinary income on the date of grant of the shares equal to the excess of the fair market value of the restricted shares (determined without regard to the risk of forfeiture or restrictions on transfer) over any purchase price paid for the shares. If a Section 83(b) election has not been made, any dividends received with respect to restricted shares of stock that are subject at that time to a risk of forfeiture or restrictions on transfer generally will be treated as compensation that is taxable as ordinary income to the recipient.

Section 409A. Section 409A of the Code contains certain requirements for non-qualified deferred compensation arrangements with respect to an individual’s deferral and distribution elections and permissible distribution events. Awards granted under the Equity Plan with a deferral feature will be subject to the requirements of Section 409A. If an Award is subject to and fails to satisfy the requirements of Section 409A, the recipient of that Award may recognize ordinary income on the amounts deferred under the Award, to the extent vested, which may be prior to when the compensation is actually or

constructively received. Also, if an Award that is subject to Section 409A fails to comply with Section 409A's provisions, Section 409A imposes an additional 20% federal income tax on compensation recognized as ordinary income, as well as interest on such deferred compensation. In addition, certain states (such as California) have laws similar to Section 409A and as a result, failure to comply with such similar laws may result in additional state income, penalty and interest charges.

Tax Effect for the Company. The Company generally will be entitled to a tax deduction in connection with an Award under the Equity Plan in an amount equal to the ordinary income realized by a participant and at the time the participant recognizes such income (for example, the exercise of a nonstatutory stock option). Special rules limit the deductibility of compensation paid to the Company's Chief Executive Officer, Chief Financial Officer and to each of its three most highly compensated executive officers (other than our Chief Executive Officer and our Chief Financial Officer). Under Section 162(m), the annual compensation paid to any of these specified executives will be deductible only to the extent that it does not exceed \$1,000,000. However, the Company can preserve the deductibility of certain compensation in excess of \$1,000,000 if the conditions of Section 162(m) are met. These conditions include stockholder approval of the Equity Plan, setting limits on the number of Awards that any individual may receive and for Awards other than certain stock options and stock appreciation rights, establishing performance criteria that must be met before the Award actually will vest or be paid. The Equity Plan has been designed to permit the Compensation Committee to grant Awards that qualify as performance-based for purposes of satisfying the conditions of Section 162(m), thereby permitting the Company to continue to receive a federal income tax deduction in connection with such Awards.

THE FOREGOING IS ONLY A SUMMARY OF THE EFFECT OF UNITED STATES FEDERAL INCOME TAXATION UPON PARTICIPANTS AND THE COMPANY WITH RESPECT TO THE GRANT, EXERCISE AND/OR VESTING OF AWARDS UNDER THE EQUITY PLAN. IT DOES NOT PURPORT TO BE COMPLETE, AND DOES NOT DISCUSS THE TAX CONSEQUENCES OF A PARTICIPANT'S DEATH OR THE PROVISIONS OF THE INCOME TAX LAWS OF ANY MUNICIPALITY, STATE OR FOREIGN COUNTRY IN WHICH THE PARTICIPANT MAY RESIDE.

Recommendation of the Board of Directors

The Board of Directors recommends approval of the proposed 2013 Equity Incentive Plan. The proxy holders intend to vote all proxies they hold in favor of the proposal. If no instruction is given, the proxy holders intend to vote FOR approval of the Plan.

PROPOSAL 3—RATIFICATION OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Board of Directors, upon the recommendation of its Audit Committee, has ratified the selection of Crowe Horwath LLP to serve as our independent registered public accounting firm for 2013, subject to ratification by our shareholders. A representative of Crowe Horwath LLP will be present at the Annual Meeting to answer questions and will have the opportunity to make a statement if so desired.

We are asking our shareholders to ratify the selection of Crowe Horwath LLP as our independent registered public accounting firm. Although ratification is not required by our Bylaws, the SEC or The NASDAQ Stock Market, the Board is submitting the selection of Crowe Horwath LLP to our shareholders for ratification because we value our shareholders' views on the Company's independent registered public accounting firm and as a matter of good corporate practice. In the event that our shareholders fail to ratify the selection of Crowe Horwath LLP, however, we reserve the discretion to retain Crowe Horwath LLP as our independent registered public accounting firm for 2013. Even if the selection is ratified, the Audit Committee, in its discretion, may select a different independent registered public accounting firm at any time during the year if it determines that such a change would be in the best interests of the Company and our shareholders.

Audit Committee Report

In accordance with its written charter adopted by the Company's Board of Directors, the Audit Committee assists the Board in fulfilling its responsibility for oversight of the quality and integrity of the accounting, auditing, and financial reporting practices of the Company. During 2012, the Committee met 10 times, and the Committee chair, as representative of the Audit Committee, discussed the interim financial information contained in each quarterly earnings announcement with the Chief Financial Officer prior to public release. The Committee discussed the interim financial statements with the Chief Financial Officer and the independent auditors prior to the filing of each quarterly Form 10-Q.

In discharging its oversight responsibility as to the audit process, the Audit Committee obtained from the independent auditors a formal written statement describing all relationships between the auditors and the Company that might bear on the auditors' independence, discussed with the auditors any relationships that may impact their objectivity and independence and satisfied itself as to the auditors' independence. The Committee reviewed with both the independent auditors and the internal auditors their audit plans, scope, and results.

The Committee discussed and reviewed with the independent auditors all communications required by generally accepted auditing standards, including those described in Statement on Auditing Standards No. 61, as amended, "Communication with Audit Committees," (AICPA, Professional Standards, Vol. AU Section 380) and discussed and reviewed the results of the independent auditors' audit of the consolidated financial statements. The Committee also reviewed and discussed the results of the internal audit examinations.

The Committee reviewed the audited financial statements of the Company as of and for the year ended December 31, 2012, with management and the independent auditors. The Committee has also reviewed "Management's Report on Internal Control over Financial Reporting" and the independent registered public accounting firm's opinion on the effectiveness of the Company's internal control over financial reporting, and discussed these reports and opinions with management and the independent registered public accounting firm prior to the Company's filing of its Annual Report on Form 10-K for the year ended December 31, 2012.

Based on the above-mentioned review and discussion with management and the independent auditors, the Committee recommended to the Board of Directors that the Company's audited financial statements be included in its Annual Report on Form 10-K for the year ended December 31, 2012, for filing with the SEC.

Heritage Commerce Corp
Audit Committee

Humphrey P. Polanen, Chairman
Celeste V. Ford
Steven L. Hallgrimson
Laura Roden

March 8, 2013

The Audit Committee report shall not be deemed incorporated by reference by any general statement incorporating by reference this proxy statement into any filing under the Securities Act of 1933 or the Securities Act of 1934, and shall not otherwise be deemed filed under these Acts.

Independent Registered Public Accounting Firm Fees

The following table summarizes the aggregate fees billed to the Company by its independent auditor:

<u>Category of Services</u>	<u>Fiscal Year 2012</u>	<u>Fiscal Year 2011</u>
Audit fees(1)	\$315,000	\$571,500
Audit-related fees(2)	68,900	55,325
Tax fees(3)	49,685	47,350
Total accounting fees	<u>\$433,585</u>	<u>\$674,175</u>

- (1) Fees for audit services for 2012 and 2011 consisted of the audit of the Company’s annual financial statements, review of the consolidated financial statements included in the Company’s Quarterly Reports on Form 10-Q, and the audit of the Company’s internal control over financial reporting as required by Section 404 of the Sarbanes-Oxley Act of 2002. Fees for 2011 include services related to the Company’s registration statements filed with the SEC in 2011.
- (2) Fees for audit related services for 2012 and 2011 consisted of financial accounting and reporting consultations, consents and other services related to SEC matters, and audits of the consolidated financial statements of the Company’s employee benefit plans.
- (3) Fees for tax services for 2012 and 2011 consisted of tax compliance and tax planning and advice.
 - Fees for tax compliance services totaled \$38,935 and \$41,000 in 2012 and 2011, respectively. Tax compliance services are those rendered based upon facts already in existence or transactions that have already occurred to document, compute, and obtain government approval for amounts to be included in tax filings. Such services consisted primarily of preparation of the Company’s consolidated federal and state income tax returns, assistance with state tax credits, and assistance regarding audits of the Company’s California state tax returns.
 - Tax planning and advice services are those rendered with respect to proposed transactions, assistance regarding the Internal Revenue Code Section 280(G) “excise tax gross-up” disclosures in the proxy statement for hypothetical events, and consultation with management regarding various internal control and accounting matters. Tax planning and advice services totaled \$10,750 and \$6,350 in 2012 and 2011, respectively.

The ratio of tax planning and advice fees and all other fees to audit fees, audit-related fees and tax compliance fees was 2.54% for 2012 and 0.95% for 2011.

In considering the nature of the services provided by the independent registered public accounting firm, the Audit Committee determined that such services are compatible with the provision of independent audit services. The Audit Committee discussed these services with the independent registered public accounting firm and Company management to determine that they are permitted under the rules and regulations concerning auditor independence promulgated by the SEC and the Public Company Accounting Oversight Board.

Policy on Audit Committee Pre-Approval of Audit and Permissible Non-Audit Services of Independent Registered Public Accounting Firm

Under applicable SEC rules, the Audit Committee is required to pre-approve the audit and non-audit services performed by the independent registered public accountants in order to ensure that they do not

impair the auditors' independence. The SEC's rules specify the types of non-audit services that the independent registered public accountants may not provide to its audit client and establish the Audit Committee's responsibility for administration of the engagement of the independent registered public accountants.

Consistent with the SEC's rules, the Audit Committee Charter requires that the Audit Committee review and pre-approve all audit services and permitted non-audit services provided by the independent registered public accountants to the Company or any of its subsidiaries. The Audit Committee may delegate pre-approval authority to the Chair of the Audit Committee and if it does, the decisions of that member must be presented to the full Audit Committee at its next scheduled meeting.

Recommendation of the Audit Committee and the Board of Directors

The Audit Committee of the Board of Directors and the Board of Directors recommends approval of the ratification of the appointment of Crowe Horwath LLP as the Company's independent registered public accounting firm for the year ending December 31, 2013. The proxy holders intend to vote all proxies they hold in favor of the proposal. If no instruction is given, the proxy holders intend to vote FOR approval of the proposal.

OTHER BUSINESS

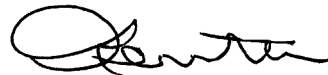
If any matters not referred to in this proxy statement come before the meeting, including matters incident to conducting the meeting, the proxy holders will vote the shares represented by proxies in accordance with their best judgment. Management is not aware of any other business to come before the meeting and, as of the date of the preparation of this proxy statement, no shareholder has submitted to management any proposal to be acted upon at the meeting.

SHAREHOLDER PROPOSALS

Under certain circumstances, shareholders are entitled to present proposals at shareholders' meetings, provided that the proposal is presented in a timely manner and in a form that complies with applicable regulations. Any shareholder proposals intended to be presented for consideration at the 2014 Annual Meeting of Shareholders, and to be included in the Company's proxy statement for that meeting under SEC Rule 14a-8, must be received by the Company for inclusion in the proxy statement and form of proxy for that meeting no later than December 16, 2013, in a form that complies with applicable regulations. If the date of next year's Annual Meeting is moved more than 30 days before or after the anniversary of this year's Annual Meeting, the deadline for inclusion is instead a reasonable time before the Company begins to print and mail its proxy materials.

For a shareholder proposal to be presented at the Annual Meeting that is not intended to be included in the Company's proxy statement under SEC Rule 14a-8, the proposal must be submitted at least 45 days before the date this proxy statement and form of proxy is first mailed to shareholders. If the date of next year's Annual Meeting is more than 30 days before or after the anniversary of this year's Annual Meeting, the deadline for submitting a proposal is instead a reasonable time before the Company begins to print and mail its proxy materials.

HERITAGE COMMERCE CORP



Debbie Reuter
Corporate Secretary

April 17, 2013
San Jose, California

HERITAGE COMMERCE CORP
2013 Equity Incentive Plan

1. *ESTABLISHMENT, PURPOSE AND TERM OF PLAN.*

1.1 *Establishment.* The Heritage Commerce Corp 2013 Equity Incentive Plan (the “**Plan**”) is hereby established effective as of _____, 2013, the date of its approval by the shareholders of the Company (the “**Effective Date**”).

1.2 *Purpose.* The purpose of the Plan is to advance the interests of the Company, its subsidiaries, and its shareholders by providing an incentive to attract, retain and reward persons performing services for the Company and its subsidiaries and by motivating such persons to contribute to the growth and profitability of the Company and its subsidiaries. The Plan seeks to achieve this purpose by providing for Awards in the form of Options, Stock Appreciation Rights, Restricted Stock, Performance Shares, Performance Units and Restricted Stock Units.

1.3 *Term of Plan.* The Plan shall continue in effect until the earlier of its termination by the Board or the date on which all of the shares of Stock available for issuance under the Plan have been issued and all restrictions on such shares under the terms of the Plan and the agreements evidencing Awards granted under the Plan have lapsed. However, all Awards shall be granted, if at all, within ten (10) years from the Effective Date.

2. *DEFINITIONS AND CONSTRUCTION.*

2.1 *Definitions.* Whenever used herein, the following terms shall have their respective meanings set forth below:

(a) “**Affiliate**” means (i) an entity, other than a Parent Corporation, that directly, or indirectly through one or more intermediary entities, controls the Company or (ii) an entity, other than a Subsidiary Corporation, that is controlled by the Company directly, or indirectly through one or more intermediary entities. For this purpose, the term “**control**” (including the term “**controlled by**”) means the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of the relevant entity, whether through the ownership of voting securities, by contract or otherwise; or shall have such other meaning assigned such term for the purposes of registration on Form S-8 under the Securities Act.

(b) “**Award**” means any Option, SAR, Restricted Stock, Performance Share, Performance Unit or Restricted Stock Unit granted under the Plan.

(c) “**Award Agreement**” means a written agreement between the Company and a Participant setting forth the terms, conditions and restrictions of the Award granted to the Participant. An Award Agreement may be an “Option Agreement,” an “SAR Agreement,” a “Restricted Stock Agreement,” a “Performance Share Agreement,” a “Performance Unit Agreement” or a “Restricted Stock Unit Agreement.”

(d) “**Board**” means the Board of Directors of the Company.

(e) “**Cause**” means, unless otherwise defined by the Participant’s Award Agreement or contract of employment or service, any of the following: (i) the Participant’s theft, dishonesty, or falsification of any Participating Company documents or records; (ii) the Participant’s improper use or disclosure of a Participating Company’s confidential or proprietary information; (iii) any action by the Participant which has a detrimental effect on a Participating Company’s reputation or business; (iv) the Participant’s failure or inability to perform any reasonable assigned duties after written notice from a Participating Company of, and a reasonable opportunity to cure, such

failure or inability; (v) any material breach by the Participant of any employment or service agreement between the Participant and a Participating Company, which breach is not cured pursuant to the terms of such agreement; or (vi) the Participant's conviction (including any plea of guilty or nolo contendere) of any criminal act which impairs the Participant's ability to perform his or her duties with a Participating Company.

(f) “**Change of Control**” has the meaning set forth in *Section 12.1(b)*.

(g) “**Code**” means the Internal Revenue Code of 1986, as amended, and any applicable regulations promulgated thereunder.

(h) “**Committee**” means the Compensation Committee or other committee of the Board duly appointed to administer the Plan and having such powers as shall be specified by the Board. If no committee of the Board has been appointed to administer the Plan, the Board shall exercise all of the powers of the Committee granted herein, and, in any event, the Board may in its discretion exercise any or all of such powers.

(i) “**Company**” means Heritage Commerce Corp, a California corporation, or any successor corporation thereto.

(j) “**Consultant**” means a person engaged to provide consulting or advisory services (other than as an Employee or a member of the Board) to a Participating Company, provided that the identity of such person, the nature of such services or the entity to which such services are provided would not preclude the Company from offering or selling securities to such person pursuant to the Plan in reliance on registration on a Form S-8 Registration Statement under the Securities Act.

(k) “**Director**” means a member of the Board.

(l) “**Disability**” means the permanent and total disability of the Participant, within the meaning of Section 22(e)(3) of the Code.

(m) “**Dividend Equivalent**” means a credit, made at the discretion of the Committee or as otherwise provided by the Plan, to the account of a Participant in an amount equal to the cash dividends paid on one share of Stock for each share of Stock represented by an Award held by such Participant.

(n) “**Employee**” means any person treated as an employee (including an Officer or a member of the Board who is also treated as an employee) in the records of a the Company and, with respect to any Incentive Stock Option granted to such person, who is an employee for purposes of Section 422 of the Code; provided, however, that neither service as a member of the Board nor payment of a director's fee shall be sufficient to constitute employment for purposes of the Plan. The Company shall determine in good faith and in the exercise of its discretion whether an individual has become or has ceased to be an Employee and the effective date of such individual's employment or termination of employment, as the case may be. For purposes of an individual's rights, if any, under the Plan as of the time of the Company's determination, all such determinations by the Company shall be final, binding and conclusive, notwithstanding that the Company or any court of law or governmental agency subsequently makes a contrary determination.

(o) “**Exchange Act**” means the Securities Exchange Act of 1934, as amended.

(p) “**Fair Market Value**” means, as of any date, the value of a share of Stock or other property as determined by the Committee, in its discretion, or by the Company, in its discretion, if such determination is expressly allocated to the Company herein, subject to the following:

(i) If, on such date, the Stock is listed on a national or regional securities exchange or market system, the Fair Market Value of a share of Stock shall be the closing price of a share of Stock (or the mean of the closing bid and asked prices of a share of Stock if the Stock is so quoted instead) as quoted on The Nasdaq Stock Market, the New York Stock Exchange or such other national or regional securities exchange or market system constituting the primary market for the Stock, as reported in The Wall Street Journal or such other source as the Company deems reliable. If the relevant date does not fall on a day on which the Stock has traded on such securities exchange or market system, the date on which the Fair Market Value shall be established shall be the last day on which the Stock was so traded prior to the relevant date, or such other appropriate day as shall be determined by the Committee, in its discretion.

(ii) If, on such date, the Stock is not readily tradable on an established securities market, the Fair Market Value of a share of Stock shall be as determined by the Committee by reasonable application of a reasonable valuation method, consistently applied. Notwithstanding the foregoing, no Award granted under the Plan is intended to provide for a deferral of compensation within the meaning of Section 409A such that the Fair Market Value of a share of Stock shall be determined in all respects in a manner that is consistent with that intention.

(q) “**Incentive Stock Option**” means an Option intended to be (as set forth in the Award Agreement) and which qualifies as an incentive stock option within the meaning of Section 422(b) of the Code.

(r) “**Insider**” means an Officer, a member of the Board or any other person whose transactions in Stock are subject to Section 16 of the Exchange Act.

(s) “**Nonstatutory Stock Option**” means an Option not intended to be (as set forth in the Award Agreement) an incentive stock option within the meaning of Section 422(b) of the Code.

(t) “**Officer**” means any person designated by the Board as an officer of the Company.

(u) “**Option**” means the right to purchase Stock at a stated price for a specified period of time granted to a Participant pursuant to *Section 6* of the Plan. An Option may be either an Incentive Stock Option or a Nonstatutory Stock Option.

(v) “**Ownership Change Event**” has the meaning set forth in *Section 12.1(a)*.

(w) “**Parent Corporation**” means any present or future “**parent corporation**” of the Company, as defined in Section 424(e) of the Code.

(x) “**Participant**” means any eligible person who has been granted one or more Awards.

(y) “**Participating Company**” means the Company or any Parent Corporation, Subsidiary Corporation or Affiliate.

(z) “**Participating Company Group**” means, at any point in time, all entities collectively which are then Participating Companies.

(aa) “**Performance Award**” means an Award of Performance Shares or Performance Units.

(bb) “**Performance Award Formula**” means, for any Performance Award, a formula or table established by the Committee pursuant to *Section 9.3* of the Plan which provides the basis for computing the value of a Performance Award at one or more threshold levels of attainment of

the applicable Performance Goal(s) measured as of the end of the applicable Performance Period.

(cc) “**Performance Goal**” means a performance goal established by the Committee pursuant to *Section 9.3* of the Plan.

(dd) “**Performance Period**” means a period established by the Committee pursuant to *Section 9.3* of the Plan at the end of which one or more Performance Goals are to be measured.

(ee) “**Performance Share**” means a bookkeeping entry representing a right granted to a Participant pursuant to *Section 9* of the Plan to receive a payment equal to the value of a Performance Share, as determined by the Committee, based on performance.

(ff) “**Performance Unit**” means a bookkeeping entry representing a right granted to a Participant pursuant to *Section 9* of the Plan to receive a payment equal to the value of a Performance Unit, as determined by the Committee, based upon performance.

(gg) “**Restricted Stock Award**” means an Award of a Restricted Stock.

(hh) “**Restricted Stock Unit**” means a bookkeeping entry representing a right granted to a Participant pursuant to *Section 10* of the Plan to receive a share of Stock on a date determined in accordance with the provisions of *Section 10* and the Participant’s Award Agreement.

(ii) “**Restriction Period**” means the period established in accordance with *Section 8.5* of the Plan during which shares subject to a Restricted Stock Award are subject to Vesting Conditions.

(jj) “**Rule 16b-3**” means Rule 16b-3 under the Exchange Act, as amended from time to time, or any successor rule or regulation.

(kk) “**SAR**” or “**Stock Appreciation Right**” means a bookkeeping entry representing, for each share of Stock subject to such SAR, a right granted to a Participant pursuant to *Section 7* of the Plan to receive payment of an amount equal to the excess, if any, of the Fair Market Value of a share of Stock on the date of exercise of the SAR over the exercise price.

(ll) “**Section 162(m)**” means Section 162(m) of the Code.

(mm) “**Securities Act**” means the Securities Act of 1933, as amended.

(nn) “**Service**” means a Participant’s employment or service with the Participating Company Group, whether in the capacity of an Employee, a Director or a Consultant. A Participant’s Service shall not be deemed to have terminated merely because of a change in the capacity in which the Participant renders such Service or a change in the Participating Company for which the Participant renders such Service, provided that there is no interruption or termination of the Participant’s Service. Furthermore, a Participant’s Service shall not be deemed to have terminated if the Participant takes any military leave, sick leave, or other bona fide leave of absence approved by the Company. However, if any such leave taken by a Participant exceeds ninety (90) days, then on the one hundred eighty-first (181st) day following the commencement of such leave any Incentive Stock Option held by the Participant shall cease to be treated as an Incentive Stock Option and instead shall be treated thereafter as a Nonstatutory Stock Option, unless the Participant’s right to return to Service with the Participating Company Group is guaranteed by statute or contract. Notwithstanding the foregoing, unless otherwise designated by the Company or required by law, a leave of absence shall not be treated as Service for purposes of determining vesting under the Participant’s Award Agreement. A Participant’s Service shall be deemed to have terminated upon an actual termination of Service. Subject to the foregoing, the Company, in its discretion, shall determine whether the Participant’s Service has terminated and the effective date of such termination.

(oo) “**Specified Employee**” means a specified employee as defined in Code Section 409A(a)(2)(B) of the Code or Treasury Regulations under Code Section 409A.

(pp) “**Stock**” means the common stock of the Company, as adjusted from time to time in accordance with *Section 4.2* of the Plan.

(qq) “**Subsidiary Corporation**” means any present or future “**subsidiary corporation**” of the Company, as defined in Section 424(f) of the Code.

(rr) “**Ten Percent Owner**” means a Participant who, at the time an Option is granted to the Participant, owns stock possessing more than ten percent (10%) of the total combined voting power of all classes of stock of a Participating Company (other than an Affiliate) within the meaning of Section 422(b)(6) of the Code.

(ss) “**Treasury Regulations**” means Proposed Temporary and Final Regulations of the United States Treasury Department issued under Title 26 of the Code of Federal Regulations.

(tt) “**Vesting Conditions**” mean those conditions established in accordance with *Section 6.2*, *Section 8.5* or *Section 10.3* of the Plan prior to the satisfaction of which Options, shares subject to a Restricted Stock Award or Restricted Stock Unit Award, respectively, remain subject to forfeiture in favor of the Company upon the Participant’s termination of Service.

2.2 Construction. Captions and titles contained herein are for convenience only and shall not affect the meaning or interpretation of any provision of the Plan. Except when otherwise indicated by the context, the singular shall include the plural and the plural shall include the singular. Use of the term “or” is not intended to be exclusive, unless the context clearly requires otherwise. Reference to any statute, law, regulation or rule means such statute, law, regulation, rule as amended, modified, or replaced, in whole or in part, and in effect from time to time.

3. ADMINISTRATION.

3.1 Administration by the Committee. The Plan shall be administered by the Committee. All questions of interpretation of the Plan or of any Award shall be determined by the Committee, and such determinations shall be final and binding upon all persons having an interest in the Plan or such Award.

3.2 Authority of Officers. Any Officer shall have the authority to act on behalf of the Company with respect to any matter, right, obligation, determination or election which is the responsibility of or which is allocated to the Company herein, provided the Officer has apparent authority with respect to such matter, right, obligation, determination or election.

3.3 Administration with Respect to Insiders. With respect to participation by Insiders in the Plan, at any time that any class of equity security of the Company is registered pursuant to Section 12 of the Exchange Act, the Plan shall be administered in compliance with the requirements, if any, of Rule 16b-3.

3.4 Committee Complying with Section 162(m). If the Company is a “**publicly held corporation**” within the meaning of Section 162(m), the Board may establish a Committee of “**outside directors**” within the meaning of Section 162(m) to approve the grant of any Award which might reasonably be anticipated to result in the payment of employee remuneration that alone or when combined with other employee remuneration would otherwise exceed the limit on employee remuneration deductible for income tax purposes pursuant to Section 162(m).

3.5 *Powers of the Committee.* In addition to any other powers set forth in the Plan and subject to the provisions of the Plan, the Committee shall have the full and final power and authority, in its discretion:

- (a) to determine the persons to whom, and the time or times at which, Awards shall be granted and the number of shares of Stock or units to be subject to each Award;
- (b) to determine the type of Award granted and to designate Options as Incentive Stock Options or Nonstatutory Stock Options;
- (c) to determine the Fair Market Value of shares of Stock or other property;
- (d) to determine the terms, conditions and restrictions applicable to each Award (which need not be identical) and any shares acquired pursuant thereto, including, without limitation, (i) the exercise or purchase price of shares purchased pursuant to any Award, (ii) the method of payment for shares purchased pursuant to any Award, (iii) the method for satisfaction of any tax withholding obligation arising in connection with any Award, including by the withholding or delivery of shares of Stock, (iv) the timing, terms and conditions of the exercisability or vesting of any Award or any shares acquired pursuant thereto, (v) the Performance Award Formula and Performance Goals applicable to any Award and the extent to which such Performance Goals have been attained, (vi) the time of the expiration of any Award, (vii) the effect of the Participant's termination of Service on any of the foregoing, and (viii) all other terms, conditions and restrictions applicable to any Award or shares acquired pursuant thereto not inconsistent with the terms of the Plan;
- (e) to determine whether an Award of SARs, Performance Shares or Performance Units will be settled in shares of Stock, cash, or in any combination thereof;
- (f) to approve one or more forms of Award Agreement;
- (g) to amend, modify, extend, cancel or renew any Award or to waive any restrictions or conditions applicable to any Award or any shares acquired pursuant thereto, except as otherwise permitted in connection with an event as provided under *Section 4.2*, the Committee shall not reprice, adjust or amend the exercise price of Options or the grant price of Stock Appreciation Rights previously awarded to any Participant, whether through amendment, cancellation and replacement grant, or any other means, nor shall the Committee have any authority to take such action with respect to any Award subject to and not exempt from Section 409A;
- (h) to accelerate, continue, extend or defer the exercisability or vesting of any Award or any shares acquired pursuant thereto, including with respect to the period following a Participant's termination of Service, except that the Committee shall have no authority to take such action with respect to any Award that is subject to and is not exempt from the application of Section 409A;
- (i) to amend, modify or correct any defect in the Plan or any Award in order to avoid the application of Sections 162(m), 280G or 409A of the Code to any Award or to the Plan;
- (j) to prescribe, amend or rescind rules, guidelines and policies relating to the Plan, or to adopt sub-plans or supplements to, or alternative versions of, the Plan, including, without limitation, as the Committee deems necessary or desirable to comply with the laws or regulations of or to accommodate the tax policy, accounting principles or custom of, foreign jurisdictions whose citizens may be granted Awards; and
- (k) to correct any defect, supply any omission or reconcile any inconsistency in the Plan or any Award Agreement and to make all other determinations and take such other actions with

respect to the Plan or any Award as the Committee may deem advisable to the extent not inconsistent with the provisions of the Plan or applicable law.

3.6 *Indemnification.* In addition to such other rights of indemnification as they may have as members of the Board or the Committee or as officers or employees of the Participating Company Group, members of the Board or the Committee and any officers or employees of the Participating Company Group to whom authority to act for the Board, the Committee or the Company is delegated shall be indemnified by the Company against all reasonable expenses, including attorneys' fees, actually and necessarily incurred in connection with the defense of any action, suit or proceeding, or in connection with any appeal therein, to which they or any of them may be a party by reason of any action taken or failure to act under or in connection with the Plan, or any right granted hereunder, and against all amounts paid by them in settlement thereof (provided such settlement is approved by independent legal counsel selected by the Company) or paid by them in satisfaction of a judgment in any such action, suit or proceeding, except in relation to matters as to which it shall be adjudged in such action, suit or proceeding that such person is liable for gross negligence, bad faith or intentional misconduct in duties; provided, however, that within sixty (60) days after the institution of such action, suit or proceeding, such person shall offer to the Company, in writing, the opportunity at its own expense to handle and defend the same.

4. SHARES SUBJECT TO PLAN.

4.1 *Maximum Number of Shares Issuable.* Subject to adjustment as provided in *Section 4.2*, the maximum aggregate number of shares of Stock that may be issued under the Plan shall be one million seven hundred and fifty thousand (1,750,000) and shall consist of authorized but unissued or reacquired shares of Stock or any combination thereof. If an outstanding Award for any reason expires or is terminated or canceled without having been exercised or settled in full, or if shares of Stock acquired pursuant to an Award subject to forfeiture or repurchase are forfeited or repurchased by the Company at the Participant's purchase price, the shares of Stock allocable to the terminated portion of such Award or such forfeited or repurchased shares of Stock shall again be available for issuance under the Plan. Shares of Stock shall not be deemed to have been issued pursuant to the Plan (a) with respect to any portion of an Award that is settled in cash or (b) to the extent such shares are withheld in satisfaction of tax withholding obligations pursuant to *Section 14*. Upon payment in shares of Stock pursuant to the exercise of an SAR, the number of shares available for issuance under the Plan shall be reduced only by the number of shares actually issued in such payment. If the exercise price of an Option is paid by tender to the Company, or attestation to the ownership, of shares of Stock owned by the Participant, the number of shares available for issuance under the Plan shall be reduced by the net number of shares for which the Option is exercised.

4.2 *Adjustments for Changes in Capital Structure.* Subject to any required action by the shareholders of the Company, in the event of any change in the Stock effected without receipt of consideration by the Company, whether through merger, consolidation, reorganization, reincorporation, recapitalization, reclassification, stock dividend, stock split, reverse stock split, split-up, split-off, spin-off, combination of shares, exchange of shares, or similar change in the capital structure of the Company, or in the event of payment of a dividend or distribution to the shareholders of the Company in a form other than Stock (excepting normal cash dividends) that has a material effect on the Fair Market Value of shares of Stock, appropriate adjustments shall be made in the number and class of shares subject to the Plan and to any outstanding Awards, and in the exercise or purchase price per share under any outstanding Award in order to prevent dilution or enlargement of Participants' rights under the Plan. For purposes of the foregoing, conversion of any convertible securities of the Company shall not be treated as “**effected without receipt of consideration by the Company.**” Any fractional share resulting from an adjustment pursuant to this *Section 4.2* shall be rounded down to the nearest whole number, and in no event may the exercise or purchase price under any Award be decreased to an amount less than the par value, if any, of the stock subject to such Award. The adjustments determined by the Committee pursuant to this *Section 4.2* shall be final, binding and conclusive.

5. ELIGIBILITY AND AWARD LIMITATIONS.

5.1 *Persons Eligible for Awards.* Awards may be granted only to Employees, Consultants and Directors. For purposes of the foregoing sentence, “**Employees**,” “**Consultants**” and “**Directors**” shall include prospective Employees, prospective Consultants and prospective Directors to whom Awards are granted in connection with written offers of an employment or other service relationship with the Participating Company Group; provided, however, that no Stock subject to any such Award shall vest, become exercisable or be issued prior to the date on which such person commences Service. The maximum number of shares of Stock with respect to an Award or Awards may be granted to any Participant under the Plan shall not exceed five percent (5%) of the total outstanding shares of Stock issued and outstanding.

5.2 *Participation.* Awards are granted solely at the discretion of the Committee. Eligible persons may be granted more than one (1) Award. However, eligibility in accordance with this Section shall not entitle any person to be granted an Award, or, having been granted an Award, to be granted an additional Award.

5.3 *Incentive Stock Option Limitations.*

(a) *Persons Eligible.* An Incentive Stock Option may be granted only to a person who, on the effective date of grant, is an Employee of the Company, a Parent Corporation or a Subsidiary Corporation (each being an “**ISO-Qualifying Corporation**”). Any person who is not an Employee of an ISO-Qualifying Corporation on the date of the grant of an Option to such person may be granted only a Nonstatutory Stock Option. An Incentive Stock Option granted to a prospective Employee upon the condition that such person become an Employee of an ISO-Qualifying Corporation shall be deemed granted effective on the date such person commences Service with an ISO-Qualifying Corporation, with an exercise price determined as of such date in accordance with *Section 6.1*.

(b) *Fair Market Value Limitation.* To the extent that options designated as Incentive Stock Options (granted under all stock option plans of the Participating Company Group, including the Plan) become exercisable by a Participant for the first time during any calendar year for stock having a Fair Market Value greater than One Hundred Thousand Dollars (\$100,000), the portion of such options which exceeds such amount shall be treated as Nonstatutory Stock Options. For purposes of this Section, options designated as Incentive Stock Options shall be taken into account in the order in which they were granted, and the Fair Market Value of stock shall be determined as of the time the option with respect to such stock is granted. If the Code is amended to provide for a different limitation from that set forth in this Section, such different limitation shall be deemed incorporated herein effective as of the date and with respect to such Options as required or permitted by such amendment to the Code. If an Option is treated as an Incentive Stock Option in part and as a Nonstatutory Stock Option in part by reason of the limitation set forth in this Section, the Participant may designate which portion of such Option the Participant is exercising. In the absence of such designation, the Participant shall be deemed to have exercised the Incentive Stock Option portion of the Option first. Upon exercise, shares issued pursuant to each such portion shall be separately identified.

6. *TERMS AND CONDITIONS OF OPTIONS.* Options shall be evidenced by Award Agreements specifying the number of shares of Stock covered thereby, in such form as the Committee shall from time to time establish. No Option or purported Option shall be a valid and binding obligation of the Company unless evidenced by a fully executed Award Agreement. Award Agreements evidencing Options may incorporate all or any of the terms of the Plan by reference and shall comply with and be subject to the following terms and conditions:

6.1 *Exercise Price.* The exercise price for each Option shall be established in the discretion of the Committee; provided, however, that (a) the exercise price per share shall be not less than the Fair

Market Value of a share of Stock on the date of grant of the Option and (b) no Incentive Stock Option granted to a Ten Percent Owner shall have an exercise price per share less than one hundred ten percent (110%) of the Fair Market Value of a share of Stock on the effective date of grant of the Option. Notwithstanding the foregoing, an Option (whether an Incentive Stock Option or a Nonstatutory Stock Option) may be substituted for another option or an Option may be assumed in a corporate transaction and not be treated as the grant of an Option if the substitution or modification qualifies under the provisions of Section 424(a) of the Code and the Treasury Regulations issued thereunder or under Section 409A, as applicable.

6.2 *Exercisability and Term of Options.* Options shall be exercisable at such time or times, or upon such event or events, and subject to such terms, conditions, performance criteria and restrictions as shall be determined by the Committee and set forth in the Award Agreement evidencing such Option; provided, however, that (a) no Option shall be exercisable after the expiration of ten (10) years after the effective date of grant of such Option, (b) no Incentive Stock Option granted to a Ten Percent Owner shall be exercisable after the expiration of five (5) years after the effective date of grant of such Option, and (c) no Option granted to a prospective Employee, prospective Consultant or prospective Director may become exercisable prior to the date on which such person commences Service. Subject to the foregoing, unless otherwise specified by the Committee in the grant of an Option, any Option granted hereunder shall terminate ten (10) years after the effective date of grant of the Option, unless earlier terminated in accordance with its provisions.

6.3 *Payment of Exercise Price.*

(a) *Forms of Consideration Authorized.* Except as otherwise provided below, payment of the exercise price for the number of shares of Stock being purchased pursuant to any Option shall be made (i) in cash, by check or in cash equivalent, (ii) by tender to the Company, or attestation to the ownership, of shares of Stock owned by the Participant having a Fair Market Value not less than the exercise price, (iii) by delivery of a properly executed notice of exercise together with irrevocable instructions to a broker providing for the assignment to the Company of the proceeds of a sale or loan with respect to some or all of the shares being acquired upon the exercise of the Option (including, without limitation, through an exercise complying with the provisions of Regulation T as promulgated from time to time by the Board of Governors of the Federal Reserve System) (a “Cashless Exercise”), (iv) by such other consideration as may be approved by the Committee from time to time to the extent permitted by applicable law, or (v) by any combination thereof. The Committee may at any time or from time to time grant Options which do not permit all of the foregoing forms of consideration to be used in payment of the exercise price or which otherwise restrict one or more forms of consideration.

(b) *Limitations on Forms of Consideration.*

(i) *Tender of Stock.* Notwithstanding the foregoing, an Option may not be exercised by tender to the Company, or attestation to the ownership, of shares of Stock to the extent such tender or attestation would constitute a violation of the provisions of any law, regulation or agreement restricting the redemption of the Company’s stock. Unless otherwise provided by the Committee, an Option may not be exercised by tender to the Company, or attestation to the ownership, of shares of Stock unless such shares either have been owned by the Participant for more than six (6) months (and not used for another Option exercise by attestation during such period) or were not acquired, directly or indirectly, from the Company.

(ii) *Cashless Exercise.* The Company reserves, at any and all times, the right, in the Company’s sole and absolute discretion, to establish, decline to approve or terminate any program or procedures for the exercise of Options by means of a Cashless Exercise, including with respect to one or more Participants specified by the Company notwithstanding that such program or procedures may be available to other Participants.

6.4 *Effect of Termination of Service.*

(a) *Option Exercisability.* Subject to earlier termination of the Option as otherwise provided herein and unless otherwise provided by the Committee in the grant of an Option and set forth in the Award Agreement, an Option shall be exercisable after a Participant's termination of Service only during the applicable time period determined in accordance with this Section and thereafter shall terminate:

(i) *Disability.* If the Participant's Service terminates because of the Disability of the Participant, the Option, to the extent unexercised and exercisable on the date on which the Participant's Service terminated, may be exercised by the Participant (or the Participant's guardian or legal representative) at any time prior to the expiration of one (1) year) (or such longer period of time as determined by the Committee, in its discretion) after the date on which the Participant's Service terminated, but in any event no later than the date of expiration of the Option's term as set forth in the Award Agreement evidencing such Option (the "**Option Expiration Date**").

(ii) *Death.* If the Participant's Service terminates because of the death of the Participant, the Option, to the extent unexercised and exercisable on the date on which the Participant's Service terminated, may be exercised by the Participant's legal representative or other person who acquired the right to exercise the Option by reason of the Participant's death at any time prior to the expiration of one (1) year) (or such longer period of time as determined by the Committee, in its discretion) after the date on which the Participant's Service terminated, but in any event no later than the Option Expiration Date. The Participant's Service shall be deemed to have terminated on account of death if the Participant dies within ninety (90) days (or such longer period of time as determined by the Committee, in its discretion) after the Participant's termination of Service.

(iii) *Termination for Cause.* Notwithstanding any other provision of the Plan to the contrary, if the Participant's Service is terminated for Cause, the Option shall terminate and cease to be exercisable immediately upon such termination of Service.

(iv) *Other Termination of Service.* If the Participant's Service terminates for any reason, except Disability, death or Cause, the Option, to the extent unexercised and exercisable by the Participant on the date on which the Participant's Service terminated, may be exercised by the Participant at any time prior to the expiration of ninety (90) days (or such longer period of time as determined by the Committee, in its discretion) after the date on which the Participant's Service terminated, but in any event no later than the Option Expiration Date.

(b) *Extension if Exercise Prevented by Law.* Notwithstanding the foregoing, other than termination of Service for Cause, if the exercise of an Option within the applicable time periods set forth in *Section 6.4(a)* is prevented by the provisions of *Section 13* below, the Option shall remain exercisable until ninety (90) days (or with respect to a Nonstatutory Option such longer period of time as determined by the Committee, in its discretion) after the date the Participant is notified by the Company that the Option is exercisable, but in any event no later than the Option Expiration Date.

(c) *Extension if Participant Subject to Section 16(b).* Notwithstanding the foregoing, other than termination of Service for Cause, if a sale within the applicable time periods set forth in *Section 6.4(a)* of shares acquired upon the exercise of a Nonstatutory Option would subject the Participant to suit under Section 16(b) of the Exchange Act, the Nonstatutory Option shall remain exercisable until the earliest to occur of (i) the tenth (10th) day following the date on which a sale of such shares by the Participant would no longer be subject to such suit, (ii) the one

hundred and ninetieth (190th) day after the Participant's termination of Service, or (iii) the Option Expiration Date.

6.5 *Transferability of Options.* During the lifetime of the Participant, an Option shall be exercisable only by the Participant or the Participant's guardian or legal representative. Prior to the issuance of shares of Stock upon the exercise of an Option, the Option shall not be subject in any manner to anticipation, alienation, sale, exchange, transfer, assignment, pledge, encumbrance, or garnishment by creditors of the Participant or the Participant's beneficiary, except transfer by will or by the laws of descent and distribution.

7. *TERMS AND CONDITIONS OF STOCK APPRECIATION RIGHTS.* Stock Appreciation Rights shall be evidenced by Award Agreements specifying the number of shares of Stock subject to the Award, in such form as the Committee shall from time to time establish. No SAR or purported SAR shall be a valid and binding obligation of the Company unless evidenced by a fully executed Award Agreement. Award Agreements evidencing SARs may incorporate all or any of the terms of the Plan by reference and shall comply with and be subject to the following terms and conditions:

7.1 *Types of SARs Authorized.* SARs may be granted in tandem with all or any portion of a related Option (a "**Tandem SAR**") or may be granted independently of any Option (a "**Freestanding SAR**").

7.2 *Exercise Price.* The exercise price for each SAR shall be established in the discretion of the Committee; provided, however, that (a) the exercise price per share subject to a Tandem SAR shall be the exercise price per share under the related Option and (b) the exercise price per share subject to a Freestanding SAR shall be not less than the Fair Market Value of a share of Stock on the effective date of grant of the SAR.

7.3 *Exercisability and Term of SARs.*

(a) *Tandem SARs.* Tandem SARs shall be exercisable only at the time and to the extent, and only to the extent, that the related Option is exercisable, subject to such provisions as the Committee may specify where the Tandem SAR is granted with respect to less than the full number of shares of Stock subject to the related Option. The Committee may, in its discretion, provide in any Award Agreement evidencing a Tandem SAR that such SAR may not be exercised without the advance approval of the Company and, if such approval is not given, then the Option shall nevertheless remain exercisable in accordance with its terms. A Tandem SAR shall terminate and cease to be exercisable no later than the date on which the related Option expires or is terminated or canceled. Upon the exercise of a Tandem SAR with respect to some or all of the shares subject to such SAR, the related Option shall be canceled automatically as to the number of shares with respect to which the Tandem SAR was exercised. Upon the exercise of an Option related to a Tandem SAR as to some or all of the shares subject to such Option, the related Tandem SAR shall be canceled automatically as to the number of shares with respect to which the related Option was exercised.

(b) *Freestanding SARs.* Freestanding SARs shall be exercisable at such time or times, or upon such event or events, and subject to such terms, conditions, performance criteria and restrictions as shall be determined by the Committee and set forth in the Award Agreement evidencing such SAR; provided, however, that no Freestanding SAR shall be exercisable after the expiration of five (5) years after the effective date of grant of such SAR.

7.4 *Exercise of SARs.* Upon the exercise (or deemed exercise pursuant to *Section 7.5*) of an SAR, the Participant (or the Participant's legal representative or other person who acquired the right to exercise the SAR by reason of the Participant's death) shall be entitled to receive payment of an amount for each share with respect to which the SAR is exercised equal to the excess, if any, of the Fair Market Value of a share of Stock on the date of exercise of the SAR over the exercise price.

Payment of such amount shall be made in cash, shares of Stock, or any combination thereof as determined by the Committee. Unless otherwise provided in the Award Agreement evidencing such SAR, payment shall be made in a lump sum as soon as practicable following the date of exercise of the SAR. The Award Agreement evidencing any SAR may provide for payment in a lump sum or deferred payment in installments. When payment is to be made in shares of Stock, the number of shares to be issued shall be determined on the basis of the Fair Market Value of a share of Stock on the date of exercise of the SAR. For purposes of *Section 7*, an SAR shall be deemed exercised on the date on which the Company receives notice of exercise from the Participant.

7.5 Deemed Exercise of SARs. If, on the date on which an SAR would otherwise terminate or expire, the SAR by its terms remains exercisable immediately prior to such termination or expiration and, if so exercised, would result in a payment to the holder of such SAR, then any portion of such SAR which has not previously been exercised shall automatically be deemed to be exercised as of such date with respect to such portion and payment shall be made to the Participant (or such Participant's legal representative or other person who acquired the right to receive such payment by reason of the Participant's death).

7.6 Effect of Termination of Service. Subject to earlier termination of the SAR as otherwise provided herein and unless otherwise provided by the Committee in the grant of an SAR and set forth in the Award Agreement, an SAR shall be exercisable after a Participant's termination of Service only during the applicable time period determined in accordance with *Section 6.4* (treating the SAR as if it were an Option) and thereafter shall terminate.

7.7 Nontransferability of SARs. During the lifetime of the Participant, an SAR shall be exercisable only by the Participant or the Participant's guardian or legal representative. Prior to the exercise of an SAR, the SAR shall not be subject in any manner to anticipation, alienation, sale, exchange, transfer, assignment, pledge, encumbrance, or garnishment by creditors of the Participant or the Participant's beneficiary, except transfer by will or by the laws of descent and distribution.

8. TERMS AND CONDITIONS OF RESTRICTED STOCK AWARDS. Restricted Stock Awards shall be evidenced by Award Agreements specifying the number of shares of Stock subject to the Award, in such form as the Committee shall from time to time establish. No Restricted Stock Award or purported Restricted Stock Award shall be a valid and binding obligation of the Company unless evidenced by a fully executed Award Agreement. Award Agreements evidencing Restricted Stock Awards may incorporate all or any of the terms of the Plan by reference and shall comply with and be subject to the following terms and conditions:

8.1 Restricted Stock Awards Authorized. Restricted Stock Awards may be granted upon such conditions as the Committee shall determine, including, without limitation, upon the attainment of one or more Performance Goals described in *Section 9.4*. If either the grant of a Restricted Stock Award or the lapsing of the Restriction Period is to be contingent upon the attainment of one or more Performance Goals, the Committee shall follow procedures substantially equivalent to those set forth in *Sections 9.3* through *9.5(a)*.

8.2 Vesting and Restrictions on Transfer. Shares issued pursuant to any Restricted Stock Award may or may not be made subject to Vesting Conditions based upon the satisfaction of such Service requirements, conditions, restrictions or performance criteria, including, without limitation, Performance Goals as described in *Section 9.4*, as shall be established by the Committee and set forth in the Award Agreement evidencing such Award. During any Restriction Period in which shares acquired pursuant to a Restricted Stock Award remain subject to Vesting Conditions, such shares may not be sold, exchanged, transferred, pledged, assigned or otherwise disposed of other than pursuant to an Ownership Change Event, as defined in *Section 13.1*, or as provided in *Section 8.5*. Upon request by the Company, each Participant shall execute any agreement evidencing such transfer restrictions prior to the receipt of shares of Restricted Stock and shall promptly present to the Company any and all

certificates representing shares of Restricted Stock acquired hereunder for the placement on such certificates of appropriate legends evidencing any such transfer restrictions.

8.3 *Voting Rights; Dividends and Distributions.* Except as provided in this *Section 8.3* and any Award Agreement, during the Restriction Period applicable to shares subject to a Restricted Stock Award, the Participant shall have all of the rights of a shareholder of the Company holding shares of Stock, including the right to vote such shares and to receive all dividends and other distributions paid with respect to such shares. However, in the event of a dividend or distribution paid in shares of Stock or any other adjustment made upon a change in the capital structure of the Company as described in *Section 4.2*, then any and all new, substituted or additional securities or other property (other than normal cash dividends) to which the Participant is entitled by reason of the Participant's Restricted Stock Award shall be immediately subject to the same Vesting Conditions as the shares subject to the Restricted Stock Award with respect to which such dividends or distributions were paid or adjustments were made.

8.4 *Effect of Termination of Service.* Unless otherwise provided by the Committee in the grant of a Restricted Stock Award and set forth in the Award Agreement, if a Participant's Service terminates for any reason, whether voluntary or involuntary (including the Participant's death or disability), then the Participant shall forfeit to the Company any shares acquired by the Participant pursuant to a Restricted Stock Award which remain subject to Vesting Conditions as of the date of the Participant's termination of Service.

8.5 *Nontransferability of Restricted Stock Award Rights.* Prior to the issuance of shares of Stock pursuant to a Restricted Stock Award, rights to acquire such shares shall not be subject in any manner to anticipation, alienation, sale, exchange, transfer, assignment, pledge, encumbrance or garnishment by creditors of the Participant or the Participant's beneficiary, except transfer by will or the laws of descent and distribution. All rights with respect to a Restricted Stock Award granted to a Participant hereunder shall be exercisable during his or her lifetime only by such Participant or the Participant's guardian or legal representative.

8.6 *Issuance and Delivery of Shares.* Any Restricted Stock granted under the Plan shall be issued at the time such Awards are granted and may be evidenced in such manner as the Committee may deem appropriate, including book-entry registration or issuance of a stock certificate or certificates, which certificate or certificates shall be held by the Company (or in an escrow established by the Company). Such certificate or certificates shall be registered in the name of the Participant and shall bear an appropriate legend referring to the restrictions applicable to such Restricted Stock. Shares representing Restricted Stock that is no longer subject to restrictions shall be delivered to the Participant promptly after the applicable restrictions lapse or are waived.

9. *TERMS AND CONDITIONS OF PERFORMANCE AWARDS.* Performance Awards shall be evidenced by Award Agreements in such form as the Committee shall from time to time establish. No Performance Award or purported Performance Award shall be a valid and binding obligation of the Company unless evidenced by a fully executed Award Agreement. Award Agreements evidencing Performance Awards may incorporate all or any of the terms of the Plan by reference and shall comply with and be subject to the following terms and conditions:

9.1 *Types of Performance Awards Authorized.* Performance Awards may be in the form of either Performance Shares or Performance Units. Each Award Agreement evidencing a Performance Award shall specify the number of Performance Shares or Performance Units subject thereto, the Performance Award Formula, the Performance Goal(s) and Performance Period applicable to the Award, and the other terms, conditions and restrictions of the Award.

9.2 *Initial Value of Performance Shares and Performance Units.* Unless otherwise provided by the Committee in granting a Performance Award, each Performance Share shall have an initial value

equal to the Fair Market Value of one (1) share of Stock, subject to adjustment as provided in *Section 4.2*, on the effective date of grant of the Performance Share, and each Performance Unit shall have an initial value of one hundred dollars (\$100). The final value payable to the Participant in settlement of a Performance Award determined on the basis of the applicable Performance Award Formula will depend on the extent to which Performance Goals established by the Committee are attained within the applicable Performance Period established by the Committee.

9.3 *Establishment of Performance Period, Performance Goals and Performance Award Formula.* In granting each Performance Award, the Committee shall establish in writing the applicable Performance Period, Performance Award Formula and one or more Performance Goals which, when measured at the end of the Performance Period, shall determine on the basis of the Performance Award Formula the final value of the Performance Award to be paid to the Participant. Unless otherwise permitted in compliance with the requirements under Section 162(m) with respect to “**performance-based compensation**,” the Committee shall establish the Performance Goal(s) and Performance Award Formula applicable to each Performance Award no later than the earlier of (a) the date ninety (90) days after the commencement of the applicable Performance Period or (b) the date on which 25% of the Performance Period has elapsed, and, in any event, at a time when the outcome of the Performance Goals remains substantially uncertain. Once established, the Performance Goals and Performance Award Formula shall not be changed during the Performance Period. The Company shall notify each Participant granted a Performance Award of the terms of such Award, including the Performance Period, Performance Goal(s) and Performance Award Formula.

9.4 *Measurement of Performance Goals.* Performance Goals shall be established by the Committee on the basis of targets to be attained (“**Performance Targets**”) with respect to one or more measures of business or financial performance (each, a “**Performance Measure**”), subject to the following:

(a) *Performance Measures.* Performance Measures shall have the same meanings as used in the Company’s financial statements, or, if such terms are not used in the Company’s financial statements, they shall have the meaning applied pursuant to generally accepted accounting principles, or as used generally in the financial banking industry. Performance Measures shall be calculated with respect to the Company and each Subsidiary Corporation consolidated therewith for financial reporting purposes or such division or other business unit as may be selected by the Committee. For purposes of the Plan, unless otherwise determined by the Committee at the time the Committee establishes the Performance Goal(s) and Performance Award Formula applicable to a Performance Award, the Performance Measures applicable to a Performance Award shall be calculated in accordance with generally accepted accounting principles, but prior to the accrual or payment of any Performance Award for the same Performance Period and excluding the effect (whether positive or negative) of any change in accounting standards or any extraordinary, unusual or nonrecurring item, as determined by the Committee, occurring after the establishment of the Performance Goals applicable to the Performance Award. Performance Measures may be one or more of the following, as determined by the Committee: revenue, costs, expenses (including expense efficiency ratios and other expense measures), earnings (including one or more of net profit after tax, gross profit, operating profit, earnings before interest and taxes, earnings before interest, taxes, depreciation and amortization and net earnings), earnings per share, earnings per share from continuing operations, operating income, pre-tax income, operating income margin, net income, margins (including one or more of gross, operating and net income margins), returns (including one or more of return on actual or proforma assets, net assets, equity, investment, capital and net capital employed), shareholder return (including total shareholder return relative to an index or peer group), stock price, growth of loans and deposits, economic value added, cash generation, cash flow, unit volume, working capital, market share, cost reductions and strategic plan development and implementation. Such goals may reflect

absolute entity or business unit performance or a relative comparison to the performance of a peer group of entities or other external measure of the selected performance criteria. Pursuant to rules and conditions adopted by the Committee on or before the 90th day of the applicable performance period for which Performance Goals are established, the Committee may appropriately adjust (provided the outcome remains substantially uncertain) any evaluation of performance under such goals to exclude the effect of certain events, including any of the following events: asset write-downs; litigation or claim judgments or settlements; changes in tax law, accounting principles or other such laws or provisions affecting reported results; severance, contract termination and other costs related to exiting certain business activities; and gains or losses from the disposition of businesses or assets or from the early extinguishment of debt.

(b) *Performance Targets.* Performance Targets may include a minimum, maximum, target level and intermediate levels of performance, with the final value of a Performance Award determined under the applicable Performance Award Formula by the level attained during the applicable Performance Period. A Performance Target may be stated as an absolute value or as a value determined relative to a standard selected by the Committee.

9.5 *Settlement of Performance Awards.*

(a) *Determination of Final Value.* As soon as practicable following the completion of the Performance Period applicable to a Performance Award, the Committee shall certify in writing the extent to which the applicable Performance Goals have been attained and the resulting final value of the Award earned by the Participant and to be paid upon its settlement in accordance with the applicable Performance Award Formula.

(b) *Discretionary Adjustment of Award Formula.* In its discretion, the Committee may, either at the time it grants a Performance Award or at any time thereafter, provide for the positive or negative adjustment of the Performance Award Formula applicable to a Performance Award granted to any Participant who is not a “covered employee” within the meaning of Section 162(m) (a “Covered Employee”) to reflect such Participant’s individual performance in his or her position with the Company or such other factors as the Committee may determine. If permitted under a Covered Employee’s Award Agreement, the Committee shall have the discretion, on the basis of such criteria as may be established by the Committee, to reduce some or all of the value of the Performance Award that would otherwise be paid to the Covered Employee upon its settlement notwithstanding the attainment of any Performance Goal and the resulting value of the Performance Award determined in accordance with the Performance Award Formula. No such reduction may result in an increase in the amount payable upon settlement of another Participant’s Performance Award.

(c) *Effect of Leaves of Absence.* Unless otherwise required by law, payment of the final value, if any, of a Performance Award held by a Participant who has taken in excess of thirty (30) days in leaves of absence during a Performance Period shall be prorated on the basis of the number of days of the Participant’s Service during the Performance Period during which the Participant was not on a leave of absence.

(d) *Notice to Participants.* As soon as practicable following the Committee’s determination and certification in accordance with *Sections 9.5(a)* and *(b)*, the Company shall notify each Participant of the determination of the Committee.

(e) *Payment in Settlement of Performance Awards.* As soon as practicable following the Committee’s determination and certification in accordance with *Sections 9.5(a)* and *(b)*, payment shall be made to each eligible Participant (or such Participant’s legal representative or other person who acquired the right to receive such payment by reason of the Participant’s death) of the final value of the Participant’s Performance Award. Payment of such amount shall be made in

cash, shares of Stock, or a combination thereof as determined by the Committee. Unless otherwise provided in the Award Agreement evidencing a Performance Award, payment shall be made in a lump sum. In no event shall payment of a Performance Award be made later than the 15th day of the third month following the taxable year of the Participant in which the Participant has a legally binding right to the Performance Award.

(f) *Provisions Applicable to Payment in Shares.* If payment is to be made in shares of Stock, the number of such shares shall be determined by dividing the final value of the Performance Award by the Fair Market Value of a share of Stock. Shares of Stock issued in payment of any Performance Award may be fully vested and freely transferable shares or may be shares of Stock subject to Vesting Conditions as provided in *Section 8.2*. Any shares subject to Vesting Conditions shall be evidenced by an appropriate Award Agreement and shall be subject to the provisions of *Sections 8.2 through 8.5* above.

9.6 *Voting Rights; Dividend Equivalent Rights and Distributions.* Participants shall have no voting rights with respect to shares of Stock represented by Performance Share Awards until the date of the issuance of such shares, if any (as evidenced by the appropriate entry on the books of the Company or of a duly authorized transfer agent of the Company). However, the Committee, in its discretion, may provide in the Award Agreement evidencing any Performance Share Award that the Participant shall be entitled to receive Dividend Equivalents with respect to the payment of cash dividends on Stock having a record date prior to the date on which the Performance Shares are settled or forfeited. Such Dividend Equivalents, if any, shall be credited to the Participant in the form of additional whole Performance Shares as of the date of payment of such cash dividends on Stock. The number of additional Performance Shares (rounded to the nearest whole number) to be so credited shall be determined by dividing (a) the amount of cash dividends paid on such date with respect to the number of shares of Stock represented by the Performance Shares previously credited to the Participant by (b) the Fair Market Value per share of Stock on such date. Dividend Equivalents may be paid currently or may be accumulated and paid to the extent that Performance Shares become nonforfeitable, as determined by the Committee in the Award Agreement. Settlement of Dividend Equivalents may be made in cash, shares of Stock, or a combination thereof as determined by the Committee in the Award Agreement, and may be paid on the same basis as settlement of the related Performance Share as provided in *Section 9.5*. Dividend Equivalents shall not be paid with respect to Performance Units. In the event of a dividend or distribution paid in shares of Stock or any other adjustment made upon a change in the capital structure of the Company as described in *Section 4.2*, appropriate adjustments shall be made in the Participant's Performance Share Award so that it represents the right to receive upon settlement any and all new, substituted or additional securities or other property (other than normal cash dividends) to which the Participant would be entitled by reason of the shares of Stock issuable upon settlement of the Performance Share Award, and all such new, substituted or additional securities or other property shall be immediately subject to the same Performance Goals as are applicable to the Award.

9.7 *Effect of Termination of Service.* Unless otherwise provided by the Committee in the grant of a Performance Award and set forth in the Award Agreement, the effect of a Participant's termination of Service on the Performance Award shall be as follows:

(a) *Death or Disability.* If the Participant's Service terminates because of the death or Disability of the Participant before the completion of the Performance Period applicable to the Performance Award, the final value of the Participant's Performance Award shall be determined by the extent to which the applicable Performance Goals have been attained with respect to the entire Performance Period and shall be prorated based on the number of months of the Participant's Service during the Performance Period. Payment shall be made following the end of the Performance Period within the time period specified by *Section 9.5(e)* in any manner permitted by *Section 9.5*.

(b) *Other Termination of Service.* If the Participant's Service terminates for any reason except death or Disability before the completion of the Performance Period applicable to the Performance Award, such Award shall be forfeited in its entirety; provided, however, that in the event of an involuntary termination of the Participant's Service, the Committee, in its sole discretion, may waive the automatic forfeiture of all or any portion of any such Award.

9.8 *Nontransferability of Performance Awards.* Prior to settlement in accordance with the provisions of the Plan, no Performance Award shall be subject in any manner to anticipation, alienation, sale, exchange, transfer, assignment, pledge, encumbrance, or garnishment by creditors of the Participant or the Participant's beneficiary, except transfer by will or by the laws of descent and distribution. All rights with respect to a Performance Award granted to a Participant hereunder shall be exercisable during his or her lifetime only by such Participant or the Participant's guardian or legal representative.

10. *TERMS AND CONDITIONS OF RESTRICTED STOCK UNIT AWARDS.* Restricted Stock Unit Awards shall be evidenced by Award Agreements specifying the number of Restricted Stock Units subject to the Award, in such form as the Committee shall from time to time establish. No Restricted Stock Unit Award or purported Restricted Stock Unit Award shall be a valid and binding obligation of the Company unless evidenced by a fully executed Award Agreement. Award Agreements evidencing Restricted Stock Units may incorporate all or any of the terms of the Plan by reference and shall comply with and be subject to the following terms and conditions:

10.1 *Grant of Restricted Stock Unit Awards.* Restricted Stock Unit Awards may be granted upon such conditions as the Committee shall determine, including, without limitation, upon the attainment of one or more Performance Goals described in *Section 9.4*. If either the grant of a Restricted Stock Unit Award or the Vesting Conditions with respect to such Award is to be contingent upon the attainment of one or more Performance Goals, the Committee shall follow procedures substantially equivalent to those set forth in *Sections 9.3* through *9.5(a)*.

10.2 *Purchase Price.* No monetary payment (other than applicable tax withholding, if any) shall be required as a condition of receiving a Restricted Stock Unit Award.

10.3 *Vesting.* Restricted Stock Units may or may not be made subject to Vesting Conditions based upon the satisfaction of such Service requirements, conditions, restrictions or performance criteria, including, without limitation, Performance Goals as described in *Section 9.4*, as shall be established by the Committee and set forth in the Award Agreement evidencing such Award.

10.4 *Voting Rights, Dividend Equivalent Rights and Distributions.* Participants shall have no voting rights with respect to shares of Stock represented by Restricted Stock Units until the date of the issuance of such shares (as evidenced by the appropriate entry on the books of the Company or of a duly authorized transfer agent of the Company). However, the Committee, in its discretion, may provide in the Award Agreement evidencing any Restricted Stock Unit Award that the Participant shall be entitled to receive Dividend Equivalents with respect to the payment of cash dividends on Stock having a record date prior to date on which Restricted Stock Units held by such Participant are settled. Such Dividend Equivalents, if any, shall be paid by crediting the Participant with additional whole Restricted Stock Units as of the date of payment of such cash dividends on Stock. The number of additional Restricted Stock Units (rounded to the nearest whole number) to be so credited shall be determined by dividing (a) the amount of cash dividends paid on such date with respect to the number of shares of Stock represented by the Restricted Stock Units previously credited to the Participant by (b) the Fair Market Value per share of Stock on such date. Such additional Restricted Stock Units shall be subject to the same terms and conditions and shall be settled in the same manner and at the same time (or as soon thereafter as practicable) as the Restricted Stock Units originally subject to the Restricted Stock Unit Award. In the event of a dividend or distribution paid in shares of Stock or any other adjustment made upon a change in the capital structure of the Company as described in

Section 4.2, appropriate adjustments shall be made in the Participant's Restricted Stock Unit Award so that it represents the right to receive upon settlement any and all new, substituted or additional securities or other property (other than normal cash dividends) to which the Participant would be entitled by reason of the shares of Stock issuable upon settlement of the Award, and all such new, substituted or additional securities or other property shall be immediately subject to the same Vesting Conditions as are applicable to the Award.

10.5 *Effect of Termination of Service.* Unless otherwise provided by the Committee in the grant of a Restricted Stock Unit Award and set forth in the Award Agreement, if a Participant's Service terminates for any reason, whether voluntary or involuntary (including the Participant's death or disability), then the Participant shall forfeit to the Company any Restricted Stock Units pursuant to the Award which remain subject to Vesting Conditions as of the date of the Participant's termination of Service.

10.6 *Settlement of Restricted Stock Unit Awards.* The Company shall issue to a Participant on the earlier of the date on which Restricted Stock Units subject to the Participant's Restricted Stock Unit Award satisfy applicable Vesting Conditions or on such other date determined by the Committee, in its discretion and set forth in the Award Agreement but no later than the 15th day of the third month following the taxable year of the Participant in which the Participant has satisfied the applicable Vesting Conditions, one (1) share of Stock (and/or any other new, substituted or additional securities or other property pursuant to an adjustment described in *Section 10.4*) for each Restricted Stock Unit then becoming vested or otherwise to be settled on such date, subject to the withholding of applicable taxes.

10.7 *Nontransferability of Restricted Stock Unit Awards.* Prior to the issuance of shares of Stock in settlement of a Restricted Stock Unit Award, the Award shall not be subject in any manner to anticipation, alienation, sale, exchange, transfer, assignment, pledge, encumbrance, or garnishment by creditors of the Participant or the Participant's beneficiary, except transfer by will or by the laws of descent and distribution. All rights with respect to a Restricted Stock Unit Award granted to a Participant hereunder shall be exercisable during his or her lifetime only by such Participant or the Participant's guardian or legal representative.

11. *STANDARD FORMS OF AWARD AGREEMENT.*

11.1 *Award Agreements.* Each Award shall comply with and be subject to the terms and conditions set forth in the appropriate form of Award Agreement approved by the Committee and as amended from time to time. Any Award Agreement may consist of an appropriate form of Notice of Grant and a form of Agreement incorporated therein by reference, or such other form or forms as the Committee may approve from time to time.

11.2 *Authority to Vary Terms.* The Committee shall have the authority from time to time to vary the terms of any standard form of Award Agreement either in connection with the grant or amendment of an individual Award or in connection with the authorization of a new standard form or forms; provided, however, that the terms and conditions of any such new, revised or amended standard form or forms of Award Agreement are not inconsistent with the terms of the Plan.

12. *CHANGE IN CONTROL.*

12.1 *Definitions.*

(a) An "**Ownership Change Event**" shall be deemed to have occurred if any of the following occurs with respect to the Company: (i) the direct or indirect sale or exchange in a single or series of related transactions by the shareholders of the Company of more than fifty percent (50%) of the voting stock of the Company; (ii) a merger, reorganization or consolidation in which the Company is a party; (iii) the sale, exchange, or transfer of all or substantially all of the assets of

the Company (other than a sale, exchange or transfer to one or more subsidiaries of the Company); or (iv) a liquidation or dissolution of the Company.

(b) A “**Change in Control**” shall mean (i) an Ownership Change Event or series of related Ownership Change Events (collectively, a “**Transaction**”) in which the shareholders of the Company immediately before the Transaction do not retain immediately after or acquire in the Transaction, in substantially the same proportions as their ownership of shares of the Company’s voting stock immediately before the Transaction, direct or indirect beneficial ownership of more than fifty percent (50%) of the total combined voting power of the outstanding voting securities of the Company, or in the case of an Ownership Change Event described in *Section 12.1(a)(iii)*, the entity to which the assets of the Company were transferred (the “**Transferee**”), (ii) a sale of equity securities of the Company representing more than fifty percent (50%) of the total combined voting power of the outstanding voting securities of the Company, or (iii) a liquidation or dissolution of the Company. For purposes of the preceding sentence, indirect beneficial ownership shall include, without limitation, an interest resulting from ownership of the voting securities of one or more corporations or other business entities which own the Company or the Transferee, as the case may be, either directly or through one or more subsidiary corporations or other business entities. The Committee shall have the right to determine whether multiple sales or exchanges of the voting securities of the Company or multiple Ownership Change Events are related, and its determination shall be final, binding and conclusive. Notwithstanding the foregoing, in the case of an Award that is not exempt from Section 409A but rather is subject to Section 409A, (A) the exercise of the Committee’s discretion shall be strictly ministerial and not involve the exercise of any discretionary authority, and (B) in no event shall a Transaction be treated as a Change in Control unless such event also qualifies as a change in ownership or effective control of a corporation, or a change in the ownership of a substantial portion of the assets of a corporation within the meaning of Treasury Regulations Section 1.409A-3(i)(5).

12.2 Effect of Change in Control on Options. Upon a Change of Control (i) the Company shall deliver to each Participant, no less than thirty (30) days prior to the consummation of the Change of Control, written notification of the proposed Change of Control and the Participant’s right to exercise all Options granted pursuant to this Plan, whether or not vested under the Plan or applicable Option Award Agreement, and (ii) all outstanding Options granted pursuant to the Plan shall completely vest and become immediately exercisable as to all shares granted pursuant to the Option immediately prior to such Change of Control. This right of exercise shall be conditional upon consummation of the Change of Control. Upon the occurrence of the Change of Control all then outstanding Options shall terminate; provided, however, that any outstanding Options not exercised as of the occurrence of the Change of Control shall not terminate if there is a successor corporation which assumes the outstanding Options or substitutes for such Options, new options covering the stock of the successor corporation with appropriate adjustments as to the number and kind of shares and prices. Notwithstanding anything to the contrary herein, each adjustment made to an Incentive Stock Option shall comply with the rules of Section 424(a) of the Code, and no adjustment shall be made that would cause any Incentive Stock Option to become a Nonstatutory Stock Option.

12.3 Effect of Change of Control on SAR Awards. Notwithstanding any other provision of the Plan to the contrary, the Committee, in its sole discretion, may provide in any Award Agreement or, in the event of a Change in Control, may take such actions as it deems appropriate to provide for the acceleration of the exercisability and vesting in connection with such Change in Control of any or all outstanding SARs and shares acquired upon the exercise of such SARs upon such conditions and to such extent as the Committee shall determine.

12.4 Effect of Change in Control on Restricted Stock Awards. Each Award Agreement evidencing a Restricted Stock Award shall provide in the event of a Change in Control for the lapse of the Restriction Period applicable to the shares subject to the Restricted Stock Award held by a

Participant whose Service has not terminated prior to the Change in Control, effective immediately prior to and conditioned upon the Change in Control.

12.5 *Effect of Change in Control on Performance Awards.* The Committee may, in its discretion, provide in any Award Agreement evidencing a Performance Award that, in the event of a Change in Control, the Performance Award held by a Participant whose Service has not terminated prior to the Change in Control shall become payable effective as of the date of the Change in Control to such extent as specified in such Award Agreement.

12.6 *Effect of Change in Control on Restricted Stock Unit Awards.* Each Award Agreement evidencing a Restricted Stock Unit Award shall provide that the Restricted Stock Unit Award held by a Participant whose Service has not terminated prior to the Change in Control shall be settled effective immediately prior to and conditioned upon the Change in Control.

13. *COMPLIANCE WITH SECURITIES LAW.* The grant of Awards and the issuance of shares of Stock pursuant to any Award shall be subject to compliance with all applicable requirements of federal, state and foreign law with respect to such securities and the requirements of any stock exchange or market system upon which the Stock may then be listed. In addition, no Award may be exercised or shares issued pursuant to an Award unless (a) a registration statement under the Securities Act shall at the time of such exercise or issuance be in effect with respect to the shares issuable pursuant to the Award or (b) in the opinion of legal counsel to the Company, the shares issuable pursuant to the Award may be issued in accordance with the terms of an applicable exemption from the registration requirements of the Securities Act. The inability of the Company to obtain from any regulatory body having jurisdiction the authority, if any, deemed by the Company's legal counsel to be necessary to the lawful issuance and sale of any shares hereunder shall relieve the Company of any liability in respect of the failure to issue or sell such shares as to which such requisite authority shall not have been obtained. As a condition to issuance of any Stock, the Company may require the Participant to satisfy any qualifications that may be necessary or appropriate, to evidence compliance with any applicable law or regulation and to make any representation or warranty with respect thereto as may be requested by the Company.

14. *TAX WITHHOLDING.*

14.1 *Tax Withholding in General.* The Company shall have the right to deduct from any and all payments made under the Plan, or to require the Participant, through payroll withholding, cash payment or otherwise, including by means of a Cashless Exercise of an Option, to make adequate provision for, the federal, state, local and foreign taxes, if any, required by law to be withheld by the Participating Company Group with respect to an Award or the shares acquired pursuant thereto. The Company shall have no obligation to deliver shares of Stock, to release shares of Stock from an escrow established pursuant to an Award Agreement, or to make any payment in cash under the Plan until the Participating Company Group's tax withholding obligations have been satisfied by the Participant.

14.2 *Withholding in Shares.* The Company shall have the right, but not the obligation, to deduct from the shares of Stock issuable to a Participant upon the exercise or settlement of an Award, or to accept from the Participant the tender of, a number of whole shares of Stock having a Fair Market Value, as determined by the Company, equal to all or any part of the tax withholding obligations of the Participating Company Group. The Fair Market Value of any shares of Stock withheld or tendered to satisfy any such tax withholding obligations shall not exceed the amount determined by the applicable minimum statutory withholding rates.

15. *AMENDMENT OR TERMINATION OF PLAN.* The Committee may amend, suspend or terminate the Plan at any time. However, without the approval of the Company's shareholders, there shall be (a) no increase in the maximum aggregate number of shares of Stock that may be issued under the Plan (except by operation of the provisions of *Section 4.2*), (b) no change in the class of persons eligible to receive Incentive Stock Options, and (c) no other amendment of the Plan that would require approval of

the Company's shareholders under any applicable law, regulation or rule. No amendment, suspension or termination of the Plan shall affect any then outstanding Award unless expressly provided by the Committee. In any event, no amendment, suspension or termination of the Plan may adversely affect any then outstanding Award without the consent of the Participant unless necessary to comply with any applicable law, regulation or rule.

16. MISCELLANEOUS PROVISIONS.

16.1 *Provision of Information.* Each Participant shall be given access to information concerning the Company equivalent to that information generally made available to the Company's common shareholders.

16.2 *Rights as Employee, Consultant or Director.* No person, even though eligible pursuant to Section 5, shall have a right to be selected as a Participant, or, having been so selected, to be selected again as a Participant. Nothing in the Plan or any Award granted under the Plan shall confer on any Participant a right to remain an Employee, Consultant or Director or interfere with or limit in any way any right of a Participating Company to terminate the Participant's Service at any time. To the extent that an Employee of a Participating Company other than the Company receives an Award under the Plan, that Award shall in no event be understood or interpreted to mean that the Company is the Employee's employer or that the Employee has an employment relationship with the Company.

16.3 *Rights as a Shareholder.* A Participant shall have no rights as a shareholder with respect to any shares covered by an Award until the date of the issuance of such shares (as evidenced by the appropriate entry on the books of the Company or of a duly authorized transfer agent of the Company). No adjustment shall be made for dividends, distributions or other rights for which the record date is prior to the date such shares are issued, except as provided in Section 4.2 or another provision of the Plan.

16.4 *Section 409A Provisions.* Notwithstanding anything in the Plan or any Award Agreement to the contrary, to the extent that any amount or benefit that constitutes "deferred compensation" to a Participant under Section 409A of the Code and applicable guidance thereunder is otherwise payable or distributable to a Participant under the Plan or any Award Agreement solely by reason of the occurrence of a Change in Control or due to the Participant's disability or "separation from service" (as such term is defined under Section 409A), such amount or benefit will not be payable or distributable to the Participant by reason of such circumstance unless the Committee determines in good faith that (i) the circumstances giving rise to such Change in Control, disability or separation from service meet the definition of a change in ownership or control, disability, or separation from service, as the case may be, in Section 409A(a)(2)(A) of the Code and Treasury Regulations, or (ii) the payment or distribution of such amount or benefit would be exempt from the application of Section 409A by reason of the short-term deferral exemption or otherwise. Any payment or distribution that otherwise would be made to a Participant who is a Specified Employee (as determined by the Committee in good faith) on account of separation from service may not be made before the date which is six (6) months after the date of the Specified Employee's separation from service unless the payment or distribution is exempt from the application of Section 409A by reason of the short term deferral exemption or otherwise.

16.5 *Fractional Shares.* The Company shall not be required to issue fractional shares upon the exercise or settlement of any Award.

16.6 *Severability.* If any one or more of the provisions (or any part thereof) of this Plan shall be held invalid, illegal or unenforceable in any respect, such provision shall be modified so as to make it valid, legal and enforceable, and the validity, legality and enforceability of the remaining provisions (or any part thereof) of the Plan shall not in any way be affected or impaired thereby.

16.7 *Beneficiary Designation.* Subject to applicable laws and procedures, each Participant may file with the Company a written designation of a beneficiary who is to receive any benefit under the Plan to which the Participant is entitled in the event of such Participant's death before he or she receives any or all of such benefit. Each designation will revoke all prior designations by the same Participant, shall be in a form prescribed by the Company, and will be effective only when filed by the Participant in writing with the Company during the Participant's lifetime. If a married Participant designates a beneficiary other than the Participant's spouse, the effectiveness of such designation may be subject to the consent of the Participant's spouse. If a Participant dies without an effective designation of a beneficiary who is living at the time of the Participant's death, the Company will pay any remaining unpaid benefits to the Participant's legal representative.

HERITAGE COMMERCE CORP
2012 Annual Report on Form 10-K

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

(MARK ONE)

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

For the fiscal year ended December 31, 2012

OR

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

FOR THE TRANSITION PERIOD FROM TO

Commission file number 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 Number)

150 Almaden Boulevard
San Jose, California 95113
(Address of Principal Executive Offices including Zip Code)

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

Securities registered pursuant to Section 12(b) of the Act:

Title of Each Class	Name of Each Exchange on which Registered
Common Stock, no par value	The NASDAQ Stock Market LLC (NASDAQ Global Select Market)

Securities registered pursuant to Section 12(g) of the Act: None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Act. Yes No

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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of Registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K, or any amendment to this Form 10-K.

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

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 Act). Yes No

The aggregate market value of the common stock held by non-affiliates of the Registrant as of June 30, 2012, based upon the closing price on that date of \$6.50 per share as reported on the NASDAQ Global Select Market, and 19,571,334 shares held, was approximately \$127.2 million.

As of February 8, 2013, there were 26,332,147 shares of the Registrant's common stock (no par value) outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Registrant's definitive proxy statement to be filed with the Securities and Exchange Commission pursuant to Regulation 14A in connection with the 2013 Annual Meeting of Shareholders to be held on May 23, 2013 are incorporated by reference into Part III of this Report. The proxy statement will be filed with the Securities and Exchange Commission not later than 120 days after the Registrant's fiscal year ended December 31, 2012.

HERITAGE COMMERCE CORP
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FOR YEAR ENDED DECEMBER 31, 2012

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Annual Report

Cautionary Note Regarding Forward-Looking Statements

This Report on Form 10-K contains various statements that may constitute forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, Rule 175 promulgated thereunder, and Section 21E of the Securities Exchange Act of 1934, as amended, Rule 3b-6 promulgated thereunder 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. The forward-looking statements could be affected by many factors, including but not limited to:

- Competition for loans and deposits and failure to attract or retain deposits and loans;
- Local, regional, and national economic conditions and events and the impact they may have on us and our customers, and our assessment of that impact on our estimates including, the allowance for loan losses;
- Risks associated with concentrations in real estate related loans;
- Changes in the level of nonperforming assets and charge-offs and other credit quality measures, and their impact on the adequacy of the Company’s allowance for loan losses and the Company’s provision for loan losses;
- The effects of and changes in trade, monetary and fiscal policies and laws, including the interest rate policies of the Federal Open Market Committee of the Federal Reserve Board;
- Stability of funding sources and continued availability of borrowings;
- Our ability to raise capital or incur debt on reasonable terms;
- Regulatory limits on Heritage Bank of Commerce’s ability to pay dividends to the Company;
- Continued volatility in credit and equity markets and its effect on the global economy;
- The impact of reputational risk on such matters as business generation and retention, funding and liquidity;
- Oversupply of inventory and continued deterioration in values of California commercial real estate;
- A prolonged slowdown in construction activity;
- The effect of changes in laws and regulations (including laws and regulations concerning taxes, banking, securities, and executive compensation) which we must comply, including but not limited to, the Dodd-Frank Act of 2010;
- The effects of security breaches and computer viruses that may affect our computer systems;
- Changes in consumer spending, borrowings and saving habits;

- Changes in the competitive environment among financial or bank holding companies and other financial service providers;
- The effect of changes in accounting policies and practices, as may be adopted by the regulatory agencies, as well as the Public Company Accounting Oversight Board, the Financial Accounting Standards Board and other accounting standard setters;
- The costs and effects of legal and regulatory developments, including resolution of legal proceedings or regulatory or other governmental inquiries, and the results of regulatory examinations or reviews;
- The ability to increase market share and control expenses; 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-K. 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.

PART I

ITEM 1 — BUSINESS

General

Heritage Commerce Corp, a California corporation organized in 1997, is a bank holding company registered under the Bank Holding Company Act of 1956, as amended. We provide a wide range of banking services through Heritage Bank of Commerce, our wholly-owned subsidiary and our principal asset. Heritage Bank of Commerce is a California state-chartered bank headquartered in San Jose, California and has been conducting business since 1994.

Heritage Bank of Commerce is a multi-community independent bank that offers a full range of commercial banking services to small and medium-sized businesses and their owners, managers and employees. We operate through 10 full service branch offices 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. Our market includes the headquarters of a number of technology based companies in the region commonly known as “Silicon Valley.”

Our lending activities are diversified and include commercial, real estate, construction and land development, consumer and SBA guaranteed loans. We generally lend in markets where we have a physical presence through our branch offices and an SBA loan production office. We attract deposits throughout our market area with a customer-oriented product mix, competitive pricing, and convenient locations. We offer a wide range of deposit products for business banking and retail markets. We offer a multitude of other products and services to complement our lending and deposit services.

As a bank holding company, Heritage Commerce Corp is subject to the supervision of the Board of Governors of the Federal Reserve System (the “Federal Reserve”). We are required to file with the Federal Reserve reports and other information regarding our business operations and the business operations of our subsidiaries. As a California chartered bank, Heritage Bank of Commerce is subject to primary supervision, periodic examination, and regulation by the California Department of Financial Institutions (“DFI”), and by the Federal Reserve, as its primary federal regulator.

Our principal executive office is located at 150 Almaden Boulevard, San Jose, California 95113, telephone number: (408) 947-6900.

At December 31, 2012, we had consolidated assets of \$1.69 billion, deposits of \$1.48 billion and shareholders' equity of \$169.7 million. Excluding the short-term deposits of \$271.9 million at the Federal Reserve Bank offsetting the short-term demand deposits from one customer, total assets and deposits at December 31, 2012 were \$1.42 billion and \$1.21 billion, respectively.

When we use "we", "us", "our" or the "Company", we mean the Company on a consolidated basis with Heritage Bank of Commerce. When we refer to "HCC" or the "holding company", we are referring to Heritage Commerce Corp on a standalone basis. When we use "HBC", we mean Heritage Bank of Commerce on a standalone basis.

The Internet address of the Company's website is "<http://www.heritagecommercecorp.com>." The Company makes available free of charge through the Company's website, the Company's annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and amendments to these reports. The Company makes these reports available on its website on the same day they appear on the Securities and Exchange Commission's ("SEC") website.

Heritage Bank of Commerce

HBC is a California state-chartered bank headquartered in San Jose, California. It was incorporated in November 1993 and opened for business in January 1994. HBC operates through ten full service branch offices. The locations of HBC's current offices are:

San Jose:	Administrative Office Main Branch 150 Almaden Boulevard San Jose, CA 95113
Danville:	Branch Office 387 Diablo Road Danville, CA 94526
Fremont:	Branch Office 3137 Stevenson Boulevard Fremont, CA 94538
Gilroy:	Branch Office 7598 Monterey Street Suite 110 Gilroy, CA 95020
Los Altos:	Branch Office 419 South San Antonio Road Los Altos, CA 95032
Los Gatos:	Branch Office 15575 Los Gatos Boulevard Los Gatos, CA 95032
Morgan Hill:	Branch Office 18625 Sutter Boulevard Morgan Hill, CA 95037
Mountain View:	Branch Office 175 E. El Camino Real Mountain View, CA 94040

Pleasanton: Branch Office
300 Main Street
Pleasanton, CA 94566

Walnut Creek: Branch Office
101 Ygnacio Valley Road
Suite 100
Walnut Creek, CA 94596

HBC is a full-service community bank offering an array of banking products and services to the communities it serves, including accepting time and demand products and originating commercial loans, commercial real estate loans, construction loans, and small business and consumer loans.

Lending Activities

Our commercial loan portfolio is comprised of operating secured and unsecured loans advanced for working capital, equipment purchases and other business purposes. Generally short-term loans have maturities ranging from thirty days to one year, and “term loans” have maturities 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 generally provide for floating or fixed interest rates, with monthly payments of both principal and interest. Repayment of secured and unsecured commercial loans depends substantially on the borrower’s underlying business, financial condition and cash flows, as well as the sufficiency of the collateral. Compared to real estate, the collateral may be more difficult to monitor, evaluate and sell. It may also depreciate more rapidly than real estate. Such risks can be significantly affected by economic conditions. HBC’s commercial loans are primarily originated for locally-oriented commercial activities in communities where HBC has a physical presence through its branch offices and a loan production office.

HBC actively engages in Small Business Administration (“SBA”) lending. HBC has been designated as an SBA Preferred Lender since 1999.

The commercial real estate loan portfolio is comprised of loans secured by commercial real estate. These loans are generally advanced based on the borrower’s cash flow, and the underlying collateral provides a secondary source of payment. HBC generally restricts real estate term loans to no more than 75% of the property’s appraised value or the purchase price of the property, depending on the type of property and its utilization. HBC offers both fixed and floating rate loans. Maturities on such loans are generally restricted to between five and ten years (with amortization ranging from fifteen to twenty-five years and a balloon payment due at maturity, and amortization of thirty years on loans secured by apartments); however, SBA and certain real estate loans that can be sold in the secondary market may be advanced for longer maturities. Commercial real estate loans typically involve large balances to single borrowers or groups of related borrowers. Since payments on these loans are often dependent on the successful operation or management of the properties, as well as the business and financial condition of the borrower, repayment of such loans may be subject to adverse conditions in the real estate market, adverse economic conditions or changes in applicable government regulations. If the cash flow from the project decreases, or if leases are not obtained or renewed, the borrower’s ability to repay the loan may be impaired.

We make commercial construction loans for rental properties, commercial buildings and homes built by developers on speculative, undeveloped property. The terms of commercial construction loans are made in accordance with our loan policy. Advances on construction loans are made in accordance with a schedule reflecting the cost of construction, but are generally limited to a 75% loan-to-completed-appraised-value ratio. Repayment of construction loans on non-residential properties is normally expected from the property’s eventual rental income, income from the borrower’s operating entity or the sale of the subject property. In the case of income-producing property, repayment is usually expected from permanent

financing upon completion of construction. At times we provide the permanent mortgage financing on our construction loans on income-producing property. Construction loans are interest-only loans during the construction period, which typically do not exceed 18 months. If HBC provides permanent financing the short-term loan converts to permanent, amortizing financing following the completion of construction. Generally, before making a commitment to fund a construction loan, we require an appraisal of the property by a state-certified or state-licensed appraiser. We review and inspect properties before disbursement of funds during the term of the construction loan. The repayment of construction loans is dependent upon the successful and timely completion of the construction of the subject property, as well as the sale of the property to third parties or the availability of permanent financing upon completion of all improvements. Construction loans expose us to the risk that improvements will not be completed on time, and in accordance with specifications and projected costs. Construction delays, the financial impairment of the builder, interest rate increases or economic downturn may further impair the borrower's ability to repay the loan. In addition, the borrower may not be able to obtain permanent financing or ultimate sale or rental of the property may not occur as anticipated. HBC utilizes underwriting guidelines to assess the likelihood of repayment from sources such as sale of the property or permanent mortgage financing prior to making the construction loan.

Our home equity line loan portfolio is comprised of home equity lines of credit to customers in our markets. Home equity lines of credit are underwritten in a manner such that they result in credit risk that is substantially similar to that of residential mortgage loans. Nevertheless, home equity lines of credit have greater credit risk than residential mortgage loans because they are often secured by mortgages that are subordinated to the existing first mortgage on the property, which we may or may not hold, and they are not covered by private mortgage insurance coverage.

The consumer loan portfolio is composed of miscellaneous consumer loans including loans for financing automobiles, various consumer goods and other personal purposes. Consumer loans are generally secured. Repossessed collateral for a defaulted consumer loan may not provide an adequate source of repayment for the outstanding loan, and the remaining deficiency may not warrant further substantial collection efforts against the borrower. In addition, consumer loan collections are dependent on the borrower's continued financial stability, which can be adversely affected by job loss, divorce, illness or personal bankruptcy. Furthermore, the application of various federal and state laws, including federal and state bankruptcy and insolvency laws, may limit the amount which can be recovered on such loans.

As of December 31, 2012, the percentage of our total loans for each of the principal areas in which we directed our lending activities were as follows: (i) commercial and industrial 46% (including SBA loans); (ii) real estate secured loans 44%; (iii) land and construction loans 3%; and (iv) consumer (including home equity) 7%. While no specific industry concentration is considered significant, our lending operations are located in market areas dependent on technology and real estate industries and their supporting companies.

Investments

Our investment policy is established by the Board of Directors. The general investment strategies are developed and authorized by our Finance and Investment Committee of the Board of Directors. The investment policy is reviewed annually by the Finance and Investment Committee, and any changes to the policy are subject to approval by the full Board of Directors. The overall objectives of the investment policy are to maintain a portfolio of high quality and diversified investments to maximize interest income over the long term and to minimize risk, to provide collateral for borrowings, and to provide additional earnings when loan production is low. The policy dictates that investment decisions take into consideration the safety of principal, liquidity requirements and interest rate risk management. All securities transactions are reported to the Board of Directors' Finance and Investment Committee on a monthly basis.

Sources of Funds

Deposits traditionally have been our primary source of funds for our investment and lending activities. We also are able to borrow from the Federal Home Loan Bank of San Francisco and the Federal Reserve Bank of San Francisco to supplement cash flow needs. Our additional sources of funds are scheduled loan payments, maturing investments, loan repayments, income on other earning assets, and the proceeds of loan sales and securities sales.

Interest rates, maturity terms, service fees and withdrawal penalties are established on a periodic basis. Deposit rates and terms are based primarily on current operating strategies and market interest rates, liquidity requirements and our deposit growth goals.

We offer a wide range of deposit products for retail and business banking markets including checking accounts, interest-bearing transaction accounts, savings accounts, time deposits and retirement accounts. Our branch network enables us to attract deposits from throughout our market area with a customer-oriented product mix, competitive pricing, and convenient locations. HBC joined the Certificate of Deposit Account Registry Service (CDARS®) program in August 2008, which enables our local customers to obtain expanded FDIC insurance coverage on their deposits. At December 31, 2012, HBC had approximately 14,600 deposit accounts totaling \$1.48 billion, including brokered deposits, compared to 14,900 deposit accounts totaling approximately \$1.05 billion as of December 31, 2011. Late in the fourth quarter of 2012, the Company received significantly large demand deposits from one customer, which were deposited at HBC on a temporary short-term basis. Total deposits, excluding the short-term demand deposits of \$271.9 million to one customer, were \$1.2 billion at December 31, 2012.

Other Banking Services

We offer a multitude of other products and services to complement our lending and deposit services. These include cashier's checks, traveler's checks, bank-by-mail, ATMs, night depositories, safe deposit boxes, direct deposit, automated payroll services, electronic funds transfers, online banking, online bill pay, and other customary banking services. HBC currently operates ATMs at five different locations. In addition, we have established a convenient customer service group accessible by toll-free telephone to answer questions and promote a high level of customer service. HBC does not have a trust department. In addition to the traditional financial services offered, HBC offers remote deposit capture, automated clearing house origination, electronic data interchange and check imaging. HBC continues to investigate products and services that it believes addresses the growing needs of its customers and to analyze other markets for potential expansion opportunities.

U.S. Treasury Capital Purchase Program

On November 21, 2008, HCC issued 40,000 shares of Series A Fixed Rate Cumulative Perpetual Preferred Stock ("Series A Preferred Stock") to the U.S. Treasury under the terms of the U.S. Treasury Capital Purchase Program for \$40.0 million with a liquidation preference of \$1,000 per share. The Series A Preferred Stock carried a coupon of 5% for five years and 9% thereafter. The Series A Preferred Stock was non-voting, cumulative, and perpetual and could be redeemed at 100% of its liquidation preference plus accrued and unpaid dividends. In addition, HCC issued a warrant to the U.S. Treasury to purchase 462,963 shares of HCC's common stock. The warrant is exercisable immediately at a price of \$12.96 per share, and will expire after a period of 10 years from issuance. The U.S. Treasury may transfer a portion or portions of the warrant, and/or exercise the warrant at any time. The U.S. Treasury has agreed not to exercise voting power with respect to any common shares issued to it upon exercise of the warrant. At December 31, 2012, there had been no changes to the number of common shares covered by the warrant nor had the U.S. Treasury exercised any portion of the warrant.

Under the terms of the Capital Purchase Program, HCC was prohibited from increasing dividends above \$0.08 per share on its common stock, and from making certain repurchases of equity securities,

including its common stock, without the U.S. Treasury's consent. Furthermore, as long as the Series A Preferred Stock was outstanding, dividend payments and repurchases or redemptions relating to certain equity securities, including HCC's common stock, were prohibited until all accrued and unpaid dividends were paid on the Series A Preferred Stock.

On March 7, 2012, the Company repurchased all of the Series A Preferred Stock in the aggregate amount of \$40 million and paid a final dividend to the U.S. Treasury in the amount of \$122,000. At the time the Company repurchased the Series A Preferred Stock, it did not repurchase the related warrant. The warrant was outstanding as of the date of this report. For complete discussion and disclosure see "*Item 7 — Management Discussion and Analysis of Financial Condition and Results of Operations — Capital Resources*" presented elsewhere in this report.

2010 Private Placement

On June 21, 2010, HCC issued to various institutional investors 53,996 shares of Series B Mandatorily Convertible Cumulative Perpetual Preferred Stock ("Series B Preferred Stock") and 21,004 shares of Series C Convertible Perpetual Preferred Stock ("Series C Preferred Stock") for an aggregate purchase price of \$75 million. The Series B Preferred Stock was mandatorily convertible into common stock upon approval by the shareholders at a conversion price of \$3.75 per share. The Series C Preferred Stock is mandatorily convertible into common stock at a conversion price of \$3.75 per share upon both approval by the shareholders and, thereafter, a subsequent transfer of the Series C Preferred Stock to third parties not affiliated with the holder in a widely dispersed offering. At HCC's Special Meeting of Shareholders held on September 15, 2010, HCC's shareholders approved the issuance of common stock upon the conversion of the Series B Preferred Stock and upon the conversion of the Series C Preferred Stock as required by The NASDAQ Stock Market and California corporate law. As a result, on September 16, 2010, the Series B Preferred Stock was converted into 14,398,992 shares of common stock of HCC and the shares of Series B Preferred Stock ceased to be outstanding. The Series C Preferred Stock remains outstanding until it has been converted into common stock in accordance with its terms. The Series C Preferred Stock is non-voting except in the case of certain transactions that would affect the rights of the holders of the Series C Preferred Stock or applicable law. Holders of Series C Preferred Stock will receive dividends if and only to the extent dividends are paid to holders of common stock. The Series C Preferred Stock is not redeemable by HCC or by the holders and has a liquidation preference of \$1,000 per share. The Series C Preferred Stock ranks senior to HCC's common stock.

Correspondent Banks

Correspondent bank deposit accounts are maintained to enable the Company to transact types of activity that it would otherwise be unable to perform or would not be cost effective due to the size of the Company or volume of activity. The Company has utilized several correspondent banks to process a variety of transactions.

Competition

The banking and financial services business in California generally, and in the Company's market areas specifically, is highly competitive. The industry continues to consolidate and unregulated competitors have entered banking markets with products targeted at highly profitable customer segments. Many larger unregulated competitors are able to compete across geographic boundaries, and provide customers with meaningful alternatives to most significant banking services and products. These consolidation trends are likely to continue. The increasingly competitive environment is a result primarily of changes in regulation, changes in technology and product delivery systems, and the consolidation among financial service providers.

With respect to commercial bank competitors, the business is dominated by a relatively small number of major banks that operate a large number of offices within our geographic footprint. For the combined Santa Clara, Alameda and Contra Costa county region, the three counties within which the Company operates, the top three institutions are all multi-billion dollar entities with an aggregate of 271 offices that control a combined 53.38% of deposit market share based on June 30, 2012 FDIC market share data. HBC ranks fifteenth with 0.84% share of total deposits based on June 30, 2012 market share data. These banks have, among other advantages, the ability to finance wide-ranging advertising campaigns and to allocate their resources to regions of highest yield and demand. Larger banks are seeking to expand lending to small businesses, which are traditionally community bank customers. They can also offer certain services that we do not offer directly, but may offer indirectly through correspondent institutions. By virtue of their greater total capitalization, these banks also have substantially higher lending limits than we do. For customers whose needs exceed our legal lending limit, we arrange for the sale, or “participation,” of some of the balances to financial institutions that are not within our geographic footprint.

In addition to other large regional banks and local community banks, our competitors include savings institutions, securities and brokerage companies, mortgage companies, credit unions, finance companies and money market funds. In recent years, we have also witnessed increased competition from specialized companies that offer wholesale finance, credit card, and other consumer finance services, as well as services that circumvent the banking system by facilitating payments via the internet, wireless devices, prepaid cards, or other means. Technological innovations have lowered traditional barriers of entry and enabled many of these companies to compete in financial services markets. Such innovation has, for example, made it possible for non-depository institutions to offer customers automated transfer payment services that previously were considered traditional banking products. In addition, many customers now expect a choice of delivery channels, including telephone and smart phones, mail, personal computer, ATMs, self-service branches, and/or in-store branches. Competitors offering such products include traditional banks and savings associations, credit unions, brokerage firms, asset management groups, finance and insurance companies, internet-based companies, and mortgage banking firms.

Strong competition for deposits and loans among financial institutions and non-banks alike affects interest rates and other terms on which financial products are offered to customers. Mergers between financial institutions have placed additional pressure on other banks within the industry to remain competitive by streamlining operations, reducing expenses, and increasing revenues. Competition has also intensified due to federal and state interstate banking laws enacted in the mid-1990’s, which permit banking organizations to expand into other states. The relatively large and expanding California market has been particularly attractive to out of state institutions. The Gramm-Leach-Bliley Act of 1999 has made it possible for full affiliations to occur between banks and securities firms, insurance companies, and other financial companies, and has also intensified competitive conditions. *See Item 1 — “Business — Supervision and Regulation — Heritage Commerce Corp — Financial Modernization”.*

In order to compete with the other financial service providers, the Company principally relies upon community-oriented, personalized service, local promotional activities, personal relationships established by officers, directors, and employees with its customers, and specialized services tailored to meet its customers’ needs. Our “preferred lender” status with the Small Business Administration allows us to approve SBA loans faster than many of our competitors. In those instances where the Company is unable to accommodate a customer’s needs, the Company seeks to arrange for such loans on a participation basis with other financial institutions or to have those services provided in whole or in part by its correspondent banks. *See Item 1 — “Business — Correspondent Banks.”*

Economic Conditions, Government Policies, Legislation, and Regulation

The Company’s profitability, like most financial institutions, is primarily dependent on interest rate differentials. In general, the difference between the interest rates paid by HBC on interest-bearing liabilities, such as deposits and other borrowings, and the interest rates received by HBC on interest

earning assets, such as loans extended to customers and securities held in the investment portfolio, will comprise the major portion of the Company's earnings. These rates are highly sensitive to many factors that are beyond the control of the Company and HBC, such as inflation, recession and unemployment, and the impact which future changes in domestic and foreign economic conditions might have on the Company and HBC cannot be predicted.

The Company's business is also influenced by the monetary and fiscal policies of the federal government and the policies of regulatory agencies, particularly the Board of Governors of the Federal Reserve Board. The Federal Reserve implements national monetary policies (with objectives such as curbing inflation and combating recession) through its open-market operations in U.S. Government securities by adjusting the required level of reserves for depository institutions subject to its reserve requirements, and by varying the target Federal funds and discount rates applicable to borrowings by depository institutions. The actions of the Federal Reserve in these areas influence the growth of bank loans, investments, and deposits and also affect interest earned on interest earning assets and paid on interest bearing liabilities. The nature and impact of any future changes in monetary and fiscal policies on the Company cannot be predicted.

From time to time, federal and state legislation is enacted which may have the effect of materially increasing the cost of doing business, limiting or expanding permissible activities, or affecting the competitive balance between banks and other financial services providers. In addition, the various bank regulatory agencies often adopt new rules and regulations and policies to implement and enforce existing legislation. It cannot be predicted whether, or in what form, any such legislation or regulations or changes in policy may be enacted or the extent to which the business of the Company would be affected thereby. The Company cannot predict whether or when potential legislation will be enacted and, if enacted, the effect that it, or any implemented regulations and supervisory policies, would have on our financial condition or results of operations. In addition, the outcome of any examination, litigation or investigation initiated by state or federal authorities may result in necessary changes in our operations and increased compliance costs.

The Dodd-Frank Wall Street Reform and Consumer Protection Act

The Dodd-Frank Act of 2010, as amended ("Dodd-Frank"), represents landmark legislation which followed other legislative and regulatory initiatives in 2008 and 2009 in response to the economic downturn and financial industry instability. Dodd-Frank impacts many aspects of the financial industry and, in many cases, will impact larger and smaller financial institutions and community banks differently over time. Many of the following key provisions of Dodd-Frank affecting the financial industry are now effective or are in the proposed rule or implementation stage:

- the creation of a Financial Services Oversight Counsel to identify emerging systemic risks and improve interagency cooperation;
- expanded FDIC authority to conduct the orderly liquidation of certain systemically significant non-bank financial companies in addition to depository institutions;
- the establishment of strengthened capital and liquidity requirements for banks and bank holding companies, including minimum leverage and risk-based capital requirements no less than the strictest requirements in effect for depository institutions as of the date of enactment;
- enhanced regulation of financial markets, including the derivative and securitization markets, and the elimination of certain proprietary trading activities by banks;
- requirement by statute that bank holding companies serve as a source of financial strength for their depository institution subsidiaries;

- the elimination and phase out of trust preferred securities from Tier 1 capital with certain exceptions;
- a permanent increase of the previously implemented temporary increase of FDIC deposit insurance to \$250,000 and an extension of federal deposit coverage through December 31, 2012, for the full net amount held by depositors in non-interest bearing transaction accounts;
- authorization for financial institutions to pay interest on business checking accounts;
- changes in the calculation of FDIC deposit insurance assessments, such that the assessment base will no longer be the institution's deposit base, but instead, will be its average consolidated total assets less its average tangible equity and increase the minimum reserve ratio for the Deposit Insurance Fund from 1.15% to 1.35%;
- the elimination of remaining barriers to de novo interstate branching by banks;
- expanded restrictions on transactions with affiliates and insiders under Section 23A and 23B of the Federal Reserve Act and lending limits for derivative transactions, repurchase agreements and securities lending and borrowing transactions;
- the transfer of oversight of federally chartered thrift institutions to the Office of the Comptroller of the Currency and state-chartered savings banks to the FDIC, and the elimination of the Office of Thrift Supervision;
- provisions that affect corporate governance and executive compensation at most United States publicly traded companies, including: (i) stockholder advisory votes on executive compensation; (ii) executive compensation "clawback" requirements for companies listed on national securities exchanges in the event of materially inaccurate statements of earnings, revenues, gains or other criteria; (iii) enhanced independence requirements for compensation committee members; and (iv) authority for the SEC to adopt proxy access rules which would permit stockholders of publicly traded companies to nominate candidates for election as director and have those nominees included in a company's proxy statement; and
- the creation of a Consumer Financial Protection Bureau, which is authorized to promulgate and enforce consumer protection regulations relating to bank and non-bank financial products and examine and enforce these regulations on banks with more than \$10 billion in assets.

Although a significant number of the rules and regulations mandated by the Dodd-Frank have been finalized, many of the new requirements called for have yet to be implemented and will likely be subject to implementing regulations over the course of several years. Given the uncertainty associated with the manner in which the provisions of the Dodd-Frank will be implemented by the various regulatory agencies, the full extent of the impact such requirements will have on financial institutions' operations is unclear. There can be no assurance that these or future reforms (such as possible new standards for commercial real estate lending or new stress testing guidance for all banks) arising out of studies and reports required by Dodd-Frank will not significantly increase our compliance or other operating costs or otherwise have a significant impact on our business, financial condition and results of operations. Dodd-Frank is likely to impose upon us more stringent capital, liquidity and leverage requirements or otherwise adversely affect our business. As a result of the changes required by Dodd-Frank, the profitability of our business activities may be impacted and we may be required to make changes to certain of our business practices. These changes may also require us to invest significant management attention and resources to evaluate and make any changes necessary to comply with new statutory and regulatory requirements.

Troubled Asset Relief and Capital Purchase Program

In response to economic downturn and financial industry instability included the Emergency Economic Stabilization Act of 2008 (“EESA”), enacted on October 3, 2008, and the American Recovery and Reinvestment Act of 2009 (“ARRA”), enacted on February 17, 2009.

Pursuant to EESA, the United States Department of the Treasury (“U.S. Treasury”) was authorized to create the \$700 billion Troubled Assets Relief Program (“TARP”) to purchase, insure, hold and sell a wide variety of financial instruments, and, as implemented under the Capital Purchase Program, included authorization for up to \$250 billion in senior preferred stock of qualifying United States banks and savings associations or their holding companies.

On November 21, 2008, the Company entered into a Securities Purchase Agreement — Standard Terms with the U.S. Treasury, pursuant to which, among other things, the Company sold Series A Preferred Stock and a warrant to purchase 462,963 shares of common stock to the U.S. Treasury for an aggregate purchase price of \$40 million. Under the terms of the Capital Purchase Program, the Company was prohibited from increasing dividends on its common stock and from making certain repurchases of equity securities, including its common stock, without the U.S. Treasury’s consent. Furthermore, as long as the Series A Preferred Stock was outstanding, dividend payments and repurchases or redemptions relating to certain equity securities, including the Company’s common stock, were prohibited until all accrued and unpaid dividends were paid on the Series A Preferred Stock.

In order to participate in the Capital Purchase Program, financial institutions were required to adopt certain standards for executive compensation and corporate governance. These standards generally applied to the Chief Executive Officer, Chief Financial Officer and the three next most highly compensated senior executive officers. The standards included: (i) ensuring that incentive compensation for senior executives does not encourage unnecessary and excessive risks that threaten the value of the financial institution; (ii) requiring clawback of any bonus or incentive compensation paid to a senior executive based on statements of earnings, gains or other criteria that are later proven to be materially inaccurate; (iii) prohibiting golden parachute payments to senior executives; and (iv) agreeing not to deduct for tax purposes executive compensation in excess of \$500,000 for these senior executives.

ARRA includes a wide variety of programs intended to stimulate the economy and provide for extensive infrastructure, energy, health, and education needs. ARRA imposes certain additional, more stringent executive compensation and corporate expenditure limits on all current and future TARP recipients until the U.S. Treasury is repaid, which is permitted under ARRA without penalty and without the need to raise new capital, subject to the U.S. Treasury’s consultation with the recipient’s appropriate regulatory agency.

The executive compensation standards under ARRA include, but are not limited to: (i) prohibitions on bonuses, retention awards and other incentive compensation, other than restricted stock grants which do not fully vest during the TARP period up to one-third of an employee’s total annual compensation; (ii) prohibitions on golden parachute payments for departure from a company; (iii) an expanded clawback of bonuses, retention awards, and incentive compensation if payment is based on materially inaccurate statements of earnings, revenues, gains or other criteria; (iv) prohibitions on compensation plans that encourage manipulation of reported earnings; (v) retroactive review of bonuses, retention awards and other compensation previously provided by TARP recipients if found by the U.S. Treasury to be inconsistent with the purposes of TARP or otherwise contrary to the public interest; (vi) establishment of a companywide policy regarding “excessive or luxury expenditures,” and (vii) inclusion in a participant’s proxy statements for annual stockholder meetings of a non-binding “Say on Pay” stockholder vote on the compensation of executives.

The Company complied with the executive compensation requirements through March 7, 2012, the date of the Company's repurchase of the Series A Preferred Stock, and has certified as to such compliance in the exhibits attached to this report pursuant to Section 111(b) of EESA.

On March 7, 2012, the Company repurchased all shares of the Series A Preferred Stock in the aggregate amount of \$40 million and paid a final dividend to the U.S. Treasury of \$122,000. At the time the Company repurchased the Series A Preferred Stock, it did not repurchase the related warrant. The warrant was outstanding as of the date of this report. For complete discussion and disclosure see "*Management's Discussion and Analysis of Financial Condition and Results of Operations — Capital Resources*" presented elsewhere in this report.

Supervision and Regulation

Introduction

Banking is a complex, highly regulated industry. The primary goals of the regulatory scheme are to maintain a safe and sound banking system, protect depositors and the Federal Deposit Insurance Corporation's ("FDIC") insurance fund, and facilitate the conduct of sound monetary policy. In furtherance of these goals, Congress and the states have created several largely autonomous regulatory agencies and enacted numerous laws that govern banks, bank holding companies and the financial services industry. Consequently, the growth and earnings performance of the Company can be affected not only by management decisions and general economic conditions, but also by the requirements of applicable state and federal statutes, regulations and the policies of various governmental regulatory authorities, including the Federal Reserve, FDIC, and the DFI.

The system of supervision and regulation applicable to financial services businesses governs most aspects of the business of the Company, including: (i) the scope of permissible business; (ii) investments; (iii) reserves that must be maintained against deposits; (iv) capital levels that must be maintained; (v) the nature and amount of collateral that may be taken to secure loans; (vi) the establishment of new branches; (vii) mergers and consolidations with other financial institutions; and (viii) the payment of dividends.

Set forth below is a description of the significant elements of the laws and regulations applicable to HCC and HBC. The description is qualified in its entirety by reference to the full text of the statutes, regulations and policies that are described. Also, such statutes, regulations and policies are continually under review by the U.S. Congress and state legislatures and federal and state regulatory agencies. A change in statutes, regulations or regulatory policies applicable to HCC or HBC could have a material effect on our business.

Heritage Commerce Corp

General. As a bank holding company, HCC is registered under the Bank Holding Company Act of 1956, as amended ("BHCA"), and is subject to regulation by the Federal Reserve. Under the BHCA, HCC is subject to periodic examination by the Federal Reserve. HCC is also required to file periodic reports of its operations and any additional information regarding its activities and those of its subsidiaries as may be required by the Federal Reserve.

HCC is also a bank holding company within the meaning of Section 1280 of the California Financial Code. Consequently, HCC is subject to examination by, and may be required to file reports with, the DFI. DFI approval may be required for certain mergers and acquisitions.

HCC's stock is traded on the NASDAQ Global Select Market (under the trading symbol "HTBK"), and HCC is subject to rules and regulations of The NASDAQ Stock Market, including those related to corporate governance. HCC is also subject to the periodic reporting requirements of Section 13 of the Securities Exchange Act of 1934 (the "Exchange Act") which requires HCC to file annual, quarterly and other current reports with the SEC. HCC is subject to additional regulations including, but not limited to,

the proxy and tender offer rules promulgated by the SEC under Sections 13 and 14 of the Exchange Act, the reporting requirements of directors, executive officers and principal shareholders regarding transactions in the HCC's common stock and short swing profits rules promulgated by the SEC under Section 16 of the Exchange Act, and certain additional reporting requirements by principal shareholders of HCC promulgated by the SEC under Section 13 of the Exchange Act.

Affiliate Transactions. HCC and HBC are deemed affiliates of each other within the meaning of the Federal Reserve Act, and transactions between affiliates are subject to certain restrictions, including compliance with Sections 23A and 23B of the Federal Reserve Act and their implementing regulations. Generally, Sections 23A and 23B: (i) limit the extent to which a financial institution or its subsidiaries may engage in covered transactions (A) with an affiliate (as defined in such sections) to an amount equal to 10% of such institution's capital and surplus; and (B) with all affiliates, in the aggregate to an amount equal to 20% of such capital and surplus; and (ii) require all transactions with an affiliate, whether or not covered transactions, to be on terms substantially the same, or at least as favorable to the institution or subsidiary, as the terms provided or that would be provided to a non-affiliate. Dodd-Frank enhances the requirements for certain transactions with affiliates under Sections 23A and 23B, including an expansion of the definition of "covered transactions" and increasing the amount of time for which collateral requirements regarding covered transactions must be maintained. The term "covered transaction" includes the making of loans, purchase of assets, issuance of a guarantee and other similar types of transactions.

Source of Strength Doctrine. Federal Reserve policy requires bank holding companies to act as a source of financial and managerial strength to their subsidiary banks. Under this policy, the holding company is expected to commit resources to support its bank subsidiary, including at times when the holding company may not be in a financial position to provide it. It is the Federal Reserve's position that bank holding companies should stand ready to use their available resources to provide adequate capital to their subsidiary banks during periods of financial stress or adversity. Bank holding companies must also maintain the financial flexibility and capital raising capacity to obtain additional resources for assisting their subsidiary bank. A bank holding company's failure to meet its source-of-strength obligations may constitute an unsafe and unsound practice or a violation of the Federal Reserve Board's regulations, or both. The source-of-strength doctrine most directly affects bank holding companies where a bank holding company's subsidiary bank fails to maintain adequate capital levels. In such a situation, the subsidiary bank will be required by the bank's federal regulator to take "prompt corrective action." Any capital loans by a bank holding company to its subsidiary bank are subordinate in right of payment to deposits and to certain other indebtedness of such subsidiary bank. The BHCA provides that, in the event of a bank holding company's bankruptcy, any commitment by the bank holding company to a federal bank regulatory agency to maintain the capital of a bank subsidiary will be assumed by the bankruptcy trustee and entitled to priority of payment.

Dodd-Frank has added additional guidance regarding the source of strength doctrine and had directed the regulatory agencies to promulgate new regulations to increase the capital requirements for bank holding companies to a level that matches those of banking institutions.

Investments and Acquisition of other Banks. Subject to certain exceptions, the BHCA and the Change in Bank Control Act of 1978, together with the applicable regulations, require Federal Reserve approval (or, depending on the circumstances, no notice of disapproval) prior to any person or company acquiring "control" of a bank or bank holding company. A conclusive presumption of control exists if an individual or company acquires the power, directly or indirectly, to direct the management or policies of an insured depository institution or to vote 25% or more of any class of voting securities of any insured depository institution. A rebuttable presumption of control exists if a person or company acquires 10% or more but less than 25% of any class of voting securities of an insured depository institution and either the institution has registered securities under the Exchange Act, or no other person will own a greater percentage of that

class of voting securities immediately after the acquisition. Our common stock is registered under Section 12 of the Exchange Act.

As a bank holding company, we are required to obtain prior approval from the Federal Reserve before: (i) acquiring all or substantially all of the assets of a bank or bank holding company; (ii) acquiring direct or indirect ownership or control of more than 5% of the outstanding voting stock of any bank or bank holding company (unless we own a majority of such bank's voting shares); or (iii) merging or consolidating with any other bank or bank holding company. In determining whether to approve a proposed bank acquisition, federal bank regulators will consider, among other factors, the effect of the acquisition on competition, the public benefits expected to be received from the acquisition, the projected capital ratios and levels on a post-acquisition basis, and the acquiring institution's record of addressing the credit needs of the communities it serves, including the needs of low and moderate income neighborhoods, consistent with the safe and sound operation of the bank under the Community Reinvestment Act of 1977 ("CRA").

Tie-in Arrangements. Federal law prohibits a bank holding company and any subsidiary banks from engaging in certain tie-in arrangements in connection with the extension of credit. Thus, for example, HBC may not extend credit, lease or sell property, or furnish any services, or fix or vary the consideration for any of the foregoing on the condition that: (i) the customer must obtain or provide some additional credit, property or services from or to HBC other than a loan, discount, deposit or trust services; (ii) the customer must obtain or provide some additional credit, property or service from or to HCC or HBC; or (iii) the customer must not obtain some other credit, property or services from competitors, except reasonable requirements to assure soundness of credit extended.

Interstate Banking and Branching. The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 (the "Interstate Banking Act") regulates the interstate activities of banks and bank holding companies and establishes a framework for nationwide interstate banking and branching. Dodd-Frank eliminates interstate branching restrictions that were implemented as part of the Interstate Banking Act, and removes many restrictions on de novo interstate branching by national and state chartered banks.

In 1995, California enacted legislation to implement important provisions of the Interstate Banking Act discussed above and to repeal California's previous interstate banking laws, which were largely preempted by the Interstate Banking Act.

The changes affected by the Interstate Banking Act and California laws have increased competition in the environment in which the Company operates to the extent that out of state financial institutions directly or indirectly enter the Company's market areas. It appears that the Interstate Banking Act has contributed to accelerated consolidation within the banking industry.

Permitted Activities. Bank holding companies are limited to managing or controlling banks, furnishing services to or performing services for its subsidiaries, and engaging in other activities that the Federal Reserve determines by regulation or order to be so closely related to banking or managing or controlling banks as to be a proper incident thereto. In determining whether a particular activity is permissible, the Federal Reserve must consider whether the performance of such an activity reasonably can be expected to produce benefits to the public that outweigh possible adverse effects. Possible benefits include greater convenience, increased competition, and gains in efficiency. Possible adverse effects include undue concentration of resources, decreased or unfair competition, conflicts of interest, and unsound banking practices. Despite prior approval, the Federal Reserve may order a bank holding company or its subsidiaries to terminate any activity or to terminate ownership or control of any subsidiary when the Federal Reserve has reasonable cause to believe that a serious risk to the financial safety, soundness or stability of any bank subsidiary of that bank holding company may result from such an activity.

Financial Modernization. The Gramm-Leach-Bliley Act (the “GLBA”), which became effective in March 2000, permits greater affiliation among banks, securities firms, insurance companies, and other companies under a new type of financial services company known as a “financial holding company.” A financial holding company essentially is a bank holding company with significantly expanded powers. Financial holding companies are authorized by statute to engage in a number of financial activities previously impermissible for bank holding companies, including securities underwriting, dealing and market making; sponsoring mutual funds and investment companies; insurance underwriting and agency; and merchant banking activities. The GLBA also permits the Federal Reserve and the U.S. Treasury to authorize additional activities for financial holding companies if they are “financial in nature” or “incidental” to financial activities. A bank holding company may become a financial holding company if each of its subsidiary banks is well capitalized, well managed, and, except in limited circumstances, in satisfactory compliance with the CRA. A financial holding company must provide notice to the Federal Reserve within 30 days after commencing activities previously determined by statute or by the Federal Reserve and U.S. Treasury to be permissible. HCC has not and has no present plans to submit notice to the Federal Reserve to be a financial holding company. In addition, HBC is subject to other provisions of the GLBA, including those relating to CRA, privacy and the safe-guarding of confidential customer information, regardless of whether HCC elects to become a financial holding company or to conduct activities through a financial subsidiary of HBC.

The Company does not believe that the GLBA has had, or will have in the near term, a material adverse effect on its operations. However, to the extent that it permits banks, securities firms, and insurance companies to affiliate, the financial services industry may experience further consolidation. The GLBA is intended to grant to community banks certain powers as a matter of right that larger institutions have accumulated on an ad hoc basis. Nevertheless, the GLBA may have the result of increasing the amount of competition from larger institutions and other types of companies offering financial products, many of which may have substantially more financial resources than HCC and HBC.

The Sarbanes Oxley Act of 2002. The Sarbanes Oxley Act of 2002 (“SOX”) became effective on July 30, 2002, and represents the most far reaching corporate and accounting reform legislation since the enactment of the Securities Act of 1933 and the Exchange Act. SOX is intended to provide a permanent framework that improves the quality of independent audits and accounting services, improves the quality of financial reporting, strengthens the independence of accounting firms and increases the responsibility of management for corporate disclosures and financial statements.

SOX’s provisions are significant to all companies that have a class of securities registered under Section 12 of the Exchange Act, or are otherwise reporting to the SEC (or the appropriate federal banking agency) pursuant to Section 15(d) of the Exchange Act, including HCC (collectively, “public companies”). In addition to SEC rulemaking to implement SOX, The NASDAQ Stock Market has adopted corporate governance rules intended to allow shareholders to more easily and effectively monitor the performance of companies and directors. The principal provisions of SOX provide for and include, among other things: (i) the creation of an independent accounting oversight board; (ii) auditor independence provisions that restrict non-audit services that accountants may provide to their audit clients; (iii) additional corporate governance and responsibility measures, including the requirement that the chief executive officer and chief financial officer of a public company certify financial statements; (iv) the forfeiture of bonuses or other incentive based compensation and profits from the sale of a public company’s securities by directors and senior officers in the twelve month period following initial publication of any financial statements that later require restatement; (v) an increase in the oversight of, and enhancement of certain requirements relating to, audit committees of public companies and how they interact with the public company’s independent auditors; (vi) requirements that audit committee members must be independent and are barred from accepting consulting, advisory or other compensatory fees from the public company; (vii) requirements that public companies disclose whether at least one member of the audit committee is a “financial expert” (as such term is defined by the SEC) and if not discuss, why the audit committee does not

have a financial expert; (viii) expanded disclosure requirements for corporate insiders, including accelerated reporting of stock transactions by insiders and a prohibition on insider trading during pension blackout periods; (ix) a prohibition on personal loans to directors and officers, except certain loans made by insured financial institutions on non-preferential terms and in compliance with other bank regulatory requirements; (x) disclosure of a code of ethics and filing a Form 8-K for a change or waiver of such code; (xi) a range of enhanced penalties for fraud and other violations; and (xii) expanded disclosure and certification relating to a public company's disclosure controls and procedures and internal controls over financial reporting.

Heritage Bank of Commerce

General. As a California commercial bank whose deposits are insured by the FDIC, HBC is subject to regulation, supervision, and regular examination by the DFI and by the Federal Reserve, as HBC's primary Federal regulator, and must additionally comply with certain applicable regulations of the Federal Reserve. Specific federal and state laws and regulations which are applicable to banks regulate, among other things, the scope of their business, their investments, their reserves against deposits, the timing of the availability of deposited funds, their activities relating to dividends, investments, loans, the nature and amount of and collateral for certain loans, borrowings, capital requirements, certain check-clearing activities, branching, and mergers and acquisitions. California banks are also subject to statutes and regulations including Federal Reserve Regulation O and Federal Reserve Act Sections 23A and 23B and Regulation W, which restrict or limit loans or extensions of credit to "insiders", including officers, directors and principal shareholders, and loans or extension of credit by banks to affiliates or purchases of assets from affiliates, including parent bank holding companies, except pursuant to certain exceptions and terms and conditions at least as favorable to those prevailing for comparable transactions with unaffiliated parties. Dodd-Frank expanded definitions and restrictions on transactions with affiliates and insiders under Section 23A and 23B and also lending limits for derivative transactions, repurchase agreements and securities lending and borrowing transactions.

Pursuant to the Federal Deposit Insurance Act ("FDIA") and the California Financial Code, California state chartered commercial banks may generally engage in any activity permissible for national banks. Therefore, HBC may form subsidiaries to engage in the many so-called "closely related to banking" or "nonbanking" activities commonly conducted by national banks in operating subsidiaries or subsidiaries of bank holding companies. Further, pursuant to GLBA, California banks may conduct certain "financial" activities in a subsidiary to the same extent as may a national bank, provided the bank is and remains "well-capitalized," "well-managed" and in satisfactory compliance with the CRA.

HBC is a member of the Federal Home Loan Bank ("FHLB") of San Francisco. Among other benefits, each FHLB serves as a reserve or central bank for its members within its assigned region and makes available loans or advances to its members. Each FHLB is financed primarily from the sale of consolidated obligations of the FHLB system. As an FHLB member, HBC is required to own a certain amount of capital stock in the FHLB. At December 31, 2012, HBC was in compliance with the FHLB's stock ownership requirement. Federal Reserve stock is carried at cost and may be sold back to the Federal Reserve at its carrying value. Cash dividends received are reported as income.

Depositor Preference. In the event of the "liquidation or other resolution" of an insured depository institution, the claims of depositors of the institution, including the claims of the FDIC as subrogee of insured depositors, and certain claims for administrative expenses of the FDIC as a receiver, will have priority over other general unsecured claims against the institution. If an insured depository institution fails, insured and uninsured depositors, along with the FDIC, will have priority in payment ahead of unsecured, non-deposit creditors, including the parent bank holding company, with respect to any extensions of credit they have made to such insured depository institution.

Community Reinvestment Act. The CRA is intended to encourage insured depository institutions, while operating safely and soundly, to help meet the credit needs of their communities. The CRA specifically directs the federal bank regulatory agencies, in examining insured depository institutions, to assess their record of helping to meet the credit needs of their entire community, including low- and moderate-income neighborhoods, consistent with safe and sound banking practices. The CRA further requires the agencies to take a financial institution's record of meeting its community credit needs into account when evaluating applications for, among other things, domestic branches, consummating mergers or acquisitions, or holding company formations.

The federal banking agencies have adopted regulations which measure a bank's compliance with its CRA obligations on a performance based evaluation system. This system bases CRA ratings on an institution's actual lending service and investment performance rather than the extent to which the institution conducts needs assessments, documents community outreach or complies with other procedural requirements. The ratings range from "outstanding" to a low of "substantial noncompliance." HBC had a CRA rating of "satisfactory" as of its most recent regulatory examination.

Other Consumer Protection Laws and Regulations. The bank regulatory agencies are increasingly focusing attention on compliance with consumer protection laws and regulations. Banks have been advised to carefully monitor compliance with various consumer protection laws and regulations. The Federal Interagency Task Force on Fair Lending issued a policy statement on discrimination in home mortgage lending describing three methods that federal agencies will use to prove discrimination: overt evidence of discrimination, evidence of disparate treatment, and evidence of disparate impact. In addition to CRA and fair lending requirements, HBC is subject to numerous other federal consumer protection statutes and regulations. Due to heightened regulatory concern related to compliance with consumer protection laws and regulations generally, HBC may incur additional compliance costs or be required to expend additional funds for investments in the local communities it serves.

Loans to Directors, Executive Officers and Principal Shareholders. The authority of HBC to extend credit to our directors, executive officers and principal shareholders, including their immediate family members and corporations and other entities that they control, is subject to substantial restrictions and requirements under Sections 22(g) and 22(h) of the Federal Reserve Act and Regulation O promulgated thereunder, as well as the Sarbanes-Oxley Act of 2002. These statutes and regulations impose specific limits on the amount of loans our subsidiary bank may make to directors and other insiders, and specified approval procedures must be followed in making loans that exceed certain amounts. In addition, all loans HBC makes to directors and other insiders must satisfy the following requirements:

- the loans must be made on substantially the same terms, including interest rates and collateral, as prevailing at the time for comparable transactions with persons not affiliated with us or HBC;
- the subsidiary bank must follow credit underwriting procedures at least as stringent as those applicable to comparable transactions with persons who are not affiliated with us or HBC; and
- the loans must not involve a greater than normal risk of non-payment or include other features not favorable to HBC.

Furthermore, HBC must periodically report all loans made to directors and other insiders to the bank regulators, and these loans are closely scrutinized by the regulators for compliance with Sections 22(g) and 22(h) of the Federal Reserve Act and Regulation O. Each loan to directors or other insiders must be pre-approved by the HBC board of directors with the interested director abstaining from voting.

Environmental Regulation. Federal, state and local laws and regulations regarding the discharge of harmful materials into the environment may have an impact on HBC. Since HBC is not involved in any business that manufactures, uses or transports chemicals, waste, pollutants or toxins that might have a material adverse effect on the environment, HBC's primary exposure to environmental laws is through its

lending activities and through properties or businesses HBC may own, lease or acquire. Based on a general survey of HBC's loan portfolio, conversations with local appraisers and the type of lending currently and historically done by HBC, management is not aware of any potential liability for hazardous waste contamination that would be reasonably likely to have a material adverse effect on the Company as of December 31, 2012.

Safeguarding of Customer Information and Privacy. The Federal Reserve and other bank regulatory agencies have adopted guidelines for safeguarding confidential, personal customer information. These guidelines require financial institutions to create, implement and maintain a comprehensive written information security program designed to ensure the security and confidentiality of customer information, protect against any anticipated threats or hazards to the security or integrity of such information and protect against unauthorized access to or use of such information that could result in substantial harm or inconvenience to any customer. HBC has adopted a customer information security program to comply with such requirements.

Financial institutions are also required to implement policies and procedures regarding the disclosure of nonpublic personal information about consumers to non-affiliated third parties. In general, financial institutions must provide explanations to consumers on policies and procedures regarding the disclosure of such nonpublic personal information, and, except as otherwise required by law, prohibits disclosing such information except as provided in HBC's policies and procedures. HBC has implemented privacy policies addressing these restrictions which are distributed regularly to all existing and new customers of HBC.

USA Patriot Act of 2001. On October 26, 2001, President Bush signed the USA Patriot Act of 2001 (the "Patriot Act"). Enacted in response to the terrorist attacks on September 11, 2001, the Patriot Act is intended to strengthen the ability of U.S. law enforcement agencies and intelligence communities to work cohesively to combat terrorism on a variety of fronts. The impact of the Patriot Act on financial institutions of all kinds has been significant and wide-ranging. The Patriot Act substantially enhanced existing anti-money laundering and financial transparency laws, and required appropriate regulatory authorities to adopt rules to promote cooperation among financial institutions, regulators, and law enforcement entities in identifying parties that may be involved in terrorism or money laundering. Under the Patriot Act, financial institutions are subject to prohibitions regarding specified financial transactions and account relationships, as well as enhanced due diligence and "know your customer" standards in their dealings with foreign financial institutions and foreign customers. For example, the enhanced due diligence policies, procedures, and controls generally require financial institutions to take reasonable steps:

- to conduct enhanced scrutiny of account relationships to guard against money laundering and report any suspicious transactions;
- to ascertain the identity of the nominal and beneficial owners of, and the source of funds deposited into, each account as needed to guard against money laundering and report any suspicious transactions;
- to ascertain for any foreign bank, the shares of which are not publicly traded, the identity of the owners of the foreign bank, and the nature and extent of the ownership interest of each such owner; and
- to ascertain whether any foreign bank provides correspondent accounts to other foreign banks and, if so, the identity of those foreign banks and related due diligence information.

The Patriot Act also requires all financial institutions to establish anti-money laundering programs, which must include, at a minimum:

- the development of internal policies, procedures, and controls;
- the designation of a compliance officer;

- an ongoing employee training program; and
- an independent audit function to test the programs.

Material deficiencies in anti-money laundering compliance can result in public enforcement actions by the banking agencies, including the imposition of civil money penalties and supervisory restrictions on growth and expansion. Such enforcement actions could also have serious reputation consequences for the Company.

Office of Foreign Assets Control Regulation. The United States has imposed economic sanctions that affect transactions with designated foreign countries, nationals and others. These are typically known as the “OFAC” rules based on their administration by the U.S. Treasury Department Office of Foreign Assets Control (the “OFAC”). The OFAC-administered sanctions targeting countries take many different forms. Generally, however, they contain one or more of the following elements: (i) restrictions on trade with or investment in a sanctioned country, including prohibitions against direct or indirect imports from and exports to a sanctioned country and prohibitions on “U.S. persons” engaging in financial transactions relating to making investments in, or providing investment related advice or assistance to, a sanctioned country; and (ii) a blocking of assets in which the government or specially designated nationals of the sanctioned country have an interest, by prohibiting transfers of property subject to U.S. jurisdiction (including property in the possession or control of U.S. persons). Blocked assets (e.g., property and bank deposits) cannot be paid out, withdrawn, set off or transferred in any manner without a license from the OFAC. Failure to comply with these sanctions could have serious legal and reputational consequences.

Enforcement Authority

The federal and California regulatory structure gives the bank regulatory agencies extensive discretion in connection with their supervisory and enforcement activities and examination policies, including policies with respect to the classification of assets and the establishment of adequate loan loss reserves for regulatory purposes. The regulatory agencies have adopted guidelines to assist in identifying and addressing potential safety and soundness concerns before an institution’s capital becomes impaired. The guidelines establish operational and managerial standards generally relating to: (i) internal controls, information systems, and internal audit systems; (ii) loan documentation; (iii) credit underwriting; (iv) interest-rate exposure; (v) asset growth and asset quality; and (vi) compensation, fees, and benefits. Further, the regulatory agencies have adopted safety and soundness guidelines for asset quality and for evaluating and monitoring earnings to ensure that earnings are sufficient for the maintenance of adequate capital and reserves. If, as a result of an examination, the DFI or the Federal Reserve should determine that the financial condition, capital resources, asset quality, earnings prospects, management, liquidity, or other aspects of HBC’s operations are unsatisfactory or that HBC or its management is violating or has violated any law or regulation, the DFI and the Federal Reserve, and separately the FDIC as insurer of the HBC’s deposits, have residual authority to:

- Require affirmative action to correct any conditions resulting from any violation or practice;
- Direct an increase in capital and the maintenance of higher specific minimum capital ratios, which may preclude HBC from being deemed well capitalized and restrict its ability to accept certain brokered deposits;
- Restrict HBC’s growth geographically, by products and services, or by mergers and acquisitions, including bidding in FDIC receiverships for failed banks;
- Enter into or issue informal or formal enforcement actions, including required Board of Directors’ resolutions, memoranda of understanding, written agreements and consent or cease and desist orders or prompt corrective action orders to take corrective action and cease unsafe and unsound practices;

- Require prior approval of senior executive officer or director changes; remove officers and directors and assess civil monetary penalties; and
- Take possession of and close and liquidate HBC or appoint the FDIC as receiver.

Deposit Insurance

The FDIC is an independent federal agency that insures deposits, up to prescribed statutory limits, of federally insured banks and savings institutions and safeguards the safety and soundness of the banking and savings industries. The FDIC insures our customer deposits through the Deposit Insurance Fund (the “DIF”) up to prescribed limits for each depositor. Pursuant to Dodd-Frank, the maximum deposit insurance amount has been permanently increased to \$250,000 and all non-interest-bearing transaction accounts are insured through December 31, 2012. The amount of FDIC assessments paid by each DIF member institution is based on its relative risk of default as measured by regulatory capital ratios and other supervisory factors. Due to the increased number of bank failures and losses incurred by DIF, as well as the recent extraordinary programs in which the FDIC has been involved to support the banking industry generally, the FDIC’s DIF was substantially depleted and the FDIC has incurred substantially increased operating costs. In November, 2009, the FDIC adopted a requirement for institutions to prepay in 2009 their estimated quarterly risk-based assessments for the fourth quarter of 2009 and for all of 2010, 2011, and 2012. HBC was exempted from the prepayment requirement by the FDIC.

As required by Dodd-Frank, the FDIC adopted a new DIF restoration plan which became effective on January 1, 2011. Among other things, the plan: (i) raises the minimum designated reserve ratio, which the FDIC is required to set each year, to 1.35% (from the former minimum of 1.15%) and removes the upper limit on the designated reserve ratio (which was formerly capped at 1.50%) and consequently on the size of the DIF; (ii) requires that the fund reserve ratio reach 1.35% by September 30, 2020; (iii) eliminates the requirement that the FDIC provide dividends from the DIF when the reserve ratio is between 1.35% and 1.50%; and (iv) continues the FDIC’s authority to declare dividends when the reserve ratio at the end of a calendar year is at least 1.50%, but grants the FDIC sole discretion in determining whether to suspend or limit the declaration or payment of dividends. The FDIA continues to require that the FDIC’s Board of Directors consider the appropriate level for the designated reserve ratio annually and, if changing the designated reserve ratio, engage in notice-and-comment rulemaking before the beginning of the calendar year. The FDIC has set a long-term goal of getting its reserve ratio up to 2% of insured deposits by 2027. In connection with these changes, we expect our FDIC deposit insurance premiums to increase.

On February 7, 2011, the FDIC approved a final rule, as mandated by Dodd-Frank, changing the deposit insurance assessment system from one that is based on total domestic deposits to one that is based on average consolidated total assets minus average tangible equity. Under these rules, an institution with total assets of less than \$10 billion will be assigned to a Risk Category. Each institution is assigned to one of four risk categories based on its capital, supervisory ratings and other factors. Well capitalized institutions that are financially sound with only a few minor weaknesses are assigned to Risk Category I. Risk Categories II, III and IV present progressively greater risks to the DIF. A range of initial base assessment rates will apply to each category, subject to adjustment downward based on unsecured debt issued by the institution and, except for an institution in Risk Category I, adjustment upward if the institution’s brokered deposits exceed 10% of its domestic deposits, to produce total base assessment rates. Total base assessment rates range from 2.5 to 9 basis points for Risk Category I, 9 to 24 basis points for Risk Category II, 18 to 33 basis points for Risk Category III, and 30 to 45 basis points for Risk Category IV, all subject to further adjustment upward if the institution holds more than a de minimis amount of unsecured debt issued by another FDIC-insured institution. The FDIC may increase or decrease its rates by 2.0 basis points without further rulemaking. In an emergency, the FDIC may also impose a special assessment. In addition, the final rule creates a scorecard-based assessment system for larger banks (those with more than \$10 billion in assets) and suspends dividend payments if the DIF reserve ratio exceeds 1.50%, but provides for decreasing assessment rates when the DIF reserve ratio reaches certain thresholds.

Larger insured depository institutions will likely pay higher assessments to the DIF than under the old system. Additionally, the final rule includes a new adjustment for depository institution debt whereby an institution would pay an additional premium equal to 50 basis points on every dollar of long-term, unsecured debt held as an asset that was issued by another insured depository institution (excluding debt guaranteed under the Transaction Account Guaranty Program) to the extent that all such debt exceeds 3% of the other insured depository institution's Tier 1 capital. The new rule became effective for the quarter beginning April 1, 2011.

Our FDIC insurance expense totaled \$918,000 for 2012. FDIC insurance expense includes deposit insurance assessments and Financing Corporation ("FICO") assessments related to outstanding FICO bonds to fund interest payments on bonds to recapitalize the predecessor to the DIF. These assessments will continue until the FICO bonds mature in 2017. The FICO assessment rates, which are determined quarterly, was 0.00165% of average total assets less average tangible equity for the first and second quarters of 2012, and 0.00160% of average total assets less average tangible equity for the third quarter of 2012. As of the date of this report, the Company had not received the FICO assessment for the fourth quarter of 2012.

We are generally unable to control the amount of premiums that we are required to pay for FDIC insurance. If there are additional bank or financial institution failures or if the FDIC otherwise determines, we may be required to pay even higher FDIC premiums than the recently increased levels. These announced increases and any future increases in FDIC insurance premiums may have a material and adverse effect on our earnings and could have a material adverse effect on the value of, or market for, our common stock.

The FDIC may terminate a depository institution's deposit insurance upon a finding that the institution's financial condition is unsafe or unsound or that the institution has engaged in unsafe or unsound practices that pose a risk to the DIF or that may prejudice the interest of the bank's depositors. The termination of deposit insurance for a bank would also result in the revocation of the bank's charter by the DFI.

Capital Adequacy Requirements

Bank holding companies and banks are subject to various regulatory capital requirements administered by state and federal banking agencies. Increased capital requirements are expected as a result of expanded authority set forth in Dodd-Frank and the Basel III international supervisory developments discussed below. Capital adequacy guidelines and, additionally for banks, prompt corrective action regulations involve quantitative measures of assets, liabilities, and certain off-balance sheet items calculated under regulatory accounting practices. Capital amounts and classifications are also subject to qualitative judgments by regulators about components, risk weighting, and other factors. *See "Item 7 — Management's Discussion and Analysis of Financial Condition and Results of Operations — Capital Resources."*

The current risk-based capital guidelines for bank holding companies and banks adopted by the federal banking agencies are intended to provide a measure of capital that reflects the degree of risk associated with a banking organization's operations for both transactions reported on the balance sheet as assets, such as loans, and those recorded as off-balance sheet items, such as commitments, letters of credit and recourse arrangements. The risk-based capital ratio is determined by classifying assets and certain off-balance sheet financial instruments into weighted categories, with higher levels of capital being required for those categories perceived as representing greater risks and dividing its qualifying capital by its total risk-adjusted assets and off-balance sheet items. Bank holding companies and banks engaged in significant trading activity may also be subject to the market risk capital guidelines and be required to incorporate additional market and interest rate risk components into their risk-based capital standards.

Qualifying capital is classified depending on the type of capital:

- “Tier 1 capital” currently includes common equity and trust preferred securities, subject to certain criteria and quantitative limits. Under Dodd-Frank, for institutions like HCC with less than \$15 billion in total consolidated assets, existing trust preferred capital still qualifies as Tier 1; however, under proposed rules issued to implement the capital requirements of Dodd-Frank and Basel III, trust preferred securities would be phased out of Tier 1 capital at a rate of 10% per year over a ten year period. Small bank holding companies with less than \$500 million in assets could issue new trust preferred which could still qualify as Tier 1; however, the market for any new trust preferred capital raises is uncertain.
- “Tier 2 capital” includes hybrid capital instruments, other qualifying debt instruments, a limited amount of the allowance for loan and lease losses, and a limited amount of unrealized holding gains on equity securities. Following the phase-out period under Dodd-Frank, trust preferred securities will be treated as Tier 2 capital for those financial institutions with consolidated assets in excess of \$15 billion.
- “Tier 3 capital” consists of qualifying unsecured debt.

The sum of Tier 2 and Tier 3 capital may not exceed the amount of Tier 1 capital.

Under the current capital guidelines, there are three fundamental capital ratios: a total risk-based capital ratio, a Tier 1 risk-based capital ratio, and a Tier 1 leverage ratio. To be deemed “well capitalized” a bank must have a total risk-based capital ratio, a Tier 1 risk-based capital ratio and a Tier 1 leverage ratio of at least 10%, 6% and 5%, respectively. At December 31, 2012, the respective capital ratios of HCC and HBC exceeded the minimum percentage requirements to be deemed “well-capitalized” under the regulatory framework for prompt corrective action. As of December 31, 2012, HBC’s total risk-based capital ratio was 15.3% and its Tier 1 risk-based capital ratio was 14.0%. As of December 31, 2012, HCC’s total risk-based capital ratio was 16.2% and its Tier 1 risk-based capital ratio was 15.0%.

HCC and HBC are also required to comply with minimum leverage ratio requirements. The leverage ratio is the ratio of a banking organization’s Tier 1 capital to its total adjusted quarterly average assets (as defined for regulatory purposes). The requirements necessitate a minimum leverage ratio of 3.0% for bank holding companies and banks that either have the highest supervisory rating or have implemented the appropriate federal regulatory authority’s risk-adjusted measure for market risk. All other bank holding companies and banks are required to maintain a minimum leverage ratio of 4.0%, unless a different minimum is specified by an appropriate regulatory authority. As of December 31, 2012, HBC’s leverage capital ratio was 10.7%, and HCC’s leverage capital ratio was 11.5%, both ratios exceeding regulatory minimums.

The federal banking agencies may change existing capital guidelines or adopt new capital guidelines in the future and have required many banks and bank holding companies subject to enforcement actions to maintain capital ratios in excess of the minimum ratios otherwise required to be deemed well capitalized, in which case institutions may no longer be deemed well capitalized and may therefore be subject to restrictions on taking brokered deposits.

Basel Accords

The federal bank regulatory authorities’ risk-based capital guidelines are based upon the 1988 capital accord (referred to as “Basel I”) of the International Basel Committee on Banking Supervision (“Basel Committee”). The Basel Committee is a committee of central banks and bank supervisors/regulators from the major industrialized countries that develops broad policy guidelines for use by each country’s supervisors in determining the supervisory policies they apply. A new framework and accord referred to as Basel II evolved from 2004 to 2006 out of the efforts to revise capital adequacy standards for internationally active banks. Basel II emphasizes internal assessment of credit, market and operational

risk; supervisory assessment and market discipline in determining minimum capital requirements and became mandatory for large or “core” international banks outside the United States in 2008 (total assets of \$250 billion or more or consolidated foreign exposures of \$10 billion or more). Basel II was optional for others, and if adopted, must first be complied with in a “parallel run” for two years along with the existing Basel I standards. The Company is not required to comply with Basel II and has not elected to apply the Basel II standards.

The United States federal banking agencies issued a proposed rule for banking organizations that do not use the “advanced approaches” under Basel II. While this proposed rule generally parallels the relevant approaches under Basel II, it diverges where United States markets have unique characteristics and risk profiles. A definitive final rule has not yet been issued. The United States banking agencies indicated, however, that they would retain the minimum leverage requirement for all United States banks.

In June 2008, the federal banking agencies issued a proposed rule for banking organizations that do not use the “advanced approaches” of Basel II with the option to adopt a method to determine required regulatory capital that is more risk sensitive than the current Basel I-based rules. The proposed standardized framework addresses: (i) expanding the number of risk-weight categories to which credit exposures may be assigned; (ii) using loan-to-value ratios to risk weight most residential mortgages to enhance the risk sensitivity of the capital requirement; (iii) providing a capital charge for operational risk using the Basic Indicator Approach under the international Basel II capital accord; (iv) emphasizing the importance of a bank’s assessment of its overall risk profile and capital adequacy; and (v) providing for comprehensive disclosure requirements to complement the minimum capital requirements and supervisory process through market discipline. A definitive final rule has not been issued. The United States banking agencies indicated, however, that they would retain the minimum leverage requirement for all United States banks.

In January 2009, the Basel Committee proposed to reconsider regulatory capital standards, supervisory and risk-management requirements and additional disclosures to further strengthen the Basel II framework in response to the worldwide economic downturn. In December 2009, the Basel Committee released two consultative documents proposing significant changes to bank capital, leverage and liquidity requirements to enhance the Basel II framework which had not yet been fully implemented internationally and even less so in the United States. The Group of Twenty Finance Ministers and Central Bank Governors (commonly referred to as the G-20), including the United States, endorsed the reform package, referred to as Basel III, and proposed phase in timelines in November, 2010.

Basel III provides for increases in the minimum Tier 1 common equity ratio and the minimum requirement for the Tier 1 capital ratio. Basel III additionally includes a “capital conservation buffer” on top of the minimum requirement designed to absorb losses in periods of financial and economic distress; and an additional required countercyclical buffer percentage to be implemented according to a particular nation’s circumstances. These capital requirements are further supplemented under Basel III by a non-risk-based leverage ratio.

The Basel III liquidity proposals have three main elements: (i) a “liquidity coverage ratio” designed to meet the bank’s liquidity needs over a 30-day time horizon under an acute liquidity stress scenario; (ii) a “net stable funding ratio” designed to promote more medium and long-term funding over a one-year time horizon; and (iii) a set of monitoring tools that the Basel Committee indicates should be considered as the minimum types of information that banks should report to supervisors.

In June 2012, the U.S. federal bank regulatory agencies jointly issued a notice of proposed rulemaking to increase capital requirements for almost all banks and bank holding companies as required by Dodd-Frank and make them consistent with the international Basel III agreement. Higher risk weighting would be required for exposures that are more than 90 days past due or are on nonaccrual status and for certain commercial real estate facilities that finance the acquisition, development or construction of real property. The proposed rules also require unrealized gains and losses on certain securities holdings to be

included in calculating capital ratios. The proposed rules would apply to all depository institutions and top-tier bank holding companies with assets of \$500 million or more. The proposed rules include new minimum risk-based capital and leverage ratios, which would be phased in during 2013 and 2014, and would refine the definition of what constitutes “capital” for purposes of calculating those ratios. The new minimum capital level requirements would be: (i) a new common equity Tier 1 capital ratio of 4.5%; (ii) a Tier 1 capital ratio of 6% (increased from 4%); (iii) a total capital ratio of 8% (unchanged from current rules); and (iv) a Tier 1 leverage ratio of 4% for all institutions. The proposed rules would also establish a “capital conservation buffer” of 2.5% above the new regulatory minimum capital ratios, and would result in the following minimum ratios: (i) a common equity Tier 1 capital ratio of 7.0%, (ii) a Tier 1 capital ratio of 8.5%, and (iii) a total capital ratio of 10.5%. The new capital conservation buffer requirement would be phased in beginning in January 2016 at 0.625% of risk-weighted assets and would increase each year until fully implemented in January 2019. An institution would be subject to limitations on paying dividends, engaging in share repurchases, and paying discretionary executive bonuses, if its capital level falls below the buffer amount. These limitations would establish a maximum percentage of eligible retained income that could be utilized for such actions.

The proposed rules, including alternative requirements for smaller community financial institutions, would, when finalized, become effective in stages through 2019. The proposed rules would also remove the grandfather exemption in Section 171 of Dodd-Frank for banks with less than \$15 billion in assets, but more than \$500 million, and would require the phase out of the inclusion of trust preferred securities from Tier I capital instead over ten years, beginning in 2013. The proposed new framework was to have been effective January 1, 2013; however, due to the number of comment letters received by the federal banking agencies in response to the notice of proposed rule-making, the initial implementation has been postponed indefinitely. While the proposed new regulatory capital requirements will likely result in generally higher regulatory capital standards for the Company, it is difficult at this time to predict when or how many of the proposed provisions will ultimately be adopted or whether broader exemptions may be provided for community banks. In addition, bank regulators may also continue their past policies of expecting banks to maintain additional capital beyond the new minimum requirements. The implementation of more stringent requirements to maintain higher levels of capital or to maintain higher levels of liquid assets could adversely impact the Company’s net income and return on equity, restrict the ability to pay dividends and require the raising of additional capital.

Prompt Corrective Action Provisions

The FDIA provides a framework for regulation of depository institutions and their affiliates, including parent holding companies, by their federal banking regulators. Among other things, it requires the relevant federal banking regulator to take “prompt corrective action” with respect to a depository institution if that institution does not meet certain capital adequacy standards, including requiring the prompt submission of an acceptable capital restoration plan. Supervisory actions by the appropriate federal banking regulator under the prompt corrective action rules generally depend upon an institution’s classification within five capital categories as defined in the regulations. The relevant capital measures are the capital ratio, the Tier 1 capital ratio, and the leverage ratio.

The federal banking agencies have also adopted non-capital safety and soundness standards to assist examiners in identifying and addressing potential safety and soundness concerns before capital becomes impaired. These include operational and managerial standards relating to: (i) internal controls, information systems and internal audit systems; (ii) loan documentation; (iii) credit underwriting; (iv) asset quality and growth; (v) earnings; (vi) risk management; and (vii) compensation and benefits.

A depository institution's category of compliance under the prompt corrective action regulations will depend upon how its capital levels compare with various relevant capital measures and the other factors established by the regulations. A bank will be:

- “well capitalized” if the institution has a total risk-based capital ratio of 10.0% or greater, a Tier 1 risk-based capital ratio of 6.0% or greater, and a leverage ratio of 5.0% or greater, and is not subject to any order or written directive by any such regulatory authority to meet and maintain a specific capital level for any capital measure;
- “adequately capitalized” if the institution has a total risk-based capital ratio of 8.0% or greater, a Tier 1 risk-based capital ratio of 4.0% or greater, and a leverage ratio of 4.0% or greater (or 3% if the institution receives the highest rating from its primary regulator) and is not “well capitalized”;
- “undercapitalized” if the institution has a total risk-based capital ratio that is less than 8.0%, a Tier 1 risk-based capital ratio of less than 4.0%, or a leverage ratio of less than 4.0% (or 3% if the institution receives the highest rating from its primary regulator);
- “significantly undercapitalized” if the institution has a total risk-based capital ratio of less than 6.0%, a Tier 1 risk-based capital ratio of less than 3.0%, or a leverage ratio of less than 3.0%; and
- “critically undercapitalized” if the institution's tangible equity is equal to or less than 2.0% of average quarterly tangible assets.

An institution may be downgraded to, or deemed to be in, a capital category that is lower than indicated by its capital ratios if it is determined to be in an unsafe or unsound condition or if it receives an unsatisfactory examination rating with respect to certain matters.

The FDIA generally prohibits a depository institution from making any capital distributions (including payment of a dividend) or paying any management fee to its parent holding company if the depository institution would thereafter be “undercapitalized.” “Undercapitalized” institutions are subject to growth limitations and are required to submit a capital restoration plan. The regulatory agencies may not accept such a plan without determining, among other things, that the plan is based on realistic assumptions and is likely to succeed in restoring the depository institution's capital. In addition, for a capital restoration plan to be acceptable, the depository institution's parent holding company must guarantee that the institution will comply with such capital restoration plan. The bank holding company must also provide appropriate assurances of performance. The aggregate liability of the parent holding company is limited to the lesser of (i) an amount equal to 5.0% of the depository institution's total assets at the time it became undercapitalized; and (ii) the amount which is necessary (or would have been necessary) to bring the institution into compliance with all capital standards applicable with respect to such institution as of the time it fails to comply with the plan. If a depository institution fails to submit an acceptable plan, it is treated as if it is “significantly undercapitalized.” “Significantly undercapitalized” depository institutions may be subject to a number of requirements and restrictions, including orders to sell sufficient voting stock to become “adequately capitalized,” requirements to reduce total assets, and cessation of receipt of deposits from correspondent banks. “Critically undercapitalized” institutions are subject to the appointment of a receiver or conservator.

The appropriate federal banking agency may, under certain circumstances, reclassify a well-capitalized insured depository institution as adequately capitalized. The FDIA provides that an institution may be reclassified if the appropriate federal banking agency determines (after notice and opportunity for a hearing) that the institution is in an unsafe or unsound condition or deems the institution to be engaging in an unsafe or unsound practice. The appropriate agency is also permitted to require an adequately capitalized or undercapitalized institution to comply with the supervisory provisions as if the institution were in the next lower category (but not treat a significantly undercapitalized institution as critically undercapitalized) based on supervisory information other than the capital levels of the institution.

Dividends

It is the Federal Reserve's policy that bank holding companies should generally pay dividends on common stock only out of income available over the past year, and only if prospective earnings retention is consistent with the organization's expected future needs and financial condition. It is also the Federal Reserve's policy that bank holding companies should not maintain dividend levels that undermine their ability to be a source of strength to its banking subsidiaries. Additionally, in consideration of the current financial and economic environment, the Federal Reserve has indicated that bank holding companies should carefully review their dividend policy and has discouraged payment ratios that are at maximum allowable levels unless both asset quality and capital are very strong.

HBC is a legal entity that is separate and distinct from its holding company. HCC receives cash through dividends paid by HBC. Subject to the regulatory restrictions which currently further restrict the ability of HBC to declare and pay dividends, future cash dividends by HBC will depend upon management's assessment of future capital requirements, contractual restrictions, and other factors.

The powers of the Board of Directors of HBC to declare a cash dividend to HCC is subject to California law, which restricts the amount available for cash dividends to the lesser of a bank's retained earnings or net income for its last three fiscal years (less any distributions to shareholders made during such period). Where this test is not met, cash dividends may still be paid, with the prior approval of the DFI in an amount not exceeding the greatest of (i) retained earnings of the bank; (ii) the net income of the bank for its last fiscal year; or (iii) the net income of the bank for its current fiscal year. A bank may also with the prior approval of the DFI and approval of the bank's shareholders distribute a dividend in connection with a reduction of capital of the bank. If the DFI determines that the shareholders' equity of the bank paying the dividend is not adequate or that the payment of the dividend would be unsafe or unsound for the bank, the DFI may order the bank not to pay the dividend. Since HBC is an FDIC-insured institution, it is also possible, depending upon its financial condition and other factors, that the FDIC could assert that the payment of dividends or other payments might, under some circumstances, constitute an unsafe or unsound practice and thereby prohibit such payments.

During the first quarter of 2012, the Company repurchased all of the \$40 million Series A Preferred Stock issued to the U.S. Treasury Department under the TARP Capital Purchase Program. The Company used available cash and proceeds from a \$30 million cash distribution approved by the DFI from the HBC to HCC. During the third quarter of 2012, the Company completed the redemption of \$14 million fixed-rate subordinated debt. A \$15 million distribution approved by the DFI from HBC to HCC provided the cash for the redemption.

The California General Corporation Law prohibits HCC from making distributions, including dividends, to holders of its common stock or preferred stock unless either of the following tests are satisfied: (i) the amount of retained earnings immediately prior to the distribution equals or exceeds the sum of (A) the amount of the proposed distribution plus (B) any cumulative dividends in arrears on all shares having a preference with respect to the payment of dividends over the class or series to which the applicable distribution is being made; or (ii) immediately after the distribution, the value of HCC's consolidated assets would equal or exceed the sum of its total liabilities, plus the amounts that would be payable to satisfy the preferential rights of other shareholders upon a dissolution that are superior to the rights of the shareholders receiving the distribution.

Under the terms of our trust preferred financings, including our related subordinated debentures, we cannot declare or pay any dividends or distributions (other than stock dividends) on, or redeem, purchase, acquire or make a liquidation payment with respect to, any shares of our capital stock if: (i) an event of default under any of the subordinated debenture agreements has occurred and is continuing; or (ii) if we give notice of our election to begin an extension period whereby we may defer payment of interest on the trust preferred securities for a period of up to sixty consecutive months as long as we are in compliance with all covenants of the agreement. The Company was in compliance with all of the covenants of the

agreements and current with respect to interest accrued on trust preferred subordinated debt at December 31, 2012.

Federal Banking Agency Compensation Guidelines

Guidelines adopted by the federal banking agencies prohibit excessive compensation as an unsafe and unsound practice and describe compensation as excessive when the amounts paid are unreasonable or disproportionate to the services performed by an executive officer, employee, director or principal stockholder. In June 2010, the federal bank regulatory agencies jointly issued additional comprehensive guidance on incentive compensation policies (the “Incentive Compensation Guidance”) intended to ensure that the incentive compensation policies of banking organizations do not undermine the safety and soundness of such organizations by encouraging excessive risk-taking. The Incentive Compensation Guidance, which covers all employees that have the ability to materially affect the risk profile of an organization, either individually or as part of a group, is based upon the key principles that a banking organization’s incentive compensation arrangements should: (i) provide incentives that do not encourage risk-taking beyond the organization’s ability to effectively identify and manage risks; (ii) be compatible with effective internal controls and risk management; and (iii) be supported by strong corporate governance, including active and effective oversight by the organization’s board of directors. Any deficiencies in compensation practices that are identified may be incorporated into the organization’s supervisory ratings, which can affect its ability to make acquisitions or perform other actions. The Incentive Compensation Guidance provides that enforcement actions may be taken against a banking organization if its incentive compensation arrangements or related risk-management control or governance processes pose a risk to the organization’s safety and soundness and the organization is not taking prompt and effective measures to correct the deficiencies.

On February 7, 2011, the Board of Directors of the FDIC approved a joint proposed rule to implement Section 956 of Dodd-Frank for banks with \$1 billion or more in assets. Section 956 prohibits incentive-based compensation arrangements that encourage inappropriate risk taking by covered financial institutions and are deemed to be excessive, or that may lead to material losses. The proposed rule would move the U.S. closer to aspects of international compensation standards by: (i) requiring deferral of a substantial portion of incentive compensation for executive officers of particularly large institutions described above; (ii) prohibiting incentive-based compensation arrangements for covered persons that would encourage inappropriate risks by providing excessive compensation; (iii) prohibiting incentive-based compensation arrangements for covered persons that would expose the institution to inappropriate risks by providing compensation that could lead to a material financial loss; (iv) requiring policies and procedures for incentive-based compensation arrangements that are commensurate the size and complexity of the institution; and (v) requiring annual reports on incentive compensation structures to the institution’s appropriate Federal regulator.

The scope, content and application of the U.S. banking regulators’ policies on incentive compensation continue to evolve in the aftermath of the economic downturn. It cannot be determined at this time whether compliance with such policies will adversely affect the ability of the Company to hire, retain and motivate key employees.

Other Pending and Proposed Legislation

Other legislative and regulatory initiatives which could affect HCC, HBC and the banking industry in general may be proposed or introduced before the United States Congress, the California legislature and other governmental bodies in the future. Such proposals, if enacted, may further alter the structure, regulation and competitive relationship among financial institutions, and may subject HCC or HBC to increased regulation, disclosure and reporting requirements. In addition, the various banking regulatory agencies often adopt new rules and regulations to implement and enforce existing legislation. It cannot be predicted whether, or in what form, any such legislation or regulations may be enacted or the extent to which the business of HCC or HBC would be affected thereby.

Employees

At December 31, 2012, the Company had 190 full-time equivalent employees. The Company's employees are not represented by any union or collective bargaining agreement and the Company believes its employee relations are satisfactory.

ITEM 1A — RISK FACTORS

Our business, financial condition and results of operations are subject to various risks, including those discussed below. The risks discussed below are those that we believe are the most significant risks, although additional risks not presently known to us or that we currently deem less significant may also adversely affect our business, financial condition and results of operations, perhaps materially.

Risks Relating to Recent Economic Conditions and Governmental Response Efforts

Our business has been and may continue to be adversely affected by several business and economic conditions.

We are operating in an uncertain economic environment. While there are signs of economic conditions improving, the persistent high unemployment rate, weak business and consumer spending, the U.S. budget deficit and uncertainty in European economies underline that the economy remains uncertain. Economic recovery has been and is expected to be slow in 2013. The continuing housing slump has resulted in reduced demand for the constructions of new housing, further declines in home prices, and increased delinquencies on construction, residential and commercial real estate loans. Business activity across a wide range of industries and regions is greatly affected. Local and state governments are in difficulty due to the reduction in sales taxes resulting from the lack of consumer spending and property taxes resulting from declining property values. Financial institutions continue to be affected by the contraction of the real estate market, elevated foreclosure rates, long-term high unemployment and underemployment rates and a stricter regulatory environment. While our market areas have not experienced the same degree of challenge in unemployment as other areas, the effects of these issues have trickled down to households and businesses in our markets. There can be no assurance that the recent economic improvement is sustainable and credit worthiness of our borrowers will not deteriorate. Continual economic uncertainty and slow growth could adversely affect or financial condition and results of operations, including a decline in demand for loans and other products and services, a decline in low cost or non-interest bearing deposits, a decline in the value of the collateral for our real estate loans, and an increase in loan delinquencies, non-performing assets, and net charge-offs. If our deposit growth level outpaces our loan growth, we could as a result have excess liquidity earning a less favorable yield. As the economy is uncertain, businesses are wary about capital expenditures or expansion of working capital and consumers are de-leveraging their debts. Hence, we have noticed a low level of loan demand due to an unfavorable economic climate and intensified competition for creditworthy borrowers, all of which could impact our ability to generate profitable loans.

Government responses to economic conditions may adversely affect our operations, financial condition and earnings.

On July 21, 2010, the President signed the Dodd-Frank Act. The Dodd-Frank Act has changed the bank regulatory framework with the creation of an independent Consumer Financial Protection Bureau that has assumed the consumer protection responsibilities of the various federal banking agencies, and is expected to establish more stringent capital standards for banks and bank holding companies. The legislation requires additional regulations affecting the lending, funding, trading and investment activities of banks and bank holding companies. Bank regulatory agencies also have been responding aggressively to concerns and adverse trends identified in examinations. Ongoing uncertainty and adverse developments in the financial services industry and the domestic and international credit markets, and the effect of new legislation and regulatory actions in response to these conditions, may adversely affect our operations by

restricting our business operations, including our ability to originate or sell loans, modify loan terms, or foreclose on property securing loans. These events may have a significant adverse effect on our financial performance and operating flexibility. In addition, these factors could affect the performance and value of our loan and investment securities portfolios, which also would negatively affect our financial performance.

Furthermore, the Board of Governors of the Federal Reserve System, in an attempt to help the overall economy, has, among other things, kept interest rates low through its targeted Federal funds rate and the purchase of mortgage-backed securities. If the Federal Reserve increases the Federal funds rate, overall interest rates will likely rise, which may negatively impact the housing markets and the U.S. economic recovery. In addition, deflationary pressures, while possibly lowering our operating costs, could have a significant negative effect on our borrowers, especially our business borrowers, and the values of underlying collateral securing loans, which could negatively affect our financial performance.

The short-term and long-term impact of the changing regulatory capital requirements and anticipated new capital rules are uncertain.

On June 7, 2012, the Federal Reserve Board approved proposed rules that would substantially amend the regulatory risk-based capital rules applicable to us. The FDIC subsequently approved these proposed rules on June 12, 2012. The proposed rules implement the “Basel III” regulatory capital reforms and changes required by the Dodd-Frank Act.

In June 2012, federal banking regulators jointly proposed rules that require agencies general risk-based and leverage capital requirements to incorporate “Basel III” capital requirements and implement provisions of Dodd-Frank. The proposed rules include new minimum risk-based capital and leverage ratios, which would be phased in during 2013 and 2014, and would refine the definition of what constitutes “capital” for purposes of calculating those ratios. The proposed new minimum capital level requirements applicable to the Company would be: (i) a new common equity Tier 1 capital ratio of 4.5%; (ii) a Tier 1 capital ratio of 6% (increased from 4%); (iii) a total capital ratio of 8% (unchanged from current rules). In addition, we would have to maintain an additional capital conservation buffer of 2.5% of total risk-weighted assets. We would be subject to limitations on paying dividends, engaging in share repurchases, and paying discretionary bonuses if our capital level fell below the buffer amount. These limitations would establish a maximum percentage of eligible retained income that could be utilized for such actions. Under the proposed rules, trust preferred securities and underlying subordinated debt would be phased out of Tier 1 capital at a rate of 10% per year over a 10 year period. While the proposed Basel III changes and other regulatory capital requirements will likely result in generally higher regulatory capital standards, it is difficult at this time to predict when or how any new standards will ultimately be applied to the Company. In addition, in the current economic and regulatory environment, bank regulators may impose capital requirements that are more stringent than those required by applicable existing regulations.

The application of more stringent capital requirements for the Company could, among other things, result in lower returns on invested capital, require the raising of additional capital, and result in regulatory actions if we were to be unable to comply with such requirements. Furthermore, the imposition of liquidity requirements in connection with the implementation of Basel III could result in our having to lengthen the term of our funding, restructure our business models, and/or increase our holdings of liquid assets. Implementation of changes to asset risk weightings for risk based capital calculations, items included or deducted in calculating regulatory capital and/or additional capital conservation buffers could result in management modifying its business strategy and could limit our ability to make distributions, including paying out dividends or buying back shares.

Dodd-Frank may have a material impact on our operations and the cost of our operations.

Dodd-Frank has significantly changed the current bank regulatory structure and affected the lending, deposit, investment, trading and operating activities of financial institutions and their holding companies. Dodd-Frank requires various federal agencies to adopt a broad range of new implementing rules and regulations, and to prepare numerous studies and reports for Congress. The federal agencies are given significant discretion in drafting the implementing rules and regulations, and consequently, many of the details and much of the impact of Dodd-Frank may not be known for many months or years.

Dodd-Frank broadened the base for Federal Deposit Insurance Corporation deposit insurance assessments. Assessments are now based on the average consolidated total assets less tangible equity capital of a financial institution, rather than deposits. Dodd-Frank also permanently increased the maximum amount of deposit insurance for banks, savings institutions and credit unions to \$250,000 per account, and non-interest bearing transaction accounts have unlimited deposit insurance through December 31, 2012.

Dodd-Frank created a new Consumer Financial Protection Bureau with broad powers to supervise and enforce consumer protection laws. The Consumer Financial Protection Bureau has broad rule-making authority for a wide range of consumer protection laws that apply to all banks and savings institutions, including the authority to prohibit “unfair, deceptive or abusive” acts and practices. The Consumer Financial Protection Bureau has examination and enforcement authority over all banks and savings institutions with more than \$10 billion in assets. Although we have less than \$10 billion in assets, we will continue to be examined for compliance with the consumer laws by our primary bank regulators. Dodd-Frank also weakens the federal preemption rules that have been applicable for national banks and federal savings associations, and gives state attorneys general the ability to enforce federal consumer protection laws. Dodd-Frank requires the implementation of regulations for bank and savings and loan holding companies which establish capital standards that are no less stringent than those applicable to depository institutions themselves. Dodd-Frank also provided for originators of certain securitized loans to retain a percentage of the risk, directed the Federal Reserve Board to regulate pricing of certain debit card interchange fees, contained a number of reforms related to mortgage origination and authorized depository institutions to pay interest on business checking accounts. It is difficult to predict at this time what specific impact Dodd-Frank and implementing rules and regulations will have on community banks. However, it is expected that at a minimum they will increase our operating and compliance costs.

The FDIC's restoration plan and the related increased assessment rate could adversely affect our earnings.

As a result of a series of financial institution failures and other market developments, the deposit insurance fund, or DIF, of the FDIC has been significantly depleted and reduced the ratio of reserves to insured deposits. As a result of economic conditions and the enactment of Dodd-Frank, the FDIC has increased the deposit insurance assessment rates and thus raised deposit premiums for insured depository institutions. If these increases are insufficient for the DIF to meet its funding requirements, further special assessments or increases in deposit insurance premiums may be required which we may be required to pay. We are generally unable to control the amount of premiums that we are required to pay for FDIC insurance. If there are additional bank or financial institution failures, we may be required to pay even higher FDIC premiums than the recently increased levels. Any future additional assessments, increases or required prepayments in FDIC insurance premiums may materially adversely affect our results of operations.

Risks Related to Our Market and Business

We are subject to credit risk.

There are inherent risks associated with our lending activities. These risks include, among other things, the impact of changes in interest rates and changes in the economic conditions in the markets

where we operate as well as those across the United States and abroad. Increases in interest rates and/or weakening economic conditions could adversely impact the ability of borrowers to repay outstanding loans or the value of the collateral securing these loans. We are also subject to various laws and regulations that affect our lending activities. Failure to comply with applicable laws and regulations could subject us to regulatory enforcement action that could result in the assessment of significant civil money penalties against us.

We seek to mitigate the risks inherent in our loan portfolio by adhering to specific underwriting practices. Although we believe that our underwriting criteria are appropriate for the various kinds of loans we make, we may incur losses on loans that meet our underwriting criteria, and these losses may exceed the amounts set aside as reserves in our allowance for loan losses. Due to recent economic conditions affecting the real estate market, many lending institutions, including us, have experienced substantial declines in the performance of their loans, including construction, land development loans and land loans. The value of real estate collateral supporting many construction and land development loans, land loans, commercial loans and multi family loans have declined and may continue to decline. Negative developments in the financial industry and credit markets may continue to adversely impact our financial condition and results of operations.

Our interest expense may increase following the repeal of the federal prohibition on payment of interest on demand deposits.

The federal prohibition on the ability of financial institutions to pay interest on demand deposit accounts was repealed as part of Dodd-Frank. As a result, beginning on July 21, 2011, financial institutions could commence offering interest on demand deposits to compete for clients. Our interest expense will increase and our net interest margin will decrease if HBC begins offering interest on demand deposits to attract additional customers or maintain current customers, which could have a material adverse effect on our financial condition, net income and results of operations.

Our allowance for loan losses may not be adequate to cover actual loan losses, which could adversely affect our earnings.

We maintain an allowance for loan losses for probable incurred losses in the portfolio. The allowance is established through a provision for loan losses based on management's evaluation of the risks inherent in the loan portfolio and the general economy. The allowance is also appropriately increased for new loan growth. The allowance is based upon a number of factors, including the size of the loan portfolio, asset classifications, economic trends, industry experience and trends, industry and geographic concentrations, estimated collateral values, management's assessment of the credit risk inherent in the portfolio, historical loan loss experience and loan underwriting policies.

In addition, we evaluate all loans identified impaired loans and allocate an allowance based upon our estimation of the potential loss associated with those problem loans. While we strive to carefully manage and monitor credit quality and to identify loans that may be deteriorating, at any time there are loans included in the portfolio that may result in losses, but that have not yet been identified as potential problem loans. Through established credit practices, we attempt to identify deteriorating loans and adjust the allowance for loan losses accordingly. However, because future events are uncertain and because we may not successfully identify all deteriorating loans in a timely manner, there may be loans that deteriorate in an accelerated time frame. As a result, future additions to the allowance may be necessary. Further, because the loan portfolio contains a number of commercial real estate, construction, and land development loans with relatively large balances, a deterioration in the credit quality of one or more of these loans may require a significant increase to the allowance for loan losses. Changes in economic conditions affecting borrowers, new information regarding existing loans and their collateral, identification of additional problem loans and other factors, may also require an increase in our allowance for loan losses. Our regulators, as an integral part of their examination process, periodically review our allowance

for loan losses and may require us to increase our allowance for loan losses by recognizing additional provisions for loan losses charged to expense, or to decrease our allowance for loan losses by recognizing loan charge-offs, net of recoveries. Any such additional provisions for loan losses or charge-offs, as required by these regulatory agencies, could have a material adverse effect on our financial condition and results of operations.

Nonperforming assets take significant time to resolve and adversely affect our results of operations and financial condition.

At December 31, 2012, nonperforming loans were 2.24% of the total loan portfolio and 1.07% of total assets. Nonperforming loans were 1.28% of total assets at December 31, 2012, excluding the short-term deposits of \$271.9 million at the Federal Reserve Bank offsetting the short-term demand deposits from one customer. Nonperforming assets adversely affect our earnings in various ways. Until economic and market conditions improve, we may continue to incur losses relating to an increase in nonperforming assets. We do not record interest income on nonaccrual loans or other real estate owned, thereby adversely affecting our income, and increasing our loan administration costs. Upon foreclosure or similar proceedings, we record the repossessed asset at the estimated fair value, less costs to sell, which may result in a loss. An increase in the level of nonperforming assets increases our risk profile and may impact the capital levels our regulators believe are appropriate in light of the increased risk profile. While we reduce problem assets through collection efforts, asset sales, workouts, restructurings and otherwise, decreases in the value of the underlying collateral, or in these borrowers' performance or financial condition, whether or not due to economic and market conditions beyond our control, could adversely affect our business, results of operations and financial condition. In addition, the resolution of nonperforming assets requires significant commitments of time from management and our directors, which can be detrimental to the performance of their other responsibilities.

We may be required to make additional provisions for loan losses and charge off additional loans in the future, which could adversely affect our results of operations.

For the year ended December 31, 2012, we recorded a \$2.8 million provision for loan losses, charged-off \$5.5 million of loans, and recovered \$1.0 million of loans. Since 2008 there has been a significant slowdown in the real estate markets in portions of counties in California where a majority of our loan customers, including our largest borrowing relationships, are based. This slowdown reflects declining prices in real estate, higher levels of inventories of homes and higher vacancies in commercial and industrial properties, all of which have contributed to financial strain on real estate developers and suppliers. At December 31, 2012, we had \$354.9 million in commercial and residential real estate loans and \$22.4 million in land and construction real estate loans, excluding loans held-for-sale, of which \$4.7 million and \$2.2 million, respectively, were on nonaccrual. Construction loans and commercial real estate loans comprise a substantial portion of our nonperforming assets. Continued deterioration in the real estate market could affect the ability of our loan customers to service their debt, which could result in additional loan charge-offs and provisions for loan losses in the future, which could have a material adverse effect on our financial condition, results of operations and capital.

Our business is subject to interest rate risk and variations in interest rates may negatively affect our financial performance.

Our earnings and cash flows are highly dependent upon net interest income. Net interest income is the difference between interest income earned on interest earning assets such as loans and securities and interest expense paid on interest-bearing liabilities such as deposits and borrowed funds.

Interest rates are sensitive to many factors outside our control, including general economic conditions and policies of various governmental and regulatory agencies and, in particular, the FRB, which regulates the supply of money and credit in the United States. Changes in monetary policy, including changes in

interest rates, could influence not only the interest we receive on loans and securities and interest we pay on deposits and borrowings, but could also affect our ability to originate loans and obtain deposits, and the fair value of our financial assets and liabilities. Our portfolio of securities is subject to interest rate risk and will generally decline in value if market interest rates increase, and generally increase in value if market interest rates decline.

In response to the recessionary state of the national economy, the gloomy housing market and the volatility of financial markets, the Federal Open Market Committee of the FRB (“FOMC”) started a series of decreases in Federal funds target rate with seven decreases in 2008, bringing the target rate to a historically low range of 0% to 0.25% through December 2012. In their public statements after the first FOMC meeting in 2012, they expect the exceptionally low interest rates to continue through 2014.

Changes in interest rates and monetary policy can impact the demand for new loans, the credit profile of our borrowers, the yields earned on loans and securities and rates paid on deposits and borrowings. Given our current volume and mix of interest bearing liabilities and interest earning assets, we would expect our interest rate spread (the difference in the rates paid on interest bearing liabilities and the yields earned on interest earning assets) as well as net interest income to increase if interest rates rise and, conversely, to decline if interest rates fall. Additionally, increasing levels of competition in the banking and financial services business may decrease our net interest spread as well as net interest margin by forcing us to offer lower lending interest rates and pay higher deposit interest rates. Although we believe our current level of interest rate sensitivity is reasonable, significant fluctuations in interest rates (such as a sudden and substantial increase in Prime and Overnight Fed Funds rates) as well as increasing competition may require us to increase rates on deposits at a faster pace than the yield we receive on interest earning assets increases. The impact of any sudden and substantial move in interest rates and/or increased competition may have an adverse effect on our business, financial condition and results of operations, as our net interest income (including the net interest spread and margin) may be negatively impacted.

Additionally, a sustained decrease in market interest rates could adversely affect our earnings. When interest rates decline, borrowers tend to refinance higher-rate, fixed-rate loans at lower rates, prepaying their existing loans. Under those circumstances, we would not be able to reinvest those prepayments in assets earning interest rates as high as the rates on the prepaid loans. In addition, our commercial real estate and commercial loans, which carry interest rates that, in general, adjust in accordance with changes in the prime rate, will adjust to lower rates. We are also significantly affected by the level of loan demand available in our market. The inability to make sufficient loans directly affects the interest income we earn. Lower loan demand will generally result in lower interest income realized as we place funds in lower yielding investments.

Liquidity risk could impair our ability to fund operations and jeopardize our financial condition.

Liquidity is essential to our business. An inability to raise funds through deposits, borrowings, the sale of loans and other sources could have a substantial negative effect on our liquidity. Our access to funding sources in amounts adequate to finance our activities could be impaired by factors that affect us specifically or the financial services industry in general. Factors that could detrimentally impact our access to liquidity sources include a decrease in the level of our business activity due to a market downturn in markets in which our loans are concentrated or adverse regulatory action against us. Our ability to borrow could also be impaired by factors that are not specific to us, such as a severe disruption of the financial markets or negative views and expectations about the prospects for the financial services industry as a whole.

If we lost a significant portion of our low-cost deposits, it would negatively impact our liquidity and profitability.

Our profitability depends in part on our success in attracting and retaining a stable base of low-cost deposits. At December 31, 2012, 38% of our deposit base was comprised of noninterest bearing deposits, excluding \$271.9 million of short-term demand deposits from one customer. While we generally do not believe these core deposits are sensitive to interest rate fluctuations, the competition for these deposits in our markets is strong and customers are increasingly seeking investments that are safe, including the purchase of U.S. Treasury securities and other government guaranteed obligations, as well as the establishment of accounts at the largest, most-well capitalized banks. If we were to lose a significant portion of our low-cost deposits, it would negatively impact our liquidity and profitability.

We borrow from the Federal Home Loan Bank and the Federal Reserve, and there can be no assurance these programs will continue in their current manner.

We, at times, utilize the Federal Home Loan Bank of San Francisco for overnight borrowings and term advances; we also borrow from the Federal Reserve Bank of San Francisco and from correspondent banks under our Federal funds lines of credit. The amount loaned to us is generally dependent on the value of the collateral pledged. These lenders could reduce the percentages loaned against various collateral categories, could eliminate certain types of collateral and could otherwise modify or even terminate their loan programs, particularly to the extent they are required to do so because of capital adequacy or other balance sheet concerns. Any change or termination of the programs under which we borrow from the Federal Home Loan Bank of San Francisco, the Federal Reserve Bank of San Francisco or correspondent banks could have an adverse effect on our liquidity and profitability.

Our results of operations may be adversely affected by other-than-temporary impairment charges relating to our securities portfolio.

We may be required to record future impairment charges on our securities, including our stock in the Federal Home Loan Bank of San Francisco, if they suffer declines in value that we consider other-than-temporary. Numerous factors, including the lack of liquidity for re-sales of certain securities, the absence of reliable pricing information for securities, adverse changes in the business climate, adverse regulatory actions or unanticipated changes in the competitive environment, could have a negative effect on our securities portfolio in future periods. Significant impairment charges could also negatively impact our regulatory capital ratios and result in HBC not being classified as “well-capitalized” for regulatory purposes.

We depend on cash dividends from our subsidiary bank to meet our cash obligations which may impair our ability to fulfill our obligations.

As a holding company, dividends from our subsidiary bank provide a substantial portion of our cash flow used to service the interest payments on our trust preferred securities, dividends on our preferred stock and other obligations, including any cash dividends on our common stock. Various statutory provisions restrict the amount of dividends HBC can pay to HCC without regulatory approval. See “Item 1 — Business-Supervision and Regulation — Dividends.”

We may need to raise additional capital in the future and such capital may not be available when needed or at all.

We may need to raise additional capital in the future to provide us with sufficient capital resources and liquidity to meet our commitments and business needs. Our ability to raise additional capital, if needed, will depend on, among other things, conditions in the capital markets at that time, which are outside of our control, and our financial performance. The ongoing liquidity crisis and the loss of confidence in financial institutions may increase our cost of funding and limit our access to some of our

customary sources of capital, including, but not limited to, inter-bank borrowings, repurchase agreements and borrowings from the discount window of the Federal Reserve.

We cannot be assured that such capital will be available to us on acceptable terms or at all. Any occurrence that may limit our access to the capital markets, such as a decline in the confidence of debt purchasers, depositors of HBC or counterparties participating in the capital markets may adversely affect our capital costs and our ability to raise capital and, in turn, our liquidity. An inability to raise additional capital on acceptable terms when needed could have a material adverse effect on our business, financial condition and results of operations.

Our profitability is dependent upon the economic conditions of the markets in which we operate.

We operate primarily in Santa Clara County, Contra Costa County and Alameda County and, as a result, our financial condition and results of operations are subject to changes in the economic conditions in those areas. Our success depends upon the business activity, population, income levels, deposits and real estate activity in these markets. Although our customers' business and financial interests may extend well beyond these market areas, adverse economic conditions that affect these market areas could reduce our growth rate, affect the ability of our customers to repay their loans to us and generally affect our financial condition and results of operations. Our lending operations are located in market areas dependent on technology and real estate industries and their supporting companies. Thus, our borrowers could be adversely impacted by a downturn in these sectors of the economy that could reduce the demand for loans and adversely impact the borrowers' ability to repay their loans, which would, in turn, increase our nonperforming assets. Because of our geographic concentration, we are less able than regional or national financial institutions to diversify our credit risks across multiple markets.

Our loan portfolio has a large concentration of real estate loans in California, which involve risks specific to real estate values.

A downturn in our real estate markets in California could adversely affect our business because many of our loans are secured by real estate. Real estate lending (including commercial, land development and construction) is a large portion of our loan portfolio. At December 31, 2012, approximately \$421.2 million, or 52% of our loan portfolio, was secured by various forms of real estate, including residential and commercial real estate. Included in the \$421.2 million of loans secured by real estate were \$228.3 million (or 54%) of owner-occupied loans. The real estate securing our loan portfolio is concentrated in California which has experienced a significant decline in real estate values. There have been adverse developments affecting real estate values in one or more of our markets. The market value of real estate can fluctuate significantly in a short period of time as a result of market conditions in the geographic area in which the real estate is located. Real estate values and real estate markets are generally affected by changes in national, regional or local economic conditions, the rate of unemployment, fluctuations in interest rates and the availability of loans to potential purchasers, changes in tax laws and other governmental statutes, regulations and policies and acts of nature, such as earthquakes and natural disasters particular to California. Additionally, commercial real estate lending typically involves larger loan principal amounts and the repayment of the loans generally is dependent, in large part, on sufficient income from the properties securing the loans to cover operating expenses and debt service. If real estate values, including values of land held for development, decline, the value of real estate collateral securing our loans could be significantly reduced. Our ability to recover on defaulted loans by foreclosing and selling the real estate collateral would then be diminished and we would be more likely to suffer losses on defaulted loans.

Our construction and land development loans are based upon estimates of costs and value associated with the complete project. These estimates may be inaccurate and we may be exposed to more losses on these projects than on other loans.

At December 31, 2012, land and construction loans, including land acquisition and development total \$22.4 million or 3% of our loan portfolio. This amount was comprised of 14% owner occupied and 86% non-owner occupied construction and land loans. Risk of loss on a construction loan depends largely upon whether our initial estimate of the property's value at completion of construction equals or exceeds the cost of the property construction (including interest) and the availability of permanent take-out financing. During the construction phase, a number of factors can result in delays and cost overruns. Because of the uncertainties inherent in estimating construction costs, as well as the market value of the completed project, it is relatively difficult to evaluate accurately the total funds required to complete a project and the related loan-to-value ratio. As a result, construction loans often involve the disbursement of substantial funds with repayment dependent primarily on the completion of the project and the ability of the borrower to sell the property, rather than the ability of the borrower or guarantor to repay principal and interest. If estimates of value are inaccurate or if actual construction costs exceed estimates, the value of the property securing the loan may be insufficient to ensure full repayment. If our appraisal of the value of the completed project proves to be overstated, our collateral may be inadequate for the repayment of the loan upon completion of construction of the project. If we are forced to foreclose on a project prior to or at completion due to a default, there can be no assurance that we will be able to recover all of the unpaid balance of, and accrued interest on, the loan as well as related foreclosure and holding costs. In addition, we may be required to fund additional amounts to complete the project and may have to hold the property for an unspecified period of time.

Our use of appraisals in deciding whether to make a loan on or secured by real property does not ensure the value of the real property collateral.

In considering whether to make a loan secured by real property, we generally require an appraisal of the property. However, an appraisal is only an estimate of the value of the property at the time the appraisal is conducted, and an error in fact or judgment could adversely affect the reliability of an appraisal. In addition, events occurring after the initial appraisal may cause the value of the real estate to decrease. As a result of any of these factors the value of collateral backing a loan may be less than supposed, and if a default occurs we may not recover the outstanding balance of the loan.

We must effectively manage our growth strategy.

We seek to expand our franchise safely and consistently. A successful growth strategy requires us to manage multiple aspects of the business simultaneously, such as following adequate loan underwriting standards, balancing loan and deposit growth without increasing interest rate risk or compressing our net interest margin, maintaining sufficient capital, and recruiting, training and retaining qualified professionals. We may also experience a lag in profitability associated with the new branch openings.

As part of our general growth strategy, we may expand into additional communities or attempt to strengthen our position in our current markets by opening new offices, subject to any regulatory constraints on our ability to open new offices. To the extent that we are able to open additional offices, we are likely to experience the effects of higher operating expenses relative to operating income from the new operations for a period of time, which may have an adverse effect on our levels of reported net income, return on average equity and return on average assets. Our current growth strategies involve internal growth from our current offices and, subject to any regulatory constraints on our ability to open new branch offices, the addition of new offices over time, so that the additional overhead expenses associated with these openings are absorbed prior to opening other new offices.

Potential acquisitions may disrupt our business and adversely affect our results of operations.

We have in the past and, subject to any regulatory constraints on our ability to undertake any acquisitions, we may in the future seek to grow our business by acquiring other businesses. We cannot predict the frequency, size or timing of our acquisitions, and we typically do not comment publicly on a possible acquisition until we have signed a definitive agreement. There can be no assurance that our acquisitions will have the anticipated positive results, including results related to the total cost of integration, the time required to complete the integration, the amount of longer-term cost savings, continued growth, or the overall performance of the acquired company or combined entity. Integration of an acquired business can be complex and costly. If we are not able to successfully integrate future acquisitions, there is a risk that our results of operations could be adversely affected. In addition, if goodwill recorded in connection with potential future acquisitions was determined to be impaired, then we would be required to recognize a charge against operations, which could materially and adversely affect our results of operations during the period in which the impairment was recognized.

We have a significant deferred tax asset and cannot assure that it will be fully realized.

Deferred tax assets and liabilities are the expected future tax amounts for the temporary differences between the carrying amounts and tax basis of assets and liabilities computed using enacted tax rates. We regularly assess available positive and negative evidence to determine whether it is more likely than not that our net deferred tax asset will be realized. Realization of a deferred tax asset requires us to apply significant judgment and is inherently speculative because it requires estimates that cannot be made with certainty. At December 31, 2012, we had a net deferred tax asset of \$19.3 million. If we were to determine at some point in the future that we will not achieve sufficient future taxable income to realize our net deferred tax asset, we would be required, under generally accepted accounting principles, to establish a full or partial valuation allowance which would require us to incur a charge to operations for the period in which the determination was made.

We face strong competition from financial service companies and other companies that offer banking services.

We face substantial competition in all phases of our operations from a variety of different competitors. Our competitors, including larger commercial banks, community banks, savings and loan associations, mutual savings banks, credit unions, consumer finance companies, insurance companies, securities dealers, brokers, mortgage bankers, investment advisors, money market mutual funds and other financial institutions, compete with lending and deposit gathering services offered by us. Many of these competing institutions have much greater financial and marketing resources than we have. Due to their size, many competitors can achieve larger economies of scale and may offer a broader range of products and services than we can. If we are unable to offer competitive products and services, our business may be negatively affected. Some of the financial services organizations with which we compete are not subject to the same degree of regulation as is imposed on bank holding companies and federally insured financial institutions or are not subject to increased supervisory oversight arising from regulatory examinations. As a result, these non-bank competitors have certain advantages over us in accessing funding and in providing various services.

We anticipate intense competition will be continued for the coming year due to the recent consolidation of many financial institutions and more changes in legislature, regulation and technology. Further, we expect loan demand to continue to be challenging due to the uncertain economic climate and the intensifying competition for creditworthy borrowers, both of which could lead to loan rate concession pressure and could impact our ability to generate profitable loans. We expect we may see tighter competition in the industry as banks seek to take market share in the most profitable customer segments, particularly the small business segment and the mass-affluent segment, which offers a rich source of deposits as well as more profitable and less risky customer relationships. Further, with the rebound of the equity markets, our deposit customers may perceive alternative investment opportunities as providing

superior expected returns. Technology and other changes have made it more convenient for bank customers to transfer funds into alternative investments or other deposit accounts such as online virtual banks and non-bank service providers. The current low interest rate environment could increase such transfers of deposits to higher yielding deposits or other investments. Efforts and initiatives we undertake to retain and increase deposits, including deposit pricing, can increase our costs. When our customers move money into higher yielding deposits or in favor of alternative investments, we can lose a relatively inexpensive source of funds, thus increasing our funding costs.

We are subject to extensive government regulation that could limit or restrict our activities, which in turn may adversely impact our ability to increase our assets and earnings.

We operate in a highly regulated environment and are subject to supervision and regulation by a number of governmental regulatory agencies, including the Federal Reserve, the DFI and the FDIC. Regulations adopted by these agencies, which are generally intended to provide protection for depositors and customers rather than for the benefit of shareholders, govern a comprehensive range of matters relating to ownership and control of our shares, our acquisition of other companies and businesses, permissible activities for us to engage in, maintenance of adequate capital levels, and other aspects of our operations. These bank regulators possess broad authority to prevent or remedy unsafe or unsound practices or violations of law. The laws and regulations applicable to the banking industry could change at any time and we cannot predict the effects of these changes on our business and profitability. Increased regulation could increase our cost of compliance and adversely affect profitability. Moreover, certain of these regulations contain significant punitive sanctions for violations, including monetary penalties and limitations on a bank's ability to implement components of its business plan, such as expansion through mergers and acquisitions or the opening of new branch offices. In addition, changes in regulatory requirements may add costs associated with compliance efforts. Furthermore, government policy and regulation, particularly as implemented through the Federal Reserve System, significantly affect credit conditions. As a result of the negative financial market and general economic trends, there is a potential for new federal or state laws and regulation regarding lending and funding practices and liquidity standards, and bank regulatory agencies have been and are expected to be aggressive in responding to concerns and trends identified in examinations, including the expected issuance of many formal enforcement orders. Negative developments in the financial industry and the impact of new legislation and regulation in response to those developments could negatively impact our business operations and adversely impact our financial performance.

Technology is continually changing and we must effectively implement new technologies.

The financial services industry is undergoing rapid technological changes with frequent introductions of new technology driven products and services. In addition to better serving customers, the effective use of technology increases efficiency and enables us to reduce costs. Our future success will depend in part upon our ability to address the needs of our customers by using technology to provide products and services that will satisfy customer demands for convenience as well as to create additional efficiencies in our operations as we continue to grow and expand our market areas. In order to anticipate and develop new technology, we employ a qualified staff of internal information system specialists and consider this area a core part of our business. We do not develop our own software products, but have been able to respond to technological changes in a timely manner through association with leading technology vendors. We must continue to make substantial investments in technology which may affect our results of operations. If we are unable to make such investments, or we are unable to respond to technological changes in a timely manner, our operating costs may increase which could adversely affect our results of operations.

System failure or breaches of our network security could subject us to increased operating costs as well as litigation and other liabilities.

The computer systems and network infrastructure we use could be vulnerable to unforeseen problems. Our operations are dependent upon our ability to protect our computer equipment against damage from physical theft, fire, power loss, telecommunications failure or a similar catastrophic event, as well as from security breaches, denial of service attacks, viruses, worms and other disruptive problems caused by hackers. Any damage or failure that causes an interruption in our operations could have a material adverse effect on our financial condition and results of operations. Computer break-ins and other disruptions could also jeopardize the security of information stored in and transmitted through our computer systems and network infrastructure, which may result in significant liability to us and may cause existing and potential customers to refrain from doing business with us. We employ external auditors to conduct auditing and testing for weaknesses in our systems, controls, firewalls and encryption to reduce the likelihood of any security failures or breaches. Although we, with the help of third party service providers and auditors, intend to continue to implement security technology and establish operational procedures to prevent such damage, there can be no assurance that these security measures will be successful. In addition, advances in computer capabilities, new discoveries in the field of cryptography or other developments could result in a compromise or breach of the algorithms we and our third party service providers use to encrypt and protect customer transaction data. A failure of such security measures could have a material adverse effect on our financial condition and results of operations.

We rely on third- party vendors for important aspects of our operation.

We depend on the accuracy and completeness of information provided by certain key vendors, including but not limited to data processing, payroll processing, technology support, investment security safekeeping, credit stress modeling, and accounting. Our ability to operate, as well as our financial condition and results of operations, could be negatively affected in the event of an interruption of an information system, an undetected error, or in the event of a natural disaster whereby certain vendors are unable to maintain business continuity.

We are exposed to the risk of environmental liabilities with respect to properties to which we take title.

In the course of our business, when a borrower defaults on a loan secured by real property, we generally purchase the property in foreclosure or accept a deed to the property surrendered by the borrower. We may also take over the management of properties when owners have defaulted on loans. While we have guidelines intended to exclude properties with an unreasonable risk of contamination, hazardous substances may exist on some of the properties that we own, manage or occupy and unknown hazardous risks could impact the value of real estate collateral. We may be held liable to a governmental entity or to third parties for property damage, personal injury, investigation and clean-up costs incurred by these parties in connection with environmental contamination, or may be required to investigate or clean up hazardous or toxic substances, or chemical releases at a property. The costs associated with investigation or remediation activities could be substantial and exceed the value of the property. In addition, if we are the owner or former owner of a contaminated site, we may be subject to common law claims by third parties based on damages and costs resulting from environmental contamination emanating from the property. If we become subject to significant environmental liabilities, our business, financial condition, results of operations and prospects could be adversely affected.

Managing operational risk is important to attracting and maintaining customers, investors and employees.

Operational risk represents the risk of loss resulting from our operations, including but not limited to, the risk of fraud by employees or persons outside the Company, the execution of unauthorized transactions by employees, transaction processing errors and breaches of the internal control system and compliance requirements. This risk of loss also includes the potential legal actions that could arise as a result of an

operational deficiency or as a result of noncompliance with applicable regulatory standards, adverse business decisions or their implementation and customer attrition due to potential negative publicity. Operational risk is inherent in all business activities and the management of this risk is important to the achievement of our business objectives. In the event of a breakdown in our internal control system, improper operation of systems or improper employee actions, we could suffer financial loss, face regulatory action and suffer damage to our reputation.

Reputational risk can adversely affect our business.

Threats to our reputation can come from many sources, including adverse sentiment about financial institutions generally, unethical practices, employee misconduct, failure to deliver minimum standards of service or quality, compliance deficiencies, and questionable or fraudulent activities of our customers. We have policies and procedures in place to protect our reputation and promote ethical conduct, but these policies and procedures may not be fully effective. Negative publicity regarding our business, employees, or customers, with or without merit, may result in the loss of customers, investors and employees, costly litigation, a decline in revenues and increased governmental regulation.

We are dependent on key personnel and the loss of one or more of those key personnel may materially and adversely affect our prospects.

Competition for qualified employees and personnel in the banking industry is intense and there are a limited number of qualified persons with knowledge of, and experience in, the California community banking industry. The process of recruiting personnel with the combination of skills and attributes required to carry out our strategies is often lengthy. Our success depends to a significant degree upon our ability to attract and retain qualified management, loan origination, finance, administrative, marketing and technical personnel and upon the continued contributions of our management and personnel. In particular, our success has been and continues to be highly dependent upon the abilities of key executives, including our Chief Executive Officer and certain other key employees.

Severe weather, natural disasters, acts of war or terrorism and other external events could significantly impact our business

Severe weather, natural disasters, acts of war or terrorism and other adverse external events could have a significant impact on our ability to conduct business. Such events could affect the stability of our deposit base, impair the ability of borrowers to repay outstanding loans, impair the value of collateral securing loans, cause significant property damage, result in loss of revenue and/or cause us to incur additional expenses. For example, our primary market areas in California are subject to earthquakes and fires. Operations in our market could be disrupted by both the evacuation of large portions of the population as well as damage and or lack of access to our banking and operation facilities. While we have not experienced such an occurrence to date, other severe weather or natural disasters, acts of war or terrorism or other adverse external events may occur in the future. Although management has established disaster recovery policies and procedures, the occurrence of any such event could have a material adverse effect on our business, which, in turn, could have a material adverse effect on our financial condition and results of operations.

Risks Related to Our Securities

Our securities are not an insured deposit.

Our securities are not bank deposits and, therefore, are not insured against loss by the FDIC, any other deposit insurance fund or by any other public or private entity. Investment in our securities is inherently risky for the reasons described in this section and elsewhere in this report and is subject to the same market forces that affect the price of securities in any company.

Our outstanding Series C Preferred Stock impacts net income available to our common shareholders and earnings per common share, and conversion of our Series C Preferred Stock or exercise of the warrant issued to the U.S. Treasury will be dilutive to holders of our common stock.

The dividends declared and the accretion on our outstanding Series C Preferred Stock reduce the net income available to common shareholders and our earnings per common share. Our Series C Preferred Stock will also receive preferential treatment in the event of our liquidation, dissolution or winding up.

The ownership interest of the existing holders of our common stock will be diluted to the extent the warrant issued to the U.S. Treasury is exercised. The shares of common stock underlying the warrant represent approximately 2% of the shares of our common stock outstanding as of December 31, 2012. Although the U.S. Treasury has agreed to not vote any of the common shares it receives upon exercise of the warrant, a transferee of any portion of the warrant or of any common shares acquired upon exercise of the warrant is not bound by this restriction. The terms of the warrant include an anti-dilution adjustment which provides that, if we issue common shares or securities convertible or exercisable into, or exchangeable for, common shares at a price that is less than 90% of the market price of such shares on the last trading day preceding the date of the agreement to sell such shares, the number of common shares to be issued would increase and the per share price of common shares to be purchased pursuant to the warrant would decrease.

The ownership interest of our existing holders of common stock will be diluted to the extent our Series C Preferred Stock is automatically converted into common stock. The Series C Preferred Stock is convertible into an aggregate of 5,601,000 shares of our common stock upon a transfer of the Series C Preferred Stock to a transferee not affiliated with the holder in a widely dispersed offering. The shares of common stock underlying the Series C Preferred Stock represent approximately 21% of the shares of our common stock outstanding on December 31, 2012.

Holders of our subordinated debt have rights that are senior to those of our common and preferred shareholders.

We have supported our continued growth through issuances of trust preferred securities from separate special purpose trusts and related issuance of subordinated debt to these trusts. At December 31, 2012, we had two issuances of trust preferred from two separate special purpose trusts outstanding totaling \$9.3 million. Payments of the principal and interest on the subordinated debt are fully and unconditionally guaranteed by us. Further, the accompanying subordinated debt we issued to the special purpose trusts are senior to our outstanding shares of common stock and preferred stock. As a result, we must make payments on the subordinated debt before any dividends can be paid on our common stock or preferred stock and, in the event of our bankruptcy, dissolution or liquidation, the holders of the subordinated debt must be satisfied before any distributions can be made on our preferred stock or common stock. We have the right to defer interest payments on our subordinated debt and the related trust preferred securities for up to five years, during which time no cash dividends may be paid on our common stock or preferred stock. In the event HCC does not have sufficient funds or HBC is unable to pay dividends to HCC, then we may be unable to pay the amounts due to the holders of the junior subordinated debt securities and we would then be unable to declare and pay any dividends on our common stock or preferred stock.

The price of our common stock may fluctuate significantly, and this may make it difficult for you to resell shares of common stock owned by you at times or at prices you find attractive.

The stock market and, in particular, the market for financial institution stocks, have experienced significant volatility. In some cases, the markets have produced downward pressure on stock prices for certain issuers without regard to those issuers' underlying financial strength. As a result, the trading volume in our common stock may fluctuate more than usual and cause significant price variations to occur.

The trading price of the shares of our common stock will depend on many factors, which may change from time to time and which may be beyond our control, including, without limitation, our financial

condition, performance, creditworthiness and prospects, future sales or offerings of our equity or equity related securities, and other factors identified above under “Cautionary Note Regarding Forward Looking Statements,” “Risk Factors” and below. These broad market fluctuations have adversely affected and may continue to adversely affect the market price of our common stock. Among the factors that could affect our stock price are:

- actual or anticipated quarterly fluctuations in our operating results and financial condition;
- changes in financial estimates or publication of research reports and recommendations by financial analysts or actions taken by rating agencies with respect to our common stock or those of other financial institutions;
- failure to meet analysts’ revenue or earnings estimates;
- speculation in the press or investment community generally or relating to our reputation, our operations, our market area, our competitors or the financial services industry in general;
- strategic actions by us or our competitors, such as acquisitions, restructurings, dispositions or financings;
- actions by our current shareholders, including sales of common stock by existing shareholders and/or directors and executive officers;
- trends in our nonperforming assets;
- the costs and effectiveness of our efforts to reduce our classified assets;
- fluctuations in the stock price and operating results of our competitors;
- future sales of our equity, equity related or debt securities;
- proposed or adopted regulatory changes or developments;
- anticipated or pending investigations, proceedings, or litigation that involve or affect us;
- trading activities in our common stock, including short selling;
- domestic and international economic factors unrelated to our performance; and
- general market conditions and, in particular, developments related to market conditions for the financial services industry.

Our common stock is listed for trading on the NASDAQ Global Select Market under the symbol “HTBK.” The trading volume has historically been significantly less than that of larger financial services companies. Stock price volatility may make it more difficult for you to sell your common stock when you want and at prices you find attractive.

A public trading market having the desired characteristics of depth, liquidity and orderliness depends on the presence in the marketplace of willing buyers and sellers of our common stock at any given time. This presence depends on the individual decisions of investors and general economic and market conditions over which we have no control. Given the relatively low trading volume of our common stock, significant sales of our common stock in the public market, or the perception that those sales may occur, could cause the trading price of our common stock to decline or to be lower than it otherwise might be in the absence of those sales or perceptions.

Federal and state law may limit the ability of another party to acquire us, which could cause the price of our securities to decline.

Federal law prohibits a person or group of persons “acting in concert” from acquiring “control” of a bank holding company unless the Federal Reserve has been given 60 days prior written notice of such

proposed acquisition and within that time period the Federal Reserve has not issued a notice disapproving the proposed acquisition or extending for up to another 30 days the period during which such a disapproval may be issued. An acquisition may be made prior to the expiration of the disapproval period if the Federal Reserve issues written notice of its intent not to disapprove the action. Under a rebuttable presumption established by the Federal Reserve, the acquisition of 10% or more of a class of voting stock of a bank or bank holding company with a class of securities registered under Section 12 of the Exchange Act would, under the circumstances set forth in the presumption, constitute the acquisition of control. In addition, any “company” would be required to obtain the approval of the Federal Reserve under the BHCA, before acquiring 25% (5% in the case of an acquiror that is, or is deemed to be, a bank holding company) or more of any class of voting stock, or such lesser number of shares as may constitute control.

Under the California Financial Code, no person may, directly or indirectly, acquire control of a California state bank or its holding company unless the DFI has approved such acquisition of control. A person would be deemed to have acquired control of HBC if such person, directly or indirectly, has the power (i) to vote 25% or more of the voting power of Heritage Bank of Commerce; or (ii) to direct or cause the direction of the management and policies of HBC. For purposes of this law, a person who directly or indirectly owns or controls 10% or more of our outstanding common stock would be presumed to control HBC.

These provisions of federal and state law may prevent a merger or acquisition that would be attractive to shareholders and could limit the price investors would be willing to pay in the future for our securities.

We may raise additional capital, which could have a dilutive effect on the existing holders of our securities and adversely affect the market price of our securities.

We are not restricted from issuing additional shares of common stock or securities that are convertible into or exchangeable for, or represent the right to receive shares of common stock. We frequently evaluate opportunities to access the capital markets taking into account our regulatory capital ratios, financial condition and other relevant considerations and, subject to market conditions, we may take further capital actions. Such actions could include, among other things, the issuance of additional shares of common stock or other securities in public or private transactions in order to further increase our capital levels above the requirements for a “well capitalized” institution established by the federal bank regulatory agencies as well as other regulatory targets. These issuances could dilute ownership interests of investors and could dilute the per share book value of our common stock.

The issuance of additional shares of preferred stock could adversely affect holders of common stock, which may negatively impact an investment in our securities.

Our Board of Directors is authorized to issue additional classes or series of preferred stock without any action on the part of the shareholders, except in certain circumstances. Our Board of Directors also has the power, without shareholder approval except in certain circumstances, to set the terms of any such classes or series of preferred stock that may be issued, including voting rights, dividend rights and preferences over the common stock with respect to dividends or upon the liquidation, dissolution or winding up of our business and other terms. If we issue preferred stock in the future that has a preference over the common stock with respect to the payment of dividends or upon liquidation, dissolution or winding up, or if we issue preferred stock with voting rights that dilute the voting power of the common stock, then the rights of holders of the common stock or the market price of the common stock could be adversely affected.

ITEM 1B — UNRESOLVED STAFF COMMENTS

None.

ITEM 2 — PROPERTIES

The main and executive offices of HCC and HBC are located at 150 Almaden Boulevard in San Jose, California 95113, with branch offices located at 15575 Los Gatos Boulevard in Los Gatos, California 95032, at 387 Diablo Road in Danville, California 94526, at 3137 Stevenson Boulevard in Fremont, California 94538, at 300 Main Street in Pleasanton, California 94566, at 101 Ygnacio Valley Road in Walnut Creek, California 94596, at 18625 Sutter Boulevard in Morgan Hill, California 95037, at 7598 Monterey Street in Gilroy, California 95020, at 419 S. San Antonio Road in Los Altos, California 94022, and at 175 E. El Camino Real in Mountain View, California 94040. The Company also has a loan production office located at 740 4th Street, Suite 114, Santa Rosa, California 95404.

Main Offices

The main offices of HBC are located at 150 Almaden Boulevard in San Jose, California on the first three floors in a fifteen-story Class-A type office building. All three floors, consisting of approximately 35,547 square feet, are subject to a direct lease dated April 13, 2000, as amended, which expires on May 31, 2015. The current monthly rent payment for the first two floors, consisting of approximately 22,723 square feet, is \$62,072 and is subject to 3% annual increases until the lease expires. The current monthly rent payment for the third floor, which consists of approximately 12,824 square feet, is \$53,861 until the lease expires. The Company has reserved the right to extend the term of the lease for two additional periods of five years each.

In January of 1997, the Company leased approximately 1,255 square feet (referred to as the “Kiosk”) located next to the primary operating area at 150 Almaden Boulevard in San Jose, California to be used for meetings, staff training and marketing events. The current monthly rent payment is \$5,271 until the lease expires on May 31, 2015. The Company has reserved the right to extend the term of the lease for two additional periods of five years each.

Branch Offices

In March of 1999, the Company leased approximately 7,260 square feet in a one-story multi-tenant office building located at 18625 Sutter Boulevard in Morgan Hill, California. The current monthly rent payment is \$12,427 until the lease expires on October 31, 2014.

In May of 2006, the Company leased approximately 2,505 square feet on the first floor in a three-story multi-tenant multi-use building located at 7598 Monterey Street in Gilroy, California. The current monthly rent payment is \$5,078 and is subject to annual increases of 2% until the lease expires on September 30, 2016. The Company has reserved the right to extend the term of the lease for two additional periods of five years each.

In April of 2007, the Company leased approximately 3,850 square feet on the first floor in a four-story multi-tenant office building located at 101 Ygnacio Valley Road in Walnut Creek, California. The current monthly rent payment is \$14,729 and is subject to annual increases of 3% until the lease expires on August 15, 2014. The Company has reserved the right to extend the term of the lease for one additional period of five years.

In June of 2007, as part of the acquisition of Diablo Valley Bank, the Company took ownership of an 8,300 square foot one-story commercial office building, including the land, located at 387 Diablo Road in Danville, California.

In February 2008, the Company extended its lease for approximately 4,840 square feet in a one-story multi-tenant shopping center located at 175 E. El Camino Real in Mountain View, California. The current monthly rent payment is \$15,741 until the lease expires on May 31, 2013.

In June of 2008, the Company leased approximately 5,213 square feet on the first floor in a two-story multi-tenant office building located at 419 S. San Antonio Road in Los Altos, California. The current monthly rent payment is \$24,501 and is subject to annual increases of 3% until the lease expires on April 30, 2018. The Company has reserved the right to extend the term of the lease for two additional periods of five years each.

In December of 2008, the Company extended its lease for approximately 1,920 square feet in a one-story stand-alone building located in an office complex at 15575 Los Gatos Boulevard in Los Gatos, California. The current monthly rent payment is \$5,943 until the lease expires on November 30, 2013. The Company has reserved the right to extend the term of the lease for one additional period of five years.

In September of 2010, the Company extended its lease for approximately 4,096 square feet in a one-story stand-alone office building located at 300 Main Street in Pleasanton, California. The current monthly rent payment is \$15,209 and is subject to annual increases of 3% until the lease expires on October 31, 2017.

In September of 2012, the Company leased, effective March 1, 2013, approximately 3,172 square feet in a one-story multi-tenant multi-use building located at 3137 Stevenson Boulevard in Fremont, California. The monthly rent payment is \$6,820 and is subject to annual increases of 3% until the lease expires on February 29, 2020.

Loan Production Office

In October of 2012, the Company renewed its lease for approximately 250 square feet of office space located at 740 Fourth Street in Santa Rosa, California. The current monthly rent payment is \$1,287 until the lease expires on October 7, 2013.

For additional information on operating leases and rent expense, refer to Note 5 to the Consolidated Financial Statements following “Item 15 — *Exhibits and Financial Statement Schedules.*”

ITEM 3 — 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 4 — MINE SAFETY DISCLOSURES

Not Applicable.

PART II

ITEM 5 — MARKET FOR REGISTRANT’S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

Market Information

The Company’s common stock is listed on the NASDAQ Global Select Market under the symbol “HTBK.” Management is aware of the following securities dealers which make a market in the Company’s common stock: Credit Suisse Securities USA, UBS Securities LLC, LATOUR TRADING LLC, Deutsche Banc Alex Brown, SG Americas Securities LLC, MORGAN STANLEY & CO. LLC, Fig Partners, LLC, Dart Executions, LLC, Jane Street Markets, LLC, Merrill Lynch, Pierce, Fenner, VIRTU FINANCIAL BD LLC, Instinet, LLC, Goldman, Sachs & Co., WEDBUSH SECURITIES INC, Apex Clearing Corporation, Susquehanna Capital Group, Interactive Brokers LLC, Barclays Capital Inc./Le, Citigroup Global Markets Inc., J.P. Morgan Securities LLC, Wedbush Securities Inc., Citadel Securities LLC, Knight Capital Americas, BNP Paribas Securities Corp., RBC Capital Market Corp., Timber Hill Inc., Keefe,

Bruyette & Woods, Inc., Sandler O'Neill & Partners, D.A. Davidson & Co., Raymond James & Associates, Sidoti & Company, LLC, and Stifel, Nicolaus, & Company. These market makers have committed to make a market for the Company's common stock, although they may discontinue making a market at any time. No assurance can be given that an active trading market will be sustained for the common stock at any time in the future.

The information in the following table for 2012 and 2011 indicates the high and low closing prices for the common stock, based upon information provided by the NASDAQ Global Select Market and cash dividend payment for each quarter presented.

<u>Quarter</u>	<u>Stock Price</u>		<u>Dividend Per Share</u>
	<u>High</u>	<u>Low</u>	
Year ended December 31, 2012:			
Fourth quarter	\$7.10	\$6.36	\$ —
Third quarter	\$7.11	\$5.96	\$ —
Second quarter	\$6.75	\$5.96	\$ —
First quarter	\$6.44	\$4.59	\$ —
Year ended December 31, 2011:			
Fourth quarter	\$5.20	\$3.75	\$ —
Third quarter	\$5.14	\$3.85	\$ —
Second quarter	\$5.44	\$4.63	\$ —
First quarter	\$5.10	\$4.27	\$ —

The closing price of our common stock on February 8, 2013 was \$6.79 per share as reported by the NASDAQ Global Select Market.

As of February 8, 2013, there were approximately 700 holders of record of common stock. There are no other classes of common equity outstanding.

Dividend Policy

The amount of future dividends will depend upon our earnings, financial condition, capital requirements and other factors, and will be determined by our board of directors on a quarterly basis. It is Federal Reserve policy that bank holding companies generally pay dividends on common stock only out of income available over the past year, and only if prospective earnings retention is consistent with the organization's expected future needs and financial condition. It is also Federal Reserve policy that bank holding companies not maintain dividend levels that undermine the holding company's ability to be a source of strength to its banking subsidiaries. Additionally, in consideration of the current financial and economic environment, the Federal Reserve has indicated that bank holding companies should carefully review their dividend policy and has discouraged payment ratios that are at maximum allowable levels unless both asset quality and capital are very strong. Under the federal Prompt Corrective Action regulations, the Federal Reserve or the FDIC may prohibit a bank holding company from paying any dividends if the holding company's bank subsidiary is classified as undercapitalized.

As a holding company, our ability to pay cash dividends is affected by the ability of our bank subsidiary, HBC, to pay cash dividends. The ability of HBC (and our ability) to pay cash dividends in the future and the amount of any such cash dividends is and could be in the future further influenced by bank regulatory requirements and approvals and capital guidelines.

We have supported our growth through the issuance of trust preferred securities from special purpose trusts and accompanying sales of subordinated debt to these trusts. The subordinated debt that we issued to the trusts is senior to our shares of common stock and Series C Preferred Stock. As a result, we must

make payments on the subordinated debt before any dividends can be paid on our common stock and Series C Preferred Stock.

The decision whether to pay dividends will be made by our Board of Directors in light of conditions then existing, including factors such as our results of operations, financial condition, business conditions, regulatory capital requirements and covenants under any applicable contractual arrangements, including agreements with regulatory authorities.

For information on the statutory and regulatory limitations on the ability of the Company to pay dividends and on HBC to pay dividends to HCC see “*Item 1 — Business — Supervision and Regulation — Dividends.*”

Securities Authorized for Issuance Under Equity Compensation Plans

The following table provides information as of December 31, 2012 regarding equity compensation plans under which equity securities of the Company were authorized for issuance:

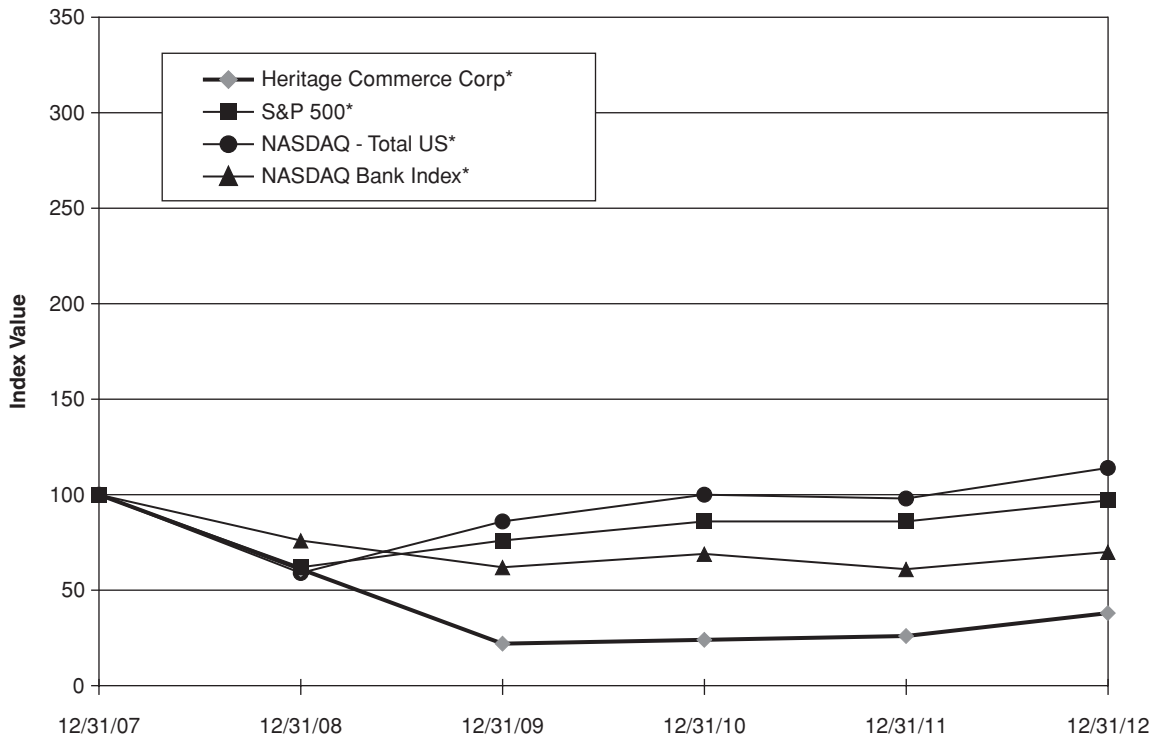
	Number of securities to be issued upon exercise of outstanding options, warrants and rights (a)	Weighted average exercise price of outstanding options, warrants and rights (b)	Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a)) (c)
Equity compensation plans approved by security holders	1,314,347(1)	\$12.90	369,912(2)
Equity compensation plans not approved by security holders	N/A	N/A	N/A

(1) Consists of 75,810 options to acquire shares of common stock issued under the Company’s 1994 stock option plan, and 1,238,537 options to acquire shares under the Company’s Amended and Restated 2004 Equity Plan.

(2) Available under the Company’s Amended and Restated 2004 Equity Plan.

Performance Graph

The following graph compares the stock performance of the Company from December 31, 2007 to December 31, 2012, to the performance of several specific industry indices. The performance of the S&P 500 Index, NASDAQ Stock Index and NASDAQ Bank Stocks were used as comparisons to the Company’s stock performance. Management believes that a performance comparison to these indices provides meaningful information and has therefore included those comparisons in the following graph.



The following chart compares the stock performance of the Company from December 31, 2007 to December 31, 2012, to the performance of several specific industry indices. The performance of the S&P 500 Index, NASDAQ Stock Index and NASDAQ Bank Stocks were used as comparisons to the Company's stock performance.

Index	Period Ended					
	12/31/07	12/31/08	12/31/09	12/31/10	12/31/11	12/31/12
Heritage Commerce Corp*	100	61	22	24	26	38
S&P 500*	100	62	76	86	86	97
NASDAQ — Total US*	100	59	86	100	98	114
NASDAQ Bank Index*	100	76	62	69	61	70

* Source: SNL Financial Bank Information Group — (434) 977-1600

ITEM 6 — SELECTED FINANCIAL DATA

The following table presents a summary of selected financial information that should be read in conjunction with the Company's consolidated financial statements and notes thereto included under Item 8 — "FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA."

SELECTED FINANCIAL DATA

	AT OR FOR YEAR ENDED DECEMBER 31,				
	2012	2011	2010	2009	2008
	(Dollars in thousands, except per share data)				
INCOME STATEMENT DATA:					
Interest income	\$ 52,565	\$ 52,031	\$ 55,087	\$ 62,293	\$ 75,957
Interest expense	4,187	5,875	10,512	16,326	24,444
Net interest income before provision for loan losses	48,378	46,156	44,575	45,967	51,513
Provision for loan losses	2,784	4,469	26,804	33,928	15,537
Net interest income after provision for loan losses	45,594	41,687	17,771	12,039	35,976
Noninterest income	8,865	8,422	8,733	8,027	6,791
Noninterest expense	40,256	39,572	88,127	44,760	42,392
Income (loss) before income taxes	14,203	10,537	(61,623)	(24,694)	375
Income tax expense (benefit)	4,294	(834)	(5,766)	(12,709)	(1,387)
Net income (loss)	9,909	11,371	(55,857)	(11,985)	1,762
Dividends and discount accretion on preferred stock	(1,206)	(2,333)	(2,398)	(2,376)	(255)
Net income (loss) available to common shareholders	\$ 8,703	\$ 9,038	\$ (58,255)	\$ (14,361)	\$ 1,507
PER COMMON SHARE DATA:					
Basic net income (loss)(1)	\$ 0.27	\$ 0.28	\$ (3.64)	\$ (1.21)	\$ 0.13
Diluted net income (loss)(2)	\$ 0.27	\$ 0.28	\$ (3.64)	\$ (1.21)	\$ 0.13
Book value per common share(3)	\$ 5.71	\$ 5.30	\$ 4.73	\$ 11.34	\$ 12.38
Tangible book value per common share(4)	\$ 5.63	\$ 5.20	\$ 4.61	\$ 7.38	\$ 8.37
Pro forma tangible book value per share, assuming Series C Preferred Stock was converted into common stock(5)	\$ 5.25	\$ 4.90	\$ 4.41	\$ 7.38	\$ 8.37
Weighted average number of shares outstanding — basic	31,904,245	31,867,584	16,026,058	11,820,509	12,002,910
Weighted average number of shares outstanding — diluted	31,930,337	31,871,394	16,026,058	11,820,509	12,039,776
Shares outstanding at period end	26,322,147	26,295,001	26,233,001	11,820,509	11,820,509
Pro forma common shares outstanding at period end, assuming Series C Preferred Stock was converted into common stock(6)	31,923,147	31,896,001	31,834,001	11,820,509	11,820,509
BALANCE SHEET DATA:					
Securities	\$ 419,384	\$ 380,455	\$ 232,165	\$ 109,966	\$ 104,475
Net loans	\$ 793,286	\$ 743,891	\$ 820,845	\$ 1,041,345	\$ 1,223,624
Allowance for loan losses	\$ 19,027	\$ 20,700	\$ 25,204	\$ 28,768	\$ 25,007
Goodwill and other intangible assets	\$ 2,000	\$ 2,491	\$ 3,014	\$ 46,770	\$ 47,412
Total assets	\$ 1,693,312	\$ 1,306,194	\$ 1,246,369	\$ 1,363,870	\$ 1,499,227
Total deposits	\$ 1,479,368	\$ 1,049,428	\$ 993,918	\$ 1,089,285	\$ 1,154,050
Securities sold under agreement to repurchase	\$ —	\$ —	\$ 5,000	\$ 25,000	\$ 35,000
Subordinated debt	\$ 9,279	\$ 23,702	\$ 23,702	\$ 23,702	\$ 23,702
Note payable	\$ —	\$ —	\$ —	\$ —	\$ 15,000
Short-term borrowings	\$ —	\$ —	\$ 2,445	\$ 20,000	\$ 55,000
Total shareholders' equity	\$ 169,741	\$ 197,831	\$ 182,152	\$ 172,305	\$ 184,267
SELECTED PERFORMANCE RATIOS:(7)					
Return (loss) on average assets	0.73%	0.89%	-4.17%	-0.83%	0.12%
Return (loss) on average tangible assets	0.73%	0.89%	-4.25%	-0.86%	0.13%
Return (loss) on average equity	5.75%	6.02%	-30.82%	-6.68%	1.15%
Return (loss) on average tangible equity	5.83%	6.11%	-35.66%	-9.06%	1.67%
Net interest margin	3.88%	3.94%	3.69%	3.53%	3.94%
Efficiency ratio, excluding impairment of goodwill	70.32%	72.51%	84.31%	82.90%	72.71%
Average net loans (excludes loans held for sale) as a percentage of average deposits	67.98%	75.91%	87.53%	98.98%	100.01%
Average total shareholders' equity as a percentage of average total assets	12.72%	14.82%	13.55%	12.46%	10.52%
SELECTED ASSET QUALITY DATA:(8)					
Net loan charge-offs to average loans	0.57%	1.12%	3.18%	2.59%	0.23%
Allowance for loan losses to total loans	2.34%	2.71%	2.98%	2.69%	2.00%
Nonperforming loans to total loans plus nonaccrual loans — loans held-for-sale	2.24%	2.20%	3.90%	5.83%	3.24%
Nonperforming assets	\$ 19,464	\$ 19,142	\$ 34,399	\$ 64,616	\$ 41,101
CAPITAL RATIOS:					
Total risk-based	16.2%	21.9%	20.9%	12.9%	13.4%
Tier 1 risk-based	15.0%	20.6%	19.7%	11.6%	12.1%
Leverage	11.5%	15.3%	14.1%	10.1%	11.3%

Notes:

- (1) Represents net income (loss) available to common shareholders divided by the average number of shares of common stock outstanding for the respective period. For years prior to 2009, earnings per share ("EPS") and weighted average shares outstanding

have been adjusted retrospectively to apply new accounting guidance that became effective in 2009. For the years reflected in the table, this change in computation did not involve a sufficient number of shares to change basic or diluted EPS from amounts previously reported.

- (2) Represents net income (loss) available to common shareholders, less net income allocated to Series C Preferred Stock, divided by the average number of shares of common stock and common stock-equivalents outstanding for the respective period.
- (3) Represents shareholders' equity minus preferred stock divided by the number of shares of common stock outstanding at the end of the period indicated.
- (4) Represents shareholders' equity minus preferred stock, minus goodwill and other intangible assets divided by the number of shares of common stock outstanding at the end of period indicated.
- (5) Represents shareholders' equity minus preferred stock, minus goodwill and other intangible assets divided by the number of shares of common stock outstanding at the end of period indicated, assuming 21,004 shares of Series C Preferred Stock was converted into 5,601,000 shares of common stock.
- (6) Assumes 21,004 shares of Series C Preferred Stock were converted into 5,601,000 shares of common stock at December 31, 2012, 2011 and 2010.
- (7) Average balances used in this table and throughout this Annual Report are based on daily averages.
- (8) Average loans and total loans exclude loans held-for-sale.

ITEM 7 — 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 HCC and its wholly-owned subsidiary, HBC. 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.

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 year ended December 31, 2012, net income was \$9.9 million and net income available to common shareholders was \$8.7 million, or \$0.27 per average diluted common share. For the year ended December 31, 2011, net income was \$11.4 million and net income available to common shareholders was \$9.0 million, or \$0.28 per average diluted common share, which included a reversal of the \$3.7 million partial valuation allowance for deferred tax assets that was established in 2010.

Significant 2012 Events

- During the first quarter of 2012, the Company repurchased all of the \$40 million Series A Preferred Stock issued to the U.S. Treasury Department under the TARP Capital Purchase Program. The Company used available cash and proceeds from a \$30 million cash distribution from the Bank to the Company. The repurchase of the Series A Preferred Stock will save \$2.0 million in annual dividends.

- During the third quarter of 2012, the Company completed the redemption of \$14 million fixed-rate subordinated debt, which will reduce approximately \$1.5 million (pre-tax) of interest expense on an annual basis going forward. A \$15 million distribution from HBC to the Company provided the cash for the redemption. The Company incurred a charge of \$601,300 in 2012 for the early payoff premium on the redemption of the subordinated debt.
- Although the repurchase of the \$40 million Series A Preferred Stock and the redemption of the \$14 million fixed-rate subordinated debt reduced regulatory capital levels, capital ratios exceed regulatory requirements for a well-capitalized financial institution at the holding company and bank level at December 31, 2012:

<u>Capital Ratios</u>	<u>Heritage Commerce Corp</u>	<u>Heritage Bank of Commerce</u>	<u>Well-Capitalized Financial Institution Regulatory Guidelines</u>
Total Risk-Based	16.2%	15.3%	10.0%
Tier 1 Risk-Based	15.0%	14.0%	6.0%
Leverage	11.5%	10.7%	5.0%

- The Company evaluated its available-for-sale portfolio and reclassified at fair value approximately \$16.4 million of the mortgage-backed securities to the held-to-maturity category during the third quarter of 2012. The related unrealized after-tax gains of approximately \$505,000 remained in accumulated other comprehensive income and will be amortized over the remaining life of the securities as an adjustment of yield, offsetting the related amortization of the premium or accretion of the discount on the transferred securities. No gains or losses were recognized at the time of reclassification.
- Late in the fourth quarter of 2012, the Company received short-term demand deposits in the amount of \$467.5 million from one customer, of which \$195.6 million was subsequently withdrawn, for a net outstanding balance of \$271.9 million at December 31, 2012. An additional \$233.7 million of these deposits were withdrawn in January 2013.

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

- The net interest margin decreased 6 basis points to 3.88% for the year ended December 31, 2012, compared to 3.94% for the year ended December 31, 2011. The decrease in the net interest margin for 2012, compared to 2011 was primarily due to lower yields on loans and securities, partially offset by a lower cost of funds. The net interest margin increased 25 basis points to 3.94% for the year ended December 31, 2011, compared to 3.69% for the year ended December 31, 2010. The increase in the net interest margin for 2011 compared to 2010 was primarily due to an increase in the yields on loans and a decrease in rates paid on deposits.
- Net interest income increased 5% to \$48.4 million for the year ended December 31, 2012, compared to \$46.2 million for the year ended December 31, 2011, primarily due to an increase in the average balance of investment securities, and a decrease in the rates paid on interest-bearing liabilities, partially offset by a decrease in the average balance of loans. Net interest income increased 4% to \$46.2 million for the year ended December 31, 2011, compared to \$44.6 million for the year ended December 31, 2010, primarily due to an increase in the average balance of investment securities, and a decrease in the average balance and rates paid on interest-bearing liabilities, partially offset by a decrease in the average balance of loans.
- The provision for loan losses was \$2.8 million for the year ended December 31, 2012, compared to \$4.5 million for the year ended December 31, 2011, and \$26.8 million for the year ended December 31, 2010. The decrease in the provision for loan losses in 2012 compared to 2011 reflects a lower volume of classified assets and the gradual strengthening of the Northern California

regional economy. The decrease in the provision for loan losses in 2011 compared to 2010 reflects a lower volume of classified and nonperforming loans and contraction of the loan portfolio.

- Noninterest income increased 5% to \$8.9 million for the year ended December 31, 2012, compared to \$8.4 million for the year ended December 31, 2011. The increase was primarily due to a higher gain on sales of securities, partially offset by a lower gain on sales of SBA loans. Noninterest income for 2012 included a \$1.6 million gain on sales of securities, compared to a \$459,000 gain on sales of securities in 2011, and a \$2.0 million gain on sales of securities in 2010. Noninterest income for 2012 included a \$702,000 gain on sales of SBA loans, compared to a \$1.5 million gain on sales of SBA loans in 2011, and a \$1.1 million gain on sales of SBA loans in 2010. Noninterest income decreased 4% to \$8.4 million for the year ended December 31, 2011, compared to \$8.7 million for the year ended December 31, 2010.
- Noninterest expense was \$40.3 million for the year ended December 31, 2012, compared to \$39.6 million, for the year ended December 31, 2011. The increase from year to year primarily resulted from the redemption of the subordinated debt, which resulted in total charges of \$601,300 during the year ended December 31, 2012, and higher salaries and employee benefits costs. Noninterest expense was \$39.6 million for the year ended December 31, 2011, compared to \$44.9 million, excluding the \$43.2 million impairment of goodwill, for the year ended December 31, 2010. Noninterest expense decreased for the year ended December 31, 2011 compared to the year ended December 31, 2010, primarily due to lower write-downs on loans held-for-sale, a decrease in salaries and benefits expense, lower professional fees and lower FDIC insurance premiums.
- The efficiency ratio was 70.32% for the year ended December 31, 2012, compared to 72.51% for the year ended December 31, 2011. The efficiency ratio was 84.31% for the year ended December 31, 2010, excluding a non-cash goodwill impairment charge of \$43.2 million.
- The income tax expense for the year ended December 31, 2012 was \$4.3 million, compared to an income tax benefit of \$834,000 for the year ended December 31, 2011, and an income tax benefit of \$5.8 million for the year ended December 31, 2010. The income tax benefit for the year ended December 31, 2011 included the reversal of the \$3.7 million partial valuation allowance for deferred tax assets that was established in 2010.

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

- Cash, interest-bearing deposits in other financial institutions and securities available-for-sale increased 64% to \$741.5 million at December 31, 2012, compared to \$453.3 million at December 31, 2011. Excluding the short-term deposits of \$271.9 million at the Federal Reserve Bank offsetting the short-term demand deposits from one customer, total cash, interest-bearing deposits in other financial institutions and securities available-for-sale increased 4% to \$469.6 million at December 31, 2012, compared to December 31, 2011.
- Securities held-to-maturity, at amortized cost, were \$51.5 million at December 31, 2012, compared to no securities held-to-maturity at December 31, 2011.
- Total loans, excluding loans held-for-sale, increased \$47.7 million, or 6%, to \$812.3 million at December 31, 2012, compared to \$764.6 million at December 31, 2011.
- Classified assets (net of SBA guarantees) decreased 38% to \$36.8 million at December 31, 2012, compared to \$59.5 million at December 31, 2011.
- The allowance for loan losses at December 31, 2012 was \$19.0 million, or 2.34% of total loans, representing 104.58% of nonperforming loans (there were no nonaccrual loans in loans held-for-sale at December 31, 2012). The allowance for loan losses at December 31, 2011 was

\$20.7 million, or 2.71% of total loans, representing 124.37% of nonperforming loans excluding nonaccrual loans in loans held-for-sale.

- Nonperforming assets were \$19.5 million, or 1.15% of total assets at December 31, 2012, compared to \$19.1 million, or 1.47% of total assets at December 31, 2011. Nonperforming assets were 1.37% of total assets at December 31, 2012, excluding the short-term deposits of \$271.9 million at the Federal Reserve Bank offsetting the short-term demand deposits from one customer.
- Net loan charge-offs were \$4.5 million for the year ended December 31, 2012, compared to \$9.0 million for the year ended December 31, 2011.
- Core deposits (excluding all time deposits, CDARS deposits and the \$271.9 million of short-term demand deposits from one customer) increased to \$883.8 million at December 31, 2012, an increase of \$122.9 million, or 16% from December 31, 2011.
 - Noninterest-bearing deposits increased 32% to \$455.8 million at December 31, 2012 from December 31, 2011, excluding \$271.9 million of short-term demand deposits from one customer received late in the fourth quarter of 2012.
 - Interest-bearing demand deposits increased 16% to \$156.0 million at December 31, 2012 from December 31, 2011.
- The ratio of noncore funding (which consists of time deposits \$100,000 and over, CDARS deposits, brokered deposits, securities under agreement to repurchase, and short-term borrowings) to total assets was 17.63% at December 31, 2012, compared to 19.90% at December 31, 2011. The ratio of noncore funding to total assets was 21.00% at December 31, 2012, excluding the short-term deposits of \$271.9 million at the Federal Reserve Bank offsetting the short-term demand deposits from one customer.
- The loan to deposit ratio was 54.91% at December 31, 2012, compared to 72.86% at December 31, 2011. The loan to deposit ratio was 67.27% at December 31, 2012, excluding the \$271.9 million of short-term demand deposits from one customer.

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 \$97.8 million in brokered deposits at December 31, 2012, compared to \$84.7 million at December 31, 2011. Deposits from title insurance companies, escrow accounts and real estate exchange facilitators decreased to \$21.4 million at December 31, 2012, compared to \$37.6 million at December 31, 2011. Certificates of deposit from the State of California totaled \$85.0 million at December 31, 2012, compared to \$50.0 million at December 31, 2011. Deposits at December 31, 2012 were \$1.5 billion, compared to \$1.0 billion at December 31, 2011. Core deposits (excluding all time deposits, CDARS deposits and the \$271.9 million of short-term demand deposits from one customer) increased to \$883.8 million at December 31, 2012, an increase of \$122.9 million, or 16% from December 31, 2011. The ratio of noncore funding to total assets was 21.00% at December 31, 2012, excluding the short-term deposits at the Federal Reserve Bank offsetting the short-term demand deposits from one customer. 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.

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 \$10.2 million at December 31, 2012, compared to \$6.4 million at December 31, 2011.

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. At December 31, 2012, we had \$373.6 million in cash and cash equivalents (\$101.7 million, excluding the short-term deposits at the Federal Reserve Bank offsetting the short-term demand deposits from one customer) and approximately \$350.5 million in available borrowing capacity from various sources including the FHLB, the FRB, and Federal funds facilities with several financial institutions. The Company also had \$293.3 million in unpledged securities available at December 31, 2012. Our loan to deposit ratio decreased to 54.91% at December 31, 2012, compared to 72.86% at December 31, 2011, primarily due to an increase in core deposits. The loan to deposit ratio was 67.27% at December 31, 2012, excluding the short-term demand deposits of \$271.9 million from one customer.

Lending

Our lending business originates primarily through our branch offices located in our primary market. The Company also has an additional SBA loan production office in Santa Rosa, California. Total loans, excluding loans held-for-sale, increased \$47.7 million, or 6%, to \$812.3 million at December 31, 2012, compared to \$764.6 million at December 31, 2011. The total loan portfolio remains well diversified with commercial and industrial (“C&I”) loans accounting for 46% of the portfolio at December 31, 2012. Commercial and residential real estate loans accounted for 44% of the total loan portfolio at December 31, 2012, of which 51% were owner-occupied by businesses. Consumer and home equity loans accounted for 7% of the total loan portfolio, and land and construction loans accounted for the remaining 3% of our total loan portfolio at December 31, 2012. The yield on the loan portfolio was 5.18% for the year ended December 31, 2012, compared to 5.32% for the year ended December 31, 2011. The decrease in the yield on the loan portfolio for year ended December 31, 2012, compared to the same period in 2011, was primarily the result of lower yields on renewals.

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. 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. Management closely monitors both total net interest income and the net interest margin (net interest income divided by average earning assets).

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.*” In addition, we believe there are measures and initiatives we can take to improve the net interest margin, including increasing loan rates, adding floors on floating rate loans, reducing nonperforming assets, managing deposit interest rates, and reducing higher cost deposits.

The net interest margin is also adversely 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 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 an accelerated time frame. As a result, future additions to the allowance for loan losses 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. A portion of the Company’s noninterest income is 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. Other sources of noninterest income include loan servicing fees, service charges and fees, cash surrender value from company owned life insurance policies, gains on the disposition of foreclosed assets, and gains on the sale of securities. The Company sold \$40.6 million of agency mortgage-backed securities for a gain on sales of securities of \$1.6 million for the year ended December 31, 2012, compared to a \$459,000 gain on sales of securities for the year ended December 31, 2011.

Noninterest Expense

Management considers the control of operating expenses to be a critical element of the Company’s performance. The Company has undertaken several initiatives to reduce its noninterest expense and improve its efficiency. Noninterest expense for the year ended December 31, 2012 was \$40.3 million, compared to \$39.6 million a year ago. The increase from year to year primarily resulted from the redemption of the \$14 million fixed-rate subordinated debt prior to its maturity date, which resulted in a charge of \$601,300 during the third quarter of 2012, and higher salaries and employee benefits costs.

Capital Management

As part of its asset and liability management 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.

On November 21, 2008, the Company issued to the U.S. Treasury under its Capital Purchase Program 40,000 shares of Series A Preferred Stock for \$40.0 million and issued a warrant to purchase 462,963 shares of common stock at an exercise price of \$12.96.

On March 7, 2012, in accordance with approvals received from the U.S. Treasury and the Federal Reserve, the Company repurchased all shares of the Series A Preferred Stock and paid the related accrued and unpaid dividends. The repurchase of the Series A Preferred Stock will save \$2.0 million in annual dividends. At the time the Company repurchased the Series A Preferred Stock, it did not repurchase the related warrant. The warrant was outstanding as of the date of this report.

On June 21, 2010, the Company issued Series C Convertible Perpetual Preferred Stock (“Series C Preferred Stock”) to a limited number of institutional investors. The Series C Preferred Stock remains outstanding until its conversion to common stock upon the transfer of the Series C Preferred Stock in accordance with its terms. Holders of Series C Preferred Stock will receive dividends if and only to the extent dividends are paid to holders of common stock.

We have supported our growth through the issuance of trust preferred securities from special purpose trusts and accompanying sales of subordinated debt to these trusts. The subordinated debt that we issued to the trusts is senior to our shares of common stock and Series C Preferred Stock. As a result, we must make payments on the subordinated debt before any dividends can be paid on our common stock and Series C Preferred Stock. Under the terms of the subordinated debt, we may defer interest payments for up to five years. During the third quarter of 2012, the Company completed the redemption of \$14 million fixed-rate subordinated debt, and has \$9.3 million of variable-rate subordinated debt outstanding at year-end 2012. The Company is current with respect to interest accrued on trust preferred subordinated debt securities as of December 31, 2012.

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 growth in earning assets, 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 that comprise the Company’s earning assets, deposits, and other interest-bearing liabilities. Net interest income can also be impacted by the reversal of interest on loans placed on nonaccrual status, and recovery of interest on loans that have been on nonaccrual and are either sold or returned to accrual status. To maintain its net interest margin, the Company must manage the relationship between interest earned and paid.

The following Distribution, Rate and Yield table presents for each of the past three years, 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

	Year Ended December 31,								
	2012			2011			2010		
	Average Balance	Interest Income/Expense	Average Yield/Rate	Average Balance	Interest Income/Expense	Average Yield/Rate	Average Balance	Interest Income/Expense	Average Yield/Rate
	(Dollars in thousands)								
Assets:									
Loans, gross(1)	\$ 787,032	\$40,800	5.18%	\$ 804,068	\$42,769	5.32%	\$ 971,025	\$49,633	5.11%
Securities — taxable	404,913	11,519	2.84%	297,231	9,088	3.06%	148,069	5,236	3.54%
Securities — tax exempt(2)	4,575	172	3.77%	—	—	N/A	—	—	N/A
Federal funds sold and interest-bearing deposits in other financial institutions	52,500	134	0.26%	68,878	174	0.25%	89,083	218	0.24%
Total interest earning assets(2)	1,249,020	52,625	4.21%	1,170,177	52,031	4.45%	1,208,177	55,087	4.56%
Cash and due from banks	21,583			21,077			21,234		
Premises and equipment, net	7,774			8,022			8,742		
Goodwill and other intangible assets	2,258			2,762			24,609		
Other assets	72,799			73,172			75,216		
Total assets	\$1,353,434			\$1,275,210			\$1,337,978		
Liabilities and shareholders' equity:									
Deposits:									
Demand, noninterest-bearing	\$ 392,131			\$ 334,676			\$ 265,546		
Demand, interest-bearing	150,476	223	0.15%	133,538	238	0.18%	153,618	341	0.22%
Savings and money market	288,980	611	0.21%	279,250	892	0.32%	297,257	1,440	0.48%
Time deposits — under \$100	27,337	132	0.48%	31,549	230	0.73%	37,889	496	1.31%
Time deposits — \$100 and Over	167,804	958	0.57%	131,756	1,298	0.99%	134,024	1,900	1.42%
Time deposits — brokered	91,278	867	0.95%	92,278	1,217	1.32%	155,558	3,750	2.41%
CDARS — money market and time deposits	5,756	9	0.16%	16,403	67	0.41%	18,252	159	0.87%
Total interest-bearing deposits	731,631	2,800	0.38%	684,774	3,942	0.58%	796,598	8,086	1.02%
Total deposits	1,123,762	2,800	0.25%	1,019,450	3,942	0.39%	1,062,144	8,086	0.76%
Subordinated debt	19,052	1,383	7.26%	23,702	1,871	7.89%	23,702	1,878	7.92%
Securities sold under agreement to repurchase	—	—	N/A	712	24	3.37%	18,767	418	2.23%
Short-term borrowings	1,518	4	0.26%	933	38	4.07%	8,347	130	1.56%
Total interest-bearing liabilities	752,201	4,187	0.56%	710,121	5,875	0.83%	847,414	10,512	1.24%
Total interest-bearing liabilities and demand, noninterest-bearing / cost of funds	1,144,332	4,187	0.37%	1,044,797	5,875	0.56%	1,112,960	10,512	0.94%
Other liabilities	36,909			41,473			43,776		
Total liabilities	1,181,241			1,086,270			1,156,736		
Shareholders' equity	172,193			188,940			181,242		
Total liabilities and shareholders' equity	\$1,353,434			\$1,275,210			\$1,337,978		
Net interest income(2) / margin		48,438	3.88%		46,156	3.94%		44,575	3.69%
Less tax equivalent adjustment(2)		(60)			—			—	
Net interest income		\$48,378			\$46,156			\$44,575	

(1) Includes loans held-for-sale. Yields and amounts earned on loans include loan fees and costs. Nonaccrual loans are included in average balance.

(2) Reflects tax equivalent adjustment for tax exempt income based on a 35% tax rate.

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 changes in average interest rates. Volume variances are equal to the increase or decrease in the average balance multiplied by prior period rates and rate variances are equal to the increase or decrease in the average rate multiplied by

the prior period average balance. Variances attributable to both rate and volume changes are equal to the change in rate multiplied by the change in average balance and are included below in the average volume column.

Volume and Rate Variances

	2012 vs. 2011			2011 vs. 2010		
	Increase (Decrease) Due to Change in:			Increase (Decrease) Due to Change in:		
	Average Volume	Average Rate	Net Change	Average Volume	Average Rate	Net Change
	(Dollars in thousands)					
Income from the interest earning assets:						
Loans, gross	\$ (851)	\$(1,118)	\$(1,969)	\$(8,890)	\$ 2,026	\$(6,864)
Securities — taxable	3,078	(647)	2,431	4,557	(705)	3,852
Securities — tax exempt(1)	172	—	172	—	—	—
Federal funds sold and interest-bearing deposits in other financial institutions . .	(45)	5	(40)	(49)	5	(44)
Total interest income on interest earning assets(1)	<u>2,354</u>	<u>(1,760)</u>	<u>594</u>	<u>(4,382)</u>	<u>1,326</u>	<u>(3,056)</u>
Expense from the interest-bearing liabilities:						
Demand, interest-bearing	23	(38)	(15)	(39)	(64)	(103)
Savings and money market	25	(306)	(281)	(59)	(489)	(548)
Time deposits — under \$100	(19)	(79)	(98)	(47)	(219)	(266)
Time deposits — \$100 and over	207	(547)	(340)	(29)	(573)	(602)
Time deposits — brokered	(10)	(340)	(350)	(836)	(1,697)	(2,533)
CDARS — money market and time deposits	(17)	(41)	(58)	(8)	(84)	(92)
Subordinated debt	(338)	(150)	(488)	—	(7)	(7)
Securities sold under agreement to repurchase	(24)	—	(24)	(608)	214	(394)
Short-term borrowings	<u>2</u>	<u>(36)</u>	<u>(34)</u>	<u>(302)</u>	<u>210</u>	<u>(92)</u>
Total interest expense on interest- bearing liabilities	<u>(151)</u>	<u>(1,537)</u>	<u>(1,688)</u>	<u>(1,928)</u>	<u>(2,709)</u>	<u>(4,637)</u>
Net interest income(1)	<u>\$2,505</u>	<u>\$ (223)</u>	<u>2,282</u>	<u>\$(2,454)</u>	<u>\$ 4,035</u>	<u>1,581</u>
Less tax equivalent adjustment(1)			(60)			—
Net interest income			<u>\$ 2,222</u>			<u>\$ 1,581</u>

(1) Reflects tax equivalent adjustment for tax exempt income based on a 35% tax rate.

The Company's net interest margin, expressed as a percentage of average earning assets was 3.88% for 2012, a decrease of 6 basis points compared to 3.94% for 2011, principally due to lower yields on loans and securities, partially offset by a lower cost of funds. The Company's net interest margin for 2011 increased 25 basis points compared to 3.69% for 2010, principally due to a higher yield on loans and a lower cost of deposits. The yield on interest earning assets decreased to 4.21% for 2012, compared to 4.45% for 2011, and 4.56% for 2010, primarily due to contraction in the loan portfolio. The cost of total deposits, including noninterest-bearing demand deposits, decreased to 0.25% for 2012, compared to 0.39% for 2011, and 0.76% for 2010, as a result of maturing higher-cost wholesale funding and a more cost-effective blend of core deposits.

Net interest income for the year ended December 31, 2012 increased \$2.2 million to \$48.4 million, compared to \$46.2 million a year ago, primarily due to an increase in the average balance of investment securities, and a decrease in the rates paid on interest-bearing liabilities, partially offset by a decrease in the average balance of loans. Net interest income for the year ended December 31, 2011 increased \$1.6 million to \$46.2 million, compared to \$44.6 million for the year ended December 31, 2010, primarily due to an increase in average balance of investment securities, and a decrease the average balance and in rates paid on interest-bearing liabilities partially offset by a decrease in the average balance of loans.

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, in contrast to 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 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 operations. 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.

The Company had a provision for loan losses of \$2.8 million for the year ended December 31, 2012, compared to a provision for loan losses of \$4.5 million for the year ended December 31, 2011, and a provision for loan losses of \$26.8 million for the year ended December 31, 2010. The decrease in the provision for loan losses in 2012 compared to 2011 and 2010 reflects the improvement in credit quality.

The allowance for loan losses represented 2.34%, 2.71% and 2.98% of total loans at December 31, 2012, 2011 and 2010, respectively. The year over year decrease in the allowance for loan losses was primarily due to improved risk grading and credit metrics on non-impaired real estate loans, as well as a decline in historical charge-off levels. Annualized net charge-offs as a percentage of average loans were 0.57% as of December 31, 2012, as compared to 1.12% as of December 31, 2011, and 3.18% as of December 31, 2010. The year over year decrease was partially offset by an increase in the allowance for loan losses on impaired real estate loans. 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:

	Year Ended December 31,			Increase (decrease) 2012 versus 2011		Increase (decrease) 2011 versus 2010	
	2012	2011	2010	Amount	Percent	Amount	Percent
	(Dollars in thousands)						
Service charges and fees on deposit							
accounts	\$2,333	\$2,355	\$2,228	\$ (22)	-1%	\$ 127	6%
Servicing income	1,743	1,743	1,719	—	0%	24	1%
Increase in cash surrender value of life							
insurance	1,720	1,706	1,677	14	1%	29	2%
Gain on sales of securities	1,560	459	1,955	1,101	240%	(1,496)	-77%
Gain on sales of SBA loans	702	1,461	1,058	(759)	-52%	403	38%
Loss on sales of other loans	—	—	(887)	—	N/A	887	-100%
Other	807	698	983	109	16%	(285)	-29%
Total	<u>\$8,865</u>	<u>\$8,422</u>	<u>\$8,733</u>	<u>\$ 443</u>	<u>5%</u>	<u>\$ (311)</u>	<u>-4%</u>

The increase in noninterest income for the year ended December 31, 2012, compared to the year ended December 31, 2011, was primarily due to a higher gain on sales of securities, partially offset by a lower gain on sales of SBA loans. The decrease in noninterest income for the year ended December 31, 2011, compared to the year ended December 31, 2010, was primarily due to a lower gain on sales of securities, which was partially offset by an \$887,000 loss on sales of other loans during 2010.

The Company sold \$40.6 million of agency mortgage-backed securities for a gain of \$1.6 million during the year ended December 31, 2012, compared to a \$459,000 gain during the year ended December 31, 2011, and a \$2.0 million gain during the year ended December 31, 2010.

A portion of the Company's noninterest income is associated with its SBA lending activity, as gain on sales of loans sold in the secondary market and servicing income from loans sold with servicing rights retained. During 2012, SBA loan sales resulted in a \$702,000 gain, compared to a \$1.5 million gain on sales of SBA loans in 2011, and a \$1.1 million gain on sales of SBA loans in 2010. The servicing assets that result from the sales 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 3.69% 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:

	Year Ended December 31,			Increase (decrease) 2012 versus 2011		Increase (decrease) 2011 versus 2010	
	2012	2011	2010	Amount	Percent	Amount	Percent
(Dollars in thousands)							
Salaries and employee benefits	\$21,722	\$20,574	\$21,234	\$1,148	6%	\$ (660)	-3%
Occupancy and equipment	3,997	4,083	4,087	(86)	-2%	(4)	0%
Professional fees	2,876	2,861	3,975	15	1%	(1,114)	-28%
Software subscriptions	1,149	1,078	1,004	71	7%	74	7%
Low income housing investment losses	1,195	1,035	795	160	15%	240	30%
Data processing	983	876	831	107	12%	45	5%
FDIC deposit insurance premiums . .	918	1,294	4,002	(376)	-29%	(2,708)	-68%
Insurance expense	911	941	1,007	(30)	-3%	(66)	-7%
Premium on redemption of subordinated debt	601	—	—	601	N/A	—	N/A
Advertising and promotion	457	435	395	22	5%	40	10%
Foreclosed assets	(45)	389	650	(434)	-112%	(261)	-40%
Writedown of loans held-for-sale . .	—	29	1,080	(29)	-100%	(1,051)	-97%
Impairment of goodwill	—	—	43,181	—	N/A	(43,181)	-100%
Other	5,492	5,977	5,886	(485)	-8%	91	2%
Total	\$40,256	\$39,572	\$88,127	\$ 684	2%	\$(48,555)	-55%

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

Noninterest Expense by Category

	2012		2011		2010	
	Amount	Percent of Total	Amount	Percent of Total	Amount	Percent of Total
(Dollars in thousands)						
Salaries and employee benefits	\$21,722	54%	\$20,574	52%	\$21,234	24%
Occupancy and equipment	3,997	10%	4,083	10%	4,087	5%
Professional fees	2,876	7%	2,861	7%	3,975	4%
Software subscriptions	1,149	3%	1,078	3%	1,004	1%
Low income housing investment losses	1,195	3%	1,035	3%	795	1%
Data processing	983	3%	876	2%	831	1%
FDIC deposit insurance premiums	918	2%	1,294	3%	4,002	5%
Insurance expense	911	2%	941	3%	1,007	1%
Premium on redemption of subordinated debt .	601	1%	—	0%	—	0%
Advertising and promotion	457	1%	435	1%	395	0%
Foreclosed assets	(45)	0%	389	1%	650	1%
Writedown of loans held-for-sale	—	0%	29	0%	1,080	1%
Impairment of goodwill	—	0%	—	0%	43,181	49%
Other	5,492	14%	5,977	15%	5,886	7%
Total	\$40,256	100%	\$39,572	100%	\$88,127	100%

Noninterest expense for the year ended December 31, 2012 increased 2% to \$40.3 million, compared to \$39.6 million for the year ended December 31, 2011. The increase from year to year primarily resulted from the early pay off premium on the redemption of the \$14 million fixed-rate subordinated debt, and an increase in salaries and employee benefits. The early payoff premium on the redemption of the \$14 million fixed-rate subordinated debt resulted in a \$601,300 charge during the year ended December 31, 2012. Salaries and employee benefits increased \$1.1 million, or 6%, for the year ended December 31, 2012 from the year ended December 31, 2011, primarily due to higher health insurance premiums and the addition of seasoned bankers in our lending group. Full-time equivalent employees were 190, 189, and 181 at December 31, 2012, 2011, and 2010, respectively. FDIC deposit insurance premiums decreased \$376,000, or 29%, for the year ended December 31, 2012, compared to 2011 due to a decrease in the FDIC deposit assessment rate as the Company's risk profile improved. Foreclosed assets expense decreased \$434,000 or 112%, for 2012, compared to 2011 due to a gain on the disposition of foreclosed assets. Other noninterest expense decreased in 2012, compared to 2011 due to lower credit related costs and management's efforts to control expenses.

Noninterest expense for the year ended December 31, 2011 declined 12% to \$39.6 million, compared to \$44.9 million (excluding the \$43.2 million impairment of goodwill) for the year ended December 31, 2010. The decrease in noninterest expense for the year ended December 31, 2011 was primarily due to lower write-downs on loans held-for-sale, a decrease in salaries and benefits expense, lower professional fees, lower FDIC insurance premiums and lower foreclosed assets expense. Salaries and employee benefits decreased \$660,000, or 3%, for the year ended December 31, 2011 from the year ended December 31, 2010, primarily due to a reduction in staff implemented in the fourth quarter of 2010. Professional fees decreased \$1.1 million, or 28%, for the year ended December 31, 2011 compared to 2010 primarily due to a decrease in legal fees related to loan workouts and litigation and decreased expenses for bank regulatory compliance. FDIC deposit insurance premiums decreased \$2.7 million, or 68%, for the year ended December 31, 2011 compared to 2010, due to a decrease in the FDIC deposit assessment rate. Foreclosed assets expense decreased \$261,000 or 40%, for 2011, compared to 2010 due to a decrease in writedowns of foreclosed assets. The Company's low income housing investment losses increased \$240,000, or 30%, to \$1.0 million for 2011, compared to \$795,000 for 2010.

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 expense in 2012 was \$4.3 million, as compared to an income tax benefit of \$834,000 in 2011, and an income tax benefit of \$5.8 million in 2010. The income tax benefit of \$834,000 in 2011 included the elimination of a \$3.7 million partial valuation allowance for the Company's deferred tax asset. The following table shows the effective income tax rates for 2012, 2011, and 2010:

	For the Year Ended December 31,		
	2012	2011	2010
Effective income tax rate	30.2%	-7.9%	-9.4%

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, goodwill impairment, and the deferred tax asset valuation allowance.

The Company has total investments of \$2.5 million in low-income housing limited partnerships as of December 31, 2012. These investments have generated annual tax credits of approximately \$845,000 for the year ended December 31, 2012, and \$846,000 for the year ended December 31, 2011, and \$1.0 million for the year ended December 31, 2010.

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.

Realization of the Company's deferred tax assets is primarily dependent upon the Company generating sufficient future 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 Federal and 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. Under generally accepted accounting principles a valuation allowance is required to be recognized if it is "more likely than not" that a deferred tax asset will not be realized. The determination of the realizability of the deferred tax assets is highly subjective and dependent upon judgment concerning management's evaluation of both positive and negative evidence, including forecasts of future income, cumulative losses, applicable tax planning strategies, and assessments of current and future economic and business conditions.

The Company had net deferred tax assets of \$19.3 million and \$21.9 million at December 31, 2012, and December 31, 2011, respectively. After consideration of the matters in the preceding paragraph, the Company determined that it is more likely than not that the net deferred tax asset at December 31, 2012 and December 31, 2011 will be fully realized in future years.

Financial Condition

As of December 31, 2012, total assets were \$1.69 billion, an increase of 30% compared to \$1.31 billion at December 31, 2011. Excluding the short-term deposits at the Federal Reserve Bank offsetting the short-term demand deposits from one customer, total assets at December 31, 2012 increased 9% from December 31, 2011. The investment securities available-for-sale portfolio totaled \$367.9 million at December 31, 2012, a decrease of 3% from \$380.5 million at December 31, 2011. In addition, securities held-to-maturity totaled \$51.5 million at December 31, 2012, compared to none at December 31, 2011. The total loan portfolio, excluding loans held-for-sale, was \$812.3 million, an increase of 6% from \$764.6 million at year-end 2011.

Total deposits were \$1.5 billion at December 31, 2012, an increase of 41% from \$1.0 billion at year-end 2011, which included the \$271.9 million of short-term demand deposits from one customer received late in the fourth quarter of 2012. In addition, there were no short-term borrowings at December 31, 2012 and December 31, 2011. Subordinated debt decreased to \$9.3 million at December 31, 2012, compared to \$23.7 million at December 31, 2011, as a result of the redemption of \$14 million fixed-rate subordinated debt during the third quarter of 2012.

Securities Portfolio

The following table reflects the estimated fair value for each category of securities at year-end:

Investment Portfolio

	December 31,		
	2012	2011	2010
(Dollars in thousands)			
Securities available-for-sale (at fair value):			
Agency mortgage-backed securities	\$291,244	\$350,348	\$232,165
Corporate bonds	55,588	—	—
Trust preferred securities	21,080	30,107	—
Total	<u>\$367,912</u>	<u>\$380,455</u>	<u>\$232,165</u>
Securities held-to-maturity (at amortized cost):			
Agency mortgage-backed securities	\$ 16,659	\$ —	\$ —
Municipals — Tax Exempt	34,813	—	—
	<u>\$ 51,472</u>	<u>\$ —</u>	<u>\$ —</u>

The table below summarizes the weighted average life and weighted average yields of securities as of December 31, 2012. The weighted average life will differ from the contractual maturities because borrowers may have the right to call, pre-pay obligations with or without call or pre-payment penalties.

	December 31, 2012 Weighted Average Life							
	After One and Within Five Years		After Five and Within Ten Years		After Ten Years		Total	
	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield
(Dollars in thousands)								
Securities available-for-sale (at fair value):								
Agency mortgage-backed securities	\$216,341	2.55%	\$ 74,903	2.36%	\$ —	—	\$291,244	2.50%
Corporate bonds	955	2.49%	54,633	3.26%	—	—	55,588	3.25%
Trust preferred securities	—	—	—	—	21,080	4.94%	21,080	4.94%
	<u>\$217,296</u>	2.55%	<u>\$129,536</u>	2.74%	<u>\$21,080</u>	4.94%	<u>\$367,912</u>	2.75%

	December 31, 2012 Weighted Average Life									
	Within One Year		After One and Within Five Years		After Five and Within Ten Years		After Ten Years		Total	
	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield
(Dollars in thousands)										
Securities held-to-maturity (at amortized cost):										
Agency mortgage-backed securities	\$693	1.26%	\$7,895	2.82%	\$ —	—	\$ 8,071	3.34%	\$16,659	3.00%
Municipals — Tax Exempt(1)	—	—	1,103	4.20%	14,588	3.80%	19,122	3.80%	34,813	3.81%
	<u>\$693</u>	1.26%	<u>\$8,998</u>	2.99%	<u>\$14,588</u>	3.80%	<u>\$27,193</u>	3.66%	<u>\$51,472</u>	3.55%

(1) Reflects tax equivalent yield based on a 35% tax rate.

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 an 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 provides liquidity to even out cash flows from the loan and deposit activities of customers; (iii) 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; and (iv) it is an alternative interest-earning use of funds when loan demand is weak or when deposits grow more rapidly than loans.

The Company's portfolio may include: (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; (iv) collateralized mortgage obligations, which generally enhance the yield of the portfolio; and (v) single entity issue trust preferred securities, which generally enhance the yield on the portfolio.

The Company classifies its securities as either available-for-sale or held-to-maturity at the time of purchase. Prior to the third quarter of 2012, the Company's securities were all 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 investment securities available-for-sale portfolio totaled \$367.9 million at December 31, 2012, a decrease of 3% from \$380.5 million at December 31, 2011. At December 31, 2012, the securities available-for-sale portfolio was comprised of \$291.2 million agency mortgage-backed securities (all issued by U.S. Government sponsored entities), \$55.6 million of corporate bonds, and \$21.1 million of single entity issue trust preferred securities.

During the third quarter of 2012, the Company evaluated its available-for-sale portfolio and reclassified at fair value approximately \$16.4 million of the mortgage-backed securities with higher price volatility and longer maturities to the held-to-maturity category. The Company transferred these securities to mitigate possible negative impacts on its regulatory capital under the proposed Basel III capital guidelines as the Company has the intent and ability to hold these securities to maturity. The related unrealized after-tax gains of approximately \$505,000 remained in accumulated other comprehensive income and will be amortized over the remaining life of the securities as an adjustment of yield, offsetting the related amortization of the premium or accretion of the discount on the transferred securities. No gains or losses were recognized at the time of reclassification. Additionally, the Company purchased \$34.8 million of tax-exempt municipal bonds in the third and fourth quarters of 2012, which are also classified as held-to-maturity. At December 31, 2012, investment securities held-to-maturity totaled \$51.5 million, at amortized cost, compared to no investment securities held-to-maturity at December 31, 2011. At December 31, 2012, the securities held-to-maturity portfolio, at amortized cost, was comprised of \$34.8 million tax-exempt municipal bonds and \$16.7 million agency mortgage-backed securities. Management considers the held-to-maturity classification of these investment securities to be appropriate based on the Company's positive intent and ability to hold these securities to maturity.

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 earning 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.

Gross loans, excluding loans held-for-sale, represented 48% of total assets (57% of total assets, excluding the short-term deposits at the Federal Reserve Bank offsetting the short-term demand deposits from one customer) at December 31, 2012, as compared to 59% of at December 31, 2011. The ratio of

loans to deposits decreased to 54.91% at December 31, 2012 from 72.86% December 31, 2011. The loan to deposit ratio was 67.27% at December 31, 2012, excluding the short-term demand deposits from one customer.

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

Loan Distribution

	December 31,									
	2012	% to Total	2011	% to Total	2010	% to Total	2009	% to Total	2008	% to Total
	(Dollars in thousands)									
Commercial	\$375,469	46%	\$366,590	48%	\$378,412	45%	\$ 427,177	40%	\$ 525,080	42%
Real estate:										
Commercial and residential	354,934	44%	311,479	41%	337,457	40%	400,731	37%	405,530	33%
Land and construction	22,352	3%	23,016	3%	62,356	7%	182,871	17%	256,567	21%
Home equity	43,865	5%	52,017	7%	53,697	6%	51,368	5%	55,490	4%
Consumer	15,714	2%	11,166	1%	13,244	2%	7,181	1%	4,310	—
Total loans	812,334	100%	764,268	100%	845,166	100%	1,069,328	100%	1,246,977	100%
Deferred loan (fees) costs, net	(21)	—	323	—	883	—	785	—	1,654	—
Loans, including deferred costs	812,313	100%	764,591	100%	846,049	100%	1,070,113	100%	1,248,631	100%
Allowance for loan losses	(19,027)		(20,700)		(25,204)		(28,768)		(25,007)	
Loans, net	<u>\$793,286</u>		<u>\$743,891</u>		<u>\$820,845</u>		<u>\$1,041,345</u>		<u>\$1,223,624</u>	

The Company's loan portfolio is concentrated in commercial (primarily manufacturing, wholesale, and services oriented entities) and commercial real estate, with the balance in land development and construction and home equity and consumer loans. An increase in the Company's loan portfolio in the year ended December 31, 2012 compared to the year ended December 31, 2011 is due to increased loan demand. Loans, excluding held-for-sale totaled \$812.3 million at December 31, 2012, an increase of 6% from \$764.6 million at December 31, 2011. The Company does not have any concentrations by industry or group of industries in its loan portfolio, however, 52% of its gross loans were secured by real property as of December 31, 2012, compared to 51% as of December 31, 2011. 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 has established concentration limits in its loan portfolio for commercial real estate loans, commercial loans, construction loans and unsecured lending, among others. All loan types are within established limits. The Company underwrites to the historical cash flow of the borrowers to determine debt service and stress tests the debt service under higher interest rate scenarios. Financial and performance covenants are used in commercial lending to allow the Company to react to a borrower's deteriorating financial condition, should that occur.

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 loans conditionally guaranteed by the SBA (collectively referred to as

“SBA loans”). The guaranteed portion of these loans is typically sold in the secondary market depending on market conditions. When the guaranteed portion of an SBA loan is sold the Company retains the servicing rights for the sold portion. During 2012, loans were sold resulting in a gain on sales of SBA loans of \$702,000.

As of December 31, 2012, commercial and residential real estate loans of \$354.9 million consist primarily of adjustable and fixed rate loans secured by deeds of trust on commercial and residential property. The commercial and residential real estate loans at December 31, 2012 consist of \$180.2 million, or 51% of commercial owner occupied properties, \$171.7 million, or 48%, of commercial investment properties, and \$3.0 million, or 1%, of residential properties. Properties securing the commercial and residential real estate loans are primarily located in the Company’s primary market, which is the Greater San Francisco Bay Area.

The Company’s commercial real estate 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 75% 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 and amortization of thirty years on loans secured by apartments); 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. Land and construction loans were \$22.4 million, or 3% of total loans at December 31, 2012.

The Company makes home equity lines of credit available to its existing customers. Home equity lines of credit are underwritten initially with a maximum 70% loan to value ratio. Home equity lines are reviewed quarterly, 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.

Additionally, 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.

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 \$27.6 million and \$46.0 million at December 31, 2012, respectively.

Loan Maturities

The following table presents the maturity distribution of the Company’s loans as of December 31, 2012. 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 December 31, 2012, approximately 65% of the Company’s loan portfolio consisted of floating interest rate loans.

Loan Maturities

	<u>Due in One Year or Less</u>	<u>Over One Year But Less than Five Years</u>	<u>Over Five Years</u>	<u>Total</u>
	(Dollars in thousands)			
Commercial	\$264,303	\$ 42,171	\$ 68,995	\$375,469
Real estate:				
Commercial and residential	110,424	160,772	83,738	354,934
Land and construction	21,852	500	—	22,352
Home equity	40,711	1,656	1,498	43,865
Consumer	14,972	650	92	15,714
Loans	<u>\$452,262</u>	<u>\$205,749</u>	<u>\$154,323</u>	<u>\$812,334</u>
Loans with variable interest rates	\$405,071	\$ 51,580	\$ 70,477	\$527,128
Loans with fixed interest rates	47,191	154,169	83,846	285,206
Loans	<u>\$452,262</u>	<u>\$205,749</u>	<u>\$154,323</u>	<u>\$812,334</u>

Loan Servicing

As of December 31, 2012, 2011, and 2010 there were \$150.2 million, \$171.0 million, and \$168.9 million, respectively, in SBA loans that were serviced by the Company for others. Activity for loan servicing rights was as follows:

	<u>2012</u>	<u>2011</u>	<u>2010</u>
	(Dollars in thousands)		
Beginning of year balance	\$ 792	\$ 915	\$1,067
Additions	184	294	325
Amortization	(267)	(417)	(477)
End of year balance	<u>\$ 709</u>	<u>\$ 792</u>	<u>\$ 915</u>

Loan servicing rights are included in Accrued Interest Receivable and Other Assets on the consolidated balance sheets and reported net of amortization. There was no valuation allowance as of December 31, 2012 and 2011, as the fair market value of the assets was greater than the carrying value.

I/O strip receivables relate to the excess servicing assets on loans sold prior to 2009. Activity for the I/O strip receivable was as follows:

	<u>2012</u>	<u>2011</u>	<u>2010</u>
	(Dollars in thousands)		
Beginning of year balance	\$2,094	\$2,140	\$2,116
Amortization	—	(96)	(236)
Unrealized holding gain (loss)	(308)	50	260
End of year balance	<u>\$1,786</u>	<u>\$2,094</u>	<u>\$2,140</u>

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.

The Company's 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 and loans held-for-sale for which the Company is no longer accruing interest; restructured loans which have been current under six months; 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 foreclosed assets. 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, and reverses any uncollected interest that had been accrued as income. The Company begins recognizing interest income only as cash interest payments are received and it has been determined 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. Foreclosed assets consist of properties and other assets acquired by foreclosure or similar means. Total foreclosed assets were \$1.3 million at December 31, 2012, compared to \$2.3 million at December 31, 2011.

The following table provides information with respect to components of the Company's nonperforming assets at the dates indicated:

Nonperforming Assets

	December 31,				
	2012	2011	2010	2009	2008
	(Dollars in thousands)				
Nonaccrual loans — held-for-sale	\$ —	\$ 186	\$ 2,026	\$ —	\$ —
Nonaccrual loans — held-for-investment	17,335	14,353	28,821	59,480	39,981
Restructured and loans 90 days past due and still accruing	859	2,291	2,256	2,895	460
Total nonperforming loans	18,194	16,830	33,103	62,375	40,441
Foreclosed assets	1,270	2,312	1,296	2,241	660
Total nonperforming assets	<u>\$19,464</u>	<u>\$19,142</u>	<u>\$34,399</u>	<u>\$64,616</u>	<u>\$41,101</u>
Nonperforming assets as a percentage of loans plus other real estate owned plus nonaccrual loans held-for-sale plus foreclosed assets	2.39%	2.50%	4.05%	6.03%	3.29%
Nonperforming assets as a percentage of total assets	1.15%	1.47%	2.76%	4.74%	2.74%

The following table presents nonperforming loans by class at year end:

	2012			2011		
	Nonaccrual	Restructured and Loans Over 90 Days Past Due and Still Accruing	Total	Nonaccrual	Restructured and Loans Over 90 Days Past Due and Still Accruing	Total
	(Dollars in thousands)					
Commercial	\$ 7,852	\$859	\$ 8,711	\$ 8,876	\$1,803	\$10,679
Real estate:						
Commercial and residential	4,676	—	4,676	2,137	—	2,137
Land and construction	2,223	—	2,223	3,514	456	3,970
Home equity	2,437	—	2,437	—	32	32
Consumer	147	—	147	12	—	12
Total	<u>\$17,335</u>	<u>\$859</u>	<u>\$18,194</u>	<u>\$14,539</u>	<u>\$2,291</u>	<u>\$16,830</u>

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 for loan losses. 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 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 loss 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 assets 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), and foreclosed assets. The principal balance of classified assets, net of SBA guarantees, was \$36.8 million at December 31, 2012, \$59.5 million at December 31, 2011, and \$91.8 million at December 31, 2010. Included in classified assets at December 31, 2011 and December 31, 2010 were \$413,000 and \$2.3 million, respectively, of loans held-for-sale. There were no loans held-for-sale included in classified assets at December 31, 2012. Loans held-for-sale are carried at the lower of cost or estimated fair value, and are not allocated an allowance for loan losses. Management of the level of classified assets 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 perform independent credit reviews of our loan portfolio. The Federal Reserve Bank of San Francisco and the California Department of Financial Institutions 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.

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:

Allowance for Loan Losses

	<u>2012</u>	<u>2011</u>	<u>2010</u>	<u>2009</u>	<u>2008</u>
	(Dollars in thousands)				
Balance, beginning of year	\$20,700	\$ 25,204	\$ 28,768	\$ 25,007	\$12,218
Charge-offs:					
Commercial	(3,935)	(7,559)	(7,098)	(16,512)	(2,731)
Real estate:					
Commercial and residential	(1,528)	(1,599)	(6,763)	(1,610)	—
Land and construction	—	(1,757)	(17,927)	(12,588)	(75)
Home equity	—	—	(25)	(764)	—
Consumer	—	(8)	(354)	(60)	—
Total charge-offs	<u>(5,463)</u>	<u>(10,923)</u>	<u>(32,167)</u>	<u>(31,534)</u>	<u>(2,806)</u>
Recoveries:					
Commercial	776	678	837	1,187	49
Real estate:					
Commercial and residential	230	381	5	10	—
Land and construction	—	879	921	170	9
Home equity	—	9	36	—	—
Consumer	—	3	—	—	—
Total recoveries	<u>1,006</u>	<u>1,950</u>	<u>1,799</u>	<u>1,367</u>	<u>58</u>
Net charge-offs	<u>(4,457)</u>	<u>(8,973)</u>	<u>(30,368)</u>	<u>(30,167)</u>	<u>(2,748)</u>
Provision for loan losses	<u>2,784</u>	<u>4,469</u>	<u>26,804</u>	<u>33,928</u>	<u>15,537</u>
Balance, end of year	<u>\$19,027</u>	<u>\$ 20,700</u>	<u>\$ 25,204</u>	<u>\$ 28,768</u>	<u>\$25,007</u>
RATIOS:					
Net charge-offs to average loans*	0.57%	1.12%	3.18%	2.59%	0.23%
Allowance for loan losses to total loans*	2.34%	2.71%	2.98%	2.69%	2.00%
Allowance for loan losses to nonperforming loans, excluding nonaccrual loans held-for-sale	104.58%	124.37%	81.10%	46.12%	61.84%

* Excludes loans held-for-sale

The Company's allowance for loan losses decreased \$1.7 million at December 31, 2012, compared to December 31, 2011. The decrease in the allowance for loan losses at December 31, 2012 was primarily due to a lower amount of classified loans and a decline in net charge-off levels.

Loan charge-offs reflect the realization of losses in the portfolio that were partially recognized previously through provisions for loan losses. Net charge-offs were \$4.5 million in 2012, compared to net charge-offs of \$9.0 million in 2011, and net charge-offs of \$30.4 million in 2010. Historical net loan charge-offs are not necessarily indicative of the amount of net charge-offs that the Company will realize in the future.

The following table provides a summary of the allocation of the allowance for loan losses for specific categories at the dates indicated. The allocation presented should not be interpreted as an indication that charges to the allowance for loan losses will be incurred in these amounts or proportions, or that the

portion of the allowance allocated to each category represents the total amount available for charge-offs that may occur within these categories.

Allocation of Loan Loss Allowance

	December 31,									
	2012		2011		2010		2009		2008	
	Allowance	Percent of Loans in each category to total loans	Allowance	Percent of Loans in each category to total loans	Allowance	Percent of Loans in each category to total loans	Allowance	Percent of Loans in each category to total loans	Allowance	Percent of Loans in each category to total loans
	(Dollars in thousands)									
Commercial	\$12,866	46%	\$13,215	48%	\$13,952	45%	\$12,687	40%	\$13,913	42%
Real estate:										
Commercial and residential	4,609	44%	6,203	41%	5,500	40%	3,467	37%	4,261	33%
Land and construction	399	3%	594	3%	4,271	7%	11,492	17%	5,014	21%
Home equity	1,026	5%	541	7%	592	6%	993	5%	367	4%
Consumer	127	2%	147	1%	889	2%	129	1%	47	0%
Unallocated	—	N/A	—	N/A	—	N/A	0	N/A	1,405	N/A
Total	<u>\$19,027</u>	<u>100%</u>	<u>\$20,700</u>	<u>100%</u>	<u>\$25,204</u>	<u>100%</u>	<u>\$28,768</u>	<u>100%</u>	<u>\$25,007</u>	<u>100%</u>

The allowance for loan losses totaled \$19.0 million, or 2.34% of total loans at December 31, 2012, compared to \$20.7 million, or 2.71% of total loans at December 31, 2011. Net charge-offs as a percentage of average loans decreased to 0.57% as of December 31, 2012, compared to 1.12% as of December 31, 2011, and 3.18% as of December 31, 2010. The allowance for loan losses related to the commercial portfolio decreased \$349,000 during the year ended December 31, 2012, compared to the year ended December 31, 2011, as a result of a provision for loan losses of \$2.8 million and net charge-offs of \$3.2 million. The decrease in the allowance for loan losses was primarily due to improved risk grading and credit metrics on commercial loans, as well as a decline in historical charge-off levels. The allowance for loan losses related to the real estate portfolio decreased \$1.3 million during the year ended December 31, 2012, compared to the year ended December 31, 2011, as a result of a credit to the provision for loan losses of \$6,000 and net charge-offs of \$1.3 million. The decrease in the allowance for loan losses was primarily due to improved risk grading and credit metrics on non-impaired real estate loans, as well as a decline in historical charge-off levels. This decrease was partially offset by an increase in the allowance for loan losses on impaired real estate loans.

Prior to 2009, management considered the unallocated portion of the allowance for loan losses necessary because of inherent subjective risk in the loan portfolio; however, this methodology did not distinguish this subjective allocation by loan segment. The unallocated portion of the allowance for loan losses was reallocated to the respective loan categories in 2009, which management believes improves its ability to allocate probable credit losses to loan segments. Management considers this matter to be a reallocation in its allowance for loan losses calculation, and believes that there would be no significant change in the balance of the allowance for loan losses if this approach was used in each of the years presented.

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 discussed in greater detail in other sections in this report. 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:

Deposits

	Year Ended December 31,					
	2012		2011		2010	
	Balance	% to Total	Balance	% to Total	Balance	% to Total
	(Dollars in thousands)					
Demand, noninterest-bearing . . .	\$ 727,684	49%	\$ 344,303	33%	\$280,258	28%
Demand, interest-bearing	155,951	10%	134,119	13%	153,917	16%
Savings and money market	272,047	18%	282,478	27%	272,399	27%
Time deposits — under \$100 . . .	25,157	2%	28,557	2%	33,499	3%
Time deposits — \$100 and over .	190,502	13%	168,874	16%	137,514	14%
Time deposits — brokered	97,807	7%	84,726	8%	98,467	10%
CDARS — money market and time deposits	10,220	1%	6,371	1%	17,864	2%
Total deposits	<u>\$1,479,368</u>	<u>100%</u>	<u>\$1,049,428</u>	<u>100%</u>	<u>\$993,918</u>	<u>100%</u>

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 of America. At December 31, 2012 and 2011, less than 6% and 5%, respectively, of deposits were from public sources.

Deposits totaled \$1.48 billion at December 31, 2012, compared to \$1.05 billion at December 31, 2011. Late in the fourth quarter of 2012, the Company received short-term demand deposits in the amount of \$454.8 million from one customer, of which \$182.9 million was subsequently withdrawn, for a net outstanding balance of \$271.9 million at December 31, 2012. An additional \$233.7 million of these deposits were withdrawn in January 2013. Noninterest-bearing demand deposits increased 32% to \$455.8 million at December 31, 2012, excluding \$271.9 million of short-term demand deposits from one customer. At December 31, 2012, the Company had \$95.3 million (at fair value) of securities pledged for \$85.0 million in certificates of deposits from the State of California. At December 31, 2011, the Company had \$56.6 million (at fair value) of securities pledged for \$50.0 million in certificates of deposits from the State of California. At December 31, 2012, brokered deposits increased \$13.1 million, or 15%, to \$97.8 million, compared to \$84.7 million at December 31, 2011. CDARS deposits were comprised of \$5.0 million of money market accounts and \$5.2 million of time deposits at December 31, 2012. All of the \$6.4 million of CDARS deposits at December 31, 2011 were time deposits.

The following table indicates the contractual maturity schedule of the Company's time deposits of \$100,000 and over, and all CDARS time deposits and brokered deposits as of December 31, 2012:

Deposit Maturity Distribution

	<u>Balance</u>	<u>% of Total</u>
	<u>(Dollars in thousands)</u>	
Three months or less	\$129,118	44%
Over three months through six months	53,174	18%
Over six months through twelve months	45,665	16%
Over twelve months	<u>65,550</u>	<u>22%</u>
Total	<u>\$293,507</u>	<u>100%</u>

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 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 ensure its ability to fund deposit withdrawals.

Return (Loss) on Equity and Assets

The following table indicates the ratios for return (loss) on average assets and average equity, and average equity to average assets for 2012, 2011, and 2010:

	<u>2012</u>	<u>2011</u>	<u>2010</u>
Return (loss) on average assets	0.73%	0.89%	-4.17%
Return (loss) on average tangible assets	0.73%	0.89%	-4.25%
Return (loss) on average equity	5.75%	6.02%	-30.82%
Return (loss) on average tangible equity	5.83%	6.11%	-35.66%
Average equity to average assets ratio	12.72%	14.82%	13.55%

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 contractual arrangements. These commitments are obligations that represent a potential credit risk to the Company, yet are not reflected in any form within the Company's consolidated balance sheets. Total unused commitments to extend credit were \$308.9 million at December 31, 2012, as compared to \$284.8 million at December 31, 2011. Unused commitments represented 38% and 37% of outstanding gross loans at December 31, 2012 and 2011, 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 the lines of credit will ever be fully utilized. For more information regarding the Company's off-balance sheet arrangements, see Note 13 to the financial statements located elsewhere herein.

The following table presents the Company's commitments to extend credit for the periods indicated:

	December 31,		December 31,	
	2012		2011	
	Fixed Rate	Variable Rate	Fixed Rate	Variable Rate
	(Dollars in thousands)			
Unused lines of credit and commitments to make loans	\$ 8,410	\$291,191	\$15,723	\$257,342
Standby letters of credit	2,200	7,051	2,291	9,482
	<u>\$10,610</u>	<u>\$298,242</u>	<u>\$18,014</u>	<u>\$266,824</u>

Contractual Obligations

The contractual obligations of the Company, summarized by type of obligation and contractual maturity, at December 31, 2012, are as follows:

	Less Than One Year	One to Three Years	Three to Five Years	After Five Years	Total
	(Dollars in thousands)				
Subordinated debt	\$ —	\$ —	\$ —	\$9,279	\$ 9,279
Short-term borrowings	—	—	—	—	—
Operating leases	2,571	3,636	1,380	208	7,795
Time deposits of \$100 or more, CDARS time deposits and brokered deposits	227,957	65,550	—	—	293,507
Total debt and operating leases	<u>\$230,528</u>	<u>\$69,186</u>	<u>\$1,380</u>	<u>\$9,487</u>	<u>\$310,581</u>

In addition to those obligations listed above, in the normal course of business, the Company will make cash distributions for the payment of interest on interest-bearing deposit accounts and debt obligations, payments for quarterly income tax estimates and contributions to certain employee benefit plans.

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 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 may utilize overnight Federal funds purchase arrangements and other borrowing arrangements with correspondent banks, solicit brokered deposits if cost effective deposits are not available from local sources and maintain 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.

One of the measures of liquidity is our loan to deposit ratio. Our loan to deposit ratio was 54.91% at December 31, 2012, compared to 72.86% at December 31, 2011. The loan to deposit ratio was 67.27% at December 31, 2012, excluding the \$271.9 million of short-term demand deposits from one customer.

FHLB and FRB Borrowings and 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. The Company had no overnight borrowings from the FHLB at December 31, 2012, and December 31, 2011. The Company had \$192.8 million of loans pledged to the FHLB as collateral on an available line of credit of \$92.9 million at December 31, 2012. The Company had \$189.7 million of loans pledged to the FHLB as collateral on an available line of credit of \$107.3 million at December 31, 2011.

The Company can also borrow from FRB's discount window. The Company had \$279.2 million of loans pledged to the FRB as collateral on an available line of credit of \$202.5 million at December 31, 2012, none of which was outstanding. The Company had \$241.2 million of loans pledged to the FRB as collateral on an available line of credit of \$166.7 million at December 31, 2011, none of which was outstanding.

At December 31, 2012, the Company had Federal funds purchase arrangements available of \$55.0 million. There were no Federal funds purchased outstanding at December 31, 2012 or 2011.

The Company may also utilize securities sold under repurchase agreements to manage our liquidity position. There were no securities sold under agreements to repurchase at December 31, 2012 and December 31 2011.

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

	December 31,		
	2012	2011	2010
	(Dollars in thousands)		
Average balance during the year	\$ 1,470	\$ 712	\$23,888
Average interest rate during the year	0.24%	3.37%	1.78%
Maximum month-end balance during the year	\$27,000	\$5,000	\$73,000
Average rate at December 31	N/A	N/A	3.09%

Split-Dollar Life Insurance Benefit Plan

The Company maintains life insurance policies for current and former directors and officers that are subject to split-dollar life insurance agreements, which continues after the participant's employment and retirement. All participants are fully vested in their split-dollar life insurance benefits. The accrued benefit liability for the split-dollar insurance agreements represents either the present value of the future death benefits payable to the participants' beneficiaries or the present value of the estimated cost to maintain life insurance, depending on the contractual terms of the participant's underlying agreement.

During 2011, participants in the split-dollar life insurance benefit plan agreed to amend their agreements related to the designation of beneficiaries for life insurance policies owned by the Company. The agreements were amended to provide a benefit for as long as the policies are in force, (including a commitment to provide replacement coverage if the policies are ever surrendered).

The split-dollar life insurance projected benefit obligation is included in "Accrued interest payable and other liabilities" on the consolidated balance sheets.

Capital Resources

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 Company:

	December 31,			Well-Capitalized Regulatory Requirements	Minimum Regulatory Requirements
	2012	2011	2010		
(Dollars in thousands)					
Capital components:					
Tier 1 Capital	\$ 157,947	\$ 199,423	\$ 185,775		
Tier 2 Capital	13,254	12,181	11,988		
Total risk-based capital	<u>\$ 171,201</u>	<u>\$ 211,604</u>	<u>\$ 197,763</u>		
Risk-weighted assets	\$1,054,394	\$ 965,756	\$ 945,499		
Average assets (regulatory purposes)	\$1,378,011	\$1,300,002	\$1,316,600		
Capital ratios:					
Total risk-based capital	16.2%	21.9%	20.9%	10.00%	8.00%
Tier 1 risk-based capital	15.0%	20.6%	19.7%	6.00%	4.00%
Leverage(1)	11.5%	15.3%	14.1%	N/A	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 the Company computed in accordance with applicable regulatory guidelines and compared to the standards for minimum capital adequacy requirements. The risk-based and leverage capital ratios are also discussed in Item 1 — “*Business — Capital Adequacy Requirements.*”

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

	December 31,			Well-Capitalized Regulatory Requirements	Minimum Regulatory Requirements
	2012	2011	2010		
(Dollars in thousands)					
Capital components:					
Tier 1 Capital	\$ 147,742	\$ 178,697	\$ 159,192		
Tier 2 Capital	13,262	12,207	11,993		
Total risk-based capital	<u>\$ 161,004</u>	<u>\$ 190,904</u>	<u>\$ 171,185</u>		
Risk-weighted assets	\$1,055,061	\$ 967,898	\$ 945,918		
Average assets for capital purposes . .	\$1,378,238	\$1,301,859	\$1,316,969		
Capital ratios					
Total risk-based capital	15.3%	19.7%	18.1%	10.00%	8.00%
Tier 1 risk-based capital	14.0%	18.5%	16.8%	6.00%	4.00%
Leverage(1)	10.7%	13.7%	12.1%	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.

Due primarily to the \$40 million repurchase of the Series A Preferred Stock during the first quarter of 2012 and the redemption of the \$14 million fixed-rate subordinated debt in the third quarter of 2012, the Company's total risk-based capital ratio, Tier 1 risk-based capital ratio, and leverage ratio at December 31, 2012 decreased to 16.2%, 15.0%, and 11.5%, compared to 21.9%, 20.6%, and 15.3% at December 31, 2011, respectively. Due primarily to a distribution from HBC to HCC to provide cash of \$30 million for the repurchase of the Series A Preferred Stock during the first quarter of 2012, and \$15 million for the redemption of the fixed-rate subordinated debt in the third quarter of 2012, HBC's total risk-based capital ratio, Tier 1 risk-based capital ratio, and leverage ratio at December 31, 2012 decreased to 15.3%, 14.0%, and 10.7%, compared to 19.7%, 18.5%, and 13.7% at December 31, 2011, respectively. However, at December 31, 2012, the Company's and HBC's capital ratios exceed the highest regulatory capital requirement of "well-capitalized" under prompt corrective action provisions.

At December 31, 2012, the Company had total shareholders' equity of \$169.7 million, including \$19.5 million in preferred stock, \$131.8 million in common stock, \$15.7 million in retained earnings, and \$2.7 million of accumulated other comprehensive income. The components of accumulated other comprehensive income at December 31, 2012 include the following balances, net of deferred taxes: (i) an unrealized gain on available-for-sale on securities of \$7.4 million; (ii) an unrealized loss on split dollar insurance contracts of (\$2.3) million; (iii) an unrealized loss on the supplemental executive retirement plan of (\$3.4) million; and (iv) an unrealized gain on interest-only strip from SBA loans of \$1.0 million.

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 \$7.0 million principal amount of 10.875% fixed-rate subordinated debt due on March 8, 2030, and common securities of \$217,000 to a

subsidiary trust, which in turn issued a similar amount of trust preferred securities. In the third quarter of 2000, the Company issued \$7.0 million principal amount of 10.60% fixed-rate subordinated debt due on September 7, 2030, and common securities of \$206,000 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. The subordinated debt is recorded as a component of long-term debt 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. Under applicable regulatory guidelines, the trust preferred securities currently qualify as Tier 1 capital. The subsidiary trusts are not consolidated in the Company's consolidated financial statements. Under the Dodd-Frank Wall Street Reform and Consumer Protection Act, certain trust preferred securities will no longer be eligible to be included as Tier 1 capital for regulatory purposes. The trust preferred securities continued to be eligible for Tier 1 capital under Dodd-Frank for bank holding companies with less than \$15 billion of assets; however, under proposed rules implementing Basel III trust preferred securities would lose eligibility for Tier 1 capital over a ten year period.

During the third quarter of 2012, the Company redeemed its 10.875% fixed-rate subordinated debentures in the amount of \$7 million issued to Heritage Capital Trust I (and the related premium cost of \$304,500) and the Company's 10.600% fixed-rate subordinated debentures in the amount of \$7 million issued to Heritage Statutory Trust I (and the related premium cost of \$296,800). The related trust securities issued by Capital Trust I and Statutory Trust I were also redeemed in connection with the subordinated debt redemption and the trusts were dissolved. The Company incurred a charge of \$601,300 in the third quarter of 2012, for the early payoff premium on the redemption of the subordinated debt.

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 Stock qualifies as a component of Tier 1 capital.

On March 7, 2012, in accordance with approvals received from the U.S. Treasury and the Federal Reserve, the Company repurchased all of the Series A Preferred Stock and paid the related accrued and unpaid dividends. The repurchase of the Series A Preferred Stock will save \$2.0 million in annual dividends. At the time the Company repurchased the Series A Preferred Stock, it did not repurchase the related warrant. The warrant is still outstanding as of the date of this report.

Series C Preferred Stock

On June 21, 2010, the Company issued to various institutional investors 21,004 shares of newly issued Series C Convertible Perpetual Preferred Stock ("Series C Preferred Stock"). The Series C Preferred Stock is mandatorily convertible into common stock at a conversion price of \$3.75 per share upon a subsequent transfer of the Series C Preferred stock to third parties not affiliates with the holder in a widely dispersed offering. The Series C Preferred Stock is non-voting except in the case of certain transactions that would affect the rights of the holders of the Series C Preferred Stock or applicable law. Holders of Series C Preferred Stock will receive dividends if and only to the extent dividends are paid to holders of common stock. The Series C Preferred Stock is not redeemable by the Company or by the holders and has a liquidation preference of \$1,000 per share. The Series C Preferred Stock ranks senior to the Company's common stock.

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 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 following table sets forth the estimated changes in the Company's net interest income that would result from the designated instantaneous parallel shift in interest rates noted, as of December 31, 2012. Computations of prospective effects of hypothetical interest rate changes are based on numerous assumptions including relative levels of market interest rates, loan prepayments and deposit decay, and should not be relied upon as indicative of actual results.

	Increase/(Decrease) in Estimated Net Interest Income	
	Amount	Percent
	(Dollars in thousands)	
Change in Interest Rates (basis points)		
+400	\$24,592	51.2%
+300	\$18,464	38.4%
+200	\$12,118	25.2%
+100	\$ 5,705	11.9%
0	\$ —	0.0%
-100	\$(4,235)	-8.8%
-200	\$(7,052)	-14.7%

This data does not reflect any actions that we may undertake in response to changes in interest rates such as changes in rates paid on certain deposit accounts based on local competitive factors, which could reduce the actual impact on net interest income, if any.

As with any method of gauging interest rate risk, there are certain shortcomings inherent to the methodology noted above. 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 methodology noted above 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

General

The Company's consolidated financial statements are prepared in accordance with accounting policies generally accepted in the United States of America and general practices in the banking industry. The financial statements include the accounts of the Company. All inter-company accounts and transactions have been eliminated in consolidation.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America 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 financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. The allowance for loan losses, carrying value of foreclosed assets, deferred tax assets and liabilities, intangible assets, loan servicing rights, interest-only strip receivables, defined benefit pension and split-dollar life insurance benefit plan and the fair values of financial instruments are particularly subject to change.

Allowance for Loan Losses

The allowance for loan losses is an estimate of the losses in our loan portfolio. Our accounting for estimated loan losses was previously discussed under the heading “*Allowance for Loan Losses.*”

Loan Sales and Servicing

The amounts of gains recorded on sales of loans and the initial recording of servicing assets and I/O strips are based on the estimated fair values of the respective components. In recording the initial value of the servicing assets and the fair value of the I/O strips receivable, the Company uses estimates which are made on management’s expectations of future prepayment and discount rates as discussed in Notes 1 and 3 to the consolidated financial statements.

Stock Based Compensation

We grant stock options to purchase our common stock also to our employees and directors under the 2004 Plan. Additionally, we have outstanding options that were granted under an option plan from which we no longer make grants. The benefits provided under all of these plans are subject to the provisions of accounting guidance related to share-based payments. Our results of operations for fiscal years 2012, 2011, and 2010 were impacted by the recognition of non-cash expense related to the fair value of our share-based compensation awards.

The determination of fair value of stock-based payment awards on the date of grant using the Black-Scholes model is affected by our stock price, as well as the input of other subjective assumptions. These assumptions include, but are not limited to, the expected term of stock options and our stock price volatility. Our stock options have characteristics significantly different from those of traded options, and changes in the assumptions can materially affect the fair value estimates.

Accounting guidance requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. If actual forfeitures vary from our estimates, we will recognize the difference in compensation expense in the period the actual forfeitures occur.

Our accounting for stock options is disclosed primarily in Notes 1 and 10 to the consolidated financial statements.

Accounting for Goodwill and Other Intangible Assets

The Company accounts for acquisitions of businesses using the purchase method of accounting. Our accounting for Goodwill was previously discussed under the heading “*Goodwill*” and disclosed primarily in Notes 1 and 6 to the consolidated financial statements.

Intangible assets consist of core deposit and customer relationship intangible assets arising from the acquisition of Diablo Valley Bank in June 2007. Our accounting for Intangible Assets was previously discussed under the heading “*Intangible Assets*” and disclosed primarily in Notes 1 and 6 to the consolidated financial statements.

Deferred Tax Assets

Our net deferred income tax asset arises from temporary differences between the carrying amount of assets and liabilities reported in the financial statements and the amounts used for income tax return purposes. Our accounting for deferred tax assets was previously discussed under the heading “*Income Tax Expense*” and disclosed primarily in Notes 1 and 9 to the consolidated financial statements.

ITEM 7A — QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

As a financial institution, the Company’s primary component of market risk is interest rate volatility. Fluctuations in interest rates will ultimately impact both the level of income and expense recorded on most of the Company’s assets and liabilities and the market value of all interest-earning assets, other than those which have a short term to maturity. Based upon the nature of the Company’s operations, the Company is not subject to foreign exchange or commodity price risk. The Company has no market risk sensitive instruments held for trading purposes. As of December 31, 2012, the Company did not use interest rate derivatives to hedge its interest rate 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 7 of this report.

ITEM 8 — FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

The financial statements and report of the Independent Registered Public Accounting Firm are set forth on pages 90 through 145.

ITEM 9 — CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURES

None.

ITEM 9A — 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 December 31, 2012. 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 that the Company’s disclosure controls were effective as of December 31, 2012, the period covered by this report.

Management’s Annual Report on Internal Control over Financial Reporting

Management of the Company is responsible for establishing and maintaining adequate internal control over financial reporting. As defined in Rule 13a-15(f) under the Exchange Act, internal control over financial reporting is a process designed by, or under the supervision of, a company’s principal executive and principal financial officers and effected by a company’s board of directors, management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the

preparation of financial statements for external purposes in accordance with generally accepted accounting principles. It includes those policies and procedures that:

- Pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of a company;
- Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of a company are being made only in accordance with authorizations of management and the board of directors of the company; and
- Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of a company's assets that could have a material effect on its financial statements.

Because of the inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

The Company's management has used the criteria established in *Internal Control — Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission ("COSO") to evaluate the effectiveness of the Company's internal control over financial reporting. Management has selected the COSO framework for its evaluation as it is a control framework recognized by the SEC and the Public Company Accounting Oversight Board, that is free from bias, permits reasonably consistent qualitative and quantitative measurement of the Company's internal controls, is sufficiently complete so that relevant controls are not omitted and is relevant to an evaluation of internal controls over financial reporting.

Based on our assessment, management has concluded that our internal control over financial reporting, based on criteria established in *Internal Control — Integrated Framework* issued by COSO was effective as of December 31, 2012.

The independent registered public accounting firm of Crowe Horwath LLP, as auditors of our consolidated financial statements, has issued an attestation report on the effectiveness of management's internal control over financial reporting based on criteria established in "*Internal Control — Integrated Framework*," issued by COSO.

Inherent Limitations on Effectiveness of Controls

The Company's management, including the Chief Executive Officer and Chief Financial Officer, does not expect that our disclosure controls or our internal control over financial reporting will prevent or detect all errors and fraud. A control system, no matter how well designed and operated, can provide only reasonable, not absolute, assurance that the control system's objectives will be met. The design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Further, because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that misstatements due to error or fraud will not occur or that all control issues and instances of fraud, if any, within the Company have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty and that breakdowns can occur because of simple error or mistake. Controls can also be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the controls. The design of any system of controls is based in part on certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions. Projections of any evaluation of controls effectiveness to future periods are subject to risks. Over time, controls may become inadequate because of changes in conditions or deterioration in the degree of compliance with policies or procedures.

Changes in Internal Control over Financial Reporting

There was no change in our internal control over financial reporting that occurred during the year ended December 31, 2012 that has materially affected or is reasonably likely to materially affect our internal control over financial reporting.

ITEM 9B — OTHER INFORMATION

None.

PART III

ITEM 10 — DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE

Information required by this item will be contained in our Definitive Proxy Statement for our 2013 Annual Meeting of Shareholders to be filed pursuant to Regulation 14A with the Securities and Exchange Commission within 120 days of December 31, 2012. Such information is incorporated herein by reference.

We have adopted a code of ethics that applies to our Chief Executive Officer, Chief Financial Officer, and to our other principal financial officers. The code of ethics is available at the Governance Documents section of our website at www.heritagecommercecorp.com. We intend to disclose future amendments to, or waivers from, certain provisions of our code of ethics on the above website within four business days following the date of such amendment or waiver.

ITEM 11 — EXECUTIVE COMPENSATION

Information required by this item will be contained in our Definitive Proxy Statement for our 2013 Annual Meeting of Shareholders to be filed pursuant to Regulation 14A with the Securities and Exchange Commission within 120 days of December 31, 2012. Such information is incorporated herein by reference.

ITEM 12 — SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

Information required by this item will be contained in our Definitive Proxy Statement for our 2013 Annual Meeting of Shareholders to be filed pursuant to Regulation 14A with the Securities and Exchange Commission within 120 days of December 31, 2012. Such information is incorporated herein by reference.

ITEM 13 — CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS AND DIRECTOR INDEPENDENCE

Information required by this item will be contained in our Definitive Proxy Statement for our 2013 Annual Meeting of Shareholders to be filed pursuant to Regulation 14A with the Securities and Exchange Commission within 120 days of December 31, 2012. Such information is incorporated herein by reference.

ITEM 14 — PRINCIPAL ACCOUNTANT FEES AND SERVICES

Information required by this item will be contained in our Definitive Proxy Statement for our 2013 Annual Meeting of Shareholders to be filed pursuant to Regulation 14A with the Securities and Exchange Commission within 120 days of December 31, 2012. Such information is incorporated herein by reference.

PART IV

ITEM 15 — EXHIBITS AND FINANCIAL STATEMENT SCHEDULES

(a)(1) FINANCIAL STATEMENTS

The Financial Statements of the Company and the Report of Independent Registered Public Accounting Firm are set forth on pages 90 through 145.

(a)(2) FINANCIAL STATEMENT SCHEDULES

All schedules to the Financial Statements are omitted because of the absence of the conditions under which they are required or because the required information is included in the Financial Statements or accompanying notes.

(a)(3) EXHIBITS

The exhibit list required by this Item is incorporated by reference to the Exhibit Index included in this report.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Company has duly caused this report on Form 10-K to be signed on its behalf by the undersigned thereunto duly authorized.

HERITAGE COMMERCE CORP

BY: /s/ WALTER T. KACZMAREK

Walter T. Kaczmarek
Chief Executive Officer

DATE: March 8, 2013

Pursuant to the requirements of Section 13 of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed below by the following persons on behalf of the registrant and in the capacities and on the date indicated:

<u>Signature</u>	<u>Title</u>	<u>Date</u>
<u>/s/ FRANK G. BISCEGLIA</u> Frank G. Bisceglia	Director	March 8, 2013
<u>/s/ JACK W. CONNER</u> Jack W. Conner	Director and Chairman of the Board	March 8, 2013
<u>/s/ JOHN M. EGGEMEYER III</u> John M. Eggemeyer III	Director	March 8, 2013
<u>/s/ CELESTE V. FORD</u> Celeste V. Ford	Director	March 8, 2013
<u>/s/ STEVEN L. HALLGRIMSON</u> Steven L. Hallgrimson	Director	March 8, 2013
<u>/s/ WALTER T. KACZMAREK</u> Walter T. Kaczmarek	Director and Chief Executive Officer and President (Principal Executive Officer)	March 8, 2013
<u>/s/ LAWRENCE D. MCGOVERN</u> Lawrence D. McGovern	Executive Vice President and Chief Financial Officer (Principal Financial and Accounting Officer)	March 8, 2013
_____	Director	
<u>/s/ HUMPHREY P. POLANEN</u> Humphrey P. Polanen	Director	March 8, 2013
<u>/s/ LAURA RODEN</u> Laura Roden	Director	March 8, 2013
<u>/s/ CHARLES T. TOENISKOETTER</u> Charles T. Toeniskoetter	Director	March 8, 2013
<u>/s/ RANSON W. WEBSTER</u> Ranson W. Webster	Director	March 8, 2013
<u>/s/ W. KIRK WYCOFF</u> W. Kirk Wycoff	Director	March 8, 2013

Annual Report

HERITAGE COMMERCE CORP
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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Board of Directors
Heritage Commerce Corp
San Jose, California

We have audited the accompanying consolidated balance sheets of Heritage Commerce Corp (the “Company”) as of December 31, 2012 and 2011, and the related consolidated statements of operations, comprehensive income (loss), changes in shareholders’ equity and cash flows for each of the years in the three-year period ended December 31, 2012. We also have audited Heritage Commerce Corp’s internal control over financial reporting as of December 31, 2012, based on criteria established in *Internal Control — Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Heritage Commerce Corp’s management is responsible for these financial statements, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting included in the accompanying Management’s Annual Report on Internal Control over Financial Reporting included in Item 9A in this Form 10-K. Our responsibility is to express an opinion on these financial statements and an opinion on the Company’s internal control over financial reporting based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audits of the financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

A company’s internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company’s internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company’s assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Heritage Commerce Corp as of December 31, 2012 and 2011, and the results of its operations and its cash flows for each of the years in the three-year period ended December 31, 2012 in conformity with accounting principles generally accepted in the United States of

America. Also in our opinion, Heritage Commerce Corp maintained, in all material respects, effective internal control over financial reporting as of December 31, 2012, based on criteria established in *Internal Control — Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

/s/ Crowe Horwath LLP

Sacramento, California
March 8, 2013

HERITAGE COMMERCE CORP
CONSOLIDATED BALANCE SHEETS

	December 31, 2012	December 31, 2011
	(Dollars in thousands)	
Assets		
Cash and due from banks	\$ 16,520	\$ 20,861
Interest-bearing deposits in other financial institutions	357,045	52,011
Total cash and cash equivalents	373,565	72,872
Securities available-for-sale, at fair value	367,912	380,455
Securities held-to-maturity, at amortized cost (fair value of \$50,964 at December 31, 2012)	51,472	—
Loans held-for-sale — SBA, at lower of cost or market, including deferred costs	3,409	753
Loans held-for-sale — other, at lower of cost or market, including deferred costs	—	413
Loans, including deferred fees and costs	812,313	764,591
Allowance for loan losses	(19,027)	(20,700)
Loans, net	793,286	743,891
Federal Home Loan Bank and Federal Reserve Bank stock, at cost	10,728	9,925
Company owned life insurance	48,358	46,388
Premises and equipment	7,469	7,980
Intangible assets	2,000	2,491
Accrued interest receivable and other assets	35,113	41,026
Total assets	<u>\$1,693,312</u>	<u>\$1,306,194</u>
Liabilities and Shareholders' Equity		
Liabilities:		
Deposits:		
Demand, noninterest-bearing	\$ 727,684	\$ 344,303
Demand, interest-bearing	155,951	134,119
Savings and money market	272,047	282,478
Time deposits-under \$100	25,157	28,557
Time deposits-\$100 and over	190,502	168,874
Time deposits-brokered	97,807	84,726
CDARS — money market and time deposits	10,220	6,371
Total deposits	1,479,368	1,049,428
Subordinated debt	9,279	23,702
Accrued interest payable and other liabilities	34,924	35,233
Total liabilities	1,523,571	1,108,363
Commitments and contingencies (Notes 5 and 13)		
Shareholders' equity:		
Preferred stock, no par value; 10,000,000 shares authorized		
Series A fixed rate cumulative preferred stock, 40,000 shares issued and outstanding (liquidation preference of \$40,250) at December 31, 2011	—	39,846
Discount on Series A preferred stock	—	(833)
Series C convertible perpetual preferred stock, 21,004 shares issued and outstanding at December 31, 2012 and December 31, 2011 (liquidation preference of \$21,004 at December 31, 2012 and December 31, 2011)	19,519	19,519
Common stock, no par value; 60,000,000 shares authorized; 26,322,147 shares issued and outstanding at December 31, 2012 and 26,295,001 shares issued and outstanding at December 31, 2011	131,820	131,172
Retained earnings	15,721	7,172
Accumulated other comprehensive income	2,681	955
Total shareholders' equity	169,741	197,831
Total liabilities and shareholders' equity	<u>\$1,693,312</u>	<u>\$1,306,194</u>

See notes to consolidated financial statements

HERITAGE COMMERCE CORP
CONSOLIDATED STATEMENTS OF OPERATIONS

	Year Ended December 31,		
	2012	2011	2010
	(Dollars in thousands, except per share data)		
Interest income:			
Loans, including fees	\$40,800	\$42,769	\$ 49,633
Securities, taxable	11,519	9,088	5,236
Securities, non-taxable	112	—	—
Interest-bearing deposits in other financial institutions	134	174	218
Total interest income	<u>52,565</u>	<u>52,031</u>	<u>55,087</u>
Interest expense:			
Deposits	2,800	3,942	8,086
Subordinated debt	1,383	1,871	1,878
Repurchase agreements	—	24	418
Short-term borrowings	4	38	130
Total interest expense	<u>4,187</u>	<u>5,875</u>	<u>10,512</u>
Net interest income before provision for loan losses	48,378	46,156	44,575
Provision for loan losses	2,784	4,469	26,804
Net interest income after provision for loan losses	<u>45,594</u>	<u>41,687</u>	<u>17,771</u>
Noninterest income:			
Service charges and fees on deposit accounts	2,333	2,355	2,228
Servicing income	1,743	1,743	1,719
Increase in cash surrender value of life insurance	1,720	1,706	1,677
Gain on sales of securities	1,560	459	1,955
Gain on sales of SBA loans	702	1,461	1,058
Loss on sales of other loans	—	—	(887)
Other	807	698	983
Total noninterest income	<u>8,865</u>	<u>8,422</u>	<u>8,733</u>
Noninterest expense:			
Salaries and employee benefits	21,722	20,574	21,234
Occupancy and equipment	3,997	4,083	4,087
Professional fees	2,876	2,861	3,975
Software subscriptions	1,149	1,078	1,004
Low income housing investment losses	1,195	1,035	795
Data processing	983	876	831
FDIC deposit insurance premiums	918	1,294	4,002
Insurance expense	911	941	1,007
Premium on redemption of subordinated debt	601	—	—
Advertising and promotion	457	435	395
Foreclosed assets	(45)	389	650
Writedown of loans held-for-sale	—	29	1,080
Impairment of goodwill	—	—	43,181
Other	5,492	5,977	5,886
Total noninterest expense	<u>40,256</u>	<u>39,572</u>	<u>88,127</u>
Income (loss) before income taxes	14,203	10,537	(61,623)
Income tax expense (benefit)	4,294	(834)	(5,766)
Net income (loss)	9,909	11,371	(55,857)
Dividends and discount accretion on preferred stock	(1,206)	(2,333)	(2,398)
Net income (loss) available to common shareholders	<u>\$ 8,703</u>	<u>\$ 9,038</u>	<u>\$(58,255)</u>
Earnings (loss) per common share:			
Basic	\$ 0.27	\$ 0.28	\$ (3.64)
Diluted	\$ 0.27	\$ 0.28	\$ (3.64)

See notes to consolidated financial statements

HERITAGE COMMERCE CORP
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)

	<u>Year ended December 31,</u>		
	<u>2012</u>	<u>2011</u>	<u>2010</u>
	(Dollars in thousands)		
Net income (loss)	\$ 9,909	\$11,371	\$(55,857)
Net unrealized holding gains (loss) on available-for-sale securities and I/O strips	4,451	12,050	(2,078)
Deferred income taxes	(1,869)	(5,061)	872
Net unamortized unrealized gain on securities available-for-sale that were reclassified to securities held-to-maturity	857	—	—
Deferred income taxes	(360)	—	—
Reclassification adjustment for (gains) realized in income	(1,560)	(459)	(1,955)
Deferred income taxes	<u>655</u>	<u>193</u>	<u>821</u>
Change in unrealized gains (loss) on securities and I/O strips, net of deferred income taxes	<u>2,174</u>	<u>6,723</u>	<u>(2,340)</u>
Net pension and other benefit plan liability adjustment	(772)	(1,926)	418
Deferred income taxes	<u>324</u>	<u>809</u>	<u>(175)</u>
Change in pension and other benefit plan liability, net of deferred income taxes	<u>(448)</u>	<u>(1,117)</u>	<u>243</u>
Other comprehensive income (loss)	<u>1,726</u>	<u>5,606</u>	<u>(2,097)</u>
Total comprehensive income (loss)	<u>\$11,635</u>	<u>\$16,977</u>	<u>\$(57,954)</u>

See notes to consolidated financial statements

HERITAGE COMMERCE CORP
CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY

Year Ended December 31, 2012, 2011, and 2010

	Preferred Stock			Common Stock		Retained Earnings/ (Accumulated Deficit)	Accumulated Other Comprehensive Income/(Loss)	Total Shareholders' Equity
	Shares	Amount	Discount	Shares	Amount			
	(Dollars in thousands)							
Balance, January 1, 2010	40,000	\$ 39,846	\$(1,598)	11,820,509	\$ 80,222	\$ 56,389	\$(2,554)	\$172,305
Net loss	—	—	—	—	—	(55,857)	—	(55,857)
Other comprehensive loss	—	—	—	—	—	—	(2,097)	(2,097)
Issuance of Series B mandatorily convertible cumulative perpetual preferred stock, net of issuance costs	53,996	50,179	—	—	—	—	—	50,179
Conversion of Series B mandatorily convertible cumulative perpetual preferred stock into common stock	(53,996)	(50,179)	—	14,398,992	50,179	—	—	—
Issuance of Series C convertible perpetual preferred stock, net of issuance costs	21,004	19,519	—	—	—	—	—	19,519
Issuance of restricted stock awards	—	—	—	13,500	—	—	—	—
Amortization of restricted stock awards, net of forfeitures and taxes	—	—	—	—	89	—	—	89
Cash dividends accrued on Series A preferred stock	—	—	—	—	—	(2,027)	—	(2,027)
Accretion of discount on Series A preferred stock	—	—	371	—	—	(371)	—	—
Stock option expense, net of forfeitures and taxes	—	—	—	—	41	—	—	41
Balance, December 31, 2010	<u>61,004</u>	<u>\$ 59,365</u>	<u>\$(1,227)</u>	<u>26,233,001</u>	<u>\$130,531</u>	<u>\$ (1,866)</u>	<u>\$(4,651)</u>	<u>\$182,152</u>
Net income	—	—	—	—	—	11,371	—	11,371
Other comprehensive income	—	—	—	—	—	—	5,606	5,606
Issuance of restricted stock awards	—	—	—	62,000	—	—	—	—
Amortization of restricted stock awards, net of forfeitures and taxes	—	—	—	—	75	—	—	75
Cash dividends accrued on Series A preferred stock	—	—	—	—	—	(1,939)	—	(1,939)
Accretion of discount on Series A preferred stock	—	—	394	—	—	(394)	—	—
Stock option expense, net of forfeitures and taxes	—	—	—	—	566	—	—	566
Balance, December 31, 2011	<u>61,004</u>	<u>\$ 59,365</u>	<u>\$ (833)</u>	<u>26,295,001</u>	<u>\$131,172</u>	<u>\$ 7,172</u>	<u>\$ 955</u>	<u>\$197,831</u>

HERITAGE COMMERCE CORP
CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY (Continued)

	Year Ended December 31, 2012, 2011, and 2010							
	Preferred Stock			Common Stock		Retained Earnings/ (Accumulated Deficit)	Accumulated Other Comprehensive Income/(Loss)	Total Shareholders' Equity
	Shares	Amount	Discount	Shares	Amount			
	(Dollars in thousands)							
Balance, December 31, 2011	61,004	\$ 59,365	\$ (833)	26,295,001	\$131,172	\$ 7,172	\$ 955	\$197,831
Net income	—	—	—	—	—	9,909	—	9,909
Other comprehensive income	—	—	—	—	—	—	1,726	1,726
Repurchase of Series A preferred stock	(40,000)	(40,000)	—	—	—	—	—	(40,000)
Series A preferred stock capitalized offering costs	—	154	—	—	—	(154)	—	—
Issuance (forfeitures) of restricted stock awards, net	—	—	—	21,500	—	—	—	—
Amortization of restricted stock awards, net of forfeitures and taxes	—	—	—	—	148	—	—	148
Cash dividends accrued on Series A preferred stock	—	—	—	—	—	(373)	—	(373)
Accretion of discount on Series A preferred stock	—	—	833	—	—	(833)	—	—
Stock option expense, net of forfeitures and taxes	—	—	—	—	461	—	—	461
Stock options exercised	—	—	—	5,646	39	—	—	39
Balance, December 31, 2012	<u>21,004</u>	<u>\$ 19,519</u>	<u>\$ —</u>	<u>26,322,147</u>	<u>\$131,820</u>	<u>\$ 15,721</u>	<u>\$ 2,681</u>	<u>\$169,741</u>

See notes to consolidated financial statements

HERITAGE COMMERCE CORP
CONSOLIDATED STATEMENTS OF CASH FLOWS

	Years ended December 31,		
	2012	2011	2010
	(Dollars in thousands)		
CASH FLOWS FROM OPERATING ACTIVITIES:			
Net income (loss)	\$ 9,909	\$ 11,371	\$ (55,857)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:			
Amortization (accretion) of discounts and premiums on securities	2,588	1,634	(1,557)
Gain on sale of securities available-for-sale	(1,560)	(459)	(1,955)
Gain on sale of SBA loans	(702)	(1,461)	(1,058)
Proceeds from sale of SBA loans originated for sale	10,040	16,857	19,824
Net change in SBA loans originated for sale	(11,994)	(7,634)	(21,599)
Loss on sale of other loans	—	—	887
Writedowns on other loans held-for-sale	—	29	1,080
Provision for loan losses	2,784	4,469	26,804
Increase in cash surrender value of life insurance	(1,720)	(1,706)	(1,677)
Depreciation and amortization	750	766	799
Goodwill impairment	—	—	43,181
Amortization of other intangible assets	491	523	575
Writedowns and (gains)/losses on sale of foreclosed assets, net	(530)	(10)	576
Stock option expense, net	461	566	41
Amortization of restricted stock awards, net	148	75	89
Effect of changes in:			
Accrued interest receivable and other assets	4,717	(675)	4,664
Accrued interest payable and other liabilities	659	(2,904)	1,064
Net cash provided by operating activities	<u>16,041</u>	<u>21,441</u>	<u>15,881</u>
CASH FLOWS FROM INVESTING ACTIVITIES:			
Purchase of securities available-for-sale	(154,414)	(233,092)	(197,978)
Purchase of securities held-to-maturity	(33,317)	—	—
Maturities/paydowns/calls of securities available-for-sale	108,026	52,427	31,864
Maturities/paydowns/calls of securities held-to-maturity	1,553	—	—
Proceeds from sales of securities available-for-sale	40,587	45,014	46,012
Net change in SBA loans previously transferred to held-for-sale	—	—	(358)
Proceeds from sales of SBA loans previously transferred to held-for-sale	—	—	2,816
Net change in other loans transferred to held-for-sale	—	49	1,223
Proceeds from sale of other loans transferred held-for-sale	220	1,769	10,303
Net change in loans	(54,042)	68,155	168,390
Changes in Federal Home Loan Bank stock and other investments	(803)	(751)	(720)
Purchase of company owned life insurance	(250)	(1,000)	—
Proceeds from redemption of company owned life insurance	—	—	308
Purchase of premises and equipment	(239)	(349)	(190)
Proceeds from sale of foreclosed assets	2,148	3,639	12,288
Net cash provided by (used in) investing activities	<u>(90,531)</u>	<u>(64,139)</u>	<u>73,958</u>
CASH FLOWS FROM FINANCING ACTIVITIES:			
Net change in deposits	429,940	55,510	(95,367)
Exercise of stock options	39	—	—
Repayment of preferred stock	(40,000)	—	—
Redemption of subordinated debt	(14,423)	—	—
Net change in securities sold under agreement to repurchase	—	(5,000)	(20,000)
Net change in short-term borrowings	—	(2,445)	(17,555)
Issuance of preferred stock, net of offering costs	—	—	69,698
Payment of cash dividends — preferred stock	(373)	(4,672)	—
Net cash provided by (used in) financing activities	<u>375,183</u>	<u>43,393</u>	<u>(63,224)</u>
Net increase in cash and cash equivalents	300,693	695	26,615
Cash and cash equivalents, beginning of year	72,872	72,177	45,562
Cash and cash equivalents, end of year	<u>\$ 373,565</u>	<u>\$ 72,872</u>	<u>\$ 72,177</u>
Supplemental disclosures of cash flow information:			
Interest paid	\$ 4,694	\$ 7,901	\$ 8,896
Income taxes paid (refund)	2,730	490	(6,357)
Supplemental schedule of non-cash investing activity:			
Due to broker for securities purchased, settling after year-end	\$ 3,493	\$ 5,175	\$ 2,902
Transfer of loans held-for-sale to loan portfolio	87	235	2,367
Transfer of portfolio loans to loans held-for-sale	—	—	17,079
Transfer securities from available-for-sale to held-to-maturity	15,498	—	—
Loans transferred to foreclosed assets	2,056	4,565	11,919
Conversion of Series B preferred stock to common stock	—	—	50,179
Cash dividend accrued on Series A preferred stock	—	—	2,027

See notes to consolidated financial statements

HERITAGE COMMERCE CORP
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(1) Summary of Significant Accounting Policies

Description of Business and Basis of Presentation

Heritage Commerce Corp (“HCC”) operates as a registered bank holding company for its wholly-owned subsidiary Heritage Bank of Commerce (“HBC” or the “Bank”), collectively referred to as the “Company”. HBC was incorporated on November 23, 1993 and commenced operations on June 8, 1994. HBC is a California state chartered bank which offers a full range of commercial and personal banking services to residents and the business/professional community in Santa Clara, Alameda, and Contra Costa counties, California. The Company acquired Diablo Valley Bank on June 20, 2007 and merged Diablo Valley Bank into HBC.

The consolidated financial statements are prepared in accordance with accounting policies generally accepted in the United States of America and general practices in the banking industry. The financial statements include the accounts of the Company. All inter-company accounts and transactions have been eliminated in consolidation.

The Company has also established the following wholly-owned Delaware business trusts that were formed to issue trust preferred and related common securities: Heritage Capital Trust I and Heritage Statutory Trust I, formed in 2000, Heritage Statutory Trust II, formed in 2001, and Heritage Statutory Trust III, formed in 2002 (“Trusts”). During the third quarter of 2012 the Company dissolved the Heritage Statutory Trust I and the Heritage Capital Trust I.

All of the common securities of the Trusts totaling \$279,000 and \$702,000 at December 31, 2012 and December 31, 2011, respectively, are owned by the Company and included in other assets on the consolidated balance sheets. The Trusts issued their preferred securities to investors, and used the proceeds to purchase subordinated debt issued by the Company. The subordinated debt payable to the Trusts is recorded as debt of the Company. The Company has fully and unconditionally guaranteed the trust preferred securities along with all obligations of the Trusts under the trust agreements. Interest income from the subordinated debt is the source of revenues for these Trusts. In accordance with generally accepted accounting principles, the Trusts are not consolidated in the Company’s financial statements.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America 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 financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. The allowance for loan losses, carrying value of foreclosed assets, deferred tax assets and liabilities, intangible assets, loan servicing rights, interest-only strip receivables, defined benefit pension and split-dollar life insurance benefit plan and the fair values of financial instruments are particularly subject to change.

Cash and Cash Equivalents

Cash and cash equivalents include cash on hand, amounts due from banks, amounts held at the Federal Reserve Bank, and Federal funds sold. The Company is required to maintain reserves against certain of the deposit accounts with the Federal Reserve Bank. Federal funds are generally sold and purchased for one-day periods.

HERITAGE COMMERCE CORP
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Cash Flows

Net cash flows are reported for customer loan and deposit transactions, notes payable, repurchase agreements and other short-term borrowings.

Securities

The Company classifies its securities as either available-for-sale or held-to-maturity at the time of purchase. Debt securities are classified as held-to-maturity and carried at amortized cost when management has the positive intent and ability to hold them to maturity. Debt securities not classified as held-to-maturity are classified as available-for-sale. Securities available-for-sale are carried at fair value, with unrealized holding gains and losses reported in other comprehensive income, net of taxes.

A decline in the fair value of any available-for-sale or held-to-maturity security below amortized cost that is deemed other than temporary results in a charge to earnings and the corresponding establishment of a new cost basis for the security. In estimating other-than-temporary losses, management considers (1) the length of time and extent that fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, (3) whether the fair value decline was affected by macroeconomic conditions, and (4) whether the Company has the intention to sell the security or more likely than not will be required to sell the security before any anticipated recovery in fair value.

Interest income includes amortization of purchase premiums or discounts. Premiums and discounts are amortized, or accreted, over the life of the related security as an adjustment to income using a method that approximates the interest method. Realized gains and losses are recorded on the trade date and determined using the specific identification method for the cost of securities sold.

Loan Sales and Servicing

The Company holds for sale the conditionally guaranteed portion of certain loans guaranteed by the Small Business Administration or the U.S. Department of Agriculture (collectively referred to as “SBA loans”). These loans are carried at the lower of aggregate cost or fair value. Net unrealized losses, if any, are recorded as a valuation allowance and charged to earnings.

Gains or losses on SBA loans held-for-sale are recognized upon completion of the sale, based on the difference between the net sales proceeds and the relative fair value of the guaranteed portion of the loan sold compared to the relative fair value of the unguaranteed portion. Prior to February 15, 2011, SBA loans that were sold were subject to a warranty for a period of 90 days. In accordance with generally accepted accounting principles, the Company treated sold SBA loans as secured borrowings during the warranty period. The secured borrowings were classified as “short-term borrowings” on the consolidated balance sheets. Effective February 15, 2011, the SBA no longer requires a warranty period in loan sales agreements. Therefore, gains on loan sales completed after February 15, 2011 are recognized upon completion of the transaction.

SBA loans are sold with servicing retained. Servicing assets recognized separately upon the sale of SBA loans consist of servicing rights and, for loans sold prior to 2009, interest-only strip receivables (“I/O strips”). The Company accounts for the sale and servicing of SBA loans based on the financial and servicing assets it controls and liabilities it has incurred, reversing recognition of financial assets when control has been surrendered, and reversing recognition of liabilities when extinguished. Servicing rights are initially recorded at fair value with the income statement effect recorded in gains on sale of loans. Servicing rights are amortized in proportion to and over the period of net servicing income and are assessed for impairment on an ongoing basis. Impairment is determined by stratifying the servicing rights

HERITAGE COMMERCE CORP
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

based on interest rates and terms. Any servicing assets in excess of the contractually specified servicing fees are reclassified at fair value as an I/O strip receivable and treated like an available for sale security. Fair value is determined using prices for similar assets with similar characteristics, when available, or based upon discounted cash flows using market-based assumptions. Impairment is recognized through a valuation allowance. The servicing rights, net of any required valuation allowance, and I/O strip receivable are included in other assets on the consolidated balance sheets.

Servicing income, net of amortization of servicing rights, is recognized as noninterest income. The initial fair value of I/O strip receivables is amortized against interest income on loans.

Loans

Loans that management has the intent and ability to hold for the foreseeable future or until maturity or payoff are stated at the principal amount outstanding, net of deferred loan origination fees and costs and an allowance for loan losses. The majority of the Company's loans have variable interest rates. Interest on loans is accrued on the unpaid principal balance and is credited to income using the effective yield interest method.

A loan portfolio segment is defined as the level at which the Company uses a systematic methodology to determine the allowance for loan losses. A loan portfolio class is defined as a group of loans having similar risk characteristics and methods for monitoring and assessing risk.

For all loan classes, when a loan is classified as nonaccrual, the accrual of interest is discontinued, any accrued and unpaid interest is reversed, and the amortization of deferred loan fees and costs is discontinued. For all loan classes, loans are classified as nonaccrual when the payment of principal or interest is 90 days past due, unless the loan is well secured and in the process of collection. Nonaccrual loans and loans past due 90 days still on accrual include both smaller balance homogeneous loans that are collectively evaluated for impairment and individually classified impaired loans. In certain circumstances, loans that are under 90 days past due may also be classified as nonaccrual. Any interest or principal payments received on nonaccrual loans are applied toward reduction of principal. Nonaccrual loans generally are not returned to performing status until the obligation is brought current, the loan has performed in accordance with the contract terms for a reasonable period of time, and the ultimate collectability of the contractual principal and interest is no longer in doubt.

Non-refundable loan fees and direct origination costs are deferred and recognized over the expected lives of the related loans using the effective yield interest method.

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 for loan losses. 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 experiencing financial

HERITAGE COMMERCE CORP
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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 loan is not collateral dependent. The amount of any impairment 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 formula driven allowance on pools of loans covers all loans that are not impaired and is based on historical losses of each loan segment adjusted for current factors. In calculating the historical component of our allowance, we aggregate our loans into one of three loan segments: Commercial, Real Estate and Consumer. Each segment of loans in the portfolio possess varying degrees of risk, based on, among other things, the type of loan being made, the purpose of the loan, the type of collateral securing the loan, and the sensitivity the borrower has to changes in certain external factors such as economic conditions. The following provides a summary of the risks associated with various segments of the Company's loan portfolio, which are factors management regularly considers when evaluating the adequacy of the allowance:

- Commercial loans consist primarily of commercial and industrial loans (business lines of credit), and other commercial purpose loans. Repayment of commercial and industrial loans is generally provided from the cash flows of the related business to which the loan was made. Adverse changes in economic conditions may result in a decline in business activity, which may impact a borrower's ability to continue to make scheduled payments.
- Real estate loans consist primarily of loans secured by commercial and residential real estate. Also included in this segment are land and construction loans and home equity lines of credit secured by real estate. As the majority of this segment is comprised of commercial real estate loans, risks associated with this segment lay primarily within these loan types. Adverse economic conditions may result in a decline in business activity and increased vacancy rates for commercial properties. These factors, in conjunction with a decline in real estate prices, may expose the Company to the potential for losses if a borrower cannot continue to service the loan with operating revenues, and the value of the property has declined to a level such that it no longer fully covers the Company's recorded investment in the loan.
- Consumer loans consist primarily of a large number of small loans and lines of credit. The majority of installment loans are made for consumer and business purchases. Weakened economic conditions may result in an increased level of delinquencies within this segment, as economic pressures may impact the capacity of such borrowers to repay their obligations.

As a result of the matters mentioned above, changes in the financial condition of individual borrowers, economic conditions, historical loss experience and the condition of the various markets in which collateral may be sold may all affect the required level of the allowance for loan losses and the associated provision for loan losses.

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

HERITAGE COMMERCE CORP
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

default. Risk factors impacting loans in each of the portfolio segments include broad deterioration of property values, reduced consumer and business spending as a result of continued high unemployment and reduced credit availability and lack of confidence in a sustainable recovery. The historical loss experience is adjusted for management's estimate of the impact of other factors based on the risks present for each portfolio segment. These other factors include consideration of the following: the overall level of concentrations and trends of classified loans, loan concentrations within a portfolio segment or division of a portfolio segment, identification of certain loan types with higher risk than other loans, existing internal risk factors and management's evaluation of the impact of local and national economic conditions on each of our loan types.

Loan Commitments and Related Financial Instruments

Financial instruments include off-balance sheet credit instruments, such as commitments to make loans and commercial letters of credit, issued to meet customer financing needs. The face amount for these items represents the exposure to loss, before considering customer collateral or ability to repay. Such financial instruments are recorded when they are funded.

Federal Home Loan Bank and Federal Reserve Bank Stock

As a member of the Federal Home Loan Bank ("FHLB") system, the Bank is required to own common stock in the FHLB based on the Bank's level of borrowings and outstanding FHLB advances. FHLB stock is carried at cost and classified as a restricted security. Both cash and stock dividends are reported as income.

As a member of the Federal Reserve Bank ("FRB") of San Francisco, the Bank is required to own stock in the FRB of San Francisco based on a specified ratio relative to our capital. FRB stock is carried at cost and may be sold back to the FRB at its carrying value. Cash dividends received are reported as income.

Company Owned Life Insurance and Split-Dollar Life Insurance Benefit Plan

The Company has purchased life insurance policies on certain directors and officers. Company owned life insurance is recorded at the amount that can be realized under the insurance contract at the balance sheet date, which is the cash surrender value adjusted for other charges or other amounts due that are probable at settlement. The purchased insurance is subject to split-dollar insurance agreements with the insured participants, which continues after the participant's employment and retirement.

Accounting guidance requires that a liability be recorded over the average life expectancy when a split-dollar life insurance agreement continues after a participant's employment or retirement. The required accrued liability is based on either the post-employment benefit cost for the continuing life insurance or the future death benefit depending on the contractual terms of the underlying agreement.

Premises and Equipment

Land is carried at cost. Premises and equipment are stated at cost. Depreciation and amortization are computed on the straight-line basis over the lesser of the respective lease terms or estimated useful lives. The Company owns one building which is being depreciated over 40 years. Furniture, equipment, and leasehold improvements are depreciated over estimated useful lives generally ranging from five to fifteen years. The Company evaluates the recoverability of long-lived assets on an ongoing basis.

HERITAGE COMMERCE CORP
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Goodwill and Intangible Assets

Goodwill resulted from the acquisition of Diablo Valley Bank in 2007 and represented the excess of the purchase price over the fair value of acquired tangible assets and liabilities and identifiable intangible assets. Goodwill was assessed at least annually for impairment and any such impairment was recognized in the period identified. During 2010, the Company determined that the \$43,181,000 of goodwill was fully impaired.

Other intangible assets consist of core deposit and customer relationship intangible assets arising from the 2007 Diablo Valley Bank acquisition. They are initially measured at fair value and then are amortized on an accelerated method over their estimated useful lives. The core deposits and customer relationship intangible assets are being amortized over ten and seven years, respectively.

Foreclosed Assets

Assets acquired through or instead of loan foreclosure are initially recorded at fair value less costs to sell when acquired, establishing a new cost basis. If fair value declines subsequent to foreclosure, a valuation allowance is recorded through expense. Operating costs after acquisition are expensed. Gains and losses on disposition are included in noninterest expense.

The carrying value of foreclosed assets was \$1,270,000 and \$2,312,000 at December 31, 2012 and 2011, respectively, and is included in other assets on the consolidated balance sheets.

Retirement Plans

Expenses for the Company's non-qualified, unfunded defined benefits plan consists of service and interest cost and amortization of gains and losses not immediately recognized. Employee 401(k) and profit sharing plan expense is the amount of matching contributions. Deferred compensation and supplemental retirement plan expense allocates the benefits over years of service.

Loss Contingencies

Loss contingencies, including claims and legal actions arising in the ordinary course of business, are recorded as liabilities when the likelihood of loss is probable and an amount or range of loss can be reasonably estimated. The Company's accounting policy for legal costs related to loss contingencies is to accrue for the probable fees that can be reasonably estimated. The Company's accounting policy for uncertain recoveries is to recognize the anticipated recovery when realization is deemed probable.

Income Taxes

The Company files consolidated Federal and combined state income tax returns. Income tax expense is the total of the current year income tax payable or refund and the change in deferred tax assets and liabilities. 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.

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 Federal

HERITAGE COMMERCE CORP
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

and 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. Under generally accepted accounting principles, a valuation allowance is required to be recognized if it is “more likely than not” that a deferred tax asset will not be realized. The determination of the realizability of the deferred tax assets is highly subjective and dependent upon judgment concerning management’s evaluation of both positive and negative evidence, including forecasts of future income, cumulative losses, applicable tax planning strategies, and assessments of current and future economic and business conditions.

The Company had net deferred tax assets of \$19,264,000 and \$21,870,000 at December 31, 2012, and December 31, 2011, respectively. After consideration of the matters in the preceding paragraph, the Company determined that it is more likely than not that the net deferred tax asset at December 31, 2012 and 2011 will be fully realized in future years.

A tax position is recognized as a benefit only if it is “more likely than not” that the tax position would be sustained in a tax examination, with a tax examination being presumed to occur. The amount recognized is the largest amount of tax benefit that is greater than 50% likely of being realized on examination. For tax positions not meeting the “more likely than not” test, no tax benefit is recorded. The Company recognizes interest and penalties related to uncertain tax positions as income tax expense.

Stock-Based Compensation

Compensation cost is recognized for stock options and restricted stock awards issued to employees, based on the fair value of these awards at the date of grant. A Black-Scholes model is utilized to estimate the fair value of stock options, while the market price of the Company’s common stock at the date of grant is used for restricted stock awards. Compensation cost is recognized over the required service period, generally defined as the vesting period. For awards with graded vesting, compensation cost is recognized on a straight-line basis over the requisite service period for the entire award. Compensation cost recognized reflects estimated forfeitures, adjusted as necessary for actual forfeitures.

Comprehensive Income (Loss)

Comprehensive income (loss) consists of net income (loss) and other comprehensive income (loss). Other comprehensive income (loss) refers to gains and losses that are included in comprehensive income (loss) but are excluded from net income (loss) because they have been recorded directly in equity under the provisions of certain accounting guidance. The Company’s sources of other comprehensive income are unrealized gains and losses on securities available-for-sale, and I/O strips, which are treated like available-for-sale securities, and the liabilities related to the Company’s defined benefit pension plan and the split-dollar life insurance benefit plan. Reclassification adjustments result from gains or losses on securities that were realized and included in net income (loss) of the current period that also had been included in other comprehensive income as unrealized holding gains and losses.

Segment Reporting

HBC is an independent community business bank with ten branch offices that offer similar products to customers. No customer accounts for more than 10 percent of revenues for HBC or the Company. While the chief decision-makers monitor the revenue streams of the various products and services, operations are managed and financial performance is evaluated on a Company wide basis. 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 bank all operate as one business segment.

HERITAGE COMMERCE CORP
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Reclassifications

Certain items in the consolidated financial statements for the years ended December 31, 2011 and 2010 were reclassified to conform to the 2012 presentation. These reclassifications did not affect previously reported net income.

Adoption of New Accounting Standards

In May 2011, the FASB issued an accounting standards update to improve the comparability between U.S. GAAP fair value accounting and reporting requirements and International Financial Reporting Standards (“IFRS”) fair value accounting and reporting requirements. Additional disclosures required by the update include: (i) disclosure of quantitative information regarding the unobservable inputs used in any fair value measurement classified as Level 3 in the fair value hierarchy in addition to an explanation of the valuation techniques used in valuing Level 3 items and information regarding the sensitivity in the valuation of Level 3 items to changes in the values assigned to unobservable inputs; (ii) categorization by level within the fair value hierarchy of items not recognized on the Statement of Financial Position at fair value but for which fair values are required to be disclosed; and (iii) instances where the fair values disclosed for non-financial assets were based on a highest and best use assumption when in fact the assets are not being utilized in that capacity. The amendments in the update were effective for interim and annual periods beginning on or after December 15, 2011. The effect of adopting this standard did not have a material effect on the Company’s operating results or financial condition, but the additional disclosures are included in Note 12.

In June 2011, the FASB issued an accounting standards update to increase the prominence of items included in Other Comprehensive Income and facilitate the convergence of U.S. GAAP with IFRS. The update prohibits continued presentation of Other Comprehensive Income in the statement of stockholders’ equity. The update requires that all non-owner changes in stockholders’ equity be presented in either a single continuous statement of comprehensive income or in two separate but continuous statements. The amendments in the update became effective for interim and annual periods beginning on or after December 15, 2011. The adoption of this amendment changed the presentation of the statement of comprehensive income for the Company to two consecutive statements, instead of presented as part of the consolidated statements of shareholders’ equity.

HERITAGE COMMERCE CORP
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(2) Securities

The amortized cost and estimated fair value of securities at year-end were as follows:

<u>2012</u>	<u>Amortized Cost</u>	<u>Gross Unrealized Gains</u>	<u>Gross Unrealized Losses</u>	<u>Estimated Fair Value</u>
		(Dollars in thousands)		
Securities available-for-sale:				
Agency mortgage-backed securities	\$281,598	\$ 9,668	\$ (22)	\$291,244
Corporate bonds	53,739	1,849	—	55,588
Trust preferred securities	20,769	375	(64)	21,080
Total	<u>\$356,106</u>	<u>\$11,892</u>	<u>\$ (86)</u>	<u>\$367,912</u>
Securities held-to-maturity:				
Agency mortgage-backed securities	\$ 16,659	\$ 2	\$(177)	\$ 16,484
Municipals — tax exempt	34,813	80	(413)	34,480
Total	<u>\$ 51,472</u>	<u>\$ 82</u>	<u>\$(590)</u>	<u>\$ 50,964</u>
<u>2011</u>	<u>Amortized Cost</u>	<u>Gross Unrealized Gains</u>	<u>Gross Unrealized Losses</u>	<u>Estimated Fair Value</u>
		(Dollars in thousands)		
Securities available-for-sale:				
Agency mortgage-backed securities	\$341,901	\$8,484	\$(37)	\$350,348
Trust preferred securities	29,947	194	(34)	30,107
Total	<u>\$371,848</u>	<u>\$8,678</u>	<u>\$(71)</u>	<u>\$380,455</u>

At December 31, 2012 and December 31, 2011, all agency mortgage-backed securities were issued by the Federal National Mortgage Association (“Fannie Mae”) the Federal Home Loan Mortgage Corporation (“Freddie Mac”), or the Government National Mortgage Association (“Ginnie Mae”). 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.

During the third quarter of 2012, the Company reclassified, at fair value, approximately \$16,373,000 in available-for-sale mortgage-backed securities to the held-to-maturity category. The related unrealized after-tax gains of approximately \$505,000 remained in accumulated other comprehensive income and will be amortized over the remaining life of the securities as an adjustment of yield, offsetting the related amortization of the premium or accretion of the discount on the transferred securities. No gains or losses were recognized at the time of reclassification.

The proceeds from sales of securities and the resulting gains and losses are listed below:

	<u>2012</u>	<u>2011</u>	<u>2010</u>
	(Dollars in thousands)		
Proceeds	\$40,587	\$45,014	\$46,012
Gross gains	1,560	480	1,956
Gross losses	—	(21)	(1)

HERITAGE COMMERCE CORP
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

	Less Than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
2012						
	(Dollars in thousands)					
Securities available-for-sale:						
Agency mortgage-backed securities	\$ 6,226	\$ (22)	\$—	\$—	\$ 6,226	\$ (22)
Trust preferred securities	5,705	(64)	—	—	5,705	(64)
Total	<u>\$11,931</u>	<u>\$ (86)</u>	<u>\$—</u>	<u>\$—</u>	<u>\$11,931</u>	<u>\$ (86)</u>
Securities held-to-maturity:						
Agency mortgage-backed securities	\$15,789	\$(177)	\$—	\$—	\$15,789	\$(177)
Municipals — Tax Exempt	21,985	(413)	—	—	21,985	(413)
Total	<u>\$37,774</u>	<u>\$(590)</u>	<u>\$—</u>	<u>\$—</u>	<u>\$37,774</u>	<u>\$(590)</u>
2011						
	(Dollars in thousands)					
Securities available-for-sale:						
Agency mortgage-backed securities	\$ 8,265	\$(37)	\$—	\$—	\$ 8,265	\$(37)
Trust preferred securities	7,007	(34)	—	—	7,007	(34)
Total	<u>\$15,272</u>	<u>\$(71)</u>	<u>\$—</u>	<u>\$—</u>	<u>\$15,272</u>	<u>\$(71)</u>

At December 31, 2012, the Company held 269 securities (168 available-for-sale and 101 held-to-maturity), of which 70 had fair values below amortized cost. No securities had been carried with an unrealized loss for over 12 months. Unrealized losses were due to higher interest rates. The issuers are of high credit quality and all principal amounts 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 December 31, 2012.

At December 31, 2011, the Company held 165 securities, of which five had fair values below amortized cost. No securities had 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, 2011.

The amortized cost and fair value of debt securities as of December 31, 2012, by contractual maturity, are shown below. The expected maturities will differ from contractual maturities if borrowers have the

HERITAGE COMMERCE CORP
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

right to call or prepay obligations with or without call or prepayment penalties. Securities not due at a single maturity date are shown separately.

	<u>Available-for-sale</u>	
	<u>Amortized Cost</u>	<u>Estimated Fair Value</u>
	(Dollars in thousands)	
Due after one through five years	\$ 920	\$ 955
Due after five through ten years	52,819	54,633
Due after ten years	20,769	21,080
Agency mortgage-backed securities	281,598	291,244
Total	<u>\$356,106</u>	<u>\$367,912</u>

	<u>Held-to-maturity</u>	
	<u>Amortized Cost</u>	<u>Estimated Fair Value</u>
	(Dollars in thousands)	
Due after one through five years	\$ 1,103	\$ 1,101
Due after five through ten years	14,588	14,566
Due after ten years	19,122	18,813
Agency mortgage-backed securities	16,659	16,484
Total	<u>\$51,472</u>	<u>\$50,964</u>

Securities with amortized cost of \$117,574,000 and \$81,945,000 as of December 31, 2012 and 2011 were pledged to secure public deposits and for other purposes as required or permitted by law or contract.

(3) Loans and Loan Servicing

Loans at year-end were as follows:

	<u>2012</u>	<u>2011</u>
	(Dollars in thousands)	
Loans held-for-investment:		
Commercial	\$375,469	\$366,590
Real estate:		
Commercial and residential	354,934	311,479
Land and construction	22,352	23,016
Home equity	43,865	52,017
Consumer	15,714	11,166
Loans	812,334	764,268
Deferred loan origination (fees) costs, net	(21)	323
Loans, including deferred fees and costs	812,313	764,591
Allowance for loan losses	(19,027)	(20,700)
Loans, net	<u>\$793,286</u>	<u>\$743,891</u>

HERITAGE COMMERCE CORP
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Changes in the allowance for loan losses were as follows:

	For the Year Ended December 31, 2012			
	Commercial	Real Estate	Consumer	Total
	(Dollars in thousands)			
Balance, beginning of year	\$13,215	\$ 7,338	\$147	\$20,700
Charge-offs	(3,935)	(1,528)	—	(5,463)
Recoveries	776	230	—	1,006
Net charge-offs	(3,159)	(1,298)	—	(4,457)
Provision (credit) for loan losses	2,810	(6)	(20)	2,784
Balance, end of year	<u>\$12,866</u>	<u>\$ 6,034</u>	<u>\$127</u>	<u>\$19,027</u>

	For the Year Ended December 31, 2011				For the Year Ended December 31, 2010
	Commercial	Real Estate	Consumer	Total	Total
	(Dollars in thousands)				
Balance, beginning of year	\$13,952	\$10,363	\$ 889	\$ 25,204	\$ 28,768
Charge-offs	(7,559)	(3,356)	(8)	(10,923)	(32,167)
Recoveries	678	1,269	3	1,950	1,799
Net charge-offs	(6,881)	(2,087)	(5)	(8,973)	(30,368)
Provision (credit) for loan losses	6,144	(938)	(737)	4,469	26,804
Balance, end of year	<u>\$13,215</u>	<u>\$ 7,338</u>	<u>\$ 147</u>	<u>\$ 20,700</u>	<u>\$ 25,204</u>

The following table presents the balance in the allowance for loan losses and the recorded investment in loans by portfolio segment, based on the impairment method as follows at year-end:

	December 31, 2012			
	Commercial	Real Estate	Consumer	Total
	(Dollars in thousands)			
Allowance for loan losses:				
Ending allowance balance attributable to loans:				
Individually evaluated for impairment	\$ 1,963	\$ 760	\$ 17	\$ 2,740
Collectively evaluated for impairment	10,903	5,274	110	16,287
Total allowance balance	<u>\$ 12,866</u>	<u>\$ 6,034</u>	<u>\$ 127</u>	<u>\$ 19,027</u>
Loans:				
Individually evaluated for impairment	\$ 10,161	\$ 9,336	\$ 147	\$ 19,644
Collectively evaluated for impairment	365,308	411,815	15,567	792,690
Total loan balance	<u>\$375,469</u>	<u>\$421,151</u>	<u>\$15,714</u>	<u>\$812,334</u>

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

	December 31, 2011			
	Commercial	Real Estate	Consumer	Total
	(Dollars in thousands)			
Allowance for loan losses:				
Ending allowance balance attributable to loans:				
Individually evaluated for impairment	\$ 2,249	\$ 76	\$ 2	\$ 2,327
Collectively evaluated for impairment	10,966	7,262	145	18,373
Total allowance balance	\$ 13,215	\$ 7,338	\$ 147	\$ 20,700
Loans:				
Individually evaluated for impairment	\$ 11,954	\$ 5,948	\$ 12	\$ 17,914
Collectively evaluated for impairment	354,636	380,564	11,154	746,354
Total loan balance	\$366,590	\$386,512	\$11,166	\$764,268

Impaired loans excluding non-accrual loans held-for-sale were as follows:

	2012	2011
	(Dollars in thousands)	
Year-end loans with no allocated allowance for loan losses	\$14,083	\$11,068
Year-end loans with allocated allowance for loan losses	5,561	6,846
Total	\$19,644	\$17,914

The following table presents loans held-for-investment individually evaluated for impairment by class of loans as of December 31, 2012 and December 31, 2011. The recorded investment included in the

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

following table represents loan principal net of any partial charge-offs recognized on the loans. The unpaid principal balance represents the recorded balance prior to any partial charge-offs.

	December 31, 2012			December 31, 2011		
	Unpaid Principal Balance	Recorded Investment	Allowance for Loan Losses Allocated	Unpaid Principal Balance	Recorded Investment	Allowance for Loan Losses Allocated
	(Dollars in thousands)					
With no related allowance recorded:						
Commercial	\$ 7,829	\$ 6,978	\$ —	\$ 7,644	\$ 5,972	\$ —
Real estate:						
Commercial and residential	2,755	2,741	—	2,916	2,057	—
Land and construction	2,310	2,223	—	3,491	3,039	—
Home Equity	2,141	2,141	—	—	—	—
Total with no related allowance recorded	15,035	14,083	—	14,051	11,068	—
With an allowance recorded:						
Commercial	3,678	3,182	1,963	6,526	5,982	2,249
Real estate:						
Commercial and residential	3,183	1,937	465	80	80	44
Land and construction	—	—	—	817	740	32
Home Equity	295	295	295	32	32	—
Consumer	147	147	17	12	12	2
Total with an allowance recorded	7,303	5,561	2,740	7,467	6,846	2,327
Total	<u>\$22,338</u>	<u>\$19,644</u>	<u>\$2,740</u>	<u>\$21,518</u>	<u>\$17,914</u>	<u>\$2,327</u>

The following table presents interest recognized and cash-basis interest earned on impaired loans for the periods indicated:

	For the Year Ended December 31, 2012					
	Commercial	Real Estate			Consumer	Total
Commercial and Residential		Land and Construction	Home Equity			
	(Dollars in thousands)					
Average of impaired loans during the period	\$11,068	\$3,376	\$2,536	\$712	\$96	\$17,788
Interest income during impairment	\$ —	\$ 1	\$ 14	\$ —	\$—	\$ 15
Cash-basis interest earned	\$ —	\$ 1	\$ 14	\$ —	\$—	\$ 15

HERITAGE COMMERCE CORP
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

For the Year Ended December 31, 2011

	Real Estate					Total
	Commercial	Commercial and Residential	Land and Construction	Home Equity	Consumer	
	(Dollars in thousands)					
Average of impaired loans during the period	\$12,613	\$2,976	\$5,726	\$1,390	\$680	\$23,385
Interest income during impairment	\$ 2	\$ —	\$ 1	\$ 1	\$ 2	\$ 6
Cash-basis interest earned	\$ —	\$ —	\$ —	\$ 1	\$ —	\$ 1

Nonperforming loans include both smaller dollar balance homogenous loans that are collectively evaluated for impairment and individually classified loans. Nonperforming loans were as follows at year-end:

	2012	2011
	(Dollars in thousands)	
Nonaccrual loans — held-for-sale	\$ —	\$ 186
Nonaccrual loans — held-for-investment	17,335	14,353
Restructured and loans over 90 days past due and still accruing	859	2,291
Total nonperforming loans	<u>\$18,194</u>	<u>\$16,830</u>
Other restructured loans	\$ 1,450	\$ 1,270
Impaired loans, excluding loans held-for-sale	\$19,644	\$17,914

The following table presents the nonperforming loans by class at year-end:

	2012			2011		
	Nonaccrual	Restructured and Loans over 90 Days Past Due and Still Accruing	Total	Nonaccrual	Restructured and Loans over 90 Days Past Due and Still Accruing	Total
	(Dollars in thousands)					
Commercial	\$ 7,852	\$859	\$ 8,711	\$ 8,876	\$1,803	\$10,679
Real estate:						
Commercial and residential	4,676	—	4,676	2,137	—	2,137
Land and construction	2,223	—	2,223	3,514	456	3,970
Home equity	2,437	—	2,437	—	32	32
Consumer	147	—	147	12	—	12
Total	<u>\$17,335</u>	<u>\$859</u>	<u>\$18,194</u>	<u>\$14,539</u>	<u>\$2,291</u>	<u>\$16,830</u>

HERITAGE COMMERCE CORP
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The following table presents the aging of past due loans as of December 31, 2012 by class of loans:

	<u>30 - 59 Days Past Due</u>	<u>60 - 89 Days Past Due</u>	<u>90 Days or Greater Past Due</u>	<u>Total Past Due</u>	<u>Loans Not Past Due</u>	<u>Total</u>
	(Dollars in thousands)					
Commercial	\$1,699	\$355	\$ 5,120	\$ 7,174	\$368,295	\$375,469
Real estate:						
Commercial and residential	1,603	—	3,290	4,893	350,041	354,934
Land and construction	—	—	78	78	22,274	22,352
Home equity	742	—	2,045	2,787	41,078	43,865
Consumer	—	—	—	—	15,714	15,714
Total	<u>\$4,044</u>	<u>\$355</u>	<u>\$10,533</u>	<u>\$14,932</u>	<u>\$797,402</u>	<u>\$812,334</u>

The following table presents the aging of past due loans as of December 31, 2011 by class of loans:

	<u>30 - 59 Days Past Due</u>	<u>60 - 89 Days Past Due</u>	<u>90 Days or Greater Past Due</u>	<u>Total Past Due</u>	<u>Loans Not Past Due</u>	<u>Total</u>
	(Dollars in thousands)					
Commercial	\$1,999	\$508	\$3,394	\$ 5,901	\$360,689	\$366,590
Real estate:						
Commercial and residential	2,293	—	—	2,293	309,186	311,479
Land and construction	—	—	1,532	1,532	21,484	23,016
Home equity	753	—	32	785	51,232	52,017
Consumer	—	—	—	—	11,166	11,166
Total	<u>\$5,045</u>	<u>\$508</u>	<u>\$4,958</u>	<u>\$10,511</u>	<u>\$753,757</u>	<u>\$764,268</u>

Past due loans 30 days or greater totaled \$14,932,000 and \$10,511,000 at December 31, 2012 and December 31, 2011, respectively, of which \$12,020,000 and \$6,312,000 were on nonaccrual. At December 31, 2012, there were also \$5,315,000 loans less than 30 days past due included in nonaccrual loans held-for-investment. At December 31, 2011, there were also \$8,041,000 loans less than 30 days past due included in nonaccrual loans held-for-investment. 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, and reverses any uncollected interest that had been accrued as income. The Company begins recognizing interest income only as cash interest payments are received and it has been determined the collection of all outstanding principal is not in doubt. The loans may or may not be collateralized, and collection efforts are pursued.

Credit Quality Indicators

Concentrations of credit risk arise when a number of clients are engaged in similar business activities, or activities in the same geographic region, or have similar features that would cause their ability to meet contractual obligations to be similarly affected by changes in economic conditions. The Company's loan portfolio is concentrated in commercial (primarily manufacturing, wholesale, and service) and real estate lending, with the balance in consumer loans. While no specific industry concentration is considered significant, the Company's lending operations are located in the Company's market areas that are dependent on the technology and real estate industries and their supporting companies. Thus, the Company's borrowers could be adversely impacted by a continued downturn in these sectors of the

HERITAGE COMMERCE CORP
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

economy which could reduce the demand for loans and adversely impact the borrowers' ability to repay their loans.

The Company categorizes loans into risk categories based on relevant information about the ability of borrowers to service their debt such as: current financial information; historical payment experience; credit documentation; public information; and current economic trends, among other factors. The Company analyzes loans individually by classifying the loans as to credit risk. This analysis is performed on a quarterly basis. Nonclassified loans generally include those loans that are expected to be repaid in accordance with contractual loans terms. Classified loans are those loans that are assigned a substandard, substandard-nonaccrual, or doubtful risk rating using the following definitions:

Substandard. Loans classified as substandard are inadequately protected by the current net worth and paying capacity of the obligor or of the collateral pledged, if any. Loans so classified have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the institution will sustain some loss if the deficiencies are not corrected.

Substandard-Nonaccrual. Loans classified as substandard-nonaccrual are inadequately protected by the current net worth and paying capacity of the obligor or of the collateral pledged, if any. Loans so classified have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the institution will sustain some loss if the deficiencies are not corrected. In addition, the Company no longer accrues interest on the loan because of the underlying weaknesses.

Doubtful. Loans classified as doubtful have all the weaknesses inherent in those classified as substandard, with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable.

Loss. Loans classified as loss are considered uncollectable or of so little value that their continuance as assets is not warranted. This classification does not necessarily mean that a loan has no recovery or salvage value; but rather, there is much doubt about whether, how much, or when the recovery would occur. Loans classified as loss are immediately charged off against the allowance for loan losses. Therefore, there is no balance to report at December 31, 2012 or 2011.

The following table provides a summary of the loan portfolio by loan type and credit quality classification for the periods indicated:

	December 31, 2012			December 31, 2011		
	Nonclassified	Classified	Total	Nonclassified	Classified	Total
	(Dollars in thousands)					
Commercial	\$355,440	\$20,029	\$375,469	\$333,506	\$33,084	\$366,590
Real estate:						
Commercial and residential . . .	345,045	9,889	354,934	294,653	16,826	311,479
Land and construction	18,858	3,494	22,352	15,343	7,673	23,016
Home equity	41,187	2,678	43,865	51,368	649	52,017
Consumer	15,321	393	15,714	10,853	313	11,166
Total	<u>\$775,851</u>	<u>\$36,483</u>	<u>\$812,334</u>	<u>\$705,723</u>	<u>\$58,545</u>	<u>\$764,268</u>

HERITAGE COMMERCE CORP
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

In order to determine whether a borrower is experiencing financial difficulty, an evaluation is performed of the probability that the borrower will be in payment default on any of its debt in the foreseeable future without the modification. This evaluation is performed under the Company's underwriting policy.

For the year ended December 31, 2012, the terms of certain loans were modified as troubled debt restructurings. The modification of the terms of such loans included a reduction of the stated interest rate of the loan, or an extension of maturity date at a stated rate of interest lower than the current market rate for new debt with similar risk.

As a result of adopting the amended guidance in determining whether a restructuring is a troubled debt restructuring, the Company reassessed all restructurings that occurred on or after January 1, 2011 for identification as troubled debt restructurings. The Company did not identify any loans as troubled debt restructurings for which the allowance for loan losses had previously been measured under a general allowance for loan losses methodology.

The book balance of troubled debt restructurings at December 31, 2012 was \$4,107,000, which included \$1,798,000 of nonaccrual loans and \$2,309,000 of accruing loans. The book balance of troubled debt restructurings at December 31, 2011 was \$7,396,000, which included \$4,323,000 of nonaccrual loans and \$3,073,000 of accruing loans. Approximately \$1,152,000 and \$574,000 in specific reserves were established with respect to these loans as of December 31, 2012 and December 31, 2011. As of December 31, 2012 and December 31, 2011, the Company had no additional amounts committed on any loan classified as a troubled debt restructuring.

The following table presents loans by class modified as troubled debt restructurings during the twelve month period ended December 31, 2012:

<u>Troubled Debt Restructurings:</u>	<u>Number of Contracts</u>	<u>During the Year Ended December 31, 2012</u>	
		<u>Pre-modification Outstanding Recorded Investment</u>	<u>Post-modification Outstanding Recorded Investment</u>
(Dollars in thousands)			
Commercial	2	\$ 87	\$ 87
Consumer	1	107	107
Total	<u>3</u>	<u>\$194</u>	<u>\$194</u>

The troubled debt restructurings described above increased the allowance for loan losses by \$41,000 through the allocation of specific reserves, and resulted in no charge-offs for the year ended December 31, 2012.

A loan is considered to be in payment default when it is 30 days contractually past due under the modified terms. There were no defaults on troubled debt restructurings within twelve months following the modification, during the year ended December 31, 2012.

At December 31, 2012 and 2011, the Company serviced SBA loans sold to the secondary market of approximately \$150,192,000 and \$170,969,000.

Servicing assets represent the servicing spread generated from the sold guaranteed portions of SBA loans. The weighted average servicing rate for all loans serviced was 1.33% and 1.36% at December 31, 2012 and 2011, respectively.

HERITAGE COMMERCE CORP
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Servicing rights are included in “accrued interest receivable and other assets” on the consolidated balance sheets. Activity for loan servicing rights follows:

	2012	2011	2010
	(Dollars in thousands)		
Balance, beginning of year	\$ 792	\$ 915	\$1,067
Additions	184	294	325
Amortization	<u>(267)</u>	<u>(417)</u>	<u>(477)</u>
Balance, end of year	<u>\$ 709</u>	<u>\$ 792</u>	<u>\$ 915</u>

There was no valuation allowance for servicing rights as of December 31, 2012 and 2011, because the estimated fair value of the servicing rights was greater than the carrying value. The estimated fair value of loan servicing rights was \$2,929,000 and \$3,200,000 at December 31, 2012 and 2011, respectively. The fair value of servicing rights at December 31, 2012 was estimated using a weighted average constant prepayment rate (“CPR”) assumption of 6.63%, and a weighted average discount rate assumption of 12.83%. The fair value of servicing rights at December 31, 2011 was estimated using a weighted average constant prepayment rate (“CPR”) assumption of 7.00%, and a weighted average discount rate assumption of 14.82%.

The weighted average discount rate and CPR assumptions used to estimate the fair value of the I/O strip receivables are the same as for the servicing rights. Management reviews the key economic assumptions used to estimate the fair value of I/O strip receivables on a quarterly basis. The fair value of the I/O strip can be adversely impacted by a significant increase in either the prepayment speed of the portfolio or the discount rate. At December 31, 2012, key economic assumptions and the sensitivity of the fair value of the I/O strip receivables to immediate 10% and 20% changes to the CPR assumption, and 1% and 2% changes to the discount rate assumption, are as follows:

	(Dollars in thousands)
Carrying amount/fair value of Interest-Only (I/O) strip	\$1,785
Prepayment speed assumption (annual rate)	6.6%
Impact on fair value of 10% adverse change in prepayment speed (CPR 7.3%)	\$ (38)
Impact on fair value of 20% adverse change in prepayment speed (CPR 8.0%)	\$ (75)
Residual cash flow discount rate assumption (annual)	12.8%
Impact on fair value of 1% adverse change in discount rate (14.1% discount rate)	\$ (61)
Impact on fair value of 2% adverse change in discount rate (15.4% discount rate)	\$ (119)

HERITAGE COMMERCE CORP
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

I/O strip receivables are included in “accrued interest receivable and other assets” on the consolidated balance sheets. Activity for I/O strip receivables follows:

	<u>2012</u>	<u>2011</u>	<u>2010</u>
	(Dollars in thousands)		
Balance, beginning of year	\$2,094	\$2,140	\$2,116
Amortization	—	(96)	(236)
Unrealized gain (loss)	(308)	50	260
Balance, end of year	<u>\$1,786</u>	<u>\$2,094</u>	<u>\$2,140</u>

(4) Premises and Equipment

Premises and equipment at year-end were as follows:

	<u>2012</u>	<u>2011</u>
	(Dollars in thousands)	
Building	\$ 3,256	\$ 3,256
Land	2,900	2,900
Furniture and equipment	7,074	6,835
Leasehold improvements	4,668	4,668
	17,898	17,659
Accumulated depreciation and amortization	(10,429)	(9,679)
Premises and equipment, net	<u>\$ 7,469</u>	<u>\$ 7,980</u>

Depreciation and amortization expense was \$750,000, \$766,000, and \$799,000 in 2012, 2011, and 2010, respectively.

(5) Leases

Operating Leases

The Company owns one of its offices and leases the others under non-cancelable operating leases with terms, including renewal options, ranging from five to fifteen years. Future minimum payments under the agreements are as follows:

<u>Year ending December 31,</u>	<u>(Dollars in thousands)</u>
2013	\$2,571
2014	2,357
2015	1,279
2016	666
2017	714
Thereafter	208
Total	<u>\$7,795</u>

Rent expense under operating leases was \$2,735,000, \$2,766,000, and \$2,727,000 respectively, in 2012, 2011, and 2010.

HERITAGE COMMERCE CORP
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(6) Goodwill and Intangible Assets

Goodwill

Goodwill resulted from the acquisition of Diablo Valley Bank in June 2007 and represented the excess of the purchase price over the fair value of acquired tangible assets and liabilities and identifiable intangible assets. Due to concerns about the Company's stock price, the condition of the banking industry in general, and the pricing of the private placement of convertible preferred stock, goodwill was tested for impairment in 2010, with the assistance of an independent valuation firm. Due to the continued depressed economic conditions and the length of time and amount by which the Company's book value exceeded market value per share, and the Company's closing of the private placement at a conversion price of \$3.75 per share, the Company determined goodwill related to the acquisition of Diablo Valley Bank of \$43,181,000 was fully impaired during 2010. The method for estimating the value of the reporting unit included a weighted average of the discounted cash flows income approach and publicly traded company approach.

Acquired Intangible Assets

Core deposit and customer relationship intangible assets acquired in the 2007 acquisition of Diablo Valley Bank were \$5,049,000 and \$276,000, respectively. These assets are amortized over their estimated useful lives. Accumulated amortization of these intangible assets was \$3,325,000 and \$2,834,000 at December 31, 2012 and 2011, respectively.

Estimated amortization expense for each of the next five years follows:

	<u>(Dollars in thousands)</u>
2013	\$473
2014	459
2015	446
2016	427
2017	195

Impairment testing of the intangible assets is performed at the individual asset level. Impairment exists if the carrying amount of the asset is not recoverable and exceeds its fair value at the date of the impairment test. For intangible assets, estimates of expected future cash flows (cash inflows less cash outflows) that are directly associated with an intangible asset are used to determine the fair value of that asset. Management makes certain estimates and assumptions in determining the expected future cash flows from core deposit and customer relationship intangibles including account attrition, expected lives, discount rates, interest rates, servicing costs and other factors. Significant changes in these estimates and assumptions could adversely impact the valuation of these intangible assets. If an impairment loss exists, the carrying amount of the intangible asset is adjusted to a new cost basis. The new cost basis is then amortized over the remaining useful life of the asset. Based on its assessment, management concluded that there was no impairment of intangible assets at December 31, 2012 and December 31, 2011.

(7) Deposits

Time deposits of \$100,000 and over, including time deposits within the Certificate of Deposit Account Registry Service ("CDARS") and brokered deposits of \$100,000 and over, were \$293,507,000 and \$259,454,000 at December 31, 2012 and 2011, respectively. At December 31, 2012, total CDARS deposits of \$10,220,000 include money market deposits of \$5,022,000, which have no scheduled maturity date, and

HERITAGE COMMERCE CORP
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

therefore, are excluded in the table below. The following table presents the scheduled maturities of time deposits, including brokered deposits for the next five years:

	December 31, 2012
	(Dollars in thousands)
2013	\$247,103
2014	40,252
2015	12,104
2016	19,126
2017	79
Total	\$318,664

At December 31, 2012, the Company had securities pledged with a fair value of \$95,283,000 for \$85,033,000 in certificates of deposits from the State of California. At December 31, 2011, the Company had securities pledged with a fair value of \$56,610,000 for \$50,000,000 in certificates of deposits from the State of California.

The CDARS program allows customers with deposits in excess of FDIC-insured limits to obtain full coverage on time deposits through a network of banks within the CDARS program. Deposits gathered through these programs are considered brokered deposits under current regulatory reporting guidelines. CDARS deposits were comprised of \$5,022,000 of money market accounts and \$5,198,000 of time deposits at December 31, 2012. All of the \$6,371,000 of CDARS deposits at December 31, 2011 were time deposits.

Deposits from executive officers, directors, and their affiliates were \$5,240,000 and \$3,602,000 at December 31, 2012 and 2011, respectively.

(8) Borrowing Arrangements

Federal Home Loan Bank Borrowings, Federal Reserve Bank Borrowings, and Available Lines of Credit

The Company maintains a collateralized line of credit with the FHLB of San Francisco. Under this line, the Company can borrow from the FHLB on a short-term (typically overnight) or long-term (over one year) basis. As of December 31, 2012, and December 31, 2011, the Company had no overnight borrowings from the FHLB. The Company had \$192,771,000 of loans and no securities pledged to the FHLB as collateral on a line of credit of \$92,949,000 at December 31, 2012. The Company had \$189,653,000 of loans and no securities pledged to the FHLB as collateral on a line of credit of \$107,268,000 at December 31, 2011.

The Company can also borrow from the FRB's discount window. The Company had approximately \$279,228,000 of loans pledged to the FRB as collateral on an available line of credit of approximately \$202,503,000 at December 31, 2012, none of which was outstanding. The Company can also borrow from the FRB's discount window. The Company had approximately \$241,196,000 of loans pledged to the FRB as collateral on an available line of credit of approximately \$166,672,000 at December 31, 2011, none of which was outstanding.

At December 31, 2012, the Company has Federal funds purchase arrangements and lines of credit available of \$55,000,000. There were no Federal funds purchased at December 31, 2012 and 2011.

HERITAGE COMMERCE CORP
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Securities Sold Under Agreements to Repurchase

Securities sold under agreements to repurchase are financing arrangements that mature within two and a half years. At maturity, the securities underlying the agreements are returned to the Company. Information concerning securities sold under agreements to repurchase is summarized as follows:

	December 31,		
	2012	2011	2010
	(Dollars in thousands)		
Average balance during the year	\$ —	\$ 712	\$18,767
Average interest rate during the year	0.00%	3.37%	2.23%
Maximum month-end balance during the year	\$ —	\$5,000	\$25,000
Average rate at December 31	N/A	N/A	3.09%

Subordinated Debt

Interest payments on the subordinated notes payable to the Company's subsidiary grantor Trusts are deductible for tax purposes. The subordinated debt is not registered with the Securities and Exchange Commission. For regulatory reporting purposes, the subordinated debt qualifies for Tier 1 capital treatment. Under the Dodd-Frank Wall Street Reform and Consumer Protection Act, certain trust preferred securities will no longer be eligible to be included as Tier 1 capital for regulatory purposes. The trust preferred securities continued to be eligible for Tier 1 capital under Dodd-Frank for bank holding companies with less than \$15,000,000,000 of assets; however, under proposed rules implementing Basel III trust preferred securities would lose eligibility for Tier 1 capital over a ten year period. Therefore, our trust preferred securities will continue to be eligible to be treated as Tier 1 capital, subject to other rules and limitations.

The table below summarizes subordinated debt as of December 31:

	2012	2011
	(Dollars in thousands)	
Subordinated debentures due to Heritage Capital Trust I with interest payable semi-annually at 10.875%, redeemable with a premium beginning March 8, 2010 and with no premium beginning March 8, 2020, due March 8, 2030	\$ —	\$ 7,217
Subordinated debentures due to Heritage Statutory Trust I with interest payable semi-annually at 10.6%, redeemable with a premium beginning September 7, 2010 and with no premium beginning September 7, 2020, due September 7, 2030	—	7,206
Subordinated debentures due to Heritage Statutory Trust II with interest payable quarterly based on 3-month Libor plus 3.58% (3.89% at December 31, 2012), redeemable with a premium beginning July 31, 2006 and with no premium beginning July 31, 2011, due July 31, 2031	5,155	5,155
Subordinated debentures due to Heritage Statutory Trust III with interest payable quarterly based on 3-month Libor plus 3.40% (3.71% at December 31, 2012), redeemable with no premium beginning September 26, 2007 and due September 26, 2032	4,124	4,124
Total	\$9,279	\$23,702

HERITAGE COMMERCE CORP
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

During the third quarter of 2012, the Company redeemed its 10.875% fixed-rate subordinated debentures in the amount of \$7,000,000 issued to Heritage Capital Trust I (and the related premium cost of \$304,500) and the Company's 10.600% fixed-rate subordinated debentures in the amount of \$7,000,000 issued to Heritage Statutory Trust I (and the related premium cost of \$296,800). The related trust securities issued by Capital Trust I and Statutory Trust I were also redeemed in connection with the subordinated debt redemption and the trusts were dissolved. A \$15,000,000 distribution from the Bank to the HCC provided the cash for the redemption. The Company incurred a charge of \$601,300 in 2012 for the early payoff premium on the redemption of the subordinated debt.

(9) Income Taxes

Income tax (benefit) consisted of the following for the year ended December 31, as follows:

	<u>2012</u>	<u>2011</u>	<u>2010</u>
	(Dollars in thousands)		
Currently (refundable) payable tax:			
Federal	\$2,944	\$ 89	\$(2,281)
State	51	140	(44)
Total currently (refundable) payable	<u>2,995</u>	<u>229</u>	<u>(2,325)</u>
Deferred tax (benefit):			
Federal	292	2,068	(4,849)
State	1,007	569	(2,292)
Deferred tax valuation allowance	—	(3,700)	3,700
Total deferred tax (benefit)	<u>1,299</u>	<u>(1,063)</u>	<u>(3,441)</u>
Income tax (benefit)	<u>\$4,294</u>	<u>\$ (834)</u>	<u>\$(5,766)</u>

The effective tax rate differs from the federal statutory rate for the years ended December 31, as follows:

	<u>2012</u>	<u>2011</u>	<u>2010</u>
Statutory Federal income tax rate	35.0%	35.0%	-35.0%
State income taxes, net of federal tax benefit	4.7%	4.4%	-2.7%
Change in valuation allowance	0.0%	-35.1%	6.0%
Low income housing credits	-6.0%	-8.0%	-1.7%
Goodwill impairment	0.0%	0.0%	24.5%
Increase in cash surrender value of life insurance	-4.2%	-5.7%	-1.0%
Non-taxable interest income	-0.3%	0.0%	-0.1%
Other, net	1.0%	1.5%	0.6%
Effective tax rate	<u>30.2%</u>	<u>-7.9%</u>	<u>-9.4%</u>

HERITAGE COMMERCE CORP
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Deferred tax assets and liabilities that result from the tax effects of temporary differences between the carrying amount of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes at December 31, are as follows:

	<u>2012</u>	<u>2011</u>
	<u>(Dollars in thousands)</u>	
Deferred tax assets:		
Allowance for loan losses	\$ 8,000	\$ 8,704
Defined postretirement benefit obligation	8,956	8,064
Tax credit carryforwards	5,296	4,876
Federal net operating loss carryforwards	—	1,289
California net operating loss carryforwards	2,281	3,164
Split-dollar life insurance benefit plan	103	106
Stock compensation	1,517	1,276
Accrued expenses	794	728
Fixed assets	678	626
Other	<u>247</u>	<u>221</u>
Total deferred tax assets	27,872	29,054
Deferred tax liabilities:		
Securities available-for-sale	(5,033)	(3,615)
FHLB stock	(263)	(263)
Prepaid expenses	(359)	(416)
I/O strips	(1,036)	(879)
Loan fees	(908)	(830)
Intangible assets	(841)	(1,047)
Other	<u>(168)</u>	<u>(134)</u>
Total deferred tax liabilities	<u>(8,608)</u>	<u>(7,184)</u>
Net deferred tax assets	<u>\$19,264</u>	<u>\$21,870</u>

Tax credit carryforwards as of December 31, 2012 consist of the following:

	<u>2012</u>	
	<u>(Dollars in thousands)</u>	
Low income housing credits	\$4,339	(begin to expire in 2028)
Alternative Minimum Tax credits	870	(no expiration date)
State tax credits, net of federal tax effects	85	(no expiration date)
New Hire Retention Credit	<u>2</u>	(expires in 2031)
Total tax credit carryforwards	<u>\$5,296</u>	

The Company does not have the ability to carryback its net operating loss and low income housing credits to recover federal income taxes paid in prior years. Under current California law, the Company cannot recover state income taxes paid in prior years.

At year-end 2012, the Company has a California net operating loss carryforward of approximately \$32,379,000 that will begin to expire in 2031, if not utilized to reduce future taxable income.

HERITAGE COMMERCE CORP
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Under generally accepted accounting principles, a valuation allowance is required if it is “more likely than not” that a deferred tax asset will not be realized. The determination of the realizability of the deferred tax assets is highly subjective and dependent upon judgment concerning management’s evaluation of both positive and negative evidence, including forecasts of future income, cumulative losses, applicable tax planning strategies, and assessments of current and future economic and business conditions.

At December 31, 2012, and December 31, 2011, the Company had net deferred tax assets of \$19,264,000 and \$21,870,000, respectively. At December 31, 2012, the Company determined that a valuation allowance for deferred tax assets was not necessary.

The Company and its subsidiaries are subject to U.S. Federal income tax as well as income tax of the State of California. The Company is no longer subject to examination by federal and state taxing authorities for years before 2009 and 2008, respectively.

(10) Equity Plan

The Company has an Amended and Restated 2004 Equity Plan (the “Equity Plan”) for directors, officers, and key employees. The Equity Plan provides for the grant of incentive and non-qualified stock options and restricted stock. The Equity Plan provides that the option price for both incentive and non-qualified stock options will be determined by the Board of Directors at no less than the fair value at the date of grant. Options granted vest on a schedule determined by the Board of Directors at the time of grant. Generally, options vest over four years. All options expire no later than ten years from the date of grant. As of December 31, 2012, there are 369,912 shares available for future grants under the Equity Plan.

Stock option activity under the Equity Plan is as follows:

<u>Total Stock Options</u>	<u>Number of Shares</u>	<u>Weighted Average Exercise Price</u>	<u>Weighted Average Remaining Contractual Life (Years)</u>	<u>Aggregate Intrinsic Value</u>
Outstanding at January 1, 2012	1,275,919	\$14.32		
Granted	231,500	\$ 6.42		
Exercised	(5,646)	\$ 4.51		
Forfeited or expired	<u>(187,426)</u>	\$14.82		
Outstanding at December 31, 2012	<u>1,314,347</u>	\$12.90	<u>5.8</u>	<u>\$937,000</u>
Vested or expected to vest	<u>1,248,630</u>		<u>5.8</u>	<u>\$890,000</u>
Exercisable at December 31, 2012	<u>972,547</u>		<u>4.8</u>	<u>\$488,000</u>

Information related to the Equity Plan for each of the last three years:

	<u>2012</u>	<u>2011</u>	<u>2010</u>
Intrinsic value of options exercised	\$10,000	\$ —	\$ —
Cash received from option exercise	\$25,000	\$ —	\$ —
Tax benefit realized from option exercises	\$ 3,000	\$ —	\$ —
Weighted average fair value of options granted	\$ 3.67	\$2.89	\$2.00

As of December 31, 2012, there was \$1,144,000 of total unrecognized compensation cost related to nonvested stock options granted under the Equity Plan. That cost is expected to be recognized over a weighted-average period of approximately 2.89 years.

HERITAGE COMMERCE CORP
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The fair value of each option grant is estimated on the date of grant using the Black-Scholes option pricing model that uses the assumptions noted in the following table, including the weighted average assumptions for the option grants in each year.

	<u>2012</u>	<u>2011</u>	<u>2010</u>
Expected life in months(1)	84	72	72
Volatility(1)	57%	60%	59%
Weighted average risk-free interest rate(2)	1.31%	1.86%	2.11%
Expected dividends(3)	0.00%	0.00%	0.00%

- (1) The expected life of employee stock options represents the weighted average period the stock options are expected to remain outstanding based on historical experience. Volatility is based on the historical volatility of the stock price over the same period of the expected life of the option.
- (2) Based on the U.S. Treasury constant maturity interest rate with a term consistent with the expected life of the option granted.
- (3) Each grant's dividend yield is calculated by annualizing the most recent quarterly cash dividend and dividing that amount by the market price of the Company's common stock as of the grant date.

The Company estimates the impact of forfeitures based on historical experience. Should the Company's current estimate change, additional expense could be recognized or reversed in future periods. The Company issues authorized shares of common stock to satisfy stock option exercises.

Pursuant to the Equity Plan, the Company granted 231,500 shares of nonqualified stock options to directors and employees during the year ended December 31, 2012. The average exercise price was \$6.42 per share, and the options vest over four years. Stock option expense related to the 231,500 shares was \$130,000 for the year ended December 31, 2012. As of December 31, 2012, there was \$721,000 of unrecognized compensation expense related to the 231,500 stock options granted during the year ended December 31, 2012.

Pursuant to the Equity Plan, the Company granted 18,000 shares of restricted common stock, at a grant price of \$6.39, to three officers pursuant to the terms of the restricted stock agreements, dated May 1, 2012. Under the terms of the agreements, the common stock is subject to risk of forfeiture until the common stock has vested. The common stock will vest upon the second anniversary of the grant date. Vesting of the shares of common stock accelerates upon the occurrence of a change in control, or the death or disability of the holder. The fair value of stock awards at the grant date was \$115,000, which is being amortized over a two year period on the straight-line method. Amortization expense related to the 18,000 shares was \$39,000 for the year ended December 31, 2012. None of the shares were vested at December 31, 2012.

Pursuant to the Equity Plan, the Company granted 30,000 shares of restricted common stock, at a grant price of \$6.13, to one officer pursuant to the terms of the restricted stock agreement, dated July 31, 2012. Under the terms of the agreement, the common stock is subject to risk of forfeiture until the common stock has vested. The common stock will vest upon the second anniversary of the grant date. Vesting of the shares of common stock accelerates upon the occurrence of a change in control, or the death or disability of the holder. The fair value of stock awards at the grant date was \$183,900, which is being amortized over a two year period on the straight-line method. Amortization expense related to the 30,000 shares was \$39,000 for the year ended December 31, 2012. None of the shares were vested at December 31, 2012.

HERITAGE COMMERCE CORP
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The Company granted 51,000 shares of restricted common stock to an executive officer pursuant to the terms of a restricted stock agreement, dated March 17, 2005. The grant price was \$18.15. Under the terms of the agreement, the restricted shares vested 25% per year at the end of years three, four, five and six, provided the executive officer was still with the Company, subject to accelerated vesting upon a change of control, termination without cause, termination by the executive officer for good reason (as defined by the executive employment agreement), death or disability. The fair value of stock award at the grant date was \$926,000, which was amortized over the six-year vesting period on the straight-line method. Amortization expense was \$33,000, and \$154,000 in 2011 and 2010, respectively. All of the shares were vested at December 31, 2011.

Pursuant to the Equity Plan, the Company granted 13,500 shares of restricted common stock to three officers pursuant to the terms of the restricted stock agreements, dated July 26, 2010. The grant price was \$3.57. Under the terms of the agreements, the shares of common stock vest upon the later of: (a) the date the Company has redeemed all of the issued and outstanding shares of the Company's Series A Fixed Rate Cumulative Perpetual Preferred Stock, or (b) the second anniversary of the grant date. Vesting of the shares of common stock accelerates upon the occurrence of a change in control, or the death or disability of the holder. The fair value of the stock award at the grant date was \$48,000, which is being amortized over two-year period on the straight-line method. Amortization expense was \$12,000, \$26,000 and \$7,000 in 2012, 2011, and 2010, respectively. There were 9,000 shares vested during the year ended December 31, 2012. There were 4,500 shares of restricted stock forfeited and the related amortized expense of \$14,000 was reversed during the year ended December 31, 2012.

Pursuant to the Equity Plan, the Company granted 62,000 shares of restricted common stock, at a grant price of \$5.16, to eight officers pursuant to the terms of the restricted stock agreements, dated June 16, 2011. Under the terms of the agreements, the shares of common stock vest upon the later of: (a) the date the Company has redeemed all of the issued and outstanding shares of the Company's Series A Fixed Rate Cumulative Perpetual Preferred Stock, or (b) the second anniversary of the grant date. Vesting of the shares of common stock accelerates upon the occurrence of a change in control, or the death or disability of the holder. The fair value of the stock awards at the grant date was \$320,000, which is being amortized over a two year period on the straight-line method. Amortization expense related to the 62,000 shares was \$120,000 and \$87,000 for the year ended December 31, 2012 and December 31, 2011, respectively. None of the shares were vested at December 31, 2012. There were 22,000 shares of restricted stock forfeited and the related amortized expense of \$48,000 was reversed during the year ended December 31, 2012.

(11) Benefit Plans

401(k) Savings Plan

The Company offers a 401(k) savings plan that allows employees to contribute up to a maximum percentage of their compensation, as established by the Internal Revenue Code. The Company made a discretionary matching contribution of up to \$1,000 for each employee's contributions in 2012, 2011 and 2010. Contribution expense was \$187,000, \$183,000, and \$187,000 in 2012, 2011 and 2010, respectively.

Employee Stock Ownership Plan

The Company sponsors a non-contributory employee stock ownership plan. To participate in this plan, an employee must have worked at least 1,000 hours during the year and must be employed by the Company at year-end. Employer contributions to the ESOP are discretionary. The Company has

HERITAGE COMMERCE CORP
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

suspended contributions to the ESOP since 2010. At December 31, 2012, the ESOP owned 137,983 shares of the Company's common stock.

Deferred Compensation Plan

The Company has a nonqualified deferred compensation plan for its directors ("Deferral Agreements"). Under the Deferral Agreements, a participating director may defer up to 100% of his or her board fees into a deferred account. The director may elect a distribution schedule of up to ten years. Amounts deferred earn interest. The Company's deferred compensation obligation of \$218,000 and \$314,000 as of December 31, 2012 and 2011 is included in "Accrued interest payable and other liabilities."

The Company has purchased life insurance policies on the lives of two of its former directors who have Deferral Agreements. It is expected that the earnings on these policies will offset the cost of the program. In addition, the Company will receive death benefit payments upon the death of the former director. The proceeds will permit the Company to "complete" the deferral program as the former director originally intended if he dies prior to the completion of the deferral program. The disbursement of deferred fees is accelerated at death and commences one month after the former director dies.

In the event of the former director's disability prior to attainment of his benefit eligibility date, the former director may request that the Board permit him to receive an immediate disability benefit equal to the annualized value of the director's deferral account.

Nonqualified Defined Benefit Pension Plan

The Company has a supplemental retirement plan covering key executives and directors ("SERP"). The SERP is an unfunded, nonqualified defined benefit plan. The combined number of active and retired/terminated participants in the SERP was 53 at December 31, 2012. The defined benefit represents a stated amount for key executives and directors that generally vests over nine years and is reduced for early retirement. The projected benefit obligation is included in "Accrued interest payable and other liabilities" on the consolidated balance sheets. The SERP has no assets and the entire projected benefit obligation is unfunded. The measurement date of the SERP is December 31.

The following table sets forth the SERP's status at December 31:

	<u>2012</u>	<u>2011</u>
	(Dollars in thousands)	
Change in projected benefit obligation:		
Projected benefit obligation at beginning of year	\$19,200	\$16,229
Service cost	1,178	944
Actuarial loss	915	1,881
Interest cost	770	826
Benefits paid	<u>(758)</u>	<u>(680)</u>
Projected benefit obligation at end of year	<u>\$21,305</u>	<u>\$19,200</u>
Amounts recognized in accumulated other comprehensive loss		
Net actuarial loss	\$ 5,851	\$ 5,189
Prior service cost	<u>—</u>	<u>27</u>
Accumulated other comprehensive loss	<u>\$ 5,851</u>	<u>\$ 5,216</u>

HERITAGE COMMERCE CORP
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Weighted-average assumptions used to determine the benefit obligation at year-end:

	2012	2011
Discount rate	3.75%	4.10%

Estimated benefit payments over the next ten years, which reflect anticipated future events, service and other assumptions, are as follows:

Year	Estimated Benefit Payments
	(Dollars in thousands)
2013	\$ 784
2014	1,079
2015	1,165
2016	1,245
2017	1,397
2018 to 2022	8,027

The components of pension cost for the SERP follow:

	2012	2011
	(Dollars in thousands)	
Components of net periodic benefit cost:		
Service cost	\$1,178	\$ 944
Interest cost	770	826
Amortization of prior service cost	27	36
Amortization of net actuarial loss	253	123
Net periodic benefit cost	\$2,228	\$1,929

The estimated net actuarial loss and prior service cost for the SERP that will be amortized from Accumulated Other Comprehensive Loss into net periodic benefit cost over the next fiscal year are \$291,000 and \$280,000 as of December 31, 2012 and 2011, respectively.

Net periodic benefit cost was determined using the following assumption:

	2012	2011
Discount rate	4.10%	5.21%

Split-Dollar Life Insurance Benefit Plan

The Company maintains life insurance policies for current and former directors and officers that are subject to split-dollar life insurance agreements, which continues after the participant's employment and retirement. All participants are fully vested in their split-dollar life insurance benefits. The accrued benefit liability for the split-dollar insurance agreements represents either the present value of the future death benefits payable to the participants' beneficiaries or the present value of the estimated cost to maintain life insurance, depending on the contractual terms of the participant's underlying agreement.

HERITAGE COMMERCE CORP
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The split-dollar life insurance projected benefit obligation is included in “Accrued interest payable and other liabilities” on the consolidated balance sheets. The measurement date of the split-dollar life insurance benefit plan is December 31.

During 2011, participants in the split-dollar life insurance benefit plan agreed to amend their agreements related to the designation of beneficiaries for life insurance policies owned by the Company. The agreements were amended to provide a benefit for as long as the policies are in force, including a commitment to provide replacement coverage if the policies are ever surrendered.

The following sets forth the funded status of the split dollar life insurance benefits.

	<u>2012</u>	<u>2011</u>
	(Dollars in thousands)	
Change in projected benefit obligation:		
Projected benefit obligation at beginning of year	\$4,525	\$ 6,361
Interest cost	185	306
Actuarial loss	7	831
Amendments to split dollar agreements	—	(2,973)
Projected benefit obligation at end of year	<u>\$4,717</u>	<u>\$ 4,525</u>

Amounts recognized in accumulated other comprehensive loss at December 31 consist of:

	<u>2012</u>	<u>2011</u>
	(Dollars in thousands)	
Net actuarial loss	\$ 624	\$ 454
Prior transition obligation	1,685	1,776
Accumulated other comprehensive loss	<u>\$2,309</u>	<u>\$2,230</u>

Weighted-average assumption used to determine the benefit obligation at year-end follow:

	<u>2012</u>	<u>2011</u>
Discount rate	3.75%	4.10%

Components of net periodic benefit cost during the year are:

	<u>2012</u>	<u>2011</u>
	(Dollars in thousands)	
Amortization of prior transition obligation	\$(73)	\$130
Interest cost	185	306
Net periodic benefit cost	<u>\$112</u>	<u>\$436</u>

The estimated net actuarial loss and prior transition obligation for the split-dollar life insurance benefit plan that will be amortized from accumulated other comprehensive loss into net periodic benefit cost over the next fiscal year are \$90,000 and \$90,000 as of December 31, 2012 and 2011, respectively.

Weighted-average assumption used to determine the net periodic benefit cost:

	<u>2012</u>	<u>2011</u>
Discount rate	4.10%	5.71%

HERITAGE COMMERCE CORP
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(12) 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 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).

	Balance	Fair Value Measurements Using		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
(Dollars in thousands)				
Assets at December 31, 2012:				
Available-for-sale securities:				
Agency mortgage-backed securities	\$291,244	\$ —	\$291,244	\$ —
Corporate bonds	55,588	—	55,588	—
Trust preferred securities	21,080	—	21,080	—
I/O strip receivables	1,786	—	1,786	—
Assets at December 31, 2011:				
Available-for-sale securities:				
Agency mortgage-backed securities	\$350,348	\$ —	\$350,348	\$ —
Trust preferred securities	30,107	—	30,107	—
I/O strip receivables	2,094	—	2,094	—

There were no transfers between Level 1 and Level 2 during the year for assets measured at fair value on a recurring basis.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Assets and Liabilities Measured on a Non-Recurring Basis

The fair value of loans held-for-sale is generally based on obtaining bids and broker indications on the estimated value of these loans held-for-sale, resulting in a Level 2 classification.

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.

Foreclosed assets are valued at the time the loan is foreclosed upon and the asset is transferred to foreclosed assets. The fair value is based primarily on third party appraisals, less costs to sell. The appraisals may utilize a single valuation approach or a combination of approaches including the comparable sales and 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 typically significant and result in a Level 3 classification of the inputs for determining fair value.

HERITAGE COMMERCE CORP
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Assets and Liabilities Measured on a Non-Recurring Basis

	<u>Balance</u>	<u>Fair Value Measurements Using</u>		
		<u>Quoted Prices in Active Markets for Identical Assets (Level 1)</u>	<u>Significant Other Observable Inputs (Level 2)</u>	<u>Significant Unobservable Inputs (Level 3)</u>
		(Dollars in thousands)		
Assets at December 31, 2012:				
Impaired loans — held-for-investment:				
Commercial	\$3,645	—	—	\$3,645
Real estate:				
Commercial and residential	3,674	—	—	3,674
Land and construction	1,723	—	—	1,723
Home equity	—	—	—	—
Consumer	130	—	—	130
	<u>\$9,172</u>	—	—	<u>\$9,172</u>
Foreclosed assets:				
Commercial and residential	\$ 83	—	—	\$ 83
Land and construction	1,187	—	—	1,187
	<u>\$1,270</u>			<u>\$1,270</u>
Assets at December 31, 2011:				
Impaired loans held-for-sale — other:				
Real estate:				
Land and construction	\$ 186	—	\$186	—
Impaired loans — held-for-investment:				
Commercial	\$6,526	—	—	\$6,526
Real estate:				
Commercial and residential	1,794	—	—	1,794
Land and construction	1,590	—	—	1,590
Home equity	32	—	—	32
Consumer	10	—	—	10
	<u>\$9,952</u>	—	—	<u>\$9,952</u>
Foreclosed assets:				
Commercial and residential	\$ 156	—	—	\$ 156
Land and construction	2,156	—	—	2,156
	<u>\$2,312</u>			<u>\$2,312</u>

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The following table shows the detail of the impaired loans held-for-investment and the impaired loans held-for-investment carried at fair value for the periods indicated:

	<u>December 31, 2012</u>	<u>December 31, 2011</u>
	(Dollars in thousands)	
Impaired loans held-for-investment:		
Book value of impaired loans held-for-investment carried at fair value	\$11,912	\$12,279
Book value of impaired loans held-for-investment carried at cost	<u>7,732</u>	<u>5,635</u>
Total impaired loans held-for-investment	<u>\$19,644</u>	<u>\$17,914</u>
Impaired loans held-for-investment carried at fair value:		
Book value of impaired loans held-for-investment carried at fair value	\$11,912	\$12,279
Specific valuation allowance	<u>(2,740)</u>	<u>(2,327)</u>
Impaired loans held-for-investment carried at fair value, net	<u>\$ 9,172</u>	<u>\$ 9,952</u>

Impaired loans held-for-investment of \$19,644,000 at December 31, 2012, after partial charge-offs of \$2,694,000 in 2012, were analyzed for additional impairment primarily using the fair value of collateral. In addition, these loans had a specific valuation allowance of \$2,740,000 at December 31, 2012. Impaired loans held-for-investment totaling \$11,912,000 at December 31, 2012 were carried at fair value as a result of the aforementioned partial charge-offs and specific valuation allowances at year-end. The remaining \$7,732,000 of impaired loans were carried at cost at December 31, 2012, 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 2012 on impaired loans held-for-investment carried at fair value at December 31, 2012 resulted in an additional provision for loan losses of \$3,856,000.

At December 31, 2012, foreclosed assets had a carrying amount of \$1,270,000, with no valuation allowance at December 31, 2012.

Impaired loans held-for-investment of \$17,914,000 at December 31, 2011, after partial charge-offs of \$3,604,000 in 2011, were analyzed for additional impairment primarily using the fair value of collateral. In addition, these loans had a specific valuation allowance of \$2,327,000 at December 31, 2011. Impaired loans held-for-investment totaling \$12,279,000 at December 31, 2011 were carried at fair value as a result of the aforementioned partial charge-offs and specific valuation allowances at year-end. The remaining \$5,635,000 of impaired loans were carried at cost at December 31, 2011, 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 2011 on impaired loans held-for-investment carried at fair value at December 31, 2011 resulted in an additional provision for loan losses of \$2,916,000.

At December 31, 2011, foreclosed assets had a carrying amount of \$2,312,000, with no valuation allowance at December 31, 2011.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The following table presents quantitative information about level 3 fair value measurements for financial instruments measured at fair value on a non-recurring basis at December 31, 2012:

	<u>Fair Value</u>	<u>Valuation Techniques</u>	<u>Unobservable Inputs</u> (Dollars in thousands)	<u>Range (Weighted Average)</u>
Impaired loans — held-for-investment:				
Commercial	\$3,645	Market Approach	Discount adjustment for differences between comparable sales	0% to 4% (1%)
Real estate:				
Commercial and residential . . .	3,674	Market Approach	Discount adjustment for differences between comparable sales	0% to 13% (1%)
Land and construction	1,723	Market Approach	Discount adjustment for differences between comparable sales	1% to 4% (2%)
Foreclosed assets:				
Land and construction	1,187	Market Approach	Discount adjustment for differences between comparable sales	0% to 23% (6%)

The Company obtains third party appraisals on its impaired loans held-for-investment and foreclosed assets to determine fair value. Generally, the third party appraisals apply the “market approach,” which is a valuation technique that uses prices and other relevant information generated by market transactions involving identical or comparable (that is, similar) assets, liabilities, or a group of assets and liabilities, such as a business. Adjustments are then made based on the type of property, age of appraisal, current status of property and other related factors to estimate the current value of collateral.

HERITAGE COMMERCE CORP
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The carrying amounts and estimated fair values of the Company's financial instruments, at December 31, 2012 were as follows:

	Carrying Amounts	Quoted Prices in Active Markets for Identical Assets (Level 1)	Estimated Fair Value		Total
			Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	
(Dollars in thousands)					
Assets:					
Cash and cash equivalents	\$ 373,565	\$373,565	\$ —	\$ —	\$ 373,565
Securities available-for-sale	367,912	—	367,912	—	367,912
Securities held-to-maturity	51,472	—	50,964	—	50,964
Loans (including loans held-for-sale), net	796,695	—	3,409	793,911	797,320
FHLB and FRB stock	10,728	—	—	—	N/A
Accrued interest receivable	3,773	—	1,514	2,259	3,773
Loan servicing rights and I/O strips receivables	2,495	—	4,715	—	4,715
Liabilities:					
Time deposits	\$ 318,664	\$ —	\$ 319,476	\$ —	\$ 319,476
Other deposits	1,160,704	—	1,160,704	—	1,160,704
Subordinated debt	9,279	—	—	5,400	5,400
Accrued interest payable	277	—	277	—	277

The carrying amounts and estimated fair values of the Company's financial instruments at December 31, 2011:

	2011	
	Carrying Amounts	Estimated Fair Value
(Dollars in thousands)		
Assets		
Cash and cash equivalents	\$ 72,872	\$ 72,872
Securities available-for-sale	380,455	380,455
Loans (including loans held-for-sale), net	745,057	745,421
FHLB and FRB stock	9,925	N/A
Accrued interest receivable	3,719	3,719
Loan servicing rights and I/O strips receivables	2,886	5,261
Liabilities		
Time deposits	\$288,528	\$289,512
Other deposits	760,900	760,900
Subordinated debt	23,702	15,950
Accrued interest payable	784	784

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

Cash and Cash Equivalents

The carrying amounts of cash on hand, noninterest and interest bearing due from bank accounts, and Fed funds sold approximate fair values and are classified as Level 1.

Loans

The fair value of loans held-for-sale is estimated based upon binding contracts and quotes from third party investors resulting in a Level 2 classification.

Fair values of loans, excluding loans held for sale, are estimated as follows: For variable rate loans that repriced frequently and with no significant change in credit risk, fair values are based on carrying values resulting in a Level 3 classification. Fair values for other loans are estimated using discounted cash flow analyses, using interest rates currently being offered for loans with similar terms to borrowers of similar credit quality resulting in a Level 3 classification. Impaired loans are valued at the lower of cost or fair value as described previously. The methods utilized to estimate the fair value of loans do not necessarily represent an exit price.

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.

Accrued Interest Receivable/Payable

The carrying amounts of accrued interest approximate fair value resulting in a Level 2 or Level 3 classification.

Deposits

The fair values disclosed for demand deposits (e.g., interest and noninterest checking, passbook savings, and certain types of money market accounts) are, by definition, equal to the amount payable on demand at the reporting date (i.e., their carrying amount) resulting in a Level 2 classification. The carrying amounts of variable rate, fixed-term money market accounts approximate their fair values at the reporting date resulting in a Level 2 classification. The carrying amounts of variable rate, certificates of deposit approximate their fair values at the reporting date resulting in a Level 2 classification. Fair values for fixed rate certificates of deposit are estimated using a discounted cash flows calculation that applies interest rates currently being offered on certificates to a schedule of aggregated expected monthly maturities on time deposits resulting in a Level 2 classification.

Subordinated Debt

The fair values of the subordinated debentures are estimated using discounted cash flow analyses based on the current borrowing rates for similar types of borrowing arrangements resulting in a Level 3 classification.

HERITAGE COMMERCE CORP
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Off-Balance Sheet Items

Fair values for off-balance sheet, credit-related financial instruments are based on fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the counterparties' credit standing. The fair value of commitments is not material.

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.

(13) Commitments and Contingencies

Financial Instruments with Off-Balance Sheet Risk

HBC is a party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its clients. These financial instruments include commitments to extend credit and standby letters of credit. Those instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amounts recognized in the balance sheets.

HBC's exposure to credit loss in the event of non-performance of the other party to the financial instrument for commitments to extend credit and standby letters of credit is represented by the contractual amount of those instruments. HBC uses the same credit policies in making commitments and conditional obligations as it does for on-balance sheet instruments. Credit risk is the possibility that a loss may occur because a party to a transaction failed to perform according to the terms of the contract. HBC controls the credit risk of these transactions through credit approvals, limits, and monitoring procedures. Management does not anticipate any significant losses as a result of these transactions.

Commitments to extend credit were as follows:

	December 31, 2012		December 31, 2011	
	Fixed Rate	Variable Rate	Fixed Rate	Variable Rate
	(Dollars in thousands)			
Unused lines of credit and commitments to make loans	\$ 8,410	\$291,191	\$15,723	\$257,342
Standby letters of credit	2,200	7,051	2,291	9,482
	\$10,610	\$298,242	\$18,014	\$266,824

Commitments generally expire within one year.

Standby letters of credit are written with conditional commitments issued by HBC to guarantee the performance of a client to a third party. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to clients.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The Company is required to maintain noninterest-bearing reserves. Reserve requirements are based on a percentage of certain deposits. As of December 31, 2012, the Company maintained reserves of \$7,064,000 in the form of vault cash and balances at the Federal Reserve Bank of San Francisco, which satisfied the regulatory requirements.

Loss Contingencies

During the first quarter of 2012, the Company accrued \$500,000 for probable costs related to an anticipated legal claim that has not yet been asserted, regarding an apparent transfer of funds for personal use by an authorized signatory of a customer. As of the date of this report, no lawsuit has been filed. This accrual was reduced by payments of \$220,000 during the last three quarters of 2012, resulting in a balance of \$280,000 at December 31, 2012. It is reasonably possible that the outcome may result in a liability exceeding the amount accrued in the financial statements; however, based on the status of the unasserted claim, a range of the reasonably possible gross loss or gross anticipated recoveries cannot be estimated.

(14) Shareholders' Equity and Earnings Per Share

Authorized Shares — On May 27, 2010, the Company's shareholders approved an amendment to the Company's Articles of Incorporation to increase the number of authorized shares of common stock from 30,000,000 to 60,000,000. The additional authorized shares provide the Company greater flexibility for stock splits and stock dividends, issuances under employee benefit plans, financings, corporate mergers and acquisitions, and other general corporate purposes. As of December 31, 2012, the Company also had 10,000,000 authorized shares of preferred stock.

Series A Preferred Stock — On November 21, 2008, the Company issued 40,000 shares of Series A Fixed Rate Cumulative Perpetual Preferred Stock ("Series A Preferred Stock") to the U.S. Treasury under the terms of the U.S. Treasury Capital Purchase Program for \$40,000,000 with a liquidation preference of \$1,000 per share. On March 7, 2012, in accordance with approvals received from the U.S. Treasury and the Federal Reserve Board, the Company repurchased all of the Series A Preferred Stock and paid all of the related accrued and unpaid dividends. HCC used available cash and proceeds from a \$30,000,000 distribution approved by the DFI from HBC to HCC. The repurchase of the Series A Preferred Stock accelerated the accretion of the remaining issuance discount on the Series A Preferred Stock.

Warrants — On November 21, 2008, in conjunction with the issuance of the Series A Preferred Stock, the Company issued a warrant to the U.S. Treasury with an initial exercise price of \$12.96 per share of common stock, with an allocated fair value of \$1,979,000. The warrant may be exercised at any time on or before November 21, 2018. The warrant, at any time is transferable at any time. The Company did not repurchase the warrant when it repurchased the Series A Preferred Stock and the warrant remains outstanding as of the date of this report. As of December 31, 2012, there were 462,963 shares issuable upon exercise of the warrant.

Series C Preferred Stock — On June 21, 2010, the Company issued to various institutional investors 21,004 shares of Series C Convertible Perpetual Preferred Stock ("Series C Preferred Stock"). The Series C Preferred Stock is mandatorily convertible into common stock at a conversion price of \$3.75 per share upon a subsequent transfer of the Series C Preferred Stock to third parties not affiliated with the holder in a widely dispersed offering. The 21,004 shares of Series C Preferred Stock remain outstanding as of December 31, 2012, and are convertible into 5,601,000 shares of common stock. The Series C Preferred Stock is non-voting except in the case of certain transactions that would affect the rights of the holders of the Series C Preferred Stock or applicable law. Holders of Series C Preferred Stock will receive dividends if and only to the extent dividends are paid to holders of common stock. The Series C Preferred Stock is

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

not redeemable by the Company or by the holders and has a liquidation preference of \$1,000 per share. The Series C Preferred Stock ranks senior to the Company's common stock.

Earnings (Loss) Per Share — Basic earnings per common share is computed by dividing net income, less dividends and discount accretion on preferred stock, by the weighted average common shares outstanding. The Series C Preferred Stock participates in the earnings of the Company and, therefore, the shares issued on the conversion of the Series C Preferred Stock are considered outstanding under the two-class method of computing basic earnings per common share during periods of earnings. Diluted earnings per share reflect potential dilution from outstanding stock options and common stock warrants, using the treasury stock method. The common stock warrant was antidilutive at December 31, 2012 and 2011. A reconciliation of these factors used in computing basic and diluted earnings per common share is as follows:

	Year ended December 31,		
	2012	2011	2010
	(Dollars in thousands)		
Net income (loss) available to common shareholders	\$ 8,703	\$ 9,038	\$ (58,255)
Less: net income allocated to Series C Preferred Stock	1,527	1,589	N/A
Net income (loss) allocated to common shareholders	\$ 7,176	\$ 7,449	\$ (58,255)
Weighted average common shares outstanding for basic earnings (loss) per common share	26,303,245	26,266,584	16,026,058
Dilutive effect of stock options outstanding, using the the treasury stock method	26,091	3,810	N/A
Shares used in computing diluted earnings (loss) per common share	26,329,336	26,270,394	16,026,058
Basic earnings per share	\$ 0.27	\$ 0.28	\$ (3.64)
Diluted earnings per share	\$ 0.27	\$ 0.28	\$ (3.64)

Comprehensive Income:

Accumulated other comprehensive income consisted of the following items, net of deferred income tax, at December 31:

	2012	2011
	(Dollars in thousands)	
Net unrealized loss on split-dollar life insurance benefit plan	\$(2,309)	\$(2,230)
Net unrealized loss on defined benefit plan	(3,394)	(3,025)
Net unrealized gain on securities available-for-sale	6,851	4,995
Net unamortized unrealized gain on securities available-for-sale that were reclassified to securities held-to-maturity	497	—
Net unrealized gain on I/O strips	1,036	1,215
Accumulated other comprehensive income	\$ 2,681	\$ 955

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(15) Capital Requirements

The Company and its subsidiary bank are subject to various regulatory capital requirements administered by the banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory — and possibly additional discretionary — actions by regulators that, if undertaken, could have a direct material effect on the Company’s financial statements and operations. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Company and HBC must meet specific capital guidelines that involve quantitative measures of assets, liabilities, and certain off-balance-sheet items as calculated under regulatory accounting practices. Capital amounts and classifications are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors.

Quantitative measures established by regulation to help ensure capital adequacy require the Company and HBC to maintain minimum amounts and ratios (set forth in the table below) of total and Tier 1 capital (as defined in the regulations) to risk-weighted assets (as defined), and of Tier 1 capital to average assets (as defined). Management believes that, as of December 31, 2012 and 2011, the Company and HBC met all capital adequacy guidelines to which they were subject.

As of December 31, 2012 HBC was categorized as “well-capitalized” under the regulatory framework for prompt corrective action. There are no conditions or events since December 31, 2012 that management believes have changed the categorization of the Company or HBC as well-capitalized.

The Company’s consolidated capital amounts and ratios are presented in the following table, together with capital adequacy requirements.

	Actual		To Be Well-Capitalized Under Regulatory Requirements		Required For Capital Adequacy Purposes	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
	(Dollars in thousands)					
As of December 31, 2012						
Total Capital	\$171,201	16.2%	\$105,419	10.0%	\$84,335	8.0%
(to risk-weighted assets)						
Tier 1 Capital	\$157,947	15.0%	\$ 63,263	6.0%	\$42,175	4.0%
(to risk-weighted assets)						
Tier 1 Capital	\$157,947	11.5%	N/A	N/A	\$55,130	4.0%
(to average assets)						
As of December 31, 2011						
Total Capital	\$211,604	21.9%	\$ 96,755	10.0%	\$77,404	8.0%
(to risk-weighted assets)						
Tier 1 Capital	\$199,423	20.6%	\$ 58,056	6.0%	\$38,704	4.0%
(to risk-weighted assets)						
Tier 1 Capital	\$199,423	15.3%	N/A	N/A	\$52,103	4.0%
(to average assets)						

HERITAGE COMMERCE CORP
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

HBC's actual capital and required amounts and ratios are presented in the following table.

	Actual		To Be Well-Capitalized Under Prompt Corrective Action Provisions		Required For Capital Adequacy Purposes	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
(Dollars in thousands)						
As of December 31, 2012						
Total Capital (to risk-weighted assets)	\$161,004	15.3%	\$105,507	10.0%	\$84,406	8.0%
Tier 1 Capital (to risk-weighted assets)	\$147,742	14.0%	\$ 63,318	6.0%	\$42,212	4.0%
Tier 1 Capital (to average assets)	\$147,742	10.7%	\$ 68,910	5.0%	\$55,128	4.0%
As of December 31, 2011						
Total Capital (to risk-weighted assets)	\$190,904	19.7%	\$ 97,004	10.0%	\$77,603	8.0%
Tier 1 Capital (to risk-weighted assets)	\$178,697	18.5%	\$ 57,956	6.0%	\$38,637	4.0%
Tier 1 Capital (to average assets)	\$178,697	13.7%	\$ 65,266	5.0%	\$52,212	4.0%

Due primarily to the repurchase of \$40,000,000 of Series A Preferred Stock during the first quarter of 2012 and the redemption of \$14,000,000 of fixed-rate subordinated debt in the third quarter of 2012, the Company's total risk-based capital ratio, Tier 1 risk-based capital ratio, and leverage ratio at December 31, 2012 decreased to 16.2%, 15.0%, and 11.5%, compared to 21.9%, 20.6%, and 15.3% at December 31, 2011, respectively. Due primarily to a distribution from HBC to HCC to provide cash of \$30,000,000 for the repurchase of the Series A Preferred Stock during the first quarter of 2012, and \$15,000,000 for the redemption of the fixed-rate subordinated debt in the third quarter of 2012, HBC's total risk-based capital ratio, Tier 1 risk-based capital ratio, and leverage ratio at December 31, 2012 decreased to 15.3%, 14.0%, and 10.7%, compared to 19.7%, 18.5%, and 13.7% at December 31, 2011, respectively. However, at December 31, 2012, the Company's and HBC's capital ratios exceed the highest regulatory capital requirement of "well-capitalized" under prompt corrective action provisions.

HCC is dependent upon dividends from HBC. Under California General Corporation Law, the holders of common stock are entitled to receive dividends when and as declared by the Board of Directors, out of funds legally available. The California Financial Code provides that a state-licensed bank may not make a cash distribution to its shareholders in excess of the lesser of the following: (i) the bank's retained earnings; or (ii) the bank's net income for its last three fiscal years, less the amount of any distributions made by the bank to its shareholders during such period. However, a bank, with the prior approval of the Commissioner of the California Department of Financial Institutions may make a distribution to its shareholders of an amount not to exceed the greater of (i) a bank's retained earnings; (ii) its net income for its last fiscal year; or (iii) its net income for the current fiscal year. Also with the prior approval of the Commissioner of the California Department of Financial Institutions and the shareholders of the bank, the bank may make a distribution to its shareholders, as a reduction in capital of the bank. In the event that the Commissioner determines that the shareholders' equity of a bank is inadequate or that the making of a distribution by a bank would be unsafe or unsound, the Commissioner may order a bank to refrain from making such a proposed distribution. At December 31, 2012, the amount available for such dividends

HERITAGE COMMERCE CORP
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

without prior regulatory approval was \$0 for HBC. Similar restrictions applied to the amount and sum of loan advances and other transfers of funds from HBC to the parent company.

(16) Parent Company only Condensed Financial Information

The condensed financial statements of Heritage Commerce Corp (parent company only) are as follows:

Condensed Balance Sheets

	December 31,	
	2012	2011
	(Dollars in thousands)	
Assets		
Cash and cash equivalents	\$ 11,193	\$ 24,347
Investment in subsidiary bank	164,949	195,041
Investment in subsidiary trusts	279	702
Other assets	2,650	2,246
Total assets	\$179,071	\$222,336
Liabilities and Shareholder's Equity		
Subordinated debt	\$ 9,279	\$ 23,702
Other liabilities	51	803
Shareholder's equity	169,741	197,831
Total liabilities and shareholder's equity	\$179,071	\$222,336

Condensed Statements of Operations

	For the Year Ended December 31,		
	2012	2011	2010
	(Dollars in thousands)		
Interest income	\$ 1	\$ 10	\$ 13
Dividend from subsidiary bank	45,000	—	—
Interest expense	(1,383)	(1,871)	(1,878)
Other expenses	(2,615)	(2,232)	(2,500)
Income (loss) before income taxes and undistributed net income (loss) of subsidiary bank	41,003	(4,093)	(4,365)
Equity in net income (loss) of subsidiary bank:			
Reduction in contributed capital and distribution from subsidiary bank	(45,000)	—	—
Net income (loss) of subsidiary bank	12,710	14,348	(52,184)
Income tax benefit	1,196	1,116	692
Net income (loss)	9,909	11,371	(55,857)
Dividends and discount accretion on preferred stock	(1,206)	(2,333)	(2,398)
Net income (loss) available to common shareholders	\$ 8,703	\$ 9,038	\$(58,255)

HERITAGE COMMERCE CORP
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Condensed Statements of Cash Flows

	<u>For the Year Ended December 31,</u>		
	<u>2012</u>	<u>2011</u>	<u>2010</u>
	(Dollars in thousands)		
Cash flows from operating activities:			
Net Income (loss)	\$ 9,909	\$ 11,371	\$(55,857)
Adjustments to reconcile net income (loss) to net cash provided by (used in) operations:			
Amortization of restricted stock award, net of forfeitures and taxes	148	75	89
Equity in undistributed loss/(net income) of subsidiary bank	32,290	(14,348)	52,184
Net change in other assets and liabilities	<u>(733)</u>	<u>(1,182)</u>	<u>1,396</u>
Net cash provided by (used in) operating activities	41,614	(4,084)	(2,188)
Cash flows from investing activities:			
Equity investment in subsidiary bank	—	—	(40,000)
Cash flows from financing activities:			
Repayment of subordinated debt	(14,423)	—	—
Payment of cash dividends — preferred stock	(373)	(4,672)	—
Repayment of preferred stock	(40,000)	—	—
Issuance of common stock, net of issuance costs	28	—	—
Issuance of preferred stock, net of issuance costs	<u>—</u>	<u>—</u>	<u>69,698</u>
Net cash provided by (used in) financing activities	<u>(54,768)</u>	<u>(4,672)</u>	<u>69,698</u>
Net increase (decrease) in cash and cash equivalents . .	(13,154)	(8,756)	27,510
Cash and cash equivalents, beginning of year	<u>24,347</u>	<u>33,103</u>	<u>5,593</u>
Cash and cash equivalents, end of year	<u>\$ 11,193</u>	<u>\$ 24,347</u>	<u>\$ 33,103</u>

HERITAGE COMMERCE CORP
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(17) Quarterly Financial Data (Unaudited)

The following table discloses the Company's selected unaudited quarterly financial data:

	For the Quarter Ended			
	12/31/12	09/30/12	06/30/12	03/31/12
	(Dollars in thousands, except per share amounts)			
Interest income	\$12,958	\$12,862	\$13,296	\$13,449
Interest expense	747	1,038	1,212	1,190
Net interest income	12,211	11,824	12,084	12,259
Provision for loan losses	669	1,200	815	100
Net interest income after provision for loan losses	11,542	10,624	11,269	12,159
Noninterest income	2,104	2,948	2,090	1,723
Noninterest expense	9,799	10,147	9,454	10,856
Income before income taxes	3,847	3,425	3,905	3,026
Income tax expense	1,178	939	1,226	951
Net income	2,669	2,486	2,679	2,075
Dividends and discount accretion on preferred stock(1)	—	—	—	(1,206)
Net income available to common shareholders	<u>\$ 2,669</u>	<u>\$ 2,486</u>	<u>\$ 2,679</u>	<u>\$ 869</u>
Earnings per common share				
Basic	\$ 0.08	\$ 0.08	\$ 0.08	\$ 0.03
Diluted	\$ 0.08	\$ 0.08	\$ 0.08	\$ 0.03

- (1) The Company repurchased the \$40 million of Series A preferred stock issued to the U.S. Treasury Department under the TARP Capital Purchase Program during the first quarter of 2012. The Series A Preferred Stock was initially recorded at a discount, and the repurchase accelerated the accretion of the remaining discount on the Series A Preferred Stock. While the accelerated accretion did not impact net income, it resulted in a one-time non-cash reduction in net income available to common shareholders of approximately \$765,000 in the first quarter of 2012. Total dividends and discount accretion on the Series A Preferred Stock, including the accelerated accretion, reduced net income available to common shareholders by \$1.2 million in the first quarter of 2012.

HERITAGE COMMERCE CORP
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

	For the Quarter Ended			
	12/31/11	09/30/11	06/30/11	03/31/11
	(Dollars in thousands, except per share amounts)			
Interest income	\$13,010	\$13,020	\$13,015	\$12,986
Interest expense	1,222	1,320	1,543	1,790
Net interest income	11,788	11,700	11,472	11,196
Provision for loan losses	1,230	1,515	955	770
Net interest income after provision for loan losses	10,558	10,185	10,517	10,426
Noninterest income	2,423	1,912	2,170	1,917
Noninterest expense	9,860	9,809	9,472	10,431
Income before income taxes	3,121	2,288	3,215	1,912
Income tax expense (benefit)(1)	234	(2,529)	1,129	331
Net income	2,887	4,817	2,086	1,581
Dividends and discount accretion on preferred stock	(601)	(532)	(604)	(596)
Net income available to common shareholders	<u>\$ 2,286</u>	<u>\$ 4,285</u>	<u>\$ 1,482</u>	<u>\$ 985</u>
Earnings (loss) per common share				
Basic	\$ 0.07	\$ 0.13	\$ 0.05	\$ 0.03
Diluted	\$ 0.07	\$ 0.13	\$ 0.05	\$ 0.03

(1) The Company eliminated a partial valuation allowance on its deferred tax asset during the third and fourth quarters of 2011.

EXHIBIT INDEX

<u>Exhibit Number</u>	<u>Description</u>
2.1	Agreement and Plan of Merger, dated February 8, 2007, by and between Heritage Commerce Corp, Heritage Bank of Commerce and Diablo Valley Bank (incorporated by reference from the Registrant's Annual Report on Form 10-K filed on March 16, 2007)
3.1	Restated Articles of Incorporation of Heritage Commerce Corp (incorporated by reference from the Registrant's Annual Report on Form 10-K filed on March 16, 2009)
3.2	Certificate of Amendment of Articles of Incorporation of Heritage Commerce Corp, as filed with the California Secretary of State on June 1, 2010 (incorporated by reference from the Registration Statement on Form S-1 filed July 23, 2010)
3.3	Bylaws, as amended, of Heritage Commerce Corp (incorporated by reference from the Registration Statement on Form S-1 filed July 23, 2010)
4.1	Indenture, dated as of July 31, 2001, between Heritage Commerce Corp, as Issuer, and State Street Bank and Trust Company of Connecticut, National Association, as Trustee (incorporated herein by reference from the Registrant's Annual Report on Form 10-K filed March 29, 2002)
4.2	Amended and Restated Declaration of Trust by and among State Street Bank and Trust Company of Connecticut, National Association as Institutional Trustee, and Heritage Commerce Corp, as Sponsor, dated as of July 31, 2001 (incorporated herein by reference from the Registrant's Form 10-K filed March 29, 2002)
4.3	Indenture, dated as of September 26, 2002, between Heritage Commerce Corp, as Issuer, and State Street Bank and Trust Company of Connecticut, National Association, as Trustee (incorporated herein by reference from the Registrant's Annual Report on Form 10-K filed March 29, 2003)
4.4	Amended and Restated Declaration of Trust by and among State Street Bank and Trust Company of Connecticut, National Association, as Institutional Trustee and Heritage Commerce Corp, as Sponsor, dated as of September 26, 2002 (incorporated herein by reference from the Registrant's Annual Report on Form 10-K filed March 29, 2003)
4.5	Warrant to Purchase Common Stock dated November 21, 2008 (incorporated herein by reference from the Registrant's Current Report on Form 8-K filed November 26, 2008)
4.6	Certificate of Determination of Series C Convertible Perpetual Preferred Stock, as filed with the California Secretary of State on June 17, 2010 (incorporated herein by reference from the Registrant's Current Report on Form 8-K as filed June 22, 2010)
10.1	Real Property Leases for Registrant's Principle Office (incorporated herein by reference from the Registrant's Current Report on Form 8-K filed March 5, 1998)
10.2	Third Amendment to Lease for Registrant's Principle Office (incorporated herein by reference from the Registrant's Current Report on Form 8-K filed August 17, 2005)
10.3	Fourth Amendment to Lease for Registrant's Principle Office (incorporated herein by reference from the Registrant's Current Report on Form 8-K filed August 17, 2005)
10.4	Fourth Amendment to Sublease for Registrant's Principle Office (incorporated herein by reference from the Registrant's Current Report on Form 8-K filed June 22, 2005)

Exhibit Number	Description
*10.5	Heritage Commerce Corp Management Incentive Plan (incorporated herein by reference from the Registrant's Current Report on Form 8-K filed May 3, 2005)
*10.6	1994 Stock Option Plan and Form of Agreement (incorporated herein by reference from the Registrant's Registration Statement on Form S-8 filed July 17, 1998)
*10.7	Amended and Restated 2004 Equity Plan (incorporated herein by reference from the Registrant's Current Report on Form 8-K filed June 2, 2009)
*10.8	Restricted Stock Agreement with Walter Kaczmarek dated March 17, 2005 (incorporated herein by reference from the Registrant's Current Report on Form 8-K filed March 22, 2005)
*10.9	2004 Stock Option Agreement with Walter Kaczmarek dated March 17, 2005 (incorporated herein by reference from the Registrant's Current Report on Form 8-K filed March 22, 2005)
*10.10	Non-qualified Deferred Compensation Plan (incorporated herein by reference from the Registrant's Annual Report on Form 10-K filed March 31, 2005)
*10.11	Amended and Restated Employment Agreement with Walter Kaczmarek, dated October 17, 2007 (incorporated herein by reference from the Registrant's Current Report on Form 8-K filed October 22, 2007)
*10.12	Amended and Restated Employment Agreement with Lawrence McGovern, dated July 21, 2011 (incorporated herein by reference from the Registrant's Current Report on Form 8-K filed July 21, 2011)
*10.13	Employment Agreement with Dan T. Kawamoto, dated June 11, 2009 (incorporated herein by reference from the Registrant's Current Report on Form 8-K filed June 16, 2009)
*10.14	Employment Agreement with Michael E. Benito, dated February 1, 2012 (incorporated by reference from the Registrant's Current Report on Form 8-K filed February 1, 2012)
*10.15	Employment Agreement with David Porter, dated June 25, 2012 (incorporated by reference from the Registrant's Current Report on Form 8-K filed June 25, 2012)
*10.16	Form of Stock Option Agreement For Amended and Restated 2004 Equity Plan (incorporated by reference from the Registrant's Annual Report on Form 10-K filed March 9, 2011)
*10.17	Form of Restricted Stock Agreement For Amended and Restated 2004 Equity Plan (incorporated by reference from the Registrant's Annual Report on Form 10-K filed March 9, 2011)
*10.18	2005 Amended and Restated Heritage Commerce Corp Supplemental Retirement Plan (incorporated herein by reference from the Registrant's Current Report on Form 8-K filed September 30, 2008)
*10.19	Form of Endorsement Method Split Dollar Plan Agreement for Executive Officers (incorporated herein by reference from the Registrant's Annual Report on Form 10-K filed March 17, 2008)
*10.20	Form of Endorsement Method Split Dollar Plan Agreement for Directors (incorporated herein by reference from the Registrant's Annual Report on Form 10-K filed March 17, 2008)

Exhibit Number	Description
*10.21	Amendment No. 1 to Employment Agreement, dated December 29, 2008 between the Company and Walter T. Kaczmarek (incorporated herein by reference from the Registrant's Current Report on Form 8-K filed January 2, 2009)
*10.22	First Amended and Restated Director Compensation Benefits Agreement dated December 29, 2008 between Jack Conner and the Company (incorporated herein by reference from the Registrant's Current Report on Form 8-K filed January 2, 2009)
*10.23	First Amended and Restated Director Compensation Benefits Agreement dated December 29, 2008 between Frank Bisceglia and the Company (incorporated herein by reference from the Registrant's Current Report on Form 8-K filed January 2, 2009)
*10.24	First Amended and Restated Director Compensation Benefits Agreement dated December 29, 2008 between Robert Moles and the Company (incorporated herein by reference from the Registrant's Current Report on Form 8-K filed January 2, 2009)
*10.25	First Amended and Restated Director Compensation Benefits Agreement dated December 29, 2008 between Humphrey Polanen and the Company (incorporated herein by reference from the Registrant's Current Report on Form 8-K filed January 2, 2009)
*10.26	First Amended and Restated Director Compensation Benefits Agreement dated December 29, 2008 between Charles Toeniskoetter and the Company (incorporated herein by reference from the Registrant's Current Report on Form 8-K filed January 2, 2009)
*10.27	First Amended and Restated Director Compensation Benefits Agreement dated December 29, 2008 between Ranson Webster and the Company (incorporated herein by reference from the Registrant's Current Report on Form 8-K filed January 2, 2009)
10.28	Letter Agreement dated November 21, 2008 between the Company and United States Treasury for Fixed Rate Cumulative Perpetual Preferred Stock, Series A and Warrant for Common Stock (incorporated herein by reference from the Registrant's Current Report on Form 8-K filed November 26, 2008)
10.29	Form of Indemnification Agreement between the Registrant and its directors and executive officers (incorporated herein by reference from the Registrant's Current Report on Form 8-K filed December 23, 2009)
10.30	Securities Purchase Agreement between the Company and each of the Purchasers, dated as of June 18, 2010 (incorporated herein from the Registrant's Current Report on Form 8-K as filed June 22, 2010)
10.31	Registration Rights Agreement between the Company and each of the Purchasers, dated as of June 18, 2010 (incorporated herein from the Registrant's Current Report on Form 8-K as filed June 22, 2010)
12.1	Calculation of consolidated ratio of earnings to fixed charges and consolidated ratio of earnings to fixed charges and preferred stock dividends
21.1	Subsidiaries of Registrant (incorporated by reference from the Registrant's Annual Report on Form 10-K filed March 16, 2007)
23.1	Consent of Crowe Horwath LLP
31.1	Certification of Registrant's Chief Executive Officer Pursuant to Section 302 of the Sarbanes Oxley Act of 2002

Exhibit Number	Description
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
99.1	Certification of Registrant's Chief Executive Officer Pursuant to the Section 111(6)(4) of the Emergency Economic Stabilization Act of 2008, as amended
99.2	Certification of Registrant's Chief Financial Officer Pursuant to the Section 111(6)(4) of the Emergency Economic Stabilization Act of 2008, as amended
101.INS	XBRL Instance Document, furnished herewith
101.SCH	XBRL Taxonomy Extension Schema Document, furnished herewith
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document, furnished herewith
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document, furnished herewith
101.LAB	XBRL Taxonomy Extension Label Linkbase Document, furnished herewith
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document, furnished herewith

* Management contract or compensatory plan or arrangement.

**CERTIFICATIONS UNDER SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002
REGARDING THE ANNUAL REPORT ON FORM 10-K
FOR THE YEAR ENDED DECEMBER 31, 2012**

I, Walter T. Kaczmarek, certify that:

1. I have reviewed this Annual Report on Form 10-K for the Year Ended December 31, 2012 of Heritage Commerce Corp;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

(a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

(b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

(c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

(d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

(a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

(b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

/s/ WALTER T. KACZMAREK

Walter T. Kaczmarek
President and Chief Executive Officer
Heritage Commerce Corp

Date: March 8, 2013

**CERTIFICATIONS UNDER SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002
REGARDING THE ANNUAL REPORT ON FORM 10-K
FOR THE YEAR ENDED DECEMBER 31, 2012**

I, Lawrence D. McGovern, certify that:

1. I have reviewed this Annual Report on Form 10-K for the Year Ended December 31, 2012 of Heritage Commerce Corp;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

(a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

(b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

(c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

(d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

(a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

(b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

/s/ LAWRENCE D. MCGOVERN

Lawrence D. McGovern
Executive Vice President and Chief Financial Officer
Heritage Commerce Corp

Date: March 8, 2013

**CERTIFICATION PURSUANT TO
18 U.S.C. SECTION 1350,
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002
REGARDING THE ANNUAL REPORT ON FORM 10-K
FOR THE YEAR ENDED DECEMBER 31, 2012**

In connection with the Annual Report of Heritage Commerce Corp (the “Company”) on Form 10-K for the year ended December 31, 2012 as filed with the Securities and Exchange Commission on the date hereof (the “Report”), I, Walter T. Kaczmarek, Chief Executive Officer of the Company, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

- (1) The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

/s/ WALTER T. KACZMAREK

Walter T. Kaczmarek
President and Chief Executive Officer
Heritage Commerce Corp

March 8, 2013

**CERTIFICATION PURSUANT TO
18 U.S.C. SECTION 1350,
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002
REGARDING THE ANNUAL REPORT ON FORM 10-K
FOR THE YEAR ENDED DECEMBER 31, 2012**

In connection with the Annual Report of Heritage Commerce Corp (the “Company”) on Form 10-K for the year ended December 31, 2012 as filed with the Securities and Exchange Commission on the date hereof (the “Report”), I, Lawrence D. McGovern, Chief Financial Officer of the Company, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

- (1) The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

/s/ LAWRENCE D. MCGOVERN

Lawrence D. McGovern
Executive Vice President and Chief Financial Officer
Heritage Commerce Corp

March 8, 2013

**CERTIFICATION PURSUANT TO SECTION 111(b)(4)
OF THE EMERGENCY ECONOMIC STABILIZATION
ACT OF 2008, AS AMENDED**

(PRINCIPAL EXECUTIVE OFFICER)

CERTIFICATION

**Heritage Commerce Corp
UST #0055**

I, Walter T. Kaczmarek, certify, based on my knowledge, that:

(i) The compensation committee of Heritage Commerce Corp (“the Company”) has discussed, reviewed, and evaluated with senior risk officers at least every six months during any part of the most recently completed fiscal year that was a TARP period, the senior executive officer (“SEO”) compensation plans and the employee compensation plans and the risks these plans pose to the Company.

(ii) The compensation committee of the Company has identified and limited during any part of the most recently completed fiscal year that was a TARP period, any features of the SEO compensation plans that could lead SEOs to take unnecessary and excessive risks that could threaten the value of the Company, and has identified any features of the employee compensation plans that pose risks to the Company and has limited those features to ensure that the Company is not unnecessarily exposed to risks;

(iii) The compensation committee has reviewed at least every six months during any part of the most recently completed fiscal year that was a TARP period, the terms of each employee compensation plan and identified any features of the plan that could encourage the manipulation of reported earnings of the Company to enhance the compensation of an employee, and has limited these features;

(iv) The compensation committee of the Company will certify to the reviews of the SEO compensation plans and employee compensation plans required under (i) and (iii) above;

(v) The compensation committee of the Company will provide a narrative description of how it limited during any part of the most recently completed fiscal year that was a TARP period the features in:

(A) SEO compensation plans that could lead SEOs to take unnecessary and excessive risks that could threaten the value of the Company;

(B) Employee compensation plans that unnecessarily expose the Company to risks; and

(C) Employee compensation plans that could encourage the manipulation of reported earnings of the Company to enhance the compensation of an employee;

(vi) The Company has required that bonus payments to SEOs or any of the next twenty most highly compensated employees, as defined in the regulations and guidance established under section 111 of EESA, be subject to a recovery or “clawback” provision during any part of the most recently completed fiscal year that was a TARP period if the bonus payments were based on materially inaccurate financial statements or any other materially inaccurate performance metric criteria;

(vii) The Company has prohibited any golden parachute payment, as defined in the regulations and guidance established under section 111 of EESA, to a SEO or any of the next five most highly compensated employees during any part of the most recently completed fiscal year that was a TARP period;

(viii) The Company has limited bonus payments to its applicable employees in accordance with section 111 of EESA and the regulations and guidance established thereunder during any part of the most recently completed fiscal year that was a TARP period;

(ix) The Company and its employees have complied with the excessive or luxury expenditures policy, as defined in the regulations and guidance established under section 111 of EESA, during any part of the most recently completed fiscal year that was a TARP period; and any expenses that, pursuant to the policy, required approval of the board of directors, a committee of the board of directors, an SEO, or an executive officer with a similar level of responsibility were properly approved;

(x) The Company permitted a non-binding shareholder resolution in compliance with any applicable federal securities rules and regulations on the disclosures provided under the federal securities laws related to SEO compensation paid or accrued during any part of the most recently completed fiscal year that was a TARP period;

(xi) The Company will disclose the amount, nature, and justification for the offering, during any part of the most recently completed fiscal year that was a TARP period, of any perquisites, as defined in the regulations and guidance established under section 111 of EESA, whose total value exceeds \$25,000 for any employee subject to the bonus payment limitations identified in paragraph (viii);

(xii) The Company will disclose whether the Company, the board of directors of the Company, or the compensation committee of the Company has engaged during any part of the most recently completed fiscal year that was a TARP period a compensation consultant; and the services the compensation consultant or any affiliate of the compensation consultant provided during this period;

(xiii) The Company has prohibited the payment of any gross-ups, as defined in the regulations and guidance established under section 111 of EESA, to the SEOs and the next twenty most highly compensated employees during any part of the most recently completed fiscal year that was a TARP period;

(xiv) The Company has substantially complied with all other requirements related to employee compensation that are provided in the agreement between the Company and Treasury, including any amendments;

(xv) The Company is not required to submit to Treasury a complete and accurate list of the SEOs and the twenty next most highly compensated employees for the current fiscal year, with the non-SEO ranked in descending order of level of annual compensation, and with the name, title, and employer of each SEO and most highly compensated employee identified because no part of the current fiscal year was or will be a TARP period; and

(xvi) I understand that a knowing and willful false or fraudulent statement made in connection with this certification may be punished by fine, imprisonment, or both.

Dated: March 8, 2013

/s/ WALTER T. KACZMAREK

Walter T. Kaczmarek
President and Chief Executive Officer
Heritage Commerce Corp

**CERTIFICATION PURSUANT TO SECTION 111(b)(4)
OF THE EMERGENCY ECONOMIC STABILIZATION
ACT OF 2008, AS AMENDED**

(PRINCIPAL EXECUTIVE OFFICER)

CERTIFICATION

**Heritage Commerce Corp
UST #0055**

I, Lawrence D. McGovern, certify, based on my knowledge, that:

(i) The compensation committee of Heritage Commerce Corp (“the Company”) has discussed, reviewed, and evaluated with senior risk officers at least every six months during any part of the most recently completed fiscal year that was a TARP period, the senior executive officer (“SEO”) compensation plans and the employee compensation plans and the risks these plans pose to the Company.

(ii) The compensation committee of the Company has identified and limited during any part of the most recently completed fiscal year that was a TARP period, any features of the SEO compensation plans that could lead SEOs to take unnecessary and excessive risks that could threaten the value of the Company, and has identified any features of the employee compensation plans that pose risks to the Company and has limited those features to ensure that the Company is not unnecessarily exposed to risks;

(iii) The compensation committee has reviewed at least every six months during any part of the most recently completed fiscal year that was a TARP period, the terms of each employee compensation plan and identified any features of the plan that could encourage the manipulation of reported earnings of the Company to enhance the compensation of an employee, and has limited these features;

(iv) The compensation committee of the Company will certify to the reviews of the SEO compensation plans and employee compensation plans required under (i) and (iii) above;

(v) The compensation committee of the Company will provide a narrative description of how it limited during any part of the most recently completed fiscal year that was a TARP period the features in:

(A) SEO compensation plans that could lead SEOs to take unnecessary and excessive risks that could threaten the value of the Company;

(B) Employee compensation plans that unnecessarily expose the Company to risks; and

(C) Employee compensation plans that could encourage the manipulation of reported earnings of the Company to enhance the compensation of an employee;

(vi) The Company has required that bonus payments to SEOs or any of the next twenty most highly compensated employees, as defined in the regulations and guidance established under section 111 of EESA, be subject to a recovery or “clawback” provision during any part of the most recently completed fiscal year that was a TARP period if the bonus payments were based on materially inaccurate financial statements or any other materially inaccurate performance metric criteria;

(vii) The Company has prohibited any golden parachute payment, as defined in the regulations and guidance established under section 111 of EESA, to a SEO or any of the next five most highly compensated employees during any part of the most recently completed fiscal year that was a TARP period;

(viii) The Company has limited bonus payments to its applicable employees in accordance with section 111 of EESA and the regulations and guidance established thereunder during any part of the most recently completed fiscal year that was a TARP period;

(ix) The Company and its employees have complied with the excessive or luxury expenditures policy, as defined in the regulations and guidance established under section 111 of EESA, during any part of the most recently completed fiscal year that was a TARP period; and any expenses that, pursuant to the policy, required approval of the board of directors, a committee of the board of directors, an SEO, or an executive officer with a similar level of responsibility were properly approved;

(x) The Company permitted a non-binding shareholder resolution in compliance with any applicable federal securities rules and regulations on the disclosures provided under the federal securities laws related to SEO compensation paid or accrued during any part of the most recently completed fiscal year that was a TARP period;

(xi) The Company will disclose the amount, nature, and justification for the offering, during any part of the most recently completed fiscal year that was a TARP period, of any perquisites, as defined in the regulations and guidance established under section 111 of EESA, whose total value exceeds \$25,000 for any employee subject to the bonus payment limitations identified in paragraph (viii);

(xii) The Company will disclose whether the Company, the board of directors of the Company, or the compensation committee of the Company has engaged during any part of the most recently completed fiscal year that was a TARP period a compensation consultant; and the services the compensation consultant or any affiliate of the compensation consultant provided during this period;

(xiii) The Company has prohibited the payment of any gross-ups, as defined in the regulations and guidance established under section 111 of EESA, to the SEOs and the next twenty most highly compensated employees during any part of the most recently completed fiscal year that was a TARP period;

(xiv) The Company has substantially complied with all other requirements related to employee compensation that are provided in the agreement between the Company and Treasury, including any amendments;

(xv) The Company is not required to submit to Treasury a complete and accurate list of the SEOs and the twenty next most highly compensated employees for the current fiscal year, with the non-SEO ranked in descending order of level of annual compensation, and with the name, title, and employer of each SEO and most highly compensated employee identified because no part of the current fiscal year was or will be a TARP period; and

(xvi) I understand that a knowing and willful false or fraudulent statement made in connection with this certification may be punished by fine, imprisonment, or both.

Dated: March 8, 2013

/s/ LAWRENCE D. MCGOVERN

Lawrence D. McGovern
Executive Vice President and
Chief Financial Officer
Heritage Commerce Corp

Corporate Information

Board of Directors

Jack W. Conner, Chairman
Frank G. Bisceglia
John M. Eggemeyer
Celeste V. Ford
Steven L. Hallgrimson
Walter T. Kaczmarek
Robert T. Moles
Humphrey P. Polanen
Laura Roden
Charles J. Toeniskoetter
Ranson W. Webster
W. Kirk Wycoff

Executive Management

Walter T. Kaczmarek
President
Chief Executive Officer
Michael E. Benito
Executive Vice President
Banking Division
William J. Del Biaggio, Jr.
Executive Vice President
Marketing & Community Relations
Dan T. Kawamoto
Executive Vice President
Chief Administrative Officer
Lawrence D. McGovern
Executive Vice President
Chief Financial Officer
David E. Porter
Executive Vice President
Chief Credit Officer

Subsidiary Bank Offices **Heritage Bank of Commerce**

San Jose Main
150 Almaden Boulevard
San Jose, CA 95113
408.947.6900

Danville
387 Diablo Road
Danville, CA 94526
925.314.2851

Fremont
3137 Stevenson Boulevard
Fremont, CA 94538
510.445.0400

Gilroy
7598 Monterey Street
Suite 110
Gilroy, CA 95020
408.842.8310

Los Altos
419 S. San Antonio Road
Los Altos, CA 94022
650.941.9300

Los Gatos
15575 Los Gatos Boulevard
Building B
Los Gatos, CA 95032
408.356.6190

Morgan Hill
Cochrane Business Ranch
18625 Sutter Boulevard
Morgan Hill, CA 95037
408.778.2320

Mountain View
175 East El Camino Real
Mountain View, CA 94040
650.919.2159

Pleasanton
300 Main Street
Pleasanton, CA 94566
925.314.2876

Walnut Creek
101 Ygnacio Valley Road
Suite 100
Walnut Creek, CA 94596
925.930.9287

Heritage Commerce Corp **Investor Relations Contact**

Debbie K. Reuter
Senior Vice President
Corporate Secretary

Transfer Agent
Wells Fargo Bank, N.A.
Shareowner Services
1110 Centre Pointe Curve
Suite 101
Mendota Heights, MN 55120
1.800.468.9716

Independent Auditors

Crowe Horwath LLP
400 Capitol Mall
Suite 1200
Sacramento, CA 95814
916.441.1000

Corporate Counsel

Buchalter Nemer
A Professional Corporation
1000 Wilshire Boulevard
Suite 1500
Los Angeles, CA 90017
213.891.0700

To get further information on Heritage Commerce Corp, or to receive regular financial updates, please visit our web site at HeritageCommerceCorp.com and click on "Information Request."

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ANNUAL REPORT  2012  ON FORM 10-K

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HeritageCommerceCorp.com