Groupon, Inc.
Form DEF 14A
April 26, 2019

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

SCHEDULE 14A
Proxy Statement Pursuant to Section 14(a) of the Securities Exchange Act of 1934
(Amendment No.)

Filed by the Registrant ý Filed by a party other than the Registrant ¨
Check the appropriate box:
¨ Preliminary Proxy Statement

¨ Confidential, for Use of the Commission Only (as permitted by Rule 14a-6(e)(2))

ý Definitive Proxy Statement

¨ Definitive Additional Materials

¨ Soliciting Material under §240.14a-12
Groupon, Inc.
(Name of Registrant as Specified In Its Charter)

(Name of Person(s) Filing Proxy Statement, if other than the Registrant)
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2019 PROXY STATEMENT

ANNUAL MEETING OF STOCKHOLDERS
THE ANNUAL MEETING OF STOCKHOLDERS OF GROUPON, INC. WILL BE HELD
June 13, 2019 | 10:00am Central Time
Winston & Strawn LLP, 35 West Wacker Drive, Chicago, Illinois 60601

NASDAQ: GRPN / ir@groupon.com

LETTER FROM THE
CHAIRMAN
Dear Stockholder:LETTER FROM THE CHAIRMAN

I am pleased to invite you to attend the Annual Meeting of Stockholders of Groupon, Inc., which will be held at Winston & Strawn LLP, 35 West Wacker Drive, Chicago, Illinois 60601 on June 13, 2019 at 10:00 a.m. Central Time. Doors will open at 9:30 a.m. Central Time.

The attached Notice of Annual Meeting of Stockholders and proxy statement contain details of the business to be conducted at the Annual Meeting.

Whether or not you attend the Annual Meeting, it is important that your shares be represented and voted at the meeting. Therefore, I urge you to promptly vote and submit your proxy via the Internet, by phone, or by signing, dating and returning the enclosed proxy card in the enclosed envelope. If you decide to attend the Annual Meeting, you will be able to vote in person, even if you have previously submitted your proxy.

We urge you to read the accompanying proxy statement carefully and to vote "FOR" the director nominees proposed by the Board of Directors, "FOR" the ratification of Deloitte & Touche LLP as our independent registered public accounting firm for fiscal year 2019, "FOR" the advisory approval of our Named Executive Officer compensation in accordance with the recommendations of the Board of Directors, “FOR” the proposal to increase the number of authorized shares under the Company’s incentive plan, and “FOR” the proposal to increase the number of shares available for purchase under the Company’s employee stock purchase plan.

On behalf of the Board of Directors, I would like to express our appreciation for your interest in Groupon.

Sincerely,

Eric Lefkofsky
Chairman of the Board

NOTICE OF 2019 ANNUAL MEETING OF STOCKHOLDERS
TO BE HELD
June 13, 2019 | 10:00am Central Time
Winston & Strawn LLP, 35 West Wacker Drive, Chicago, Illinois 60601
ITEMS OF BUSINESS
1. To elect nine directors from the nominees named in this proxy statement.
2. To ratify the selection of Deloitte & Touche LLP ("Deloitte") as our independent registered public accounting firm for fiscal year 2019.
3. To conduct an advisory vote to approve our named executive officer compensation, as described in this proxy statement.
4. To approve an amendment to the Groupon, Inc. 2011 Incentive Plan, as amended (the "2011 Incentive Plan"), to, among other items, increase the number of authorized shares thereunder.
5. To approve an amendment to the Groupon, Inc. 2012 Employee Stock Purchase Plan, as amended (the "Purchase Plan"), to, among other items, increase the number of shares available for purchase thereunder.
6. To transact other business that may properly come before the Annual Meeting.

Record Date
April 18, 2019 (the "Record Date"). Only stockholders of record at the close of business on the Record Date are entitled to receive notice of, and to vote at, the Annual Meeting.
Admission
If you are a record holder, you must provide identification, and if you hold your shares through a broker, bank or other nominee, you must also provide proof of ownership.
Proxy Voting
IMPORTANT: Please vote your shares at your earliest convenience. This will ensure the presence of a quorum at the Annual Meeting. Promptly voting your shares via the Internet, by telephone, or by signing, dating, and returning the enclosed proxy card will save the expenses and efforts of additional solicitation. If you wish to vote by mail, we have enclosed an addressed envelope, postage prepaid if mailed in the United States. Submitting your proxy now will not prevent you from voting your shares in person at the Annual Meeting, as your proxy is revocable at your option as described in the proxy statement.
Important Notice Regarding the Availability of Proxy Materials for the Annual Meeting to Be Held on June 13, 2019. We are furnishing proxy materials to our stockholders primarily via the Internet, instead of mailing printed copies of those materials to each stockholder. By doing so, we save costs and reduce the environmental impact of our Annual Meeting. We will mail a Notice of Internet Availability of Proxy Materials to certain of our stockholders. This Notice contains instructions about how to access our proxy materials and vote online or vote by telephone. If you would like to receive a paper copy of our proxy materials, please follow the instructions included in the Notice of Internet Availability of Proxy Materials. If you previously chose to receive our proxy materials electronically, you will continue to receive access to these materials via e-mail unless you elect otherwise.
By order of the Board of Directors,
Dane Drobny
General Counsel and Corporate Secretary
Chicago, Illinois
April 26, 2019
The date of this proxy statement is April 26, 2019, and it is first being delivered to stockholders on or about April 30, 2019.

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BUSINESS SUMMARY

Groupon, Inc. ("Groupon") is a global leader in local commerce, making it easy for people around the world to search and discover great businesses and merchandise. Our vision is to connect local commerce, increasing consumer buying power while driving more business to merchants through value and discovery.

We want Groupon to be the destination that consumers check first when they are out and about; the place they start when they are looking to buy just about anything, anywhere, anytime. We provide consumers with value – whether that be savings, convenience or unmatched local selection – and help them discover amazing things to do, eat, see, buy and where to travel, rewarding them in the process.

By bringing the brick-and-mortar world of local commerce onto the Internet where it can be discovered, explored and transacted, Groupon serves as the connective tissue between local merchants and customers, ultimately helping build vibrant neighborhoods in the process. In the last decade Groupon has helped save consumers more than $30 billion and pumped more than $20 billion into local communities, as we've helped tens of thousands of small businesses grow and become part of the fabric of the places and people they serve.(1) All while selling more than 1.5 billion Groupons around the globe.

Community

Moreover, strong communities aren't just part of our business; they're part of our DNA. Our team is committed to making a difference in the places our customers, merchants and employees live and work. It's core to our company values and an essential element to the success of our business. We accomplish this through a "secret formula" of employee do-goodery, customer collaboration, nonprofit investment and responsible business practices.

In 2018 alone:

ü Programs supported 340 nonprofit partners across 130 unique and vibrant communities around the world.

ü Employees donated a record-breaking 35,000 volunteer hours -- more than doubling our hours donated to local communities year over year.

ü Engaged 58% of our global employees in at least one volunteer activity.

ü Reached more than 3,000 small businesses through cause marketing campaigns, small business accelerator programs and partnerships with neighborhood commercial districts.

ü Delivered more than $370,000 to local communities through neighborhood and small business development programs.

ü Served or donated 8,421,000 meals to food insecure families and individuals through volunteer events and charitable campaigns -- nearly 10x the meals donated and served in 2017.

ü Inspired more than 23,000 students to pursue pathways in science, technology, engineering and math by sponsoring the Museum of Science & Industry (Chicago) Summer Brain Games initiative and hosting Scout Out Engineering events.

(1) As of December 31, 2018.

CORPORATE GOVERNANCE AT GROUPON

Election of Directors

As stockholders, you have the right to elect our Board of Directors (the “Board”). The Board is nominating nine nominees for election. Information to inform your vote is set forth below:

- Groupon Corporate Governance Principles & Highlights
- Board of Director Biographies
- How the Board is Selected and Evaluated
- How the Board is Organized and Governs
- How to Communicate with the Board
- Board Compensation

Groupon Corporate Governance Principles & Highlights

We believe our corporate governance practices promote the long-term interests of our stockholders, as well as maintain internal checks and balances, strengthen management accountability, engender public trust and foster responsible decision making and accountability. We regularly evaluate our corporate governance practices and policies in order to maintain a strong governance framework designed to meet these goals. In addition, our Nominating and Corporate Governance Committee ("Nominating Committee") periodically reviews evolving legal and regulatory developments and governance best practices to determine those that it believes will best serve the interests of our stockholders. Highlights of our corporate governance framework include:

Board of Directors

- Majority of Board of Directors independent (8 of 9 directors)
- Directors have diverse experience, including e-commerce and technology, marketing and advertising, finance and accounting, M&A, international and public company service
- 22% of Board of Directors comprised of women
- Independent directors meet regularly without management present
- Audit, Compensation and Nominating Committees comprised entirely of independent directors
- Director stock ownership and holding guidelines

Stockholder Voting

- Annual director elections; no classified board
- Single class of voting common stock
- Directors may be removed with or without cause
- No supermajority requirements to approve mergers or other business combinations or charter amendments
- Annual Say on Pay vote (78% of votes cast “FOR” in 2018)
- No stockholder rights plan adopted

Audit & Risk Oversight

- All members of the Audit Committee are audit committee financial experts under SEC rules
- Enterprise Risk Management program

BOARD OF DIRECTOR BIOGRAPHIES

The Board is nominating nine nominees for election. Information about the professional backgrounds, qualification and other board memberships of our nominees is set forth below.

Rich Williams Director and Chief Executive Officer	Experience • Groupon Director and Chief Executive Officer (2015-present); Chief Operating Officer (2015); President, North America (2014-2015); Senior Vice President, Marketing (2011-2014) • Mr. Williams served in a variety of marketing leadership roles at Amazon.com, Inc. (NASDAQ: AMZN) from 2008-2011, including most recently as Director, Paid Traffic • Mr. Williams served in a variety of sales and marketing leadership roles at Experian plc (LSE: EXPN) from 2000-2007 Qualifications • Public Company CEO • Technology / E-commerce • Marketing / Advertising • International Mr. Williams brings to the Board substantial experience gained from leadership positions in sales, marketing and operations at Groupon and several public companies in the e-commerce and information services industries.
Eric Lefkofsky Chairman of the Board and Independent Director	Experience • Groupon co-founder; Chairman of the Board (2015-present); Director and Chief Executive Officer (2013-2015); Office of the Chief Executive (2013); Executive Chairman (2008-2013) • Co-founder and CEO at Tempus, a leading provider of technology-enabled precision medicine solutions • Co-founder and former managing partner of Lightbank, LLC, a private investment firm specializing in information technology companies • Co-founder of Echo Global Logistics, Inc. (NASDAQ: ECHO), a technology-enabled transportation and logistics outsourcing firm • Co-founder of InnerWorkings, Inc. (NASDAQ:INWK), a global provider of managed print and promotional solutions • Founding investor of Uptake Technologies, a leading predictive analytics platform Other • Lurie Children's Hospital, Chicago, Trustee • Steppenwolf Theatre, Chicago, Chairman of the Board of Trustees • Art Institute of Chicago, Trustee • Museum of Science and Industry, Chicago, Trustee • World Business Chicago, Member of the Board of Directors • University of Chicago Booth School of Business, Adjunct Professor Qualifications • Technology / E-commerce • Marketing / Advertising • Public Company CEO • International • Audit / Finance

Mr. Lefkofsky brings to the Board an in-depth knowledge and understanding of the Company's business and operations, as one of its founders and former Chief Executive Officer, as well as expertise gained through experience as a leading entrepreneur and innovator in the technology industry.

Michael Angelakis Independent Director Member, Audit Committee	Experience • Groupon Director since 2016 (elected pursuant to the terms of an Investment Agreement, dated as of April 3, 2016, between Groupon and A-G Holdings, L.P., an affiliate of Atairos) • Atairos Management, L.P., Chairman and Chief Executive Officer (2015-present) • Comcast Corporation (NASDAQ:CMCSA), senior advisor to the Executive Management Committee; former Vice Chairman and Chief Financial Officer • Former Managing Director and a member of the Management and Investment Committees of Providence Equity Partners, a private equity firm investing in technology, media and communications companies • Former senior executive roles in the media and telecommunications industries, including Chief Executive Officer of State Cable TV Corporation and Chief Executive Officer of Aurora Telecommunications; former Vice President at Manufacturers Hanover Trust Company • Director, Hewlett Packard Enterprise Company (NYSE: HPE) • Director, TriNet Group, Inc. (NYSE: TNET) • Former Director, Duke Energy Corporation (NYSE: DUK) (2015-2017) • Director of several private communications and technology companies Other • Former Chairman of the Board, Federal Reserve Bank of Philadelphia • Former Trustee, Babson College Qualifications • Technology / E-commerce • Public Company CFO • International • Audit / Finance Mr. Angelakis brings to the Board extensive investment, financial and managerial experience and leadership gained through his senior management roles in the media and telecommunications industries, including as the chief financial officer of a public company, as well as experience as a director of other public companies.
Peter Barris Independent Director Chair, Compensation Committee	Experience • Groupon Director since 2008 (originally appointed to the Board pursuant to a general voting agreement, which terminated as a result of our initial public offering) • New Enterprise Associates, a global venture capital fund investing in technology and healthcare, Chairman and General Partner (2017-present); Managing General Partner (1999-2017) • Director of several private internet and technology companies and charitable organizations Other • Northwestern University, Vice Chairman of the Board of Trustees Qualifications & Skills • Technology / E-commerce • International • Audit / Finance Mr. Barris brings to the Board sophisticated knowledge of information technology companies that includes investments in over twenty-five information technology companies that have completed public offerings or successful mergers as well as experience serving as a director of several public companies.

Robert Bass Independent Director Chair, Audit Committee Member, Compensation Committee	Experience • Groupon Director since 2012 • Deloitte & Touche LLP, a global firm providing audit, consulting, tax and advisory services; Vice Chairman (2006-2012); Partner (1982-2012); specializing in e-commerce, mergers and acquisitions, SEC filings and related issues • While at Deloitte, Mr. Bass was responsible for all services provided to Forstmann Little and its portfolio companies and was the advisory partner for Blackstone, DIRECTV, 24 Hour Fitness, McKesson, IMG and CSC. Mr. Bass also served as advisory partner for RR Donnelley, Automatic Data Processing, Community Health Systems, and Avis Budget • Former Director and chairman of the risk and audit committee, Sims Metal Management (ASX: SGM.AX) (2013-2018) • Former director and chairman of the audit committee of NewPage Corporation (2013-2015) • Director and chairman of the audit committee of Redfin Corporation (NASDAQ: RDFN) • Director and member of the audit committee of Apex Tool Group, LLC • Trustee, Blackstone GSO Secured Lending Fund Other • Certified public accountant licensed in New York and Connecticut • Member of the American Institute of Certified Public Accountants and the Connecticut State Society of Certified Public Accountants Qualifications & Skills • Technology / E-commerce • International • Audit / Finance Mr. Bass brings to the Board a wealth of experience and knowledge of public company financial reporting and accounting, including with respect to companies in the e-commerce sector, and his experience at the highest levels of a Big Four accounting firm is an invaluable resource to the Board in its oversight of the Company's financial statements and SEC filings.
Theodore Leonsis Independent Director Chair, Nominating and Corporate Governance Committee	Experience • Groupon Director (2009-present); Lead Independent Director (2015-2019); Chairman of the Board (2013-2015); Office of the Chief Executive (2013); Vice Chairman (2011-2013) • Chairman and Chief Executive Officer of Monumental Sports & Entertainment, LLC, a sports and entertainment company that owns the NBA's Washington Wizards, the NHL's Washington Capitals, the WNBA's Washington Mystics and the Verizon Center in Washington, D.C. (2009-present) • Mr. Leonsis served as Vice Chairman Emeritus at AOL, LLC, and in a number of executive positions including Vice Chairman and President, AOL Audience Business (1993-2006) • Co-founder and partner, Revolution Growth Fund II, a private investment firm • Director, American Express Co. (NYSE: AXP) • Director of several private internet and technology companies and charitable organizations Qualifications • Technology / E-commerce • Marketing / Advertising • International

- Audit / Finance

Mr. Leonsis brings to the Board in-depth experience in digital businesses and innovative approaches, as well as expertise in identifying business opportunities and driving new strategies based on changing technologies, social media and the Internet.

Joseph Levin Independent Director Member, Compensation Committee	Experience • Groupon Director since 2017 • Chief Executive Officer and director of IAC/InteractiveCorp (NASDAQ: IAC), a media and internet company with more than 150 brands and products (2015-present) • Various senior leadership roles at IAC from 2003-2012, including Chief Executive Officer of IAC Search and Applications; Chief Executive Officer of Mindspark Interactive Network, an IAC subsidiary; and SVP, Mergers and Acquisitions and Finance • Prior to joining IAC, Mr. Levin worked in the Technology Mergers & Acquisitions group for Credit Suisse First Boston (now Credit Suisse) • Chairman of the Board of Directors, Match Group, Inc., an IAC controlled company • Chairman of the Board of Directors, ANGI Homeservices Inc., an IAC controlled company Other • Undergraduate Executive Board of Wharton School Qualifications • Technology / E-commerce • Marketing / Advertising • Public Company CEO • International • Audit / Finance Mr. Levin brings to the Board substantial e-commerce and technology industry experience, including as the chief executive officer of a public company, as well as experience as a director of other public companies.
Deborah Wahl Independent Director Member, Nominating and Corporate Governance Committee	Experience • Groupon Director since 2017 • Chief Marketing Officer of Cadillac, a brand of General Motors Company (NYSE: GM) (2018-present) • Chief Marketing Officer of McDonald's Corporation (NYSE: MCD) (2014-2017) • Chief Marketing Officer of PulteGroup, Inc. (NYSE: PHM), a homebuilding company (2009-2014) • Marketing leadership roles at Chrysler LLC, Toyota Motor Corporation (NYSE: TM), and Ford Motor Company (NYSE: F) • Director, media software company Mediaocean Other • Vice Chair, Association of National Advertisers Qualifications • Technology / E-commerce • Marketing / Advertising • International Ms. Wahl brings to the Board substantial experience in brand and consumer marketing gained from chief marketing officer and other leadership positions at several public companies.

Ann Ziegler
Independent Director

Member, Audit Committee

Member, Nominating and Corporate Governance Committee

Experience
- Groupon Director since 2014
- Senior Vice President and Chief Financial Officer of CDW Corp., a technology solutions provider (NASDAQ: CDW) (2008-2017)
- A number of executive roles at Sara Lee Corporation (1993-2008), a global consumer goods company, in finance, mergers and acquisitions, strategy, and general management, including Chief Financial Officer and Senior Vice President of Administration for Sara Lee Food and Beverage from 2005-2008
- Prior to joining Sara Lee, Ms. Ziegler was a corporate attorney at Skadden, Arps, Slate, Meagher & Flom
- Director, Hanesbrands (NYSE: HBI)
- Director, Wolters Kluwer N.V. (AEX: WKL)
- Director and audit committee member, US Foods Holding Corp. (NYSE: USFD)

Other
- Revolution Foods, Member of the Board of Directors

Qualifications
- Technology / E-commerce
- Public Company CFO
- International
- Audit / Finance

Ms. Ziegler brings to the Board substantial experience in the consumer goods and technology industries, as well as her experience as the Chief Financial Officer of a public company.

Director Nominee Qualifications and Experience
The chart below identifies certain skills and qualifications our director nominees bring to the Board, based on areas we believe are important to our success. We believe the combination of the skills and qualifications shown below demonstrates how our Board is well positioned to provide effective oversight and strategic advice to our management. We believe the categories of skills and qualifications highlighted below are particularly relevant to the oversight of our global e-commerce business. The skills and qualifications of our individual directors are described in greater detail above.

Skills & Experience	
Audit / Finance	nnnnnnn
International Experience	nnnnnnnnn
Public Company CFO / CEO Experience	nnnnnn
Marketing / Advertising	nnnnnn
Technology / E-Commerce	nnnnnnnn

BOARD SELECTION AND EVALUATION

Director Independence

Our Corporate Governance Guidelines provide that a majority of our directors will be independent, based on the listing standards of NASDAQ as well as the Board's determination that the director does not have a relationship with Groupon management that, in the opinion of the Board, would interfere with the exercise of independent judgment in carrying out director responsibilities.

Based on the review and recommendation by the Nominating Committee, the Board analyzed the independence of each director in 2018 and each director nominee and determined that Messrs. Angelakis, Barris, Bass, Lefkofsky (beginning in November 2018), Leonsis, and Levin and Mses. Wahl and Ziegler meet the standards of independence under our Corporate Governance Guidelines and applicable NASDAQ listing standards, including that each member is free of any relationship that would interfere with his or her individual exercise of independent judgment. The Board determined that Mr. Williams, our Chief Executive Officer ("CEO"), is not independent.

In particular, in making its determinations with respect to director independence, the Board considered Mr. Lefkofsky's status as a co-founder and significant stockholder of the Company, as well as his service to the Company in the Office of the Chief Executive from February 2013 to August 2013, and CEO from August 2013 to November 2015. Under applicable NASDAQ rules, Mr. Lefkofsky may be considered independent if the Board concludes that his relationship with the Company, including his former employment as an executive officer, would not interfere with his exercise of independent judgment in carrying out his responsibilities as director. After considering that Mr. Lefkofsky had not served as an executive officer or employee of the Company during the past three years and the other factors set forth above, the Board concluded that Mr. Lefkofsky is an independent director in accordance with the applicable NASDAQ rules.

Procedures for Nominating Directors; Board Composition

The Nominating Committee reviews with the Board the appropriate set of characteristics, skills and experiences for the Board as a whole, with the objective of having a Board that can best help drive the success of our business and represent stockholder interests through the exercise of sound judgment using its diversity of experience. In evaluating its overall composition, our Board and Nominating Committee take into account many factors, including: general understanding of marketing, finance and other disciplines relevant to the Company's industry or the success of a large publicly traded company in today's business environment; operational and senior leadership experience; needs and strategy of the Company relative to the overall composition of our Board; understanding of our business and technology; independence; and diversity of background, skills and experience. The Nominating Committee regularly engages in ongoing board composition planning to assure that our Board continues to maintain an appropriate mix of skills and experiences to provide fresh perspectives and effective oversight and guidance to management, while leveraging the institutional knowledge and historical perspective of our longer-tenured directors.

The Nominating Committee reviews the skills and qualifications of each candidate for nomination to the Board. The Nominating Committee considers candidates that are suggested by members of the Board, as well as management, our stockholders and any director search firm retained by the Board or the Nominating Committee. In evaluating a candidate, the Nominating Committee considers, among other things; educational and professional background; personal accomplishments; potential conflicts of interest; whether he or she also brings specific skills or expertise in areas that the Board has identified as desired; and whether he or she possess personal attributes and diverse experiences that will contribute to the effective functioning of the Board as a whole. In addition, characteristics expected of all directors include integrity, high personal and professional ethics, sound business judgment, and the ability and willingness to commit sufficient time to the Board.

In the past four years, we have added four new directors, including Rich Williams, our CEO, and three independent directors, bringing significant strategic, operational, advertising and consumer marketing experience as well as additional gender diversity to our Board.

The Nominating Committee assesses the effectiveness of its efforts to maintain an effective Board through the Board self-evaluation process and in the course of its regular responsibilities, which include annually:

- reporting to our Board on the performance and effectiveness of the Board;
- presenting to our Board individuals recommended for election to the Board at the annual stockholders meeting; and

• obtaining or performing an assessment of the Committee's own performance.

The Nominating Committee will consider stockholders' recommendations for candidates for the Board using the same criteria described above. The name of any recommended candidate for director, together with a brief biographical sketch, a document indicating the candidate's willingness to serve if elected, and evidence of the nominating stockholder's ownership of Company stock should be sent to the attention of Corporate Secretary, Groupon, Inc., 600 West Chicago Avenue, Suite 400, Chicago, Illinois 60654. A stockholder who wishes to formally nominate a candidate must follow the procedures described in Section 2.4 of our Bylaws.

HOW THE BOARD IS ORGANIZED AND GOVERNS

Board and Executive Leadership

The Board does not have a policy as to whether the Chairman should be an independent director or a member of management. At this time, Mr. Lefkofsky, an independent director, serves as Chairman of the Board.

Mr. Lefkofsky has served as Chairman of the Board since November 2015, immediately following his resignation from his role as Chief Executive Officer of the Company. At the time of Mr. Lefkofsky's appointment as Chairman of the Board in November 2015, the Board determined that it also would be beneficial to appoint a Lead Independent Director to reinforce the independence of the Board in its oversight of our business and affairs and appointed Mr. Leonsis to serve in such role. In February 2019, the Board determined that Mr. Lefkofsky is an independent director, eliminating the need for a separate Lead Independent Director. See "Director Independence" for a discussion of the factors considered by the Board in determining Mr. Lefkofsky's independence.

Our Board believes its current leadership structure is appropriate because it effectively allocates authority, responsibility and oversight between management and the independent members of our Board. It does this by giving primary responsibility for the operational leadership and strategic direction of the Company to our CEO, while enabling the Chairman to facilitate our Board's oversight of management, promote communication among management, our Board, and our independent directors, and support our Board's consideration of key governance and risk oversight matters. The Board believes its programs for overseeing risk, as described above under "Risk Oversight," would be effective under a variety of leadership frameworks and therefore do not materially affect its choice of structure.

Risk Oversight

Our Board of Directors, either directly or through its committees, exercises oversight of strategic risks to the Company, including operational, financial, compliance, legal, strategic, reputational, governance and succession planning. Key features of our risk oversight practices include:

- Management periodically reports on areas of potential risk to our Board or the relevant committee, which provides guidance, as appropriate, on risk tolerance, assessment and mitigation.
- The Audit Committee reviews and assesses the Company's processes to manage business, financial and related reporting, and compliance. It also reviews the Company's policies for risk assessment, risk management and assesses the steps management has taken to control significant risks.
- The Audit Committee oversees risks pertaining to cybersecurity. Protecting our systems, networks, data and confidential information is a priority at Groupon. As part of our cybersecurity program we employ security practices to protect and maintain the systems located at our data centers and hosting providers, invest in intrusion, anomaly, and vulnerability detection tools and engage third-party security firms to test the security of our websites and systems. In addition, we regularly evaluate and assess our systems and the controls, processes and practices to protect those systems and also conduct penetration testing against our own systems. Our Vice President, Information Security, who reports directly to our Chief Technology Officer and leads the team responsible for our cybersecurity program, strategy, policies and practices, regularly reports to the Audit Committee on the state of our cybersecurity program and provides updates on cybersecurity matters. In addition, we conduct an annual cybersecurity review with our Board of Directors.
- The Compensation Committee oversees risks relating to compensation programs and policies to ensure that our compensation programs do not encourage unnecessary risk-taking.
- The Nominating Committee oversees risks relating to our governance structure.
- Each committee charged with risk oversight reports to the Board on such matters.

Corporate Governance Guidelines and Committee Charters

Our Corporate Governance Guidelines and the charters of the three standing committees of the Board describe our governance framework. The Corporate Governance Guidelines and charters are intended to ensure our Board has the necessary authority and practices in place to review and evaluate our business operations and to make decisions that are independent of management. Our Corporate Governance Guidelines also are intended to align the interests of directors and management with those of our stockholders, and comply with or exceed the requirements of NASDAQ and applicable law. They establish the practices our Board follows with respect to such issues as:

- Board composition and member selection;
- Board meetings and involvement of senior management;
- CEO performance evaluation;
- management succession planning;
- Board committees; and
- director compensation.

Pursuant to the Corporate Governance Guidelines, the Board conducts self-evaluations to annually assess its adherence to the Corporate Governance Guidelines and committee charters and to identify opportunities to improve Board performance. The Board regularly reviews our Corporate Governance Guidelines and committee charters and updates them as necessary to reflect changes in regulatory requirements and evolving oversight practices.

Meetings and Meeting Attendance

Our Board holds regularly scheduled quarterly meetings and also holds special meetings or acts by unanimous written consent as necessary. Our Board met eight times during 2018.

All of our directors attended 75% or more of the aggregate of all Board meetings and meetings of the committees on which they served during the last fiscal year. We do not maintain a formal policy regarding director attendance at stockholder meetings. One of our directors attended the 2018 Annual Meeting.

Board Committees

Our Board has three standing committees: an Audit Committee, a Compensation Committee and a Nominating Committee. Each committee operates pursuant to a written charter and is comprised entirely of independent directors. The table below provides membership for each of the Board committees:

Director	Audit	Compensation	Nominating
Ted Leonsis			Chair
Michael Angelakis	n		
Peter Barris		Chair	
Robert Bass	Chair	n	
Joseph Levin		n	
Deborah Wahl			n
Ann Ziegler	n		n

Below is a description of each standing committee. Each committee has authority to engage legal counsel or other advisors or consultants as it deems appropriate to carry out its responsibilities.

Audit Committee

The Audit Committee assists our Board in overseeing the quality and integrity of our accounting, auditing and reporting practices. The Committee's role includes:

- overseeing the work of our accounting function and internal controls over financial reporting;
- overseeing internal audit processes;
- inquiring about significant risks, reviewing our policies for risk assessment and risk management, including cybersecurity risks, and assessing the steps management has taken to control these risks; and
- reviewing compliance with significant applicable legal and regulatory requirements.

The Audit Committee is responsible for the appointment, compensation, retention, review and oversight of the independent registered public accounting firm engaged to issue audit reports on our consolidated financial statements and internal control over financial reporting.

The Committee relies on the expertise and knowledge of management and the independent registered public accounting firm in carrying out its oversight responsibilities. The Audit Committee Charter describes the Committee's specific responsibilities. The Board has determined that each Committee member has sufficient knowledge in financial and auditing matters to serve on the Committee and is an "audit committee financial expert" as defined by SEC rules.

The Audit Committee met nine times in 2018.

Compensation Committee

The primary responsibilities of the Compensation Committee are to:

- assist our Board in establishing the annual goals and objectives relevant to the compensation of the CEO;
- evaluate and approve the compensation of the CEO;
- oversee compensation of directors;
- evaluate and approve the compensation of the Company's other executive officers;
- oversee and advise our Board on the adoption of policies that govern executive officer compensation programs and other compensation-related polices;
- oversee plans for executive officer development and succession;
- oversee administration of our equity and incentive plans, policies, practices, and programs; and
- authorize grants of equity compensation awards under our stock plan.

As permitted by law and pursuant to the terms of the 2011 Incentive Plan, the Committee may delegate to the CEO the authority to make equity compensation grants to employees who are not executive officers.

Our CEO and senior members of our Human Resources department, including our Senior Vice President, Human Resources, and Senior Director, Compensation and Benefits, are responsible for providing recommendations to the Compensation Committee regarding our executive compensation program. None of our executives participates in Compensation Committee deliberations relating to his or her own compensation. To evaluate each senior officer's overall compensation, the Compensation Committee reviews total direct and indirect compensation details prepared by management and other information deemed appropriate and advisable by the Compensation Committee.

The Compensation Committee Charter describes the specific responsibilities and functions of the Compensation Committee. See "Compensation Discussion and Analysis" for more information about the Committee's role and responsibilities.

The Compensation Committee met four times in 2018.

Nominating Committee

The principal responsibilities of the Nominating Committee are to:

- determine and recommend the slate of director nominees for election to our Board;
- identify and recommend candidates to fill director vacancies occurring between annual stockholder meetings;
- review the composition of Board committees;
- annually evaluate the performance and effectiveness of the Board; and
- monitor adherence to, review, and recommend changes to our Corporate Governance Guidelines.

The Nominating Committee Charter describes the specific responsibilities and functions of the Committee.

The Nominating Committee met four times in 2018.

HOW TO COMMUNICATE WITH THE BOARD

Stockholder Engagement

We recognize the value of stockholder feedback, and our relationship with our stockholders is an integral part of our corporate governance practices. We conduct stockholder outreach throughout the year to engage on issues that are important to our stockholders and to understand their perspectives on a variety of matters, including executive compensation and corporate governance matters.

In particular, following our 2018 annual meeting of stockholders, we reached out to our top 25 largest stockholders in order to obtain their feedback regarding our executive compensation program and corporate governance policies and practices. We met with several stockholders as a result of this outreach and heard from several other stockholders that they did not have questions or concerns that required further engagement. During these stockholder engagement meetings, we discussed a variety of matters, including the elements and structure of our executive compensation program, the performance-based compensation of our CEO and other members of senior management, the performance metrics applicable to our annual bonus program and PSUs, the implementation of multi-year vesting for PSUs, our equity usage, our Board composition, stockholders' consideration of ESG (environmental, social and governance) matters, and the effectiveness of our disclosure. We have taken into account the input and feedback of our stockholders in recent years in making changes to our executive compensation program, including, for example, when implementing multi-year vesting for PSU awards, considering performance metrics for our performance-based compensation, and providing 2018 total target compensation to our CEO and other Named Executive Officers that was comprised of over 50% performance-based compensation. In addition, based in part on stockholder feedback, we have continued to revise our disclosure in order to improve its effectiveness, including adding a stockholder letter to our quarterly disclosure package, increasing proxy statement disclosure regarding our director skills and qualifications, Board risk management (including relating to cybersecurity) and executive compensation program, and enhancing the design of our proxy statement.

In addition to the annual engagement described above, we also communicate with our stockholders through a number of routine forums, including quarterly earnings calls, SEC filings, our annual report and proxy statement, our annual meeting of stockholders, investor meetings and conferences, our Investor Relations site, and the Groupon blog. As appropriate, we relay stockholder feedback and trends on corporate governance developments to our Board and its committees and work with them to both enhance our governance practices and strengthen our disclosures.

We expect to continue this program of stockholder engagement during 2019.

Investor Relations Website

If you would like additional information about our corporate governance practices, you may view the following documents at investor.groupon.com:

- Audit Committee Charter
- Compensation Committee Charter
- Nominating Committee Charter
- Corporate Governance Guidelines
- Code of Conduct

We will provide any of the foregoing information without charge upon written request to the Corporate Secretary, Groupon, Inc., 600 West Chicago Avenue, Suite 400, Chicago, Illinois 60654. In addition, stockholders and other interested parties may communicate with any of our directors, including our independent directors or the directors as a group, by writing to the Corporate Secretary, Groupon, Inc., 600 West Chicago Avenue, Suite 400, Chicago, Illinois 60654. The Corporate Secretary will forward relevant communications to the appropriate directors depending on the facts and circumstances outlined in the communication.

BOARD COMPENSATION

We offer an annual cash and equity compensation program for our non-employee directors under our Non-Employee Directors' Compensation Plan (a sub-plan of the 2011 Incentive Plan) (the "Director Compensation Plan").

Components of Director Compensation

The table below provides a summary of the components of the Director Compensation Plan, effective January 1, 2018. These amounts were reviewed and approved based on benchmarking data and input from the Compensation Committee's consultant. Prior to 2018, director compensation amounts had not been changed since 2015.

Annual Compensation Element	Cash Retainer ($)	RSU Award ($)	Total ($)
Board of Directors	75,000	175,000	250,000
Audit Committee Chairperson	9,900	20,100	30,000
Compensation Committee Chairperson	6,600	13,400	20,000
Nominating and Governance Chairperson	4,950	10,050	15,000

Under the Director Compensation Plan each non-employee director can elect to defer 100% of the annual cash retainer and 100% of the additional annual committee chair cash retainer into an award of deferred stock units. The number of deferred stock units to be awarded is determined by dividing the amount of the cash retainer to be exchanged by the fair market value of a share of common stock as of the date on which the cash retainer would otherwise have been paid. Deferred stock units are fully vested upon issuance and will be distributed following a non-employee director's separation from service. Distributions are made in a single distribution in the form of shares.

Each non-employee director receives an annual grant of restricted stock units ("RSUs") on the date of our annual meeting of stockholders, which vests 100% on the first anniversary of the annual meeting of the stockholders as long as the non-employee director remains on the Board on the vesting date. The number of RSUs granted is determined by dividing the dollar amount of the grant by the fair market value of a share of our common stock on the date of grant.

In October 2018, the Board amended the Director Compensation Plan to allow non-employee directors to defer receipt of vested RSUs until the non-employee director's separation from service beginning with awards granted in 2019.

In the event a newly-elected or appointed non-employee director becomes an eligible participant under the Director Compensation Plan following the date of the annual meeting of stockholders but during the same calendar year as the annual meeting of stockholders, the Board may, in its sole discretion, grant such non-employee director a pro-rated RSU award with respect to his or her service during the remainder of the year.

The Company also pays or reimburses non-employee directors for reasonable travel, lodging and related expenses in connection with their attendance at Board, Committee or Company business meetings.

2018 Director Compensation

The following table sets forth the actual compensation paid to directors under the Director Compensation Plan for the fiscal year ended December 31, 2018. Mr. Williams receives no additional compensation for his services as a director of the Company.

Name	Fees Earned or Paid in Cash ($)(1)	Stock Awards ($)(2)(3)	All Other Compensation ($)	Total ($)
Michael Angelakis	75,000	175,000	—	250,000
Peter Barris	81,600	188,400	—	270,000
Robert Bass	84,900	195,100	—	280,000
Eric Lefkofsky	75,000	175,000	50,000 (4)	300,000
Joseph Levin	75,000	175,000		250,000
Theodore Leonsis	79,950	185,050	—	265,000
Deborah Wahl (5)	75,000	250,000	—	325,000
Ann Ziegler	75,000	175,000	—	250,000

(1) This column represents the amount of cash compensation earned in 2018 for Board and committee service. The following non-employee directors deferred cash compensation earned in 2018 into deferred stock units under the Director Compensation Plan and as shown in the table below.

Name	2018 Cash Fee Deferred ($)	Shares in Deferred Account Attributed to 2018 Cash Fees (#)
Peter Barris	81,600	18,940
Eric Lefkofsky	75,000	17,408
Joseph Levin	75,000	17,408
Theodore Leonsis	79,950	18,557

(2) On June 14, 2018, we granted each of our non-employee directors 37,878 RSUs, the Nominating Committee Chairman an additional 2,176 RSUs, the Compensation Committee Chairman an additional 2,901 RSUs, and our Audit Committee Chairman an additional 4,351 RSUs pursuant to the Director Compensation Plan. 100% of the RSUs will vest on the first anniversary of the grant date. As of December 31, 2018, each non-employee director had the following aggregate number of stock awards outstanding.

Name	Number of Outstanding RSUs
Michael Angelakis	37,878
Peter Barris	40,779
Robert Bass	42,229
Eric Lefkofsky	37,878
Theodore Leonsis	40,054
Joseph Levin	37,878
Deborah Wahl	37,878
Ann Ziegler	37,878

(3) Reflects the aggregate grant date fair value of RSUs granted in 2018, computed in accordance with FASB ASC Topic 718. For additional information, see Note 12 to Groupon's audited consolidated financial statements for the year ended December 31, 2018 included in Groupon's Annual Report on Form 10-K.

(4) Reflects the amount the Company paid for the cost of security services for Mr. Lefkofsky in his capacity as Chairman of our Board.

(5) Ms. Wahl joined our Board in October 2017 but did not receive director compensation during the portion of the year for which she served as a director. On February 1, 2018, Ms. Wahl was granted a pro-rated RSU award under the Director Compensation Plan with a value of $75,000 based on the number of quarterly Board meetings between the time of her election and the Annual Meeting, converted into 14,124 RSUs based on the closing price of the Company's common stock on the Nasdaq Global Select Market on February 1, 2018. Ms. Wahl's pro-rated RSU grant vested on June 13, 2018.

Security

We believe the personal safety and security of the Chairman of our Board is important to the Company's business interests. Accordingly, the Company pays the cost of security services for the Chairman in an amount that the Company believes is reasonable in light of his security needs. The aggregate incremental cost of these services is reported in the "All Other Compensation" column of the "2018 Director Compensation" table above in accordance with SEC disclosure rules. We do not consider these security measures to be a personal benefit or perquisite for our Chairman, but rather a reasonable and necessary expense for the benefit of the Company.

Director Stock Ownership Guidelines and Stock Holding Requirements

We maintain stock ownership guidelines that require each non-employee director to beneficially own Company common stock, as follows:

Ownership and Holding Guidelines	Measurement Requirements	2018 Compliance
• Common stock with a value of at least 3X the director's annual cash retainer • Meet ownership requirement by the later of April 1, 2021, or 5 years after initial election • A director must retain 50% of net shares acquired upon the vesting of equity awards until the director meets the ownership requirements	The following shares count towards compliance: • Shares owned outright and beneficially • Shares equal to the number of deferred stock units credited under our Director Compensation Plan • Unvested RSUs	• All directors were in compliance with the guidelines as of December 31, 2018 • Compliance is measured annually as of December 31st

COMPENSATION DISCUSSION
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Executive Summary
2018 Strategy and Performance Results

In 2018, we took key steps on our path to transform Groupon into a daily utility for consumers while delivering solid Adjusted EBITDA growth. We focused on several strategic actions to drive long-term growth in our business:

ü Enhance the customer experience. With a mobile-first strategy, we intend to improve the customer experience by continuing to invest in innovative, frictionless products and differentiated local supply coupled with strong national brands. In 2018, 80% of our user traffic was on mobile. As we build out our marketplaces, we want our customers to have a superior, frictionless experience when they use our product whether finding, booking, buying or redeeming an offer. We are investing in initiatives to improve the purchase and redemption experience, such as enhancing our mobile applications, testing offerings with voucherless redemption resulting in cash back directly to customers' credit cards, and adding direct booking capabilities.

ü Establish Groupon as an open platform. We ultimately want Groupon to become a daily habit for our customers and believe that significantly increasing the offerings available through our online local commerce marketplaces is critical to this goal. Our initiatives to grow our inventory of deal offerings include entering into commercial agreements with third parties that enable us to feature additional merchant offerings through our marketplaces, identifying new distribution channels through which to sell our marketplace offerings, and continuing to optimize the activities performed by our sales teams.

ü Continue to realize our international potential. In 2018, the gross profit generated by our International segment represented 32.6% of our consolidated gross profit. We maintain a long-term focus on driving International to achieve gross profit that is more comparable to that of North America. Our initiatives to grow International gross profit include increasing our international marketing spending and leveraging enhanced marketing analytics, prioritizing more technology resources in order to expand and advance its product and service offerings, growing our inventory of deal offerings by entering into commercial agreements with third parties that enable us to feature additional merchant offerings through our marketplaces, and other initiatives.

ü Maintain culture of operational efficiency. Our company runs with a fundamental emphasis on maximizing operational efficiency. While we expect to invest in our key initiatives, we will continue to do so as disciplined operators and seek out opportunities to improve our efficiency.

Our strategic focus contributed to the following financial results as of and for the period ended December 31, 2018:

Gross Profit	Income from Continuing Operations	Adjusted EBITDA[(1)]	Operating Cash Flow[(2)]
$1.32 billion	$2.0 million	$269.8 million	$190.9 million

Additionally, our strategy and financial results are described in more detail in our annual report, quarterly earnings releases and other filings with the SEC.

(1) Please see “Appendix A – Adjusted EBITDA Information and Reconciliation” for more information.
(2) Operating cash flow for the year ended December 31, 2018; $233 million for the year ended December 31, 2018, excluding the Company's operating cash outflow related to the settlement of the IBM patent litigation.

Compensation Philosophy

Our philosophy is to establish and maintain an executive compensation program that attracts proven, talented leaders who possess the skills and experience necessary to achieve our operational and strategic goals, while materially adding to our long-term value without creating excessive risk to the organization. We seek to structure executive pay to be consistent with the competitive market and to align the long-term interests of our executive officers and stockholders so that pay appropriately reflects performance in achieving our financial and operational objectives. Specifically, our executive compensation program is designed to:

- Recruit and retain talented and experienced individuals who are able to develop, implement, and deliver on long-term value creation strategies;
- Ensure that our compensation is reasonable and competitive with the pay packages made available to executives at companies with which we compete for executive talent;
- Provide a substantial portion of each executive's compensation in elements that are directly tied to our long-term value and growth;
- Reward both company and individual performance and achievement; and
- Ensure that our compensation structure does not encourage unnecessary and excessive risk-taking.

Our executive compensation program achieves our goals by incorporating certain pay practices while avoiding other, more problematic or controversial practices:

What We Do

ü Maintain an independent compensation committee.

ü Retain an independent compensation advisor which provides no other material services to us

ü Conduct an annual executive compensation review and compare our program against the competitive market and best practices

ü Establish measureable performance objectives under our annual performance bonus plan and our performance stock unit program

ü Establish maximum award levels under our annual performance bonus plan and our performance stock unit awards

ü Vest annual equity awards over multi-year periods, consistent with current market practice and our retention objectives

ü Conduct an annual stockholder advisory vote on NEO compensation

ü Regularly engage with our stockholders to get their perspectives on executive compensation and corporate governance matters

ü Conduct an annual risk assessment of our compensation programs

ü Maintain significant stock ownership and stock holding requirements for our executive officers

ü Require our executive officers to pre-clear all stock trades (other than pursuant to an approved Rule 10b5-1 trading plan) even during the open window period

ü Review the risks associated with key executive officer positions to ensure adequate succession plans are in place

What We Don't Do

û Offer pension arrangements, supplemental retirement plans or nonqualified deferred compensation arrangements to our executive officers

û Offer enhanced health and welfare benefits programs to our executive officers that are above and beyond those offered to our regular employees

û Provide excessive perquisites or other personal benefits to our executive officers

û Provide any tax reimbursement payments (including "gross-ups") on any severance or change-in-control payments or benefits

û Permit our executive officers and directors to hedge our equity securities

û Permit our executive officers and directors to pledge our equity securities, subject to limited exceptions

û Pay dividends or dividend equivalents on unvested or unearned equity awards

û Permit the repricing of stock options without stockholder approval

Stockholder Advisory Vote on Named Executive Officer Compensation

Currently, we provide an annual say-on-pay vote to ensure that stockholder input informs our compensation philosophy and decisions. In making our executive compensation decisions for 2019, the Compensation Committee considered that over 78% of the shares that voted on our "say-on-pay" proposal at the 2018 Annual Meeting of Stockholders approved the compensation of our named executive officers as disclosed in our 2018 proxy statement. The Compensation Committee believes that our current executive compensation program has been effective in implementing our compensation philosophy and objectives.

Nevertheless, the Compensation Committee recognizes that pay practices continue to evolve, and as a result, the committee continues to refine our executive compensation policies and practices in its ongoing effort to ensure our executive compensation program supports our compensation philosophy and objectives, as well as our overall corporate goals and values.

As part of our ongoing efforts, over the past three years, we have enhanced our executive compensation program and corporate governance policies and practices based, in part, on the feedback we have received from our stockholders and advice of the independent compensation consultant. In particular, in the past three years, including following the 2018 Annual Meeting, we conducted stockholder outreach to discuss our executive compensation program, among other things, with significant stockholders. For additional information, see "How to Communicate with the Board – Stockholder Engagement."

Role of Compensation Committee, Management, Compensation Consultants And Use of Market Data

Role of Compensation Committee

Our Compensation Committee is composed entirely of independent directors. The Compensation Committee approves the Company's executive compensation philosophy and oversees the Company's executive compensation policies, plans and programs to ensure that they are consistent with the long-term interests of the Company's stockholders. The Compensation Committee reviews and approves compensation actions for the CEO and other Named Executive Officers.

The Compensation Committee discharges the responsibilities of our Board of Directors with respect to the compensation of senior management, including our Named Executive Officers, and the non-employee members of our Board of Directors. For a discussion regarding the Compensation Committee's compensation philosophy and the principal objectives of our compensation programs, see "Compensation Philosophy." Specifically, the Compensation Committee has overall responsibility for overseeing the design, development, and implementation of our executive compensation program and the related policies and practices. This includes having final authority to approve and make decisions with respect to the compensation of our Named Executive Officers.

In carrying out its responsibilities, the Compensation Committee establishes the amounts and allocates the mix of compensation between base salary, annual cash incentives, and long-term incentive compensation. The Compensation Committee also designs, approves, and oversees our 2011 Incentive Plan and establishes performance targets for performance-based awards. The Compensation Committee selects balanced metrics for performance based awards that align with business strategy and are intended to drive shareholder value. The Compensation Committee grants all equity awards to our Named Executive Officers and has the authority to grant equity awards to eligible employees in accordance with the terms of the 2011 Incentive Plan.

Periodically, the Compensation Committee reviews our post-employment compensation arrangements, retirement benefits, senior leadership benefits, and perquisites. The Compensation Committee also reviews and considers risks associated with our compensation philosophy and executive compensation program as discussed under "Compensation Risk Assessment." Further, the Compensation Committee is responsible for reviewing, discussing, and approving the Compensation Discussion and Analysis for inclusion in the annual proxy statement that we file with the Securities and Exchange Commission.

To promote independent decision-making on executive compensation matters, the Compensation Committee regularly meets in executive session without management present, often with the participation of its independent compensation consultant. The Compensation Committee regularly assesses the effectiveness of our executive compensation program in driving performance, and uses stockholder feedback, market data, regulatory requirements and external trends to inform its decision-making.

The Compensation Committee reviews the elements of compensation of our Named Executive Officers on an annual basis, typically in the first quarter of the year, and will consider changes at other times if a change in the scope of an executive officer's responsibilities, or other developments or circumstances, warrant such consideration. In so doing, the Compensation Committee engages the services of a compensation consultant and considers the analysis and advice of its compensation consultant in discharging its responsibilities. Representatives of the compensation consultant attend Compensation Committee meetings and have direct access to the Compensation Committee members. The Compensation Committee has the sole authority to hire and terminate its compensation consultant.

The Compensation Committee does not establish a specific target for formulating the target total direct compensation opportunities of senior management, including our Named Executive Officers. In making decisions about the compensation of our Named Executive Officers, the members of the Compensation Committee rely primarily on their general experience and subjective considerations of various factors, including, without limitation, the following:

- our executive compensation program objectives;
- our performance against the financial, operational, and strategic objectives established by the Compensation Committee and our Board of Directors;
- an individual NEO's knowledge, skills, experience, qualifications, and tenure relative to other similarly-situated executives at the companies in our compensation peer group;
-

- the scope of an NEO's role and responsibilities compared to other similarly-situated executives at the companies in our compensation peer group;
- the performance of an individual NEO, based on a subjective assessment of his or her contributions to our overall performance, ability to lead his or her business unit or function, and work as part of a team, all of which reflect our core values;
- the potential of an individual NEO to contribute to our long-term financial, operational, and strategic objectives;
- the compensation practices of our peer group; and

• the recommendations of our CEO with respect to the compensation of our other NEOs.

These factors provide the framework for compensation decision-making and final decisions regarding the compensation opportunity for each NEO. No single factor is determinative in setting compensation levels, nor is the impact of any individual factor on the determination of pay levels quantifiable.

The Compensation Committee does not weight these factors in any predetermined manner, nor does it apply any formulas in developing its compensation recommendations.

Role of Management

Our Compensation Committee generally seeks input from our CEO and the most senior members of our Human Resources department when evaluating the performance and compensation of the Named Executive Officers, as well as during the process of searching for and negotiating compensation packages with new senior management hires. The Compensation Committee gives considerable weight to the CEO's evaluation of the other Named Executive Officers because of his direct knowledge of each executive officer's performance and contributions. Our Chief Financial Officer and Chief Accounting Officer also work with the Senior Vice President, Human Resources and Senior Director, Compensation and Benefits to advise the Compensation Committee with regard to the financial and accounting implications of our compensation programs and hiring decisions. None of our Named Executive Officers participates in Compensation Committee deliberations relating to his or her own compensation.

Independent Compensation Consultant

Reporting directly to the Compensation Committee, the independent compensation consultant provides advice, recommendations, and resources to help develop and execute our overall compensation strategy. The Compensation Committee directs the independent compensation consultant to work with the appropriate members of management to obtain information necessary to form its recommendations and evaluate management's recommendations. The independent compensation consultant also meets with the Compensation Committee during the Compensation Committee's regular meetings and in executive session, where no members of management are present, and can meet with the Compensation Committee chair and other members of the Compensation Committee outside of regular meetings. The Compensation Committee has the sole power to terminate or replace the independent compensation consultant at any time, and intends to continue to periodically review its relationship with its compensation consultant. Willis Towers Watson served as our independent compensation consultant until April 2018, and provided advice and recommendations for executive compensation during the 2018 annual compensation review process. In April 2018, the Compensation Committee engaged a new compensation consultant, Compensia.

Although we could retain our independent compensation consultant for discrete projects from time to time, neither Willis Towers Watson nor Compensia provided any other material services to Groupon (separate from consulting advice provided to the Compensation Committee). The Compensation Committee has a policy for compensation consultant independence under which any compensation consultant retained by the Compensation Committee must be independent of the Company and management. The Compensation Committee reviewed the independence of Willis Towers Watson and Compensia in light of this policy, SEC rules and NASDAQ listing standards regarding compensation consultants and has concluded that Willis Towers Watson's and Compensia's work for the Compensation Committee did not raise any conflict of interest, and both were able to provide the Compensation Committee with independent advice.

Use of Market Data

Our Compensation Committee reviews our peer group and other compensation data annually to ensure that it remains appropriate for review and comparison purposes. In 2018, our peer group included companies in the Internet Software & Services, Internet Retail and Application Software industries whose businesses align with ours and companies with a size comparable to ours based on revenue and market capitalization. Our peer group includes companies with whom we compete for executive talent, which includes larger global companies, as well as smaller companies. The technology labor market is highly competitive for executive level talent that can provide innovative leadership while managing at a global scale across several lines of business. The Compensation Committee believes that it is necessary to consider these factors in making compensation decisions in order to attract and retain talent. Our 2018 peer group companies had median revenues of $1.758 billion in 2017. Our peer group for 2018 is listed below:

Akamai Technologies Inc.	HSN, Inc.	QVC Group Inc.	Wayfair Inc.

ANGI Homeservices Inc.	IAC/InterActiveCorp	Salesforce.com, Inc.	Yelp, Inc.
Booking Holdings	Netflix, Inc.	Shutterfly, Inc.	Zillow Group Inc.
Expedia Inc.	Overstock.com Inc.	TripAdvisor Inc.	Zynga, Inc.
GrubHub Inc.	Pandora Media, Inc.	Twitter, Inc.	

We also participate in surveys of market compensation practices in our industry and broadly across other industries, and undertake specialized studies of competitive market practices using the most relevant published survey sources and public filings. When determining 2018 total direct compensation, management and Willis Towers Watson presented information to the Compensation Committee based on peer group and industry data. However, while the Compensation Committee considered this information, it did not engage in strict benchmarking to a fixed percentile. The Compensation Committee also relied on the expertise of its members and on management to develop pay packages that are appropriate for each executive. We believe that the total direct compensation of our Named Executive Officers in 2018 was consistent with our peer group and competitive market practices. Our Compensation Committee regularly reviews the compensation and benefits of our Named Executive Officers in order to ensure that it remains competitive.

Named Executive Officers

This Compensation Discussion and Analysis discusses material elements of our 2018 compensation program for the following current and former executive officers (collectively, our “Named Executive Officers” or “NEOs”):

Name	Title
Rich Williams	Chief Executive Officer
Dane Drobny	General Counsel & Corporate Secretary
Steve Krenzer	Chief Operating Officer
Mike Randolfi	Chief Financial Officer
Melissa Thomas[(1)]	Chief Accounting Officer & Treasurer
Brian Stevens[(2)]	Former Chief Accounting Officer & Treasurer

(1) Ms. Thomas was appointed as our Chief Accounting Officer, effective November 30, 2018.

(2) Mr. Stevens served as our Chief Accounting Officer until November 30, 2018.

Elements of Executive Compensation; Pay Mix and Target Opportunity

For 2018, the target total direct compensation of our Named Executive Officers consisted of base salary, an annual performance bonus opportunity, and long-term incentive compensation in the form of performance share unit awards and restricted stock unit awards. The following table provides a high level summary of 2018 pay packages of our Named Executive Officers.

Elements of Executive Compensation & 2018 Snapshot

	Compensation Element	% of Total Target Compensation (CEO) (1)	% of Total Target Compensation (NEOs other than CEO) (1)(2)	Objective	Key 2018 Decisions & Outcomes
Fixed	Base Salary	7%	14%	Competitive level of fixed compensation Attract and retain key executive talent	No base salary changes for NEOs in 2018, other than for the CEO
Variable Compensation (At-Risk Component)	Restricted Stock Units ("RSUs")	40%	34%	Award value tied to long-term growth of Groupon's stock price Retentive value in four- and five-year time-based vesting schedules	RSU component constituted significant portion of equity mix in 2018, with five-year, time-based vesting schedule for CEO and four-year, time-based vesting schedule for other executives
	Annual Performance Bonus	7%	13%	Rewards executives for achieving annual company and individual goals	Funding based 100% on Company performance 2018 payout at 48.0% of target, based on Company performance
Variable Compensation (All At Risk)	Performance Share Units ("PSUs")	45%	40%	Award value is tied to long-term growth of Groupon's stock price, and is aligned to financial performance of the Company and achievement of strategic goals	Multi-year vesting schedules introduced to help align compensation with long-term Company performance and provide retentive value Achievement of 2018 PSUs based 100% on Company performance 2018 payout at 37.7% of target, based on Company performance

(1) Amounts set forth in this table do not total 100% due to rounding on each compensation element.

(2) Amounts in this column represent the average of compensation of NEOs other than the CEO for each compensation element.

Base Salary

We offer competitive base salaries, intended to provide a level of stable fixed compensation to executives for performance of day-to-day services. In determining base salaries for our Named Executive Officers, the Compensation Committee considers a number of factors annually, including scope of the officer's responsibilities, prior experience, and qualifications; past individual performance of the officer; base salary and total compensation relative to other executives in similar positions; competitive market conditions and market data; and recommendations of the CEO (other than with respect to his own compensation).

The base salaries paid to our Named Executive Officers in 2018 are set forth in the "Summary Compensation Table" below. The following table shows the base salaries in effect during 2018, with any increases based on consideration of the factors listed above:

Name	2018 Base Salary ($)(1)
Rich Williams(2)	750,000
Dane Drobny(3)	500,000
Steve Krenzer(3)	450,000
Mike Randolfi(3)	625,000
Melissa Thomas(4)	325,000
Brian Stevens(5)	335,000

(1) Base salaries in effect as of December 31, 2018.

(2) Mr. Williams' base salary increased from $700,000 to $750,000 effective January 1, 2018.

(3) Base salaries for Mr. Randolfi, Mr. Drobny, Mr. Krenzer, and Mr. Stevens were not increased in 2018.

(4) Ms. Thomas was appointed as our Chief Accounting Officer on November 30, 2018 and this amount reflects her base salary effective starting on that date.

(5) Mr. Stevens served as our Chief Accounting Officer until November 30, 2018.

Annual Performance Bonus

2018 Annual Performance Bonus

In 2018, each of the Named Executive Officers (other than Mr. Stevens, who was not eligible to earn an annual performance bonus for 2018 based on his date of resignation) participated in our annual bonus plan (the “ABP”). Funding under the ABP is based 100% upon Company performance. For 2018, the Compensation Committee approved performance-based bonus metrics and targets for the participating Named Executive Officers, which are set forth below. The Compensation Committee may exercise downward discretion on individual payouts with respect to individual Named Executive Officer performance based on a recommendation from the CEO (other than for himself), but did not exercise any such discretion in 2018. Payout was conditioned upon the Company achieving at least one of the following threshold performance levels: (i) a minimum gross profit amount of $1.350 billion, or (ii) a minimum Adjusted EBITDA amount of $250 million for 2018, which is a non-GAAP performance measure (defined below). The performance metrics applicable to the annual bonus are shown in the table below (in millions):

Annual Bonus Plan (“ABP”)

	Performance Metrics			2018	
	Threshold (50%)	Target (100%)	Maximum (150%)[1]	Actual Achievement[2]	Total Performance Payout
Gross Profit (50% Weighting)	$1,350	$1,400	$1,435	$1,294.3 (0.0%)	48.0%
AEBITDA (50% Weighting)	$250	$265	$280	$263.8 (96.0%)	

(1) The maximum available payout under the ABP was 150% for all NEOs other than Mr. Krenzer, for whom the maximum available payout was 200% per the terms of his offer letter.

(2) Actual achievement set forth in this column is provided on a constant currency (fx neutral) basis and excludes the impact of the Company’s acquisition of Cloud Savings Company Ltd.

The following table shows the performance-based cash bonus targets and the performance bonuses paid to the Named Executive Officers for 2018:

Name	2018 Annual Performance Bonus Target ($)	2018 Performance Payout %	2018 Company Performance Bonus Paid[1] (Total) ($)
Rich Williams	750,000	48.0%	360,000
Michael Randolfi	500,000	48.0%	240,000
Dane Drobny	450,000	48.0%	216,000
Steve Krenzer	625,000	48.0%	300,000
Melissa Thomas[2]	105,479	48.0%	50,630
Brian Stevens[3]	335,000	—	—

(1) The Compensation Committee may exercise downward discretion on total performance bonus paid after the Company performance multiplier is applied, but did not exercise any such discretion for 2018.

(2) Ms. Thomas received a prorated bonus, based on the date of her appointment as Chief Accounting Officer.

(3) Mr. Stevens was not eligible to receive an annual performance bonus for 2018 based on the date of his resignation as Chief Accounting Officer.

For purposes of the Company performance-based bonus calculation, Adjusted EBITDA is defined as net income (loss) from continuing operations excluding income taxes, interest and other non-operating items, depreciation and amortization, stock-based compensation, acquisition-related expense (benefit), net and other special charges and credits, including items that are unusual in nature or infrequently occurring. Adjusted EBITDA is a non-GAAP measure that we present to aid investors in understanding our financial results. In addition, it is a key measure used by our management and Board to evaluate operating performance, generate future plans and make strategic decisions regarding the allocation of capital. See Appendix A for a reconciliation of Adjusted EBITDA to the most comparable U.S. GAAP performance measure, “Net income (loss) from continuing operations.”

Equity-Based Awards

The Company's equity program is designed to align executive interests with stockholder interests by rewarding executives for sustained long-term stockholder value creation while encouraging retention. The total value of equity grants is based on relevant market data for each position, as well as each executive's responsibilities, skills and experience. The Company's equity mix consists of both PSUs and RSUs.

RSU Awards

The long-term value of RSU awards realized by NEOs is tied to Company stock performance, with a time-based vesting component that encourages executive retention.

PSU Awards

PSU awards connect equity compensation to Company performance. Performance goals are rigorous and require Company performance for any payout, with payout ranging from 0% to 200% of target. The Compensation Committee believes that one-year PSU performance periods are appropriate at this time due to the dynamic and evolving nature of our business. To balance the objectives of a one-year PSU performance period, aligning executive interests with long-term performance and encouraging retention, we granted PSUs in 2018 that if earned, vest on four- and five-year time-based vesting schedules.

Prior to implementation of multi-year, time-based vesting schedules in 2018, PSU awards were allocated such that the Company granted a portion of the award in the year it was awarded, and committed to the executive to grant the remaining portion over subsequent years. As a result, in 2018, we granted PSUs that represent commitments made in 2016 and 2017. These PSUs vested following the end of the performance period. We no longer commit to grant PSUs in future years, but will grant PSUs in 2019, 2020, 2021, and 2022 that represent PSUs that were previously committed in 2016 and 2017.

In 2018, PSU grants constituted 45% of total equity grant value to our CEO and 40% of total equity grant value to our other NEOs.

The 2018 equity grants are disclosed below in the "Summary Compensation Table" and the "Grants of Plan-Based Awards for Fiscal 2018" table. The table below shows RSU and PSU grants to our Named Executive Officers in 2018.

Name	Number of Securities Underlying RSUs Granted in 2018 (#)	Number of Securities Underlying New PSUs with Multi-Year, Time-Based Vesting Schedule Granted in 2018 (#)	Number of Securities Underlying PSUs Committed in 2016 and 2017 and Granted in 2018 (#)(1)
Rich Williams	816,036 (2)	543,396(3)	367,195
Michael Randolfi	283,691 (4)	188,679(5)	85,702
Dane Drobny	181,737 (6)	120,754(7)	30,992
Steve Krenzer (8)	—	—	198,894
Melissa Thomas	79,331 (9)	13,402(10)	17,100
Brian Stevens (11)	94,412	62,641	43,304

(1) The PSUs in this column represent commitments made in 2016 and 2017. 100% of the 2018 PSUs committed in prior years and earned as described below vested on February 12, 2019.

(2) 163,018 RSUs will vest on October 31, 2019, and 652,076 RSUs will vest annually in equal installments beginning on October 31, 2020 and ending on October 31, 2023, in each case subject to Mr. Williams' continued employment with the Company through the applicable vesting date. 942 RSUs granted were earned as part of the 2017 annual performance bonus program, and were immediately vested on March 15, 2018 upon grant. See the "Option Exercises and Stock Vested in 2018" table.

(3) The 2018 PSUs reported on this line were earned as described below, and 20% vested on February 12, 2019. The remaining PSUs will vest in equal installments on January 2, 2020; January 2, 2021; January 2, 2022; and January

2, 2023; in each case subject to Mr. Williams' employment as of the applicable vesting date.

(4) 56,603 RSUs will vest on each of March 15, 2019 and March 15, 2020; 113,208 RSUs will vest on March 15, 2021; and 56,604 RSUs will vest on March 15, 2022, in each case subject to Mr. Randolfi's continued employment with the Company through the applicable vesting date. 673 RSUs granted were earned as part of the 2017 annual performance bonus program, and were immediately vested on March 15, 2018 upon grant. See the "Option Exercises and Stock Vested in 2018" table.

(5) The 2018 PSUs reported on this line were earned as described below, and 20% vested on February 12, 2019. Of the remaining PSUs, 25% will vest on January 2, 2020; 50% will vest on January 2, 2021; and 25% will vest on January 2, 2022; in each case subject to Mr. Randolfi's employment as of the applicable vesting date.

(6) 36,226 RSUs will vest on each of March 15, 2019 and March 15, 2020; 72,453 RSUs will vest on March 15, 2021; and 36,227 RSUs will vest on March 15, 2022; in each case subject to Mr. Drobny's continued employment with the Company through the applicable vesting date. 605 RSUs granted were earned as part of the 2017 annual performance bonus program, and were immediately vested on March 15, 2018 upon grant. See the "Option Exercises and Stock Vested in 2018" table.

(7) The 2018 PSUs reported on this line were earned as described below, and 20% vested on February 12, 2019. Of the remaining PSUs, 25% will vest on January 2, 2020; 50% will vest on January 2, 2021; and 25% will vest on January 2, 2022; in each case subject to Mr. Drobny's employment as of the applicable vesting date.

(8) Mr. Krenzer received RSU and PSU awards in October 2017 in connection with his appointment as Chief Operating Officer, and therefore did not receive any new awards during the 2018 annual compensation review.

(9) 13,402 RSUs vested on March 5, 2019; 26,804 RSUs will vest quarterly in four equal installments beginning on June 5, 2019; and 13,402 RSUs will vest quarterly in four equal installments beginning on June 5, 2020; and 25,641 RSUs will vest on September 30, 2019; in each case subject to Ms. Thomas' continued employment with the Company through the applicable vesting date. 82 RSUs granted were earned as part of the 2017 annual performance bonus program, and were immediately vested on March 30, 2018 upon grant. See the "Option Exercises and Stock Vested in 2018" table.

(10) The 2018 PSUs reported on this line were earned as described below, and 7,710 vested on February 12, 2019. Of the remaining PSUs, 2,526 shares will vest on January 2, 2020 and 1,263 shares will vest on January 2, 2021, in each case subject to Ms. Thomas' employment with the Company as of the applicable vesting date.

(11) All outstanding unvested equity was canceled in connection with Mr. Stevens' termination of employment.

2018 PSU Achievement

All PSUs for 2018 (including PSUs with multi-year, time based vesting) were earned based on achievement of certain levels of the following performance objectives in 2018, shown in the table below:

	Performance Metrics			2018	
	Threshold (50%)	Target (100%)	Maximum (150%)	Actual Achievement	Total Performance Payout
Net Customers[1] (33% Weighting)	50.80	51.05	51.55	48.06 (0.0%)	
Gross Profit per Customer (33% Weighting)	$26.92	$27.80	$28.27	$27.15 (21.0%)	37.7%
People Goals (# met)[2] (33% Weighting)	1 goal met	2 goals met	3 goals met	1 goal met (16.7%)	

(1) Expressed in millions.

(2) The People Goals metric under the 2018 PSU plan was based on achievement of up to three strategic people goals relating to the leadership, diversity and engagement.

Based on the achieved levels of the 2018 performance goals described above following completion of the performance period, the Compensation Committee approved the payout of PSUs to our Named Executive Officers for 2018 in the following amounts:

Name	Target PSUs for 2018 (#)	Number of PSUs Earned (#)
Rich Williams	910,591	343,290[1]
Michael Randolfi	274,381	103,440[2]
Dane Drobny	151,746	57,206[3]
Steve Krenzer	198,894	74,983[4]
Melissa Thomas	30,502	11,499[5]
Brian Stevens	105,945	[6]

(1) 179,405 PSUs vested on February 12, 2019. The remaining PSUs earned will vest in four equal annual installments beginning on January 2, 2020, in each case subject to Mr. Williams' employment as of the applicable vesting date.

(2) 46,536 PSUs vested on February 12, 2019. The remaining PSUs earned will vest 25% on January 2, 2020; 50% on January 2, 2021; and 25% on January 2, 2022; in each case subject to Mr. Randolfi's continuous employment with the Company as of the applicable vesting date.

(3) 20,789 PSUs vested on February 12, 2019. The remaining PSUs earned will vest 25% on January 2, 2020; 50% on January 2, 2021; and 25% on January 2, 2022; in each case subject to Mr. Drobny's continuous employment with the Company as of the applicable vesting date.

(4) 74,983 PSUs vested on February 12, 2019.

(5) 7,710 PSUs vested on February 12, 2019. Of the remaining PSUs, 2,526 shares will vest on January 2, 2020 and 1,263 shares will vest on January 2, 2021, in each case subject to Ms. Thomas' employment with the Company as of the applicable vesting date.

(6) Mr. Stevens was not eligible to earn PSUs for 2018 based on his resignation date of November 30, 2018.

Other Compensation

Employee Benefit Programs

Our employee benefit programs, including our 401(k) plan and health, life, and disability coverage programs, are designed to provide a stable array of support to our employees generally, including our NEOs, and their families. We generally do not provide perquisites to our NEOs.

Our 401(k) plan, in which all employees generally are eligible to participate, allows participants to defer compensation up to the maximum amount specified by the Code. Elective deferrals are immediately vested and non-forfeitable upon contribution by the employee. Starting on January 1, 2018, the Company matched 50% of the first 6% of eligible compensation deferred to the plan, which vests on a three-year graded vesting schedule.

We do not maintain any pension plan or arrangement under which our Named Executive Officers are entitled to participate or to receive post-retirement benefits, nor do we maintain any non-qualified deferred compensation plans or arrangements in which our Named Executive Officers are entitled to participate.

Post-Employment Compensation

Messrs. Williams, Randolfi, Drobny, and Krenzer and Ms. Thomas are each party to, and Mr. Stevens was (prior to his resignation) party to, severance benefits agreements with Groupon, which set forth the terms and conditions of certain post-employment arrangements. These agreements provide for certain benefits in the event of the Named Executive Officer’s termination of employment under specified circumstances or upon a change in control. We believe that our extension of these post-employment and change in control benefits is necessary in order to remain competitive with market practice. The material terms of these post-employment arrangements are set forth in “Named Executive Officer Compensation — Severance Benefit Agreements” for all Named Executive Officers other than Mr. Stevens, and “Named Executive Officer Compensation — Resignation of Executive Officer” for Mr. Stevens, whose employment terminated in November 2018.

Additionally, when appointed as our Chief Executive Officer, Mr. Williams received a signing bonus of $1,000,000, paid in full on November 15, 2015, which must be repaid to the Company on a prorated basis if his employment terminates for any reason, other than without "cause" or for "good reason," on or before the four-year anniversary of the payment date.

Related Compensation Policies

Hedging and Pledging Policy

Our directors and Named Executive Officers are prohibited from hedging their ownership of Company stock, including trading in options, puts, calls, or other derivative instruments related to Company stock or debt. They are also prohibited from pledging their stock as collateral for a loan and from holding their stock as collateral in a margin account. Exceptions to the pledging prohibition may be granted by the Company’s General Counsel and Chief Financial Officer (or, in certain cases, the Chairman of the Board or Chairman of the Audit Committee) in limited circumstances if the requesting person demonstrates the financial capacity to repay the loan without resort to the pledged securities.

Officer Stock Ownership Guidelines and Stock Holding Requirements

In 2016, we adopted stock ownership guidelines applicable to certain of our officers, including our Named Executive Officers. This program is designed to further strengthen alignment between the interests of our officers and our stockholders and provides as follows:

Ownership & Holding Requirements	Measurement Requirements	2018 Compliance
• Common stock with a value of at least 4X base salary (CEO) / 2X base salary (all other NEOs) • Meet ownership requirement by the later of April 1, 2021, or 5 years after first becoming subject to the guidelines • An officer must retain 50% of net shares acquired upon the vesting of equity awards until the officer meets the	The following shares count towards compliance • Shares owned outright and beneficially • Unvested RSUs • Earned but unvested PSUs subject only to time-based vesting conditions following the Compensation Committee’s certification of the applicable performance metrics	• All officers were in compliance with the guidelines as of December 31, 2018 • Compliance is measured annually as of December 31st

ownership requirements

Effect of Accounting and Tax Treatment on Compensation Decisions

Accounting Treatment

We recognize a charge to earnings for equity awards. Expense is generally recognized on a straight-line basis over the service period during which awards are expected to vest, except for awards with both performance conditions and a graded vesting schedule, for which expense is recognized using the accelerated method. We expect that our Compensation Committee will continue to review and consider the accounting impact of equity awards in addition to considering the impact for dilution when deciding on amounts and terms of equity grants.

Deductibility of Executive Compensation

Section 162(m) of the Internal Revenue Code (the "Code") generally limits the amount that we may deduct from our federal income taxes for compensation paid to certain of our executive officers to $1 million per executive officer per year. While our Compensation Committee is mindful of the benefit to us of the full deductibility of compensation, the Board and the Compensation Committee believe that we should not be constrained by the requirements of Code Section 162(m) when those requirements would impair our flexibility in compensating our executive officers in a manner that can best promote our corporate objectives. Therefore, the Board and the Compensation Committee have not adopted a policy that would require that all compensation be deductible. We intend to continue to compensate our executive officers in a manner consistent with the best interests of the Company and our stockholders.

Taxation of Parachute Payments and Deferred Compensation

We do not provide and have no obligation to provide any executive officer, including any Named Executive Officer, with a "gross-up" or other reimbursement payment for any tax liability that he or she might owe as a result of the application of Section 280G, 4999, or 409A of the Code. Sections 280G and 4999 of the Code provide that executive officers and directors who hold significant equity interests and certain other service providers may be subject to an excise tax if they receive payments or benefits in connection with a change in control that exceed certain limits prescribed by the Code, and that the employer may forfeit a deduction on the amounts subject to this additional tax. Our 2011 Incentive Plan and our 2010 Plan permit a participant to elect, in his or her discretion, to reduce a payment or acceleration of vesting under the applicable plan to the extent necessary to avoid the imposition of an excise tax under Sections 280G and 4999. Section 409A of the Code also may impose significant taxes on a service provider in the event that he or she receives deferred compensation that does not comply with the requirements of Code Section 409A. We have structured our compensation arrangements with the intention of complying with or otherwise being exempt from the requirements of Code Section 409A, but we do not guarantee any particular tax result for participants. Further, our 2011 Incentive Plan and our 2010 Plan provide that the Board may amend the terms of each plan or any award agreement to the extent necessary to comply with or effectuate an exemption from the requirements of Code Section 409A.

Compensation Risk Assessment

The Company has undertaken a risk review of the Company's employee compensation plans and arrangements in which our employees (including our Named Executive Officers) participate, to determine whether these plans and arrangements have any features that might create undue risks or encourage unnecessary and excessive risk-taking that could threaten the value of the Company. In our review, we considered numerous factors and design elements that manage and mitigate risk, without diminishing the effect of the incentive nature of compensation, including the following:

- a commission-based incentive program for sales employees that only results in payout based on measurable financial or business critical metrics;
- annual bonuses that are funded based on Company performance and are paid based on a combination of quantitative and/or qualitative factors and individual performance;
- ownership of a large percentage of our shares and equity-based awards, including performance share units, by senior management; and
- our practice of awarding long-term equity grants upon hire to our executives in order to directly tie the executive's expectation of compensation to their contributions to the long-term value of the Company.

Based on our review, we concluded that any potential risks arising from our employee compensation programs, including our executive programs, are not reasonably likely to have a material adverse effect on the Company.

NAMED EXECUTIVE OFFICER COMPENSATION

2018 Summary Compensation Table

The following Summary Compensation Table for Fiscal Years 2018, 2017, and 2016 contains compensation information for our Named Executive Officers: (i) Mr. Williams, who has served as Chief Executive Officer since November 3, 2015; (ii) Mr. Randolfi, who has served as Chief Financial Officer since April 29, 2016; (iii) Messrs. Drobny and Krenzer, and Ms. Thomas, who were our other three most highly compensated executive officers serving as of December 31, 2018, and (iv) Mr. Stevens, who would have been a named executive officer had he been serving as Chief Accounting Officer as of December 31, 2018. No compensation information is provided for 2017 and 2016 for Ms. Thomas (who became a Named Executive Officer in 2018), or 2016 for Mr. Krenzer (who joined the Company and became a Named Executive Officer in 2017).

Name and Principal Position	Year	Salary ($)	Bonus ($)	Stock Awards ($) (1) (2)	Non-Equity Incentive Plan Compensation ($)(3)	All Other Compensation ($)(4)	Total Compensation ($)
Rich Williams	2018	750,000	—	8,973,562	360,000	10,410	10,093,972
Chief Executive	2017	700,000	—	6,374,806	704,900	2,160	7,781,866
Officer	2016	700,000	140,000	6,593,680	694,421	2,160	8,130,261
Michael Randolfi	2018	500,000	—	2,898,475	240,000	10,410	3,648,885
Chief Financial	2017	482,945	—	898,661	503,500	2,160	1,887,266
Officer	2016	277,913	258,452	3,494,618	289,931	8,938	4,329,852
Dane Drobny	2018	450,000	—	1,730,965	216,000	10,410	2,407,375
General Counsel &	2017	436,356	—	905,155	453,150	2,160	1,796,821
Corporate Secretary	2016	390,000	78,000	910,293	386,892	2,160	1,767,345
Steve Krenzer	2018	625,000	—	1,034,249	300,000	—	1,959,249
Chief Operating Officer	2017	106,164	—	4,269,303	—	275,807	4,651,274
Melissa Thomas Chief Accounting Officer	2018	277,137(5)	—	476,054	50,630	8,250	812,071
Brian Stevens	2018	305,630	—	1,039,516	—	10,230	1,355,376
Former Chief	2017	331,936	—	536,378	337,398	2,160	1,207,872
Accounting Officer	2016	321,360	64,272	529,165	318,799	2,160	1,235,756

(1) Amounts disclosed in this column relate to grants of RSUs and PSUs made under our 2011 Incentive Plan. With respect to each RSU and PSU grant, the amounts disclosed generally reflect the grant date fair value computed in accordance with FASB ASC Topic 718, and does not reflect amounts actually paid to, or realized by, the Named Executive Officers in 2018, 2017 or 2016. For additional information, see Note 12 to the Company's audited consolidated financial statements for the year ended December 31, 2018, included in the Company's Annual Report on Form 10-K for the year ended December 31, 2018. Assuming achievement of the highest level of the performance conditions, the aggregate grant date fair value of the PSUs for 2018 would be as follows: Mr. Williams - $ 9,360,874; Mr. Randolfi - $ 2,820,636; Mr. Drobny - $ 1,559,950; Mr. Krenzer - $ 2,044,630; Mr. Stevens - $ 1,089,116; Ms. Thomas - $ 276,958. For further information on the RSU and PSU grants made in 2018, see the "Grants of Plan-Based Awards in 2018" table below.

(2) Amounts disclosed in this column for 2018 do not include immediately vested RSU grants made on March 15, 2018 to Messrs. Williams, Randolfi, Drobny, Krenzer, and Stevens, or the immediately vested RSU grant made on March 29, 2018 to Ms. Thomas, because these immediately vested RSUs represent payment for the above-target amounts under our annual performance bonus program for the 2017 calendar year, which above-target amounts were included in the amounts reported in the “Non-Equity Incentive Plan Compensation” column for 2017 in this table. For further information about these grants, see the section entitled “Grants of Plan-Based Awards In 2018” below.

(3) Amounts disclosed in this column for 2018 reflect cash amounts paid under our annual performance bonus program. For further information, see the section entitled "Compensation Discussion & Analysis— Annual Performance Bonus Program" above.

(4) Amounts disclosed in this column for 2018 include matching contributions under the Groupon, Inc. 401(k) Savings Plan (for 2018, $8,250 for all of our named Named Executive Officers other than Mr. Krenzer), and amounts paid by the Company for parking expenses.

(5) The amount disclosed in this column represents Ms. Thomas' rate of base pay, based on her salary in effect prior to her appointment as Chief Accounting Officer, and following such appointment.

Grants of Plan-Based Awards In 2018

The following table sets forth information regarding grants of awards made to our Named Executive Officers during 2018. We did not grant any option awards during 2018.

			Estimated Future Payouts under Non-Equity Incentive Plan Awards			Estimated Future Payouts under Equity Incentive Plan Awards (1)			Number of Securities Underlying Restricted Stock Units	Grant Date Fair Value of Stock Awards
Name (a)	Award Type(b)	Grant Date (c)	Threshold ($)(d)	Target ($)(e)	Maximum ($)(f)	Threshold (#)(g)	Target (#)(h)	Maximum (#)(i)	(#)(j)	($)[(2)](k)
Rich Williams	Annual Performance Bonus		187,500	750,000	1,125,000					
	RSU	2/13/2018							815,094	4,238,489
	RSU	3/15/2018							942	4,286
	PSU	2/13/2018				455,296	910,591	1,821,182		4,735,073
Michael Randolfi	Annual Performance Bonus		125,000	500,000	750,000					
	RSU	2/13/2018							283,018	1,471,694
	RSU	3/15/2018							673	3,062
	PSU	2/13/2018				137,191	274,381	548,762		1,426,781
Dane Drobny	Annual Performance Bonus		112,500	450,000	675,000					
	RSU	2/13/2018							181,132	941,886
	RSU	3/15/2018							605	2,753
	PSU	2/13/2018				75,873	151,746	303,492		789,079
Steve Krenzer[(3)]	Annual Performance Bonus		156,250	625,000	1,250,000					
	RSU	—							—	—
	PSU	2/13/2018				99,447	198,894	397,788		1,034,249
Melissa Thomas	Annual Performance Bonus		26,370	105,479	158,219					
	RSU	3/29/2018							82	356
	RSU	4/25/2018							53,608	249,813
	RSU	10/25/2018							25,641	84,102
	PSU	4/25/2018				15,251	30,502	61,004		142,139
Brian Stevens	Annual Performance Bonus		83,750	335,000	502,500					
	RSU	2/13/2018							93,962	488,602
	RSU	3/15/2018							450	2,048
	PSU	2/13/2018				52,973	105,945	211,890		550,914

(1) Reflects the potential number of PSUs which may be earned for performance at the threshold, target and maximum levels, respectively. These awards vested to the extent that the Company achieved certain performance measures over the one-year period beginning on January 1, 2018. See, "Compensation Discussion and Analysis — Section 5 — Pay Mix and Target Opportunity — Equity-Based Awards — PSUs" for more information on the terms of the PSUs.

(2) Reflects grant date fair value of RSUs computed in accordance with FASB ASC Topic 718. For additional information, see Note 12 to the Company's audited consolidated financial statements for the year ended December 31, 2018, included in the Company's Annual Report on Form 10-K for the year ended December 31, 2018.

(3) Mr. Krenzer received an RSU award in connection with his acceptance of the Chief Operating Officer position, and as such, did not receive an RSU award during the 2018 annual compensation review process.

Outstanding Equity Awards At 2018 Year-End

The following table lists all outstanding equity awards held by our Named Executive Officers as of December 31, 2018. There were no outstanding stock options held by our Named Executive Officers as of December 31, 2018. See "Potential Payments on Termination or Change-in-Control" for information regarding the impact of certain employment termination scenarios on outstanding equity awards.

Name	Grant Date	Number of Shares of Stock That Have Not Vested (#)	Market Value of Shares of Stock That Have Not Vested(1)($)
Rich Williams	11/03/2015 (2)	488,441	1,563,011
	10/25/2016 (3)	409,152	1,309,286
	10/31/2017 (4)	1,033,757	3,308,022
	02/13/2018 (5)	815,094	2,608,301
	02/13/2018 (6)	163,885	524,432
Michael Randolfi	04/25/2016 (7)	94,286	301,715
	02/14/2017 (8)	139,362	445,958
	02/13/2018 (9)	283,018	905,658
	02/13/2018 (10)	56,904	182,093
Dane Drobny	02/14/2017 (11)	156,801	501,763
	02/13/2018 (12)	181,132	579,622
	02/13/2018 (13)	36,417	116,534
Steve Krenzer	10/31/2017 (14)	596,688	1,909,402
Melissa Thomas	07/17/2017 (15)	59,850	191,520
	04/25/2018 (16)	53,608	171,546
	10/25/2018 (17)	25,641	82,051
	04/25/2018 (18)	3,789	12,125
Brian Stevens (19)	—	—	—

(1) Reflects the market value of outstanding RSUs and PSUs, based on the price per share of common stock of $3.20, the closing market price on December 31, 2018. These amounts do not correspond to the actual value that may be realized by the Named Executive Officers.

(2) RSUs vest according to the following schedule: 122,110 will vest on the last day of each calendar quarter over a nine month period beginning on March 31, 2019 and 122,111 will vest on December 31, 2019, in each case subject to Mr. Williams' continued employment with the Company through the applicable vesting date.

(3) RSUs vest according to the following schedule: 232,109 vested on March 15, 2019 and 177,043 will vest on March 15, 2020, in each case subject to Mr. Williams' continued employment with the Company through the applicable vesting date.

(4) RSUs vest according to the following schedule: 190,939 will vest on October 31, 2019, 370,939 will vest on October 31, 2020, 280,939 will vest on October 31, 2021, and 190,940 will vest on October 31, 2022, in each case subject to Mr. Williams' continued employment with the Company through the applicable vesting date.

(5) RSUs vest according to the following schedule: 163,018 will vest on October 31, 2019, and 652,076 will vest annually in equal installments beginning on October 31, 2020 and ending on October 31, 2023, in each case subject to Mr. Williams' continued employment with the Company through the applicable vesting date.

(6) PSUs will vest in four equal annual installments beginning on January 2, 2020, in each case subject to Mr. Williams' employment as of the applicable vesting date.

(7) RSUs vest according to the following schedule: 47,143 will vest on each of January 25, 2019 and April 25, 2019, in each case subject to Mr. Randolfi's continued employment with the Company through the applicable vesting date.

(8) RSUs vest according to the following schedule: 14,459 vested on March 15, 2019, and 124,903 will vest in equal installments quarterly beginning on June 15, 2019 and ending on March 15, 2020, in each case subject to Mr. Randolfi's continued employment with the Company through the applicable vesting date.

(9) RSUs vest according to the following schedule: 56,603 will vest on each of March 15, 2019 and March 15, 2020, 113,208 will vest on March 15, 2021, and 56,604 will vest on March 15, 2022, in each case subject to Mr. Randolfi's continued employment with the Company through the applicable vesting date.

(10) PSUs will vest 25% on January 2, 2020; 50% on January 2, 2021; and 25% on January 2, 2022; in each case subject to Mr. Randolfi's employment with the Company as of the applicable vesting date.

(11) RSUs vest according to the following schedule: 11,621 vested on March 15, 2019 and 145,180 will vest in equal installments quarterly beginning on June 15, 2019 and ending on March 15, 2020, in each case subject to Mr. Drobny's continued employment with the Company through the applicable vesting date.

(12) RSUs vest according to the following schedule: 36,226 vested on March 15, 2019, 36,226 will vest on March 15, 2020, 72,453 will vest on March 15, 2021, and 36,227 will vest on March 15, 2022, in each case subject to Mr. Drobny's continued employment with the Company through the applicable vesting date.

(13) PSUs earned will vest 25% on January 2, 2020; 50% on January 2, 2021; and 25% on January 2, 2022; in each case subject to Mr. Drobny's employment with the Company as of the applicable vesting date.

(14) RSUs vest according to the following schedule: 74,586 will vest quarterly over a two year period beginning on January 30, 2019, in each case subject to Mr. Krenzer's continued employment with the Company through the applicable vesting date.

(15) RSUs vest according to the following schedule: 59,850 will vest quarterly in six equal installments beginning on February 22, 2019, in each case subject to Ms. Thomas' continued employment with the Company through the applicable vesting date.

(16) RSUs vest according to the following schedule: 100% on September 30, 2019, subject to Ms. Thomas' continued employment with the Company through the vesting date.

(17) RSUs vest according to the following schedule: 13,402 vested on March 5, 2019, 26,804 will vest quarterly in four equal installments beginning on June 5, 2019, and 13,402 will vest quarterly in four equal installments beginning on June 5, 2020, in each case subject to Ms. Thomas' continued employment with the Company through the applicable vesting date.

(18) 2,526 PSUs will vest on January 2, 2020 and 1,263 PSUs will vest on January 2, 2021, in each case subject to Ms. Thomas’ employment with the Company as of the applicable vesting date.

(19) All of Mr. Stevens’ outstanding, unvested equity was forfeited upon his resignation from the Company on November 30, 2018.

Option Exercises and Stock Vested in 2018

The following table sets forth the number of shares of common stock acquired during 2018 by our Named Executive Officers upon the vesting of RSUs and PSUs and the value realized upon such vesting. No stock options were exercised in 2018.

Name	Number of Shares Acquired on Vesting (#)(1)	Value Realized on Vesting ($)(2)
Rich Williams	1,231,669	4,890,137
Michael Randolfi	294,874	1,322,331
Dane Drobny	262,042	1,197,371
Steve Krenzer	373,327	1,272,518
Melissa Thomas	84,742	369,838
Brian Stevens	55,018	239,722

(1) Reflects the aggregate number of shares of common stock underlying the RSUs that vested in 2018 and the aggregate number of shares of common stock underlying the 2018 PSUs that vested on February 12, 2019 following the Compensation Committee’s certification of the 2018 performance metrics. Of the amount shown for Mr. Williams, 546,435 shares of common stock were withheld to pay taxes due in connection with the vesting. Of the amount shown for Mr. Randolfi, 113,731 shares of common stock were withheld to pay taxes due in connection with the vesting. Of the amount shown for Mr. Drobny, 117,074 shares of common stock were withheld to pay taxes due in connection with the vesting. Of the amount shown for Mr. Krenzer, 138,048 shares of common stock were withheld to pay taxes due in connection with the vesting. Of the amount shown for Ms. Thomas, 30,301 shares of common stock were withheld to pay taxes due in connection with the vesting. Of the amount shown for Mr. Stevens, 22,630 shares of common stock were withheld to pay taxes due in connection with the vesting.

(2) Calculated by multiplying (i) the fair market value of common stock on the vesting date, which was determined using the closing price on the NASDAQ of a share of common stock on the date of vesting, or if such day is a holiday, on the immediately preceding trading day, by (ii) the number of shares of common stock acquired upon vesting. Of the amount shown for Mr. Williams, $2,720,615 represents net proceeds. Of the amount shown for Mr. Randolfi, $817,822 represents net proceeds. Of the amount shown for Mr. Drobny, $659,443 represents net proceeds. Of the amount shown for Mr. Krenzer, $803,209 represents net proceeds. Of the amount shown for Ms. Thomas, $236,469 represents net proceeds. Of the amount shown for Mr. Stevens, $141,309 represents net proceeds.

Severance Benefit Agreements

Each of our Named Executive Officers is party to a severance benefit agreement with the Company (a “Severance Agreement” or the “Severance Agreements”).

In 2017, the Company entered into severance agreements with Messrs. Williams, Randofi, Drobny, and Krenzer.

Under the terms of the Severance Agreements, upon a termination of a Named Executive Officer’s employment by the Company without cause, or upon a termination of employment for good reason (a “Qualifying Termination”) that is not a CIC Termination (as defined below), such individual is eligible to receive (a) a lump sum payment in an amount equal to 12 months of such individual's annual base salary, (b) to the extent such individual is enrolled in COBRA continuation coverage under the Company's group health plan on the date such payment is made, an additional lump sum payment equal to 12 times the monthly COBRA premium for such coverage, (c) accelerated vesting of such individual's time-based equity awards scheduled to vest over the 12 month period beginning on the date of termination of employment, and (d) vesting of the first tranche of such individual’s performance-based equity awards for the annual performance period in which the date of termination of employment occurs based on actual performance for the full performance period.

Upon a Qualifying Termination occurring within six months prior to, or 12 months following, a change in control (a “CIC Termination”), each Named Executive Officer is eligible to receive (a) a lump sum payment in an amount equal to 12 months of such individual's annual base salary, (b) to the extent such individual is enrolled in COBRA continuation coverage under the Company's group health plan on the date such payment is made, an additional lump sum payment equal to 12 times the monthly COBRA premium for such coverage, (c) a lump sum payment in an amount equal to the pro-rated portion of target annual cash incentive award, based on the number of days served during the year of termination, and (d) full vesting of 100% of their then-outstanding equity awards, with any performance-based equity awards deemed earned at target.

The Company entered into a severance agreement with Ms. Thomas in connection with her appointment as Chief Accounting Officer in 2018, which provides severance benefits in line with the benefits offered to other similarly situated members of senior management. Such benefits are substantially comparable to the severance benefits described above, except that for a Qualifying Termination that is not a CIC Termination, the term “6 months” shall replace the term “12 months,” the term “6 times” shall replace the term “12 times,” and the term "50% to 100% of the first tranche, based on the applicable termination date" will replace the term "first tranche"; and for a CIC Termination, the term “50%” will replace the term “100%” and subsection (c) shall not apply.

Each Named Executive Officer is also subject to non-competition and non-solicitation restrictive covenants for a period of 18 months following the termination of their employment for any reason. To receive any payments or benefits under the Severance Agreements, each Named Executive Officer must sign, and allow to become effective within 45 days following his or her termination of employment, a release of claims in substantially the form attached to the Severance Agreements. The terms “cause,” “good reason” and “change in control” are defined in the applicable Severance Agreements.

Resignation of Executive Officer

Brian Stevens. Mr. Stevens served as our Chief Accounting Officer until November 30, 2018. Mr. Stevens did not receive any cash or other compensation upon his resignation. Mr. Stevens forfeited RSU awards totaling 144,483 shares and target PSU awards totaling 105,945 shares.

Summary of Potential Benefits

The table below shows the payments and benefits potentially payable to each of our Named Executive Officers other than Mr. Stevens (who served as our Chief Accounting Officer until November 30, 2018) upon a change in control, CIC Termination or Qualifying Termination (other than a CIC Termination) based on an assumed termination date of December 31, 2018. The employment of the Named Executive Officers listed below did not actually terminate on December 31, 2018, and as a result, such Named Executive Officers did not receive any of the amounts shown in the table below. The actual amounts to be paid to such Named Executive Officers in connection with their termination of employment can only be determined at the time of such termination and will depend on the circumstances of his or her termination. In addition to the amounts shown in the table below, each Named Executive Officer is entitled to receive amounts earned during the term of employment regardless of the manner of termination, including accrued but unpaid base salary and other employee benefits to which such Named Executive Officer was entitled on the date of termination.

Executive	Payment Elements	Change in Control (no Termination) ($)	CIC Termination ($)[1]	Qualifying Termination (other than a CIC Termination)($)[2]
Rich Williams	Salary [3]	—	750,000	750,000
	Annual Performance Bonus	—	750,000[4]	—
	Restricted Stock Units	—	9,313,053[5]	3,438,422[6]
	Health Coverage [7]	—	25,683	25,683
	TOTAL	—	10,838,736	4,214,105
Mike Randolfi	Salary [3]	—	500,000	500,000
	Annual Performance Bonus	—	500,000[4]	—
	Restricted Stock Units	—	1,835,424	828,883[6]
	Health Coverage [7]	—	25,683	25,683
	TOTAL	—	2,861,107	1,354,566
Dane Drobny	Salary [3]	—	450,000	450,000
	Annual Performance Bonus	—	450,000[4]	—
	Restricted Stock Units	—	1,197,920[5]	501,542[6]
	Health Coverage [7]	—	25,683	25,683
	TOTAL	—	2,123,603	977,225
Steve Krenzer	Salary [3]	—	625,000	625,000
	Annual Performance Bonus	—	625,000[4]	—
	Restricted Stock Units	—	1,909,402[5]	954,701[6]
	Health Coverage [7]	—	25,683	25,683
	TOTAL	—	3,185,085	1,605,384
Melissa Thomas	Salary [8]		325,000	162,500
	Annual Performance Bonus		—	—
	Restricted Stock Units		228,621[9]	128,170[10]
	Health Coverage [7]		0	—
	TOTAL		553,621	290,670

(1) For each of our Named Executive Officers listed in this table, amounts in this column include cash and equity acceleration benefits as a result of a CIC Termination under the Severance Agreements.

(2) For each of our Named Executive Officers listed in this table, amounts in this column include cash and equity acceleration benefits as a result of a Qualifying Termination that is not a CIC Termination under the Severance Agreements.

(3) Represents a lump sum payment in an amount equal to 12 months of such individual's annual base salary.

(4) Represents a lump sum payment in an amount equal to the target annual cash incentive award; termination of employment on an earlier date would result in pro-ration of the target award based on the number of days served during the year in which the termination of employment occurred.

(5) Represents the dollar value of 100% accelerated vesting of such individual's service-based equity awards outstanding as of December 31, 2018. No amounts are shown for 2018 PSUs scheduled to be paid in the first quarter of 2019 because these awards were earned based on performance through December 31, 2018 as described

in the "Option Exercises and Stock Vested in 2018" table above.

(6) Represents the dollar value of accelerated vesting of such individual's service-based equity awards scheduled to vest over the 12 month period following December 31, 2018. No amounts are shown for 2018 PSUs scheduled to be paid in the first quarter of 2019 because these awards were earned based on performance through December 31, 2018 as described in the "Option Exercises and Stock Vested in 2018" table above.

(7) Represents a lump sum payment equal to twelve months of Company-paid health insurance coverage under the Consolidated Omnibus Budget Reconciliation Act of 1985, including both the employer and employee portions of the cost, based on such individual's rates and elections as of December 31, 2018.

(8) Represents a lump sum payment in an amount equal to 12 months of annual base salary in the case of a CIC Termination, and 6 months of annual base salary in the case of a Qualifying Termination that is not a CIC Termination.

(9) Represents the dollar value of 50% accelerated vesting of such individual's service-based equity awards outstanding as of December 31, 2018. No amounts are shown for 2018 PSUs scheduled to be paid in the first quarter of 2019 because these awards were earned based on performance through December 31, 2018 as described in the "Option Exercises and Stock Vested in 2018" table above.

(10) Represents the dollar value of accelerated vesting of such individual's service-based equity awards scheduled to vest over the 6 month period following December 31, 2018. No amounts are shown for 2018 PSUs scheduled to be paid in the first quarter of 2019 because these awards were earned based on performance through December 31, 2018 as described in the "Option Exercises and Stock Vested in 2018" table above.

CEO Pay Ratio

For the 2018 fiscal year, the ratio of the annual total compensation of Mr. Williams, our Chief Executive Officer ("CEO Compensation"), to the median of the annual total compensation of all of our employees and those of our consolidated subsidiaries other than Mr. Williams ("Median Annual Compensation") was 208 to 1. This ratio disclosure is a reasonable estimate calculated in a manner consistent with Item 402(u) of Regulation S-K using the data and assumptions described below. In this summary, we refer to the employee who received the Median Annual Compensation as the "Median Employee."

For purposes of this summary, CEO Compensation was $ 10,093,972. CEO Compensation for purposes of this disclosure represents the total compensation reported for Mr. Williams under "2018 Summary Compensation Table" for the 2018 fiscal year.

For purposes of this summary, Median Annual Compensation was $48,605, and was calculated by totaling for our Median Employee all applicable elements of compensation for the 2018 fiscal year in accordance with Item 402(c)(2)(x) of Regulation S-K.

The pay ratio reported above is a reasonable estimate calculated in a manner consistent with SEC rules based on our internal records and the methodology described below. To identify the Median Employee as well as determine the median employee's annual total compensation, the methodology and the material assumptions, adjustments, and estimates that were used are as follows:

- As permitted by the SEC, the Company used the same Median Employee identified for determining its 2017 CEO pay ratio. The Company determined that there had not been any changes to its employee population or compensation programs that would significantly impact the pay ratio disclosure for 2018.
- To identify the Median Employee, we first determined our employee population as of December 31, 2017 (the "Determination Date"). We had 6,592 employees, representing all full-time, part-time, seasonal and temporary employees of us and our consolidated subsidiaries (other than our CEO) as of the Determination Date. This number does not include Mr. Williams, and, consistent with the applicable SEC rules, (i) any independent contractors or "leased" workers and (ii) 79 employees from Morocco due to an office closure.
- We then measured compensation for the period beginning on January 1, 2017 and ending on December 31, 2017 for these 6,592 employees (after the exclusions noted above). This compensation measurement was calculated by totaling for each employee, cash compensation paid in 2017, including regular pay (wages and salary), all variants of overtime, variants of bonus payments, and commissions; and excluding sign on bonuses.
- A portion of our employee workforce (full-time and part-time) worked for less than the full fiscal year due to commencing employment after the beginning of the fiscal year. In determining the Median Employee, we annualized the total compensation for such individuals.

Equity Compensation Plan Information

The following table gives information about shares of our common stock that may be issued upon the exercise of options, warrants and rights under all of our existing equity compensation plans as of December 31, 2018, including our 2008 Plan, 2010 Plan, 2011 Incentive Plan, and Purchase Plan. No warrants are outstanding under any of the foregoing plans. We refer to these plans and grants collectively as our Equity Compensation Plans.

Plan Category	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	30,525,864 (1)	$1.80(2)	57,087,932 (3)
Equity compensation plans not approved by security holders	—	—	—
Total	30,525,864	$1.80	57,087,932

(1) This amount includes the following:

- 212,787 shares that may be issued in connection with outstanding stock options.
- 29,995,991 shares that may be issued in connection with stock awards.
- 317,086 shares that may be issued in connection with deferred stock units held by non-employee directors under the Director Compensation Plan.

(2) Indicates a weighted average price for 212,787 outstanding options under our 2008 Plan and our 2010 Plan. There are no outstanding options under the 2011 Plan.

(3) As of December 31, 2018, 54,927,088 shares remained available for issuance under the 2011 Incentive Plan and 2,160,844 shares available for future issuance under the Purchase Plan. Permissible awards under the 2011 Incentive Plan include stock options, stock appreciation rights, restricted stock, restricted stock units and other stock-based awards, including awards where vesting, granting, or settlement of which is contingent upon the achievement of specified performance goals, called “performance awards” and cash incentive awards.

Compensation Committee Interlocks And Insider Participation

During fiscal year 2018, Peter Barris, Robert Bass, and Joseph Levin served as members of the Compensation Committee. All members of the Committee were independent directors, and no member was an employee or former employee of Groupon. During fiscal year 2018, none of our executive officers served on the Compensation Committee (or its equivalent) or board of directors of another entity whose executive officer served on our Compensation Committee.

COMPENSATION COMMITEE REPORT

The Compensation Committee has reviewed and discussed with management the Compensation Discussion and Analysis provided above. Based on its review and discussions, the Compensation Committee recommended to the Board that the Compensation Discussion and Analysis be included in this proxy statement and the Company's Annual Report on Form 10-K for the year ended December 31, 2018.

The foregoing report was submitted by the Compensation Committee of the Board and shall not be deemed to be "soliciting material" or to be "filed" with the SEC or subject to Regulation 14A promulgated by the SEC or Section 18 of the Exchange Act, and shall not be deemed incorporated by reference into any prior or subsequent filing by us under the Securities Act or the Exchange Act.

Compensation Committee
Peter Barris (Chair)
Robert Bass
Joseph Levin

AUDIT COMMITEE REPORT

The Audit Committee serves as the representative of the Board with respect to its oversight of:

- accounting and financial reporting processes and the audit of the Company's consolidated financial statements;
- the integrity of the Company's consolidated financial statements;
- internal controls;
- legal compliance and ethics policies relating to accounting, internal controls and auditing matters;
- systems and policies to monitor and manage business risk;
- the independent registered public accounting firm's appointment, qualifications, independence and compensation; and
- the performance of the Company's internal audit function.

The Audit Committee selects the Company's independent registered public accounting firm, Deloitte, and approves the lead audit engagement partner, reviews the performance of the Company's independent registered public accounting firm in the annual audit of the Company's consolidated financial statements, including the selection and performance of the lead audit engagement partner, and reviews and approves the independent registered public accounting firm's fees. In selecting and evaluating an independent registered public accounting firm, the Audit Committee considers such factors as the quality and efficiency of the services provided by the auditor, the auditor's capabilities and the auditor's technical expertise and knowledge of the Company's operations and industry. Each year, the Audit Committee evaluates the qualifications, performance, tenure and independence of the Company's independent auditor and determines, after also considering the impact of a change in auditor, whether to re-engage the current independent auditor. Deloitte has served as the Company's independent registered public accounting firm since May 2017.

The Audit Committee is composed of three non-employee directors. The Board has determined that each member of the Audit Committee is independent under applicable NASDAQ and SEC rules and that each member qualifies as an "audit committee financial expert" under SEC rules.

The Audit Committee provides the Board such information and materials as it may deem necessary to make the Board aware of financial matters requiring the attention of the Board. The Audit Committee reviews the Company's financial disclosures and meets privately, outside the presence of management, with the Company's independent registered public accounting firm. In fulfilling its oversight responsibilities, the Audit Committee reviewed and discussed the audited consolidated financial statements in the Company's 2018 Annual Report with management, including a discussion of accounting principles, the reasonableness of significant judgments made in connection with the audited consolidated financial statements, and disclosures in the consolidated financial statements. The Audit Committee reports on these meetings to the Board.

Management has primary responsibility for preparing the Company's consolidated financial statements and for the Company's financial reporting processes. In addition, management is responsible for establishing and maintaining adequate internal control over financial reporting.

The Audit Committee reports as follows:

1. The Audit Committee has reviewed and discussed the audited consolidated financial statements for fiscal year 2018 with management.
2. The Audit Committee has discussed with Deloitte, the Company's independent registered public accounting firm for fiscal year 2018, the matters required to be discussed under the Public Company Accounting Oversight Board standards.
3. The Audit Committee has received the written disclosures and the letter from Deloitte pursuant to Rule 3526 of the Public Company Accounting Oversight Board, and has discussed with Deloitte its independence, including whether the provision of non-audit services is compatible with its independence.

The Audit Committee has adopted a policy that requires pre-approval of all audit, audit-related, tax services, and other services performed by the independent registered public accounting firm. The policy provides for pre-approval by the Audit Committee (or by one or more members of the Audit Committee pursuant to any delegated authority) of specifically defined audit and non-audit services. Unless the specific service has been previously pre-approved with respect to that fiscal year, the Audit Committee (or any member or members of the Audit Committee with such delegated authority) must approve the specific service before the independent registered public accounting firm is engaged to perform such service for the Company.

Based on the reviews and discussions described above, the Audit Committee recommended to the Board that the audited consolidated financial statements be included in Groupon's Annual Report on Form 10-K for the fiscal year ended December 31, 2018 for filing with the SEC.
The foregoing report was submitted by the Audit Committee of the Board and shall not be deemed to be "soliciting material" or to be "filed" with the SEC or subject to Regulation 14A promulgated by the SEC or Section 18 of the Exchange Act, and shall not be deemed incorporated by reference into any prior or subsequent filing by the Company under the Securities Act or the Exchange Act.

Audit Committee
Robert Bass (Chair)
Michael Angelakis
Ann Ziegler

INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Fees of Independent Registered Public Accounting Firm

The following table presents fees billed for professional audit services rendered by Deloitte for the audit of Groupon's annual consolidated financial statements for the years ended December 31, 2018 and 2017, and fees billed for other services rendered by Deloitte during this period.

	Year Ended December 31, 2018 ($)	Year Ended December 31, 2017 ($)
Audit Fees[(1)]	4,040,460	3,657,000
Audit-Related Fees	14,220	9,410
Tax Fees[(2)]	540,668	763,800
Other Fees[(3)]	—	264,000
Total	4,595,348	4,694,210

(1) Audit Fees. Audit fees for the 2018 and 2017 fiscal years include the aggregate fees incurred for the audit of the Company's annual consolidated financial statements, and audit, review and attest services rendered in connection with other regulatory or statutory filings.

(2) Tax Fees. Tax fees consist of tax compliance and advisory work related to the Company's research and development credit, tax incentives, international tax planning and intellectual property.

(3) Other Fees. Other fees include certain consulting services.

The Audit Committee has concluded that the provision of the non-audit services listed above is compatible with maintaining the independence of Deloitte.

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

The Audit Committee has established a policy for pre-approval of all audit and permissible non-audit services provided by the independent registered public accounting firm. Each year, the Audit Committee approves the terms on which the independent registered public accounting firm is engaged for the ensuing fiscal year.

CERTAIN RELATIONSHIPS AND RELATED PARTY TRANSACTIONS

Our Audit Committee is responsible for approving related party transactions, as defined in applicable rules promulgated by the SEC. Our Audit Committee operates under a written related party transaction policy pursuant to which all related party transactions are reviewed for potential conflicts of interest. In addition, our Code of Conduct requires that our directors and executive officers avoid situations where there will be an actual or perceived conflict of interest, and our Nominating Committee reviews potential conflicts of interest of directors. In 2016 in the ordinary course of our business, we have entered into the related party transaction described below. Pursuant to our related party transaction policy, this transaction was approved by our Audit Committee.

On December 28, 2016, we entered into a sublease for portions of our office space in Chicago, Illinois to Uptake, Inc. ("Uptake"), a Lightbank LLC ("Lightbank") portfolio company. Lightbank is a private investment firm specializing in information technology companies. Eric Lefkofsky, our Chairman of the Board and co-founder, owns a significant equity interest in and is a co-founder of Lightbank. The sublease was negotiated on an arm’s-length basis and is a market rate transaction on terms that the Company believes are no less favorable than would have been reached with an unrelated third party. The sublease extends through January 31, 2026 and the sublease rentals over that term total approximately $18.2 million. Pursuant to the Company’s related party transaction policy, the Company’s Audit Committee approved the sublease. For the year ended December 31, 2018, the Company recognized $2.1 million in income from the sublease.

Section 16(a) Beneficial Ownership Reporting Compliance

Section 16(a) of the Exchange Act requires our directors, executive officers, and persons who own more than 10% of our common stock to file reports of their ownership and changes in ownership of our common stock with the SEC. Our employees prepare these reports for our directors and executive officers who request it using information obtained from them and from Groupon's records. We believe that all applicable Section 16(a) filing requirements were timely met during fiscal year 2018.

Information Regarding Beneficial Ownership of Principal Stockholders, Directors And Management

The following table sets forth certain information with respect to the beneficial ownership of our common stock as of April 18, 2019 for each person who we know beneficially owns 5% or more of our outstanding capital stock; each of our directors and director nominees; each of our Named Executive Officers; and all of our directors and executive officers as a group.

Unless otherwise noted below, the address of each beneficial owner listed in the table is c/o Groupon, Inc., 600 West Chicago Avenue, Suite 400, Chicago, Illinois 60654.

We have determined beneficial ownership in accordance with the rules of the SEC. Except as indicated by the footnotes below, we believe, based on the information furnished to us, that the persons and entities named in the table below have sole voting and investment power with respect to all shares of common stock that they beneficially own, subject to applicable community property laws.

Applicable percentage ownership is based on 568,007,085 shares of common stock outstanding as of April 18, 2019. In computing the number of shares of common stock beneficially owned by a person and the percentage ownership of that person, we deemed outstanding (i) RSUs held by that person that will vest within 60 days of April 18, 2019 and (ii) shares of common stock underlying the Company's 3.25% Senior Convertible Notes due 2022 (the "Notes"), which are convertible at any time into shares of common stock, cash, or a combination thereof, at the Company's option. We did not deem these shares outstanding, however, for the purpose of computing the percentage ownership of any other person. Beneficial ownership representing less than 1% is denoted with an "*." Total percentages in the table below may not add due to rounding.

Name of Beneficial Owner	Shares of Common Stock Beneficially Owned	Approximate Percentage of Common Stock
Officers and Directors		
Eric Lefkofsky(1)	Table of Contents	

Noninterest Expense

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

	Year Ended December 31,			Increase (decrease) 2015 versus 2014		Increase (decrease) 2014 versus 2013	
	2015	**2014**	**2013**	**Amount**	**Percent**	**Amount**	**Percent**
	(Dollars in thousands)						
Salaries and employee benefits	$ 35,146	$ 26,250	$ 23,450	$ 8,896	34%	$ 2,800	12%
Occupancy and equipment	4,300	4,053	4,043	247	6%	10	0%
Acquisition and integration related costs(1)	3,546	895		2,651	296%	895	N/A
Professional fees	1,828	1,891	2,588	(63)	3%	(697)	27%
Data processing	1,371	969	1,078	402	41%	(109)	10%

Software subscriptions	1,214	999	1,289	215	22%	(290)	22%
Insurance expense	1,127	1,126	1,032	1	0%	94	9%
FDIC deposit insurance premiums	1,092	892	894	200	22%	(2)	0%
Correspondent bank charges	1,021	760	684	261	34%	76	11%
Amortization on intangible assets	1,043	510	473	533	105%	37	8%
Foreclosed assets	(94)	53	(251)	(147)	277%	304	121%
Other	7,079	5,824	5,190	1,255	22%	634	12%
Total	$ 58,673	$ 44,222	$ 40,470	$ 14,451	33%	$ 3,752	9%

(1) Does not include one-time pre-tax severance and retention cost of $2.9 million, which is included in salaries and employee benefits for the year ended December 31, 2015.

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

	2015		2014		2013	
	Amount	Percent of Total	Amount	Percent of Total	Amount	Percent of Total
			(Dollars in thousands)			
Salaries and employee benefits	$ 35,146	61%	$ 26,250	59%	$ 23,450	58%
Occupancy and equipment	4,300	7%	4,053	9%	4,043	10%
Acquisition and integration related costs(1)	3,546	6%	895	2%		0%
Professional fees	1,828	3%	1,891	4%	2,588	6%
Data processing	1,371	2%	969	2%	1,078	3%
Software subscriptions	1,214	2%	999	2%	1,289	3%
Insurance expense	1,127	2%	1,126	3%	1,032	3%
FDIC deposit insurance premiums	1,092	2%	892	2%	894	2%
Correspondent bank charges	1,021	2%	760	2%	684	2%
Amortization on intangible assets	1,043	1%	510	1%	473	1%
Foreclosed assets	(94)	0%	53	0%	(251)	1%
Other	7,079	12%	5,824	14%	5,190	13%
Total	$ 58,673	100%	$ 44,222	100%	$ 40,470	100%

(1) Does not include one-time pre-tax severance and retention cost of $2.9 million, which is included in salaries and employee benefits for the year ended December 31, 2015.

Noninterest expense for the year ended December 31, 2015 increased 33% to $58.7 million, compared to $44.2 million for the year ended December 31, 2014. The increase from year to year was primarily due to costs related to the integration of Focus, and the additional operating costs of Focus and Bay View

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Funding. Noninterest expense included total Focus pre tax acquisition and integration costs of $6.4 million for the year ended December 31, 2015. Of the total acquisition and integration costs, salaries and employee benefits (including severance and retention expenses) were $2.9 million, and other expenses related to the Focus acquisition and integration were $3.5 million for the year ended December 31, 2015. Full-time equivalent employees were 260, 242, and 193 at December 31, 2015, 2014, and 2013, respectively.

Noninterest expense for the year ended December 31, 2014 increased 9% to $44.2 million, compared to $40.5 million for the year ended December 31, 2013. The increase from year to year was primarily due to increased salaries and employee benefits expense. The increase in noninterest expense for the year ended December 31, 2014 was primarily due to two months of operating expenses incurred by Bay View Funding, one-time costs related to the Bay View Funding acquisition, and higher salaries and employee benefits costs, which were partially offset by lower professional fees, software subscriptions, and data processing expense.

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 increases in the cash surrender value of life insurance policies, interest on tax-exempt securities, certain expenses that are not allowed as tax deductions, and tax credits.

The Company's Federal and state income tax expense in 2015 was $10.1 million, compared to $7.5 million in 2014, and $6.2 million in 2013. The following table shows the effective income tax rates for the dates indicated:

	For the Year Ended December 31,		
	2015	**2014**	**2013**
Effective income tax rate	38.0%	36.0%	35.0%

The difference in the effective tax rate compared to the combined Federal and state statutory tax rate of 42% is primarily the result of tax exempt securities, the Company's investment in life insurance policies whose earnings are not subject to taxes, tax credits related to investments in low income housing limited partnerships, and Enterprise Zone hiring credits.

The Company adopted the proportional amortization method of accounting for its low income housing investments in the third quarter of 2014. The Company quantified the impact of adopting the proportional amortization method compared to the equity method to its current year and prior period financial statements. The Company determined that the adoption of the proportional amortization method did not have a material impact to its financial statements. The low income housing investment losses, net of the tax benefits received, are included in income tax expense for all periods reflected on the consolidated income statements.

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.

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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 the deferred tax assets 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 the net deferred tax assets of $22.2 million and $18.5 million at December 31, 2015, and December 31, 2014, 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 assets at December 31, 2015 and December 31, 2014 will be fully realized in future years.

Business Segment Information

The following presents the Company's operating segments. Transactions between segments consist primarily of borrowed funds. Intersegment interest expense is allocated to the Factoring segment based on the Company's prime rate and funding costs. The provision for loan loss is allocated based on the segment's allowance for loan loss determination which considers the effects of charge-offs. Noninterest income and expense directly attributable to a segment are assigned to it. Taxes are paid on a consolidated basis and allocated for segment purposes. The Factoring segment includes only factoring originated by Bay View Funding, which has been included in the results of operations since the acquisition on November 1, 2014.

	For the Twelve Months Ended Deember 31, 2015		
	Banking(1)	**Factoring**	**Consolidated**
	(Dollars in thousands)		
Interest income	$ 66,306	$ 12,437	$ 78,743
Intersegment interest allocations	1,087	(1,087)	
Total interest expense	2,422		2,422
Net interest income	64,971	11,350	76,321
Provision (credit) for loan losses	(156)	188	32
Net interest income after provision	65,127	11,162	76,289
Noninterest income	8,234	751	8,985
Noninterest expense	51,438	7,235	58,673
Intersegment expense allocations	386	(386)	
Income before income taxes	22,309	4,292	26,601
Income tax expense	8,301	1,803	10,104
Net income	$ 14,008	$ 2,489	$ 16,497
Total assets	$ 2,306,543	$ 55,036	$ 2,361,579
Loans, net of deferred fees	$ 1,318,657	$ 40,059	$ 1,358,716
Goodwill	$ 32,620	$ 13,044	$ 45,664

(1) Includes the holding company's results of operations.

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	For the Twelve Months Ended Deember 31, 2014		
	Banking(1)	Factoring(2)	Consolidated
	(Dollars in thousands)		
Interest income	$ 57,178	$ 2,078	$ 59,256
Intersegment interest allocations	31	(31)	
Total interest expense	2,033	120	2,153
Net interest income	55,176	1,927	57,103
Provision (credit) for loan losses	(338)		(338)
Net interest income after provision	55,514	1,927	57,441
Noninterest income	7,662	84	7,746
Noninterest expense	43,132	1,090	44,222
Income before income taxes	20,044	921	20,965
Income tax expense	7,151	387	7,538
Net income	$ 12,893	$ 534	$ 13,427
Total assets	$ 1,561,911	$ 55,192	$ 1,617,103
Loans, net of deferred fees	$ 1,048,631	$ 40,012	$ 1,088,643
Goodwill	$	$ 13,044	$ 13,044

(1) Includes the holding company's results of operations.

(2) Includes two months of Bay View Funding's results of operations.

Banking. For the twelve months ended December 31, 2015, our banking segment's net income increased to $14.0 million, compared with $12.9 million for the twelve months ended December 31, 2014. Net interest income increased to $65.0 million for the twelve months ended December 31, 2015, compared to $55.2 million for the twelve months ended December 31, 2014. The increase in net interest income for the twelve months ended December 31, 2015, compared to the comparable periods in 2014, was primarily as a result of the Focus acquisition and organic growth in the loan portfolio and core deposits. For the twelve months ended December 31, 2015, noninterest expense was $51.4 million, compared to $43.1 million for the twelve months ended December 31, 2014. The increase in noninterest expense for the twelve months ended December 31, 2015, was primarily due to one-time costs related to the Focus transaction, and the additional operating costs of Focus. For the twelve months ended December 31, 2015, the credit provision for loan losses was $156,000, compared with a credit for loan losses of $338,000, for the twelve months ended December 31, 2014.

Factoring. Bay View Funding's primary business operation is purchasing and collecting factored receivables. Factored receivables are receivables that have been transferred by the originating organization and typically have not been subject to previous collection efforts. In a factoring transaction, Bay View Funding directly purchases the receivables generated by its clients at a discount to their face value. The transactions are structured to provide the clients with immediate working capital when there is a mismatch between payments to the client for a good or service and the incurrence of operating costs required to provide for such good or service. The average life of the factored receivables is 33 days. The balance of the purchased receivables as of December 31, 2015 and 2014 was $40.1 million and $40.0 million, respectively. Bay View Funding's results of operations have been included in the Company's results beginning November 1, 2014. For the twleve months ended December 31, 2015, Bay View Funding provided net interest income of $11.3 million, noninterest income of $751,000, and $2.5 million of the Company's net income. For the twelve months ended December 31, 2014, two months of Bay View Funding's results of operations provided net interest income of $1.9 million, noninterest income of $84,000, and $534,000 of the Company's net income.

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Financial Condition

As of December 31, 2015, total assets were $2.36 billion, an increase of 46% compared to $1.62 billion at December 31, 2014. The investment securities available-for-sale portfolio totaled $385.1 million at December 31, 2015, an increase of 87% from $206.3 million at December 31, 2014. In addition, securities held-to-maturity totaled $109.3 million at December 31, 2015, compared to $95.4 million at December 31, 2014. The total loan portfolio, excluding loans held-for-sale, was $1.36 billion, an increase of 25% from $1.09 billion at year-end 2014, which included an increase of $113.4 million, or 10%, in the Company's legacy loan portfolio, and $141.6 million from the Focus loan portfolio.

Total deposits increased $674.4 million, or 49%, to $2.06 billion at December 31, 2015, compared to $1.39 billion at December 31, 2014, which included an increase of $297.5 million, or 21%, in the Company's legacy deposit portfolio, and $376.9 million from the Focus deposit portfolio. Deposits (excluding all time deposits and CDARS deposits) increased $686.4 million, or 61%, to $1.81 billion at December 31, 2015, from $1.13 billion at December 31, 2014.

Securities Portfolio

The following table reflects the balances for each category of securities at year-end:

	December 31,		
	2015	**2014**	**2013**
		(Dollars in thousands)	
Securities available-for-sale (at fair value):			
Agency mortgage-backed securities	$ 324,230	$ 154,172	$ 207,644
U.S. Treasury	30,003		
Trust preferred securities	15,132	15,300	20,410
U.S. Government sponsored entities	9,041		
Corporate bonds	6,673	36,863	52,046
Total	$ 385,079	$ 206,335	$ 280,100
Securities held-to-maturity (at amortized cost):			
Municipals Tax Exempt	$ 93,518	$ 79,882	$ 79,989
Agency mortgage-backed securities	15,793	15,480	15,932
	$ 109,311	$ 95,362	$ 95,921

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The table below summarizes the weighted average life and weighted average yields of securities as of December 31, 2015:

	Weighted Average Life									
	Within One Year or Less		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 available-for-sale (at fair value):										
Agency mortgage-backed securities	$		$ 129,882	2.47%	$ 190,326	2.33%	$ 4,022	2.65%	$ 324,230	2.39%
U.S. Treasury			30,003	1.15%					30,003	1.15%
Trust preferred securities							15,132	5.95%	15,132	5.95%
U.S. Government sponsored entities	1,996	0.66%	2,984	0.99%	4,061	2.04%			9,041	1.39%
Corporate bonds			6,673	2.87%					6,673	2.87%
Total	$ 1,996	0.66%	$ 169,542	2.23%	$ 194,387	2.32%	$ 19,154	5.26%	$ 385,079	2.42%
Securities held-to-maturity (at amortized cost):										
Municipals Tax Exempt(1)	$ 2,733	3.69%	$ 20,816	3.65%	$ 42,703	4.00%	$ 27,266	3.80%	$ 93,518	3.85%
Agency mortgage-backed securities			5,579	2.47%			10,214	3.27%	15,793	2.99%
Total	$ 2,733	3.69%	$ 26,395	3.40%	$ 42,703	4.00%	$ 37,480	3.65%	$ 109,311	3.73%

(1) Reflects tax equivalent yield based on a 35% Federal 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; and (iv) 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. 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 $385.1 million at December 31, 2015, compared to $206.3 million at December 31, 2014. At December 31, 2015, the Company's securities available-for-sale portfolio was comprised of $324.3 million agency mortgage-backed securities (all issued by U.S. Government sponsored entities), $30.0 million U.S. Treasuries, $15.1 million of single entity issue trust preferred securities, $9.0 million of U.S. Government agency securities, and $6.7 million of corporate bonds. The pre-tax unrealized gain on securities available-for-sale at December 31, 2015 was $501,000, compared to a pre-tax unrealized gain on securities available-for-sale of $4.8 million at December 31, 2014, and a pre-tax unrealized loss on securities available-for-sale of ($2.4) million at December 31, 2013.

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During the fourth quarter of 2015, the Company repositioned a portion of its securities portfolio. The Company received gross proceeds of $71.8 million on investment securities available-for-sale it sold during the fourth quarter of 2015 with a book value totaling $71.2 million, resulting in a gain on sale of securities of $637,000. There was also a $5,000 gain on a bond that was called in the fourth quarter of 2015 included in gain on sale of securities. The investment securities sold during the fourth quarter of 2015 consisted of $29.4 million of corporate bonds,$8.3 million of tax-exempt municipal bonds, $11.3 million of collateralized mortgage obligations, $18.2 million of mortgage-backed securities, and $4.0 million of U.S. Treasuries.

During the year ended December 31, 2015, the Company purchased $232.6 million of investment securities available-for-sale, with a weighted average book yield of 1.95%. The investment securities purchased during 2015 consisted of $202.6 million of mortgage-backed securities with a weighted average book yield of 1.99%, and $30.0 million of U.S. Treasuries with a weighted average book yield of 1.15%. The mortgage-backed securities purchased during the year ended December 31, 2015 consisted of $82.9 million of Federal National Mortgage Association ("FNMA") securities, $69.9 million of Government National Mortgage Association ("GNMA") securities, and $49.8 million of Federal Home Loan Mortgage Corporation ("FHLMC") securities, with an average book yield of 1.99%, 1.90%, and 1.99%, respectively.

At December 31, 2015, investment securities held-to-maturity totaled $109.3 million, compared to $95.4 million at December 31, 2014. At December 31, 2015, the Company's securities held-to-maturity portfolio, at amortized cost, was comprised of $93.5 million tax-exempt municipal bonds, and $15.8 million agency mortgage-backed securities.

During the year ended December 31, 2015, the Company purchased $9.5 million of investment securities held-to-maturity, with a weighted average book yield of 3.64%. The investment securities purchased during 2015 consisted of $3.2 million of mortgage-backed securities with a weighted average book yield of 2.60%, and $6.3 million of U.S. Treasuries with a weighted average book yield of 4.18%.

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 58% of total assets at December 31, 2015, as compared to 67% of total assets at December 31, 2014. The ratio of loans to deposits decreased to 65.87% at December 31, 2015 from 78.41% December 31, 2014.

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.

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Loan Distribution

	December 31,									
	2015	% to Total	2014	% to Total	2013	% to Total	2012	% to Total	2011	% to Total
	(Dollars in thousands)									
Commercial	$ 556,522	41%	$ 462,403	43%	$ 393,074	43%	$ 375,469	46%	$ 366,590	48%
Real estate:										
Commercial and residential	625,665	46%	478,335	44%	423,288	46%	354,934	44%	311,479	41%
Land and construction	84,428	6%	67,980	6%	31,443	3%	22,352	3%	23,016	3%
Home equity	76,833	6%	61,644	6%	51,815	6%	43,865	5%	52,017	7%
Consumer	16,010	1%	18,867	1%	15,677	2%	15,714	2%	11,166	1%
Loans	1,359,458	100%	1,089,229	100%	915,297	100%	812,334	100%	764,268	100%
Deferred loan (fees) costs, net	(742)		(586)		(384)		(21)		323	
Loans, including deferred fees and costs	1,358,716	100%	1,088,643	100%	914,913	100%	812,313	100%	764,591	100%
Allowance for loan losses	(18,926)		(18,379)		(19,164)		(19,027)		(20,700)	
Loans, net	$ 1,339,790		$ 1,070,264		$ 895,749		$ 793,286		$ 743,891	

The Company's loan portfolio is concentrated in commercial (primarily manufacturing, wholesale, and services oriented entities) and commercial real estate, with the remaining balance in land development and construction and home equity and consumer loans. The Company does not have any concentrations by industry or group of industries in its loan portfolio, however, 58% of its gross loans were secured by real property as of December 31, 2015, compared to 56% as of December 31, 2014. 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 uses underwriting guidelines to assess the borrowers' historical cash flow to determine debt service, and we further stress test 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 2015, loans were sold resulting in a gain on sales of SBA loans of $843,000, compared to a gain on sales of SBA loans of $971,000 for 2014, and $449,000 for 2013.

The Company's factoring receivables are from the operations of Bay View Funding whose primary business is purchasing and collecting factored receivables. Factored receivables are receivables that have been transferred by the originating organization and typically have not been subject to previous collection efforts. These receivables are acquired from a variety of companies, including but not limited to service providers, transportation companies, manufacturers, distributors, wholesalers, apparel companies, advertisers, and temporary staffing companies. The portfolio of factored receivables is included in the Company's commercial loan portfolio.

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As of December 31, 2015, commercial and residential real estate loans of $625.7 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, 2015 consist of $264.9 million, or 42% of commercial owner occupied properties, $360.8 million, or 58%, of commercial investment 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), 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. Construction loans are provided primarily in our market area, and we have extensive controls for the disbursement process. Land and construction loans increased $16.4 million to $84.4 million at December 31, 2015, from $68.0 million at December 31, 2014, primarily as a result of strong housing demand within the Company's lending area.

The Company makes home equity lines of credit available to its existing customers. Home equity lines of credit are underwritten initially with a maximum 75% loan to value ratio. Home equity lines are reviewed semi-annually, with specific emphasis on loans with a loan to value ratio greater than 70%. 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 $39.8 million and $66.3 million at December 31, 2015, respectively.

Loan Maturities

The following table presents the maturity distribution of the Company's loans (excluding loans held-for-sale), as of December 31, 2015. 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

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Journal. As of December 31, 2015, approximately 54% of the Company's loan portfolio consisted of floating interest rate loans.

	Due in One Year or Less	Over One Year But Less than Five Years	Over Five Years	Total
	(Dollars in thousands)			
Commercial	$ 465,595	$ 78,339	$ 12,588	$ 556,522
Real estate:				
Commercial and residential	71,334	268,876	285,455	625,665
Land and construction	84,180	248		84,428
Home equity	72,273	1,361	3,199	76,833
Consumer	14,793	1,124	93	16,010
Loans	$ 708,175	$ 349,948	$ 301,335	$ 1,359,458
Loans with variable interest rates	$ 646,457	$ 80,616	$ 6,251	$ 733,324
Loans with fixed interest rates	61,718	269,332	295,084	626,134
Loans	$ 708,175	$ 349,948	$ 301,335	$ 1,359,458

Loan Servicing

As of December 31, 2015, 2014, and 2013 there were $175.5 million, $130.6million, and $135.5 million, respectively, of SBA loans that were serviced by the Company for others. Activity for loan servicing rights was as follows:

	2015	2014	2013
	(Dollars in thousands)		
Beginning of year balance	$ 565	$ 525	$ 709
Additions	2,126	319	106
Amortization	(482)	(279)	(290)
End of year balance	$ 2,209	$ 565	$ 525

Loan servicing rights are included in Accrued Interest Receivable and Other Assets on the consolidated balance sheets and reported net of amortization. The increase in loan servicing rights for the year ended December 31, 2015, compared to the prior year, was primarily due to the Focus acquisition of $1.9 million in serviced SBA loans at fair value. There was no valuation allowance as of December 31, 2015 and 2014, 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:

	2015	2014	2013
	(Dollars in thousands)		
Beginning of year balance	$ 1,481	$ 1,647	$ 1,786

Unrealized holding loss		(114)		(166)		(139)
End of year balance	$	1,367	$	1,481	$	1,647

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, 2015, key economic assumptions and the sensitivity of the fair value of the I/O strip receivables to immediate changes

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to the CPR assumption of 10% and 20%, and changes to the discount rate assumption of 1% and 2%, are as follows:

		(Dollars in thousands)
Carrying amount/fair value of Interest-Only (I/O) strip	$	1,367
Prepayment speed assumption (annual rate)		7.4%
Impact on fair value of 10% adverse change in prepayment speed (CPR 8.2%)	$	(29)
Impact on fair value of 20% adverse change in prepayment speed (CPR 8.9%)	$	(58)
Residual cash flow discount rate assumption (annual)		12.5%
Impact on fair value of 1% adverse change in discount rate (13.8% discount rate)	$	(44)
Impact on fair value of 2% adverse change in discount rate (15.0% discount rate)	$	(86)

Credit Quality

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 that management is offering or will offer for sale.

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

	December 31,				
	2015	2014	2013	2012	2011
	(Dollars in thousands)				
Nonaccrual loans held-for-sale	$	$	$	$	$ 186
Nonaccrual loans held-for-investment	4,716	5,855	11,326	17,335	14,353
Restructured and loans 90 days past due and still accruing	1,662		492	859	2,291
Total nonperforming loans	6,378	5,855	11,818	18,194	16,830
Foreclosed assets	364	696	575	1,270	2,312
Total nonperforming assets	$ 6,742	$ 6,551	$ 12,393	$ 19,464	$ 19,142
Nonperforming assets as a percentage of loans plus nonaccrual loans held-for-sale plus foreclosed assets	0.50%	0.60%	1.35%	2.39%	2.50%
Nonperforming assets as a percentage of total assets	0.29%	0.41%	0.83%	1.15%	1.47%

The following table presents nonperforming loans by class at year end:

	2015			2014		
	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	$ 724	$ 1,378	$ 2,102	$ 2,534	$	$ 2,534
Real estate:						
Commercial and residential	2,992		2,992	1,651		1,651
Land and construction	219		219	1,320		1,320
Home equity	777	284	1,061	344		344
Consumer	4		4	6		6
Total	$ 4,716	$ 1,662	$ 6,378	$ 5,855	$	$ 5,855

Nonperforming assets were $6.7 million, or 0.29% of total assets, at December 31, 2015, compared to $6.6 million, or 0.41% of total assets, at December 31, 2014. At December 31, 2015, $6.0 million of the NPAs were in the Company's legacy loan portfolio, and $734,000 of the NPAs were in the Focus loan portfolio. Included in total nonperforming assets were foreclosed assets of $364,000 at December 31, 2015, compared to $696,000 at December 31, 2014.

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The following table provides a summary of the loan portfolio by loan type and credit quality classification at the dates indicated:

	December 31, 2015			December 31, 2014		
	Nonclassified	Classified*	Total	Nonclassified	Classified*	Total
	(Dollars in thousands)					
Commercial	$ 547,536	$ 8,986	$ 556,522	$ 455,767	$ 6,636	$ 462,403
Real estate:						
Commercial and residential	617,865	7,800	625,665	472,061	6,274	478,335
Land and construction	84,209	219	84,428	66,660	1,320	67,980
Home equity	75,511	1,322	76,833	60,736	908	61,644
Consumer	15,705	305	16,010	18,518	349	18,867
Total	$ 1,340,826	$ 18,632	$ 1,359,458	$ 1,073,742	$ 15,487	$ 1,089,229

* Classified loans in the table above include SBA guarantees.

The following provides a rollforward of troubled debt restructurings ("TDRs"):

	For the Year Ended December 31, 2015		
	Performing TDRs	Nonperforming TDRs	Total
	(Dollars in thousands)		
Balance at January 1, 2015	$ 167	$ 916	$ 1,083
Principal repayments	(18)	(912)	(930)
Balance at December 31, 2015	$ 149	$ 4	$ 153

	For the Year Ended December 31, 2014		
	Performing TDRs	Nonperforming TDRs	Total
	(Dollars in thousands)		
Balance at January 1, 2014	$ 492	$ 3,230	$ 3,722
Principal repayments	(462)	(2,147)	(2,609)
Net charge-offs	(30)		(30)
Change in TDR classification	167	(167)	
Balance at December 31, 2014	$ 167	$ 916	$ 1,083

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

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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 with a well-defined weakness, which are characterized by the distinct possibility that the Company will sustain a loss if the deficiencies are 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 $20.5 million at December 31, 2015 and $16.0 million at December 31, 2014. There were no loans held-for-sale included in classified assets at December 31, 2015 and December 31, 2014. Loans held-for-sale are carried at the lower of cost or estimated fair value, and are not allocated an allowance for loan losses.

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 Board and the California Department of Business Oversight   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 weaken. Also, any weakness of a prolonged nature in the technology industry would have a negative impact on the local market. The effect of such events, although uncertain at this time, could result in an increase in the level of nonperforming loans and increased loan losses, which could adversely affect the Company's future growth and profitability. No assurance of the ultimate level of credit losses can be given with any certainty.

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

	2015	2014	2013	2012	2011
	(Dollars in thousands)				
Balance, beginning of year	$ 18,379	$ 19,164	$ 19,027	$ 20,700	$ 25,204
Charge-offs:					
Commercial	(527)	(815)	(1,676)	(3,935)	(7,559)
Real estate:					
Commercial and residential	(2)		(173)	(1,362)	(1,599)
Land and construction			(1)	(133)	(1,757)
Home equity		(87)	(102)	(33)	
Consumer	(9)	(25)			(8)
Total charge-offs	(538)	(927)	(1,952)	(5,463)	(10,923)
Recoveries:					
Commercial	877	418	2,621	776	678
Real estate:					
Commercial and residential	9	35	274	230	381
Land and construction	127	26			879
Home equity	10	1	9		9
Consumer	30		1		3
Total recoveries	1,053	480	2,905	1,006	1,950
Net recoveries (charge-offs)	515	(447)	953	(4,457)	(8,973)
Provision (credit) for loan losses	32	(338)	(816)	2,784	4,469
Balance, end of year	$ 18,926	$ 18,379	$ 19,164	$ 19,027	$ 20,700
RATIOS:					
Net charge-offs (recoveries) to average loans*	0.04%	0.05%	0.11%	0.57%	1.12%
Allowance for loan losses to total loans*	1.39%	1.69%	2.09%	2.34%	2.71%
Allowance for loan losses to nonperforming loans, excluding nonaccrual loans held-for-sale	296.74%	313.90%	162.16%	104.58%	124.37%

* Excludes loans held-for-sale

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

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portion of the allowance allocated to each category represents the total amount available for charge-offs that may occur within these categories.

	December 31,									
	2015		2014		2013		2012		2011	
	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	$ 10,748	41%	$ 11,187	43%	$ 12,533	43%	$ 12,866	46%	$ 13,215	48%
Real estate:										
Commercial and residential	4,980	46%	4,707	44%	4,922	46%	4,609	44%	6,203	41%
Land and construction	1,504	6%	1,048	6%	356	3%	399	3%	594	3%
Home equity	1,592	6%	1,315	6%	1,270	6%	1,026	5%	541	7%
Consumer	102	1%	122	1%	83	2%	127	2%	147	1%
Total	$ 18,926	100%	$ 18,379	100%	$ 19,164	100%	$ 19,027	100%	$ 20,700	100%

The allowance for loan losses totaled $18.9 million, or 1.39% of total loans at December 31, 2015, compared to $18.4 million, or 1.69% of total loans at December 31, 2014. The allowance for loan losses to total loans decreased at December 31, 2015, compared to December 31, 2014, primarily due to the Focus loan portfolio, which was marked to fair market value on the acquisition date, and an increase in the Company's legacy loan balances with no default histories, coupled with the decrease in the Company's legacy nonperforming assets, improving the quality of the loan portfolio overall. The allowance for loan losses to total nonperforming loans decreased to 296.74% at December 31, 2015, compared to 313.90% at December 31, 2014. Loan charge-offs reflect the realization of losses in the portfolio that were partially recognized previously through the provision for loan losses. The Company had net recoveries of $515,000, or 0.04% of average loans, for the year ended December 31, 2015, compared to net charge-offs of $447,000, or 0.05% of average loans, for the year ended December 31, 2014.

The allowance for loan losses related to the commercial portfolio decreased $439,000 at December 31, 2015 from December 31, 2014, as a result of a credit to the provision for loan losses of $789,000 related to the commercial loan portfolio, and net recoveries of $350,000. The decrease in the allowance for loan losses was primarily due to a decline in the Company's legacy problem loans. The allowance for loan losses related to the real estate portfolio increased $1.0 million at December 31, 2015 from December 31, 2014, as a result of a provision for loan losses of $862,000 and net recoveries of $144,000. The increase in the allowance for loan losses was primarily due to an increase in the balance of real estate loans outstanding.

Goodwill and Other Intangible Assets

On November 1, 2014, estimated goodwill of $13.0 million resulted from the acquisition Bay View Funding. On August 20, 2015, estimated goodwill of $32.6 million resulted from the merger of Focus. Goodwill represents the excess of the purchase price over the fair value of acquired tangible assets and liabilities and identifiable intangible assets. The fair values of assets acquired and liabilities assumed are subject to adjustment during the first twelve months after the acquisition date if additional information becomes available to indicate a more accurate or appropriate value for an asset or liability. Total goodwill at December 31, 2015 was $45.6 million, which consisted of $13.0 million related to the Bay View Funding acquisition, and $32.6 million related to the Focus acquisition.

Goodwill impairment exists when a reporting unit's carrying value exceeds its fair value, which is determined through a qualitative assessment whether it is more likely than not that the fair value of equity of the reporting unit exceeds the carrying value ("Step Zero"). If the qualitative assessment indicates it is more likely than not that the fair value of equity of a reporting unit is less than book value, than a quantitative two-step impairment test is required. Step 1 includes the determination of the carrying value

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of the Company's single reporting unit, including the existing goodwill and intangible assets, and estimating the fair value of the reporting unit. If the carrying amount of a reporting unit exceeds its fair value, the Company is required to perform a second step to the impairment test. Step 2 requires that the implied fair value of the reporting unit goodwill be compared to the carrying amount of that goodwill. If the carrying amount of the reporting unit goodwill exceeds the implied fair value of that goodwill, an impairment loss shall be recognized in an amount equal to that excess.

The Company completed its annual impairment analysis on the goodwill from the Bay View Funding acquisition as of November 30, 2015 with the assistance of an independent valuation firm. Based on the Step Zero qualitative analysis performed, the Company determined that it is more likely than not that the fair value of the Company's equity exceeded its reported book value of equity at November 30, 2015. As such, no impairment was indicated and no further testing was required.

Other intangible assets were $8.5 million at December 31, 2015, compared to $3.3 million at December 31, 2014. Core deposit and customer relationship intangible assets arising from the acquisition of Diablo Valley Bank in June 2007 were $621,000 at December 31, 2015 and $1.1 million at December 31, 2014, net of accumulated amortization. The core deposit intangible asset arising from the acquisition of Focus was $6.0 million at December 31, 2015, net of accumulated amortization. A below market lease, customer relationship and brokered relationship, and a non-compete agreement intangible assets arising from the acquisition of Bay View Funding in November 2014 were $1.9 million at December 31, 2015 and $2.2 million at December 31, 2014, net of accumulated amortization.

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 from 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, weaken. Potentially, the most volatile deposits in a financial institution are jumbo certificates of deposit, meaning time deposits with balances that equal or exceed $250,000, 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:

	Year Ended December 31,					
	2015		2014		2013	
	Balance	% to Total	Balance	% to Total	Balance	% to Total
	(Dollars in thousands)					
Demand, noninterest-bearing	$ 821,405	40%	$ 517,662	37%	$ 431,085	34%
Demand, interest-bearing	496,278	24%	225,821	16%	195,451	15%
Savings and money market	496,843	24%	384,644	28%	347,052	27%
Time deposits under $250	62,026	3%	57,443	4%	58,655	5%
Time deposits $250 and over	160,815	8%	163,452	12%	157,996	12%
Time deposits brokered	17,825	1%	28,116	2%	55,524	4%
CDARS money market and time deposits	7,583	0%	11,248	1%	40,458	3%
Total deposits	$ 2,062,775	100%	$ 1,388,386	100%	$ 1,286,221	100%

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The Company obtains deposits from a cross-section of the communities it serves. The Company is not dependent upon funds from sources outside the United States of America. Public funds were 4% of deposits at December 31, 2015 and 7% at December 31, 2014.

Deposits totaled $2.06 billion at December 31, 2015, compared to $1.39 billion at December 31, 2014, which included an increase of $297.5 million, or 21%, in the Company's legacy deposit portfolio, and $376.9 million from the Focus deposit portfolio. Noninterest-bearing deposits increased 59% to $821.4 million at December 31, 2015, from $517.7 million, at December 31, 2014. Interest-bearing demand deposits increased 120% to $496.3 million at December 31, 2015, from $225.8 million at December 31, 2014. Savings and money market deposits increased 29% to $496.8 million at December 31, 2014, from $384.6 million at December 31, 2014. At December 31, 2015, brokered deposits decreased 37% to $17.8 million, from $28.1 million at December 31, 2014. CDARS money market and time deposits decreased to $7.6 million at December 31, 2015, from $11.2 million at December 31, 2014. Deposits (excluding all time deposits and CDARS deposits), increased $686.4 million, or 61%, to $1.81 billion at December 31, 2015, from $1.13 billion at December 31, 2014.

At December 31, 2015, the Company had $93.0 million (at fair value) of securities pledged for $78.0 million in certificates of deposits from the State of California. At December 31, 2014, the Company had $109.8 million (at fair value) of securities pledged for $98.0 million in certificates of deposits from the State of California.

CDARS deposits were comprised of $3.4 million of money market accounts and $4.2 million of time deposits at December 31, 2015. CDARS deposits were comprised of $4.0 million of money market accounts and $7.2 million of time deposits at December 31, 2014.

The following table indicates the contractual maturity schedule of the Company's time deposits of $250,000 and over, and all CDARS time deposits and brokered deposits as of December 31, 2015:

	Balance	% of Total
	(Dollars in thousands)	
Three months or less	$ 104,256	57%
Over three months through six months	39,751	22%
Over six months through twelve months	32,168	18%
Over twelve months	6,660	4%
Total	$ 182,835	100%

The Company focuses primarily on providing and servicing business deposit accounts that are frequently over $250,000 in average balance per account. As a result, certain types of business clients that the Company serves typically carry average deposits in excess of $250,000. 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 on Equity and Assets

The following table indicates the ratios for return on average assets and average equity, and average equity to average assets for the periods indicated:

	2015	2014	2013
Return on average assets	0.86%	0.88%	0.81%
Return on average tangible assets	0.88%	0.88%	0.81%
Return on average equity	8.04%	7.44%	6.77%
Return on average tangible equity	9.41%	7.60%	6.84%
Average equity to average assets ratio	10.73%	11.85%	11.90%

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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 $573.7 million at December 31, 2015, as compared to $439.3 million at December 31, 2014. Unused commitments represented 42% and 40% of outstanding gross loans at December 31, 2015 and 2014, 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 15 to the consolidated financial statements located elsewhere herein.

The following table presents the Company's commitments to extend credit for the periods indicated:

	December 31, 2015		December 31, 2014	
	Fixed Rate	Variable Rate	Fixed Rate	Variable Rate
	(Dollars in thousands)			
Unused lines of credit and commitments to make loans	$ 16,917	$ 539,897	$ 8,164	$ 415,146
Standby letters of credit	3,402	13,458	3,235	12,783
	$ 20,319	$ 553,355	$ 11,399	$ 427,929

Contractual Obligations

The contractual obligations of the Company, summarized by type of obligation and contractual maturity, at December 31, 2015, are as follows:

	Less Than One Year	One to Three Years	Three to Five Years	After Five Years	Total
	(Dollars in thousands)				
Deposits(1)	$ 2,051,677	$ 10,873	$ 225	$	$ 2,062,775
Operating leases	3,434	4,855	2,954	232	11,475
Other short-term borrowings	3,000				3,000
Other long-term liabilities(2)	919	2,962	3,220	38,196	45,297
Total contractual obligations	$ 2,059,030	$ 18,690	$ 6,399	$ 38,428	$ 2,122,547

(1) Deposits with indeterminate maturities, such as demand, savings and money market accounts, are reflected as obligations due in less than one year.

(2) Includes maximum payments related to employee benefit plans, assuming all future vesting conditions are met. Additional information is provided in Note 14 to the consolidated financial statements.

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

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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 Federal Reserve. 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 65.87% at December 31, 2015, compared to 78.41% at December 31, 2014.

FHLB and Federal Reserve 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 Federal Reserve. 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, 2015, and December 31, 2014. The Company had $245.6 million of loans pledged to the FHLB as collateral on an available line of credit of $141.9 million at December 31, 2015. The Company had $246.6 million of loans pledged to the FHLB as collateral on an available line of credit of $140.0 million at December 31, 2014.

The Company can also borrow from Federal Reserve's discount window. The Company had $395.0 million of loans pledged to the Federal Reserve as collateral on an available line of credit of $243.2 million at December 31, 2015, none of which was outstanding. The Company had $388.0 million of loans pledged to the Federal Reserve as collateral on an available line of credit of $260.4 million at December 31, 2014, none of which was outstanding.

At December 31, 2015 and 2014, the Company had Federal funds purchase arrangements available of $55.0 million. There were no Federal funds purchased outstanding at December 31, 2015 or 2014.

The Company has a $5.0 million line of credit with a correspondent bank, of which $3.0 million was outstanding at December 31, 2015.

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, 2015 and December 31, 2014.

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,		
	2015	2014	2013
	(Dollars in thousands)		
Average balance during the year	$ 578	$ 3,953	$ 58
Average interest rate during the year	3.14%	3.06%	0.20%
Maximum month-end balance during the year	$ 3,000	$ 29,796	$
Average rate at December 31,	3.00%	2.87%	N/A

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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 and the FDIC, establish a risk-adjusted ratio relating capital to different categories of assets and off-balance sheet exposures. See Business Supervision and Regulation Prompt Corrective Action Provisions.

The following table summarizes risk-based capital, risk-weighted assets, and risk-based capital ratios of the consolidated Company under the Basel III requirements as of December 31, 2015, and under the Basel I requirements as of December 31, 2014, December 31, 2013:

	December 31,		
	2015	**2014**	**2013**
	(Dollars in thousands)		
	Under Basel III	**Under Basel I**	
Capital components:			
Common equity Tier 1 capital	$ 181,222	N/A	N/A
Additional Tier 1 capital	18,077	N/A	N/A
Tier 1 Capital	199,299	$ 169,278	$ 165,162
Tier 2 Capital	19,616	16,790	14,754
Total risk-based capital	$ 218,915	$ 186,068	$ 179,916
Risk-weighted assets	$ 1,750,515	$ 1,341,094	$ 1,175,813
Average assets for capital purposes	$ 2,322,940	$ 1,598,724	$ 1,477,082
Capital ratios:			
Total risk-based capital	12.5%	13.9%	15.3%
Tier 1 risk-based capital	11.4%	12.6%	14.0%
Common equity Tier 1 risk-based capital	10.4%	N/A	N/A
Leverage(1)	8.6%	10.6%	11.2%

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

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The following table summarizes risk-based capital, risk-weighted assets, and risk-based capital ratios of HBC under the Basel III requirements as of December 31, 2015, and under the Basel I requirements as of December 31, 2014, December 31, 2013:

	December 31, 2015	December 31, 2014	December 31, 2013
	(Dollars in thousands)		
	Under Basel III	Under Basel I	
Capital components:			
Common equity Tier 1 capital	$ 200,327	N/A	N/A
Additional Tier 1 capital		N/A	N/A
Tier 1 Capital	200,327	$ 158,976	$ 149,037
Tier 2 Capital	19,616	16,789	14,790
Total risk-based capital	$ 219,943	$ 175,765	$ 163,827
Risk-weighted assets	$ 1,750,222	$ 1,340,949	$ 1,178,719
Average assets for capital purposes	$ 2,322,232	$ 1,599,173	$ 1,477,168
Capital ratios:			
Total risk-based capital	12.6%	13.1%	13.9%
Tier 1 risk-based capital	11.4%	11.9%	12.6%
Common equity Tier 1 risk-based capital	11.4%	N/A	N/A
Leverage(1)	8.6%	9.9%	10.1%

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

The following table presents the applicable well-capitalized regulatory guidelines and the standards for minimum capital adequacy requirements under the Basel III as of December 31, 2015, and under Basel I as of December 31, 2014 and December 31, 2013:

	Under Basel III			Under Basel I	
	Transitional Minimum Regulatory Requirement Effective January 1, 2015	Minimum Regulatory Requirement(1) Effective January 1, 2019	Well-capitalized by Regulatory Definition Under FDICIA(2) Effective January 1, 2015	Minimum Regulatory Requirements	Well-Capitalized Regulatory Requirements
Capital ratios:					
Total risk-based capital	8.00%	10.50%	10.00%	8.00%	10.00%
Tier 1 risk-based capital	6.00%	8.50%	8.00%	4.00%	6.00%
Common equity Tier 1 risk-based capital	4.50%	7.00%	6.50%	N/A	N/A
Leverage	4.00%	4.00%	5.00%	4.00%	5.00%

(1)

Includes 2.5% capital conservation buffer.

(2) Applies to HBC only

At December 31, 2015, the Company's and HBC's regulatory capital increased concurrent with average assets for capital purposes and risk-weighted assets due to the common stock issued in the Focus transaction, net of normal fluctuations to regulatory capital from dividends, share based compensation, and net income.

At December 31, 2015, the Company's consolidated capital ratio exceeded regulatory guidelines and HBC's capital ratios exceed the highest regulatory capital requirement of "well-capitalized" under Basel III prompt corrective action provisions. Quantitative measures established by regulation to help ensure capital adequacy require the Company and HBC to maintain minimum amounts and ratios of total risk-based capital, Tier 1 capital, and common equity Tier 1 (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, 2015, December 31, 2014, and December 31, 2013, the Company and HBC met all capital adequacy guidelines to which they were subject. There are no conditions or events since December 31, 2015, that management believes have changed the categorization of the Company or HBC as well-capitalized.

At December 31, 2015, the Company had total shareholders' equity of $245.4 million, compared to $184.4 million at December 31, 2014. The increase in total shareholders' equity at December 31, 2015 from December 31, 2014 was primarily due to the Focus acquisition and an increase in retained earnings. The Company issued 5,456,713 shares of the Company's common stock to Focus shareholders for a total value of $58.3 million based on the Company's closing stock price of $10.68 on August 20, 2015. At December 31, 2015, total shareholders' equity included $19.5 million in preferred stock, $193.3 million in common stock, $38.8 million in retained earnings, and ($6.2) million of accumulated other comprehensive loss.

The accumulated other comprehensive loss was ($6.2) million at December 31, 2015, compared to accumulated other comprehensive loss of ($1.9) million at December 31, 2014. The unrealized gain on securities available-for-sale was $296,000, net of taxes, at December 31, 2015, compared to an unrealized gain on securities available-for-sale of $2.8 million, net of taxes, at December 31, 2014. The components of other comprehensive loss, net of taxes, at December 31, 2015 include the following: an unrealized gain on available-for-sale securities of $296,000; the remaining unamortized unrealized gain on securities available-for-sale transferred to held-to-maturity of $402,000; a split dollar insurance contracts liability of ($3.6) million; a supplemental executive retirement plan liability of ($4.1) million; and an unrealized gain on interest-only strip from SBA loans of $794,000.

Series C Preferred Stock

On June 21, 2010, the Company issued to various institutional investors 21,004 shares of newly issued Series C Preferred Stock. The Series C Preferred Stock is mandatorily convertible into 5,601,000 shares of 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. The holders of Series C Preferred Stock receive dividends on an as converted basis when dividends are also declared for 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.

The book value per common share was $7.03 at December 31, 2015, compared to $6.22 at December 31, 2014, and $5.84 at December 31, 2013. The tangible book value per common share was $5.35 at December 31, 2015, compared to $5.60 at December 31, 2014, and $5.78 at December 31, 2013. On a full conversion of the Series C Preferred stock into common stock at December 31, 2015, December 31, 2014, and December 31, 2013: (i) the book value per common share would have been reduced to $6.51, $5.74, $5.43, respectively; and (ii) the tangible book value per common share would have been reduced to $5.07, $5.23, $5.38, respectively. A reduction in the book value per share and tangible

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book value per share upon full conversion would result primarily because of the 5,601,000 additional shares of common stock issued for the conversion of the 21,004 shares of Series C Preferred 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 annual net interest income that would result from the designated instantaneous parallel shift in interest rates noted, as of December 31, 2015. 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	$ 27,706	37.1%
+300	$ 20,903	28.0%
+200	$ 14,160	18.9%
+100	$ 7,215	9.7%
0	$	0.0%
100	$ (8,739)	11.7%
200	$ (17,057)	22.8%

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.

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, 2015, the Company did not use interest rate derivatives to hedge its interest rate risk.

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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 95 through 158.

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, 2015. 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, 2015, 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.

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The Company's management has used the criteria established in the 2013 *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 the 2013 *Internal Control Integrated Framework* issued by COSO was effective as of December 31, 2015.

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 the 2013 "*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, 2015 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 2016 Annual Meeting of Shareholders to be filed pursuant to Regulation 14A with the Securities and Exchange Commission within 120 days of December 31, 2015. Such information is incorporated herein by reference.

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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 2016 Annual Meeting of Shareholders to be filed pursuant to Regulation 14A with the Securities and Exchange Commission within 120 days of December 31, 2015. 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 2016 Annual Meeting of Shareholders to be filed pursuant to Regulation 14A with the Securities and Exchange Commission within 120 days of December 31, 2015. 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 2016 Annual Meeting of Shareholders to be filed pursuant to Regulation 14A with the Securities and Exchange Commission within 120 days of December 31, 2015. 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 2016 Annual Meeting of Shareholders to be filed pursuant to Regulation 14A with the Securities and Exchange Commission within 120 days of December 31, 2015. 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 95 through 158.

(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.

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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 4, 2016

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:

Signature	**Title**	**Date**
/s/ JULIANNE BIAGINI Julianne Biagini	Director	March 4, 2016
/s/ FRANK G. BISCEGLIA Frank G. Bisceglia	Director	March 4, 2016
/s/ JACK W. CONNER Jack W. Conner	Director and Chairman of the Board	March 4, 2016
/s/ J. PHILLIP DINAPOLI J. Phillip DiNapoli	Director	March 4, 2016
/s/ JOHN M. EGGEMEYER John M. Eggemeyer	Director	March 4, 2016
/s/ STEVEN L. HALLGRIMSON Steven L. Hallgrimson	Director	March 4, 2016
/s/ WALTER T. KACZMAREK Walter T. Kaczmarek	Director and Chief Executive Officer and President (Principal Executive Officer)	March 4, 2016
/s/ LAWRENCE D. MCGOVERN Lawrence D. McGovern	Executive Vice President and Chief Financial Officer (Principal Financial and Accounting Officer)	March 4, 2016
/s/ ROBERT T. MOLES Robert T. Moles	Director	March 4, 2016

/s/ HUMPHREY P. POLANEN Humphrey P. Polanen	Director	March 4, 2016
/s/ LAURA RODEN Laura Roden	Director	March 4, 2016

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Signature	Title	Date
/s/ CHARLES T. TOENISKOETTER Charles T. Toeniskoetter	Director	March 4, 2016
/s/ RANSON W. WEBSTER Ranson W. Webster	Director	March 4, 2016
/s/ W. KIRK WYCOFF W. Kirk Wycoff	Director	March 4, 2016

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HERITAGE COMMERCE CORP

INDEX TO FINANCIAL STATEMENTS
DECEMBER 31, 2015

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, 2015 and 2014, and the related consolidated statements of income, comprehensive income, changes in shareholders' equity, and cash flows for each of the years in the three-year period ended December 31, 2015. We also have audited Heritage Commerce Corp's internal control over financial reporting as of December 31, 2015, based on criteria established in the 2013 *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 consolidated 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. Our responsibility is to express an opinion on these consolidated 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, 2015 and 2014, and the results of its operations and its cash flows for each of the years in the three-year period ended December 31, 2015 in conformity with accounting principles generally accepted in the United States of

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America. Also in our opinion, Heritage Commerce Corp maintained, in all material respects, effective internal control over financial reporting as of December 31, 2015, based on criteria established in the 2013 *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

/s/ Crowe Horwath LLP

Sacramento, California
March 4, 2016

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HERITAGE COMMERCE CORP

CONSOLIDATED BALANCE SHEETS

	December 31, 2015	December 31, 2014
	(Dollars in thousands)	
Assets		
Cash and due from banks	$ 24,112	$ 23,256
Interest-bearing deposits in other financial institutions	319,980	99,147
Total cash and cash equivalents	344,092	122,403
Securities available-for-sale, at fair value	385,079	206,335
Securities held-to-maturity, at amortized cost (fair value of $109,821 at December 31, 2015 and $94,953 at December 31, 2014)	109,311	95,362
Loans held-for-sale SBA, at lower of cost or market, including deferred costs	7,297	1,172
Loans, net of deferred fees	1,358,716	1,088,643
Allowance for loan losses	(18,926)	(18,379)
Loans, net	1,339,790	1,070,264
Federal Home Loan Bank stock, Federal Reserve Bank stock and other investments, at cost	12,694	10,598
Company owned life insurance	60,021	51,257
Premises and equipment	7,773	7,451
Goodwill	45,664	13,044
Other intangible assets	8,518	3,276
Accrued interest receivable and other assets	41,340	35,941
Total assets	$ 2,361,579	$ 1,617,103

Liabilities and Shareholders' Equity		
Liabilities:		
Deposits:		
Demand, noninterest-bearing	$ 821,405	$ 517,662
Demand, interest-bearing	496,278	225,821
Savings and money market	496,843	384,644
Time deposits-under $250	62,026	55,943
Time deposits-$250 and over	160,815	164,952
Time deposits-brokered	17,825	28,116
CDARS money market and time deposits	7,583	11,248
Total deposits	2,062,775	1,388,386
Short-term borrowings	3,000	
Accrued interest payable and other liabilities	50,368	44,359
Total liabilities	2,116,143	1,432,745
Commitments and contingencies (Notes 7 and 16)		
Shareholders' equity:		
Preferred stock, no par value; 10,000,000 shares authorized		
	19,519	19,519

Series C convertible perpetual preferred stock, 21,004 shares issued and outstanding at December 31, 2015 and December 31, 2014 (liquidation preference of $21,004 at December 31, 2015 and December 31, 2014)				
Common stock, no par value; 60,000,000 shares authorized; 32,113,479 shares issued and outstanding at December 31, 2015 and 26,503,305 shares issued and outstanding at December 31, 2014		193,364		133,676
Retained earnings		38,773		33,014
Accumulated other comprehensive loss		(6,220)		(1,851)
Total shareholders' equity		245,436		184,358
Total liabilities and shareholders' equity	$	2,361,579	$	1,617,103

See notes to consolidated financial statements

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HERITAGE COMMERCE CORP

CONSOLIDATED STATEMENTS OF INCOME

	Year Ended December 31,		
	2015	2014	2013
	(Dollars in thousands, except per share data)		
Interest income:			
Loans, including fees	$ 68,259	$ 49,207	$ 41,570
Securities, taxable	6,707	7,117	8,937
Securities, exempt from Federal tax	2,183	2,025	1,530
Other investments and interest-bearing deposits in other financial institutions	1,594	907	749
Total interest income	78,743	59,256	52,786
Interest expense:			
Deposits	2,403	2,032	2,369
Subordinated debt			229
Short-term borrowings	19	121	2
Total interest expense	2,422	2,153	2,600
Net interest income before provision for loan losses	76,321	57,103	50,186
Provision (credit) for loan losses	32	(338)	(816)
Net interest income after provision for loan losses	76,289	57,441	51,002
Noninterest income:			
Service charges and fees on deposit accounts	2,803	2,519	2,457
Increase in cash surrender value of life insurance	1,697	1,600	1,654
Servicing income	1,143	1,296	1,446
Gain on sales of SBA loans	843	971	449
Gain on sales of securities	642	97	38
Other	1,857	1,263	1,170
Total noninterest income	8,985	7,746	7,214
Noninterest expense:			
Salaries and employee benefits	35,146	26,250	23,450
Occupancy and equipment	4,300	4,053	4,043
Professional fees	1,828	1,891	2,588
Other	17,399	12,028	10,389
Total noninterest expense	58,673	44,222	40,470
Income before income taxes	26,601	20,965	17,746
Income tax expense	10,104	7,538	6,206
Net income	16,497	13,427	11,540
Dividends and discount accretion on preferred stock	(1,792)	(1,008)	(336)

Net income available to common shareholders	$ 14,705	$ 12,419	$ 11,204
Earnings per common share:			
Basic	$ 0.48	$ 0.42	$ 0.36
Diluted	$ 0.48	$ 0.42	$ 0.36

See notes to consolidated financial statements

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HERITAGE COMMERCE CORP

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

	Year Ended December 31,		
	2015	**2014**	**2013**
	(Dollars in thousands)		
Net income	$ 16,497	$ 13,427	$ 11,540
Other comprehensive income (loss):			
Change in net unrealized holding gains (losses) on available-for-sale securities and I/O strips	(3,809)	7,164	(14,302)
Deferred income taxes	1,605	(3,012)	6,007
Change in net unamortized unrealized gain on securities available-for-sale that were reclassified to securities held-to-maturity	(55)	(54)	(54)
Deferred income taxes	23	23	23
Reclassification adjustment for gains realized in income	(642)	(97)	(38)
Deferred income taxes	270	41	16
Change in unrealized gains (losses) on securities and I/O strips, net of deferred income taxes	(2,608)	4,065	(8,348)
Change in net pension and other benefit plan liability adjustment	(3,036)	(3,253)	2,825
Deferred income taxes	1,275	1,366	(1,187)
Change in pension and other benefit plan liability, net of deferred income taxes	(1,761)	(1,887)	1,638
Other comprehensive income (loss)	(4,369)	2,178	(6,710)
Total comprehensive income	$ 12,128	$ 15,605	$ 4,830

See notes to consolidated financial statements

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HERITAGE COMMERCE CORP

CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY

Years Ended December 31, 2015, 2014, and 2013

	Preferred Stock		Common Stock			Accumulated Other Comprehensive	Total
	Shares	Amount	Shares	Amount	Retained Earnings	Income / (Loss)	Shareholders' Equity
	(Dollars in thousands)						
Balance, January 1, 2013	21,004	$ 19,519	26,322,147	$ 131,820	$ 15,721	$ 2,681	$ 169,741
Net income					11,540		11,540
Other comprehensive loss						(6,710)	(6,710)
Issuance of restricted stock awards, net			10,000				
Repurchase of warrant				(140)			(140)
Amortization of restricted stock awards, net of forfeitures and taxes				200			200
Cash dividend declared $0.06 per share					(1,916)		(1,916)
Stock option expense, net of fortfeitures and taxes				593			593
Stock options exercised			18,791	88			88
Balance, December 31, 2013	21,004	19,519	26,350,938	132,561	25,345	(4,029)	173,396
Net income					13,427		13,427
Other comprehensive income						2,178	2,178
Issuance of restricted stock awards, net			90,000				
Amortization of restricted stock awards, net of forfeitures and taxes				(9)			(9)
Cash dividend declared $0.18 per share					(5,758)		(5,758)
Stock option expense, net of fortfeitures and taxes				862			862
Stock options exercised			62,567	262			262
Balance, December 31, 2014	21,004	19,519	26,503,505	133,676	33,014	(1,851)	184,358
Net income					16,497		16,497
Other comprehensive loss						(4,369)	(4,369)
Issuance of 5,456,713 common shares to acquire Focus Business Bank, net of offering costs of $144			5,456,713	58,134			58,134
Issuance of restricted stock awards, net			98,855				
Amortization of restricted stock awards, net of forfeitures and taxes				265			265
Cash dividend declared $0.32 per share					(10,738)		(10,738)
Stock option expense, net of forfeitures and taxes				974			974
Stock options exercised			54,406	315			315
Balance, December 31, 2015	21,004	$ 19,519	32,113,479	$ 193,364	$ 38,773	$ (6,220)	$ 245,436

See notes to consolidated financial statements

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HERITAGE COMMERCE CORP

CONSOLIDATED STATEMENTS OF CASH FLOWS

	Year ended December 31, 2015	2014	2013
	(Dollars in thousands)		
CASH FLOWS FROM OPERATING ACTIVITIES:			
Net income	$ 16,497	$ 13,427	$ 11,540
Adjustments to reconcile net income to net cash provided by operating activities:			
Amortization of discounts and premiums on securities	1,384	1,163	2,231
Gain on sale of securities available-for-sale	(642)	(97)	(38)
Gain on sale of SBA loans	(843)	(971)	(449)
Proceeds from sale of SBA loans originated for sale	11,497	15,858	6,174
Net change in SBA loans originated for sale	(14,906)	(12,911)	(9,234)
Provision (credit) for loan losses	32	(338)	(816)
Increase in cash surrender value of life insurance	(1,697)	(1,600)	(1,654)
Gain on proceeds from company owned life insurance		(51)	
Depreciation and amortization	685	725	729
Amortization of other intangible assets	1,043	510	473
Gains on sale of foreclosed assets, net	(106)		(243)
Stock option expense, net	974	862	593
Amortization of restricted stock awards, net	265	(9)	200
Effect of changes in:			
Accrued interest receivable and other assets	16,274	(2,428)	4,694
Accrued interest payable and other liabilities	(1,963)	5,244	2,063
Net cash provided by operating activities	28,494	19,384	16,263
CASH FLOWS FROM INVESTING ACTIVITIES:			
Purchase of securities available-for-sale	(232,644)	(53,292)	(17,844)
Purchase of securities held-to-maturity	(9,482)	(4,595)	(51,044)
Maturities/paydowns/calls of securities available-for-sale	31,195	24,917	62,531
Maturities/paydowns/calls of securities held-to-maturity	3,931	3,899	3,851
Proceeds from sales of securities available-for-sale	71,832	108,603	26,944
Net change in loans	(97,898)	(131,648)	(97,910)
Changes in Federal Home Loan Bank stock, Federal Reserve Bank stock and other investments	(1,788)	(163)	293
Purchase of premises and equipment	(1,007)	(817)	(500)
Proceeds from sale of foreclosed assets	1,571		850
Proceeds from company owned life insurance		406	
Cash paid in bank acquisition, net of cash received	165,786	(21,918)	
Net cash used in investing activities	(68,504)	(74,608)	(72,829)
CASH FLOWS FROM FINANCING ACTIVITIES:			
Net change in deposits	269,266	102,165	(193,147)
Repurchase of warrant			(140)
Exercise of stock options	315	262	88
Offering costs	(144)		
Short-term borrowings	3,000		
Repayment of short-term borrowings		(31,647)	
Redemption of subordinated debt			(9,279)
Payment of cash dividends	(10,738)	(5,758)	(1,916)
Net cash provided by (used in) financing activities	261,699	65,022	(204,394)
Net increase (decrease) in cash and cash equivalents	221,689	9,798	(260,960)
Cash and cash equivalents, beginning of year	122,403	112,605	373,565

Cash and cash equivalents, end of year	$ 344,092	$ 122,403	$ 112,605

Supplemental disclosures of cash flow information:			
Interest paid	$ 2,427	$ 2,166	$ 2,685
Income taxes paid	6,904	4,280	2,021
Supplemental schedule of non-cash investing activity:			
Due to broker for securities purchased, settling after year-end	$	$	$ 961
Transfer of loans held-for-sale to loan portfolio	2,543		3,770
Loans transferred to foreclosed assets	1,236	229	33
Summary of assets acquired and liabilities assumed through acquisition:			
Cash and cash equivalents, net of cash paid for acquisition	165,786		
Securities avaiable-for-sale	53,940		
Securities held-to-maturity	8,665		
Loans held-for-sale SBA	4,416		
Net loans	170,353	42,300	
Company owned life insurance	7,067		
Premises and equipment		119	
Goodwill and other intangible assets	38,905	15,303	
Other assets, net	20,250	738	
Deposits	(405,123)		
Borrowings		(31,647)	
Other liabilities	(5,981)	(4,895)	
Common stock issued to acquire Focus Business Bank	58,278		

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.

On November 1, 2014, the Company acquired CSNK Working Capital Finance Corp. dba Bay View Funding ("Bay View Funding"), which provides business-essential working capital factoring financing to various industries throughout the United States. Bay View Funding's results of operations have been included in the Company's results of operations beginning November 1, 2014.

As discussed in Note 8, the Company completed its acquisition of Focus Business Bank ("Focus") on August 20, 2015. Focus was merged with HBC, with HBC as the surviving bank. Focus' results of operations have been included in the Company's results of operations beginning August 21, 2015.

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 also established the following wholly-owned Delaware business trusts that were formed to issue trust preferred and related common securities: Heritage Statutory Trust II, formed in 2001, and Heritage Statutory Trust III, formed in 2002 ("Trusts"). During the third quarter of 2013, the Company dissolved the Heritage Statutory Trust II and the Heritage Statutory Trust III.

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 was recorded as debt of the Company. The Company had 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 was the source of revenues for these Trusts. In accordance with generally accepted accounting principles, the Trusts were 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.

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.

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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 selling price and the carrying value of the related loan sold.

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 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.

HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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 on originated loans, or unamortized premiums or discounts on purchased or acquired loans, 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. Interest on purchased or acquired loans and the accretion (amortization) of the related purchase discount (premium) is also 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.

Acquired Loans and Leases

Loans and leases acquired through purchase or through a business combination are recorded at their fair value at the acquisition date. Credit discounts are included in the determination of fair value; therefore, an allowance for loan and lease losses is not recorded at the acquisition date. Should the Company's allowance for loan and lease losses methodology indicate that the credit discount associated with acquired, non-purchased credit impaired loans, is no longer sufficient to cover probable losses inherent in those loans, the Company will establish an allowance for those loans through a charge to provision for loan and lease losses. Acquired loans are evaluated upon acquisition for evidence of deterioration in credit quality since origination such that it is probable at acquisition that the Company will be unable to collect all contractually required payments. Such loans are classified as purchased credit impaired loans ("PCI loans"), while all other acquired loans are classified as non-PCI loans.

The Company has elected to account for PCI loans on an individual loan level. The Company estimates the amount and timing of expected cash flows for each loan. The expected cash flow in excess of the loan's carrying value, which is fair value on the date of acquisition, is referred to as the accretable yield, and is recorded as interest income over the remaining expected life of the loan. The excess of the loan's contractual principal and interest over expected cash flows is referred to as the non-accretable difference, and is not recorded in the Company's Consolidated Financial Statements.

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HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Quarterly, management performs an evaluation of expected future cash flows for PCI loans. If current expectations of future cash flows are less than management's previous expectations, other than due to decreases in interest rates and prepayment assumptions, an allowance for loan and leases losses is recorded with a charge to current period earnings through provision for loan and lease losses. If there has been a probable and significant increase in expected future cash flows over that which was previously expected, the Company would first reduce any previously established allowance for loan and lease losses, and then record an adjustment to interest income through a prospective increase in the accretable yield.

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 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. The factored receivables at Bay View Funding are included in the Company's commercial loan portfolio; however, they are evaluated for risk primarily based on the agings of the receivables. Faster turning receivables imply less risk and therefore warrant a lower associated allowance. Should the overall aging for the portfolio increase, this structure will by formula increase the allowance to reflect the increasing risk. Should the portfolio turn more quickly, it would reduce the associated allowance to reflect the reducing risk.

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HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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 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.

HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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 primarily over the participant's service period 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.

Business Combinations

The Company accounts for acquisitions of businesses using the acquisition method of accounting. Under the acquisition method, assets acquired and liabilities assumed are recorded at their estimated fair values at the date of acquisition. Management utilizes various valuation techniques including discounted cash flow analyses to determine these fair values. Any excess of the purchase price over amounts allocated to the acquired assets, including identifiable intangible assets, and liabilities assumed is recorded as goodwill.

Goodwill and Other Intangible Assets

Goodwill resulted from the acquisition of Bay View Funding on November 1, 2014 and Focus on August 20, 2015. Goodwill represents the excess of the purchase price over the fair value of acquired tangible assets and liabilities and identifiable intangible assets. Goodwill is assessed at least annually for impairment and any such impairment is recognized in the period identified.

Other intangible assets consist of core deposit and customer relationship intangible assets arising from the Diablo Valley Bank acquisition in June 2007, a core deposit intangible asset from the Focus acquisition in August 2015, and a below market value lease, customer relationship and non-compete agreement intangible assets arising from the Bay View Funding acquisition in November 2014. They are initially measured at fair value and then are amortized over their estimated useful lives. The core deposits intangible assets from the acquisitions of Diablo Valley Bank and Focus are being amortized on an accelerated method over ten years. The customer relationship intangible from the acquisition of Diablo Valley Bank was being amortized on an accelerated method over seven years, and was fully amortized at

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HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

December 31, 2014. The below market value lease, customer relationship and non-compete agreement intangible assets from the acquisition of Bay View Funding are being amortized on the straight line method over three, ten, and three 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 operations. Operating costs after acquisition are expensed. Gains and losses on disposition are included in noninterest expense.

The carrying value of foreclosed assets was $364,000 and $696,000 at December 31, 2015 and 2014, 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 refunded, the change in deferred tax assets and liabilities, and low income housing investment losses, net of tax benefits received. Some items of income and expense are recognized in different years for tax purposes 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 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.

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HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The Company had net deferred tax assets of $22,218,000 and $18,527,000 at December 31, 2015, and December 31, 2014, 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, 2015 and 2014 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 (loss) 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 a commercial bank serving customers located in Santa Clara, Alameda, Contra Costa, and San Benito counties of California. Bay View Funding provides business essential working capital factoring financing to various industries throughout the United States. No customer accounts for more than 10 percent of revenue for HBC or the Company. With the acquisition of Bay View Funding, the Company now has two reportable segments consisting of Banking and Factoring. 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. Operating segments are aggregated into one as operating results for all segments are similar. Accordingly, all of the financial service operations are considered by management to be aggregated in one reportable segment.

Reclassifications

Certain items in the consolidated financial statements for the years ended December 31, 2014 and 2013 were reclassified to conform to the 2015 presentation. These reclassifications did not affect previously reported net income or shareholders equity.

HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Adoption of New Accounting Standards

In January 2014, the Financial Accounting Standards Board ("FASB") amended existing guidance clarifying that an in substance repossession or foreclosure occurs, and a creditor is considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan, upon either (1) the creditor obtaining legal title to the residential real estate property upon completion of a foreclosure or (2) the borrower conveying all interest in the residential real estate property to the creditor to satisfy that loan through completion of a deed in lieu of foreclosure or through a similar legal agreement. Additionally, the amendments require interim and annual disclosure of both (1) the amount of foreclosed residential real estate property held by the creditor and (2) the recorded investment in consumer mortgage loans collateralized by residential real estate property that are in the process of foreclosure according to local requirements of the applicable jurisdiction. The amendments in this update are effective for public business entities for annual periods, and interim periods within those annual periods, beginning after December 15, 2014. For entities other than public business entities, the amendments in this update are effective for annual periods beginning after December 15, 2014, and interim periods within annual periods beginning after December 15, 2015. The Company has evaluated the adoption of the new guidance and has determined it did not have a material impact on the consolidated financial statements.

In January 2014, the FASB issued guidance for accounting for investments in qualified affordable housing projects, which represents a consensus of the Emerging Issues Task Force and sets forth new accounting for qualifying investments in flow through limited liability entities that invest in affordable housing projects. The new guidance allows a limited liability investor that meets certain conditions to amortize the cost of its investment in proportion to the tax credits and other tax benefits it receives. The new accounting method, referred to as the proportional amortization method, allows amortization of the tax credit investment to be reflected along with the primary benefits, the tax credits and other tax benefits, on a net basis in the income statement within the income tax expense (benefit) line. For public business entities, the guidance is effective for interim and annual periods beginning after December 15, 2014. For all other entities, the guidance is effective for annual periods beginning after December 15, 2014, and interim periods within annual periods beginning after December 15, 2015. If elected, the proportional amortization method is required to be applied retrospectively. Early adoption is permitted in the annual period for which financial statements have not been issued.

The Company adopted the proportional amortization method of accounting for its low income housing investments in the third quarter of 2014. The Company quantified the impact of adopting the proportional amortization method compared to the equity method to its current year and prior period financial statements. The Company determined that the adoption of the proportional amortization method did not have a material impact to its financial statements. The low income housing investment losses, net of the tax benefits received, are included in income tax expense for all periods reflected on the consolidated income statements. See *Note 12 Income Taxes* for more information on the adoption of the proportional method of accounting for low income housing investments.

In May 2014, the FASB issued an update to the guidance for accounting for revenue from contracts with customers. The guidance in this update affects any entity that either enters into contracts with customers to transfer goods or services or enters into contracts for the transfer of nonfinancial assets unless those contracts are within the scope of other standards (for example, insurance contracts or lease contracts). The core principle of the guidance is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. The guidance provides steps to follow to achieve the core principle. An entity should disclose sufficient information to enable users of

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

financial statements to understand the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers. Qualitative and quantitative information is required about contracts with customers, significant judgments and changes in judgments, and assets recognized from the costs to obtain or fulfill a contract. The amendments in this update become effective for annual periods and interim periods within those annual periods beginning after December 15, 2017. We are evaluating the impact of adopting the new guidance on the consolidated financial statements.

In September 2015, the FASB issued an update simplifying the accounting for measurement-period adjustments. This update applies to all entities that have reported provisional amounts for items in a business combination for which the accounting is incomplete by the end of the reporting period in which the combination occurs and during the measurement period have an adjustment to provisional amounts recognized. The amendments in this update require that an acquirer recognize adjustments to provisional amounts that are identified during the measurement period in the reporting period in which the adjustment amounts are determined. The amendments in this update require that the acquirer record, in the same period's financial statements, the effect on earnings of changes in depreciation, amortization, or other income effects, if any, as a result of the change to the provisional amounts, calculated as if the accounting had been completed at the acquisition date. The amendments in this update require an entity to present separately on the face of the income statement or disclose in the notes the portion of the amount recorded in current-period earnings by line item that would have been recorded in previous reporting periods if the adjustment to the provisional amounts had been recognized as of the acquisition date. The amendments in this update are effective for fiscal years beginning after December 15, 2015, including interim periods within those fiscal years. The amendments in this update should be applied prospectively to adjustments to provisional amounts that occur after the effective date of this update with earlier application permitted for financial statements that have not been issued. We are currently evaluating the impact of adopting the new guidance on the consolidated financial statements, but it is not expected to have a material impact.

On January 5, 2016, the FASB issued an update (ASU No. 2016-01, Financial Instruments Recognition and Measurement of Financial Assets and Liabilities). The new guidance is intended to improve the recognition and measurement of financial instruments by requiring: equity investments (other than equity method or consolidation) to be measured at fair value with changes in fair value recognized in net income; public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes; separate presentation of financial assets and financial liabilities by measurement category and form of financial assets (i.e. securities or loans and receivables) on the balance sheet or the accompanying notes to the financial statements; eliminating the requirement to disclose the fair value of financial instruments measured at amortized cost for organizations that are not public business entities; eliminating the requirement for non-public business entities to disclose the method(s) and significant assumptions used to estimate the fair value that is to be required to be disclosed for financial instruments measured at amortized cost on the balance sheet; and requiring a reporting organization to present separately in other comprehensive income the portion of the total change in fair value of a liability resulting from the change in the instrument-specific credit risk (also referred to as "own credit") when the organization has elected to measure the liability at fair value in accordance with the fair value option for financial instruments. The new guidance is effective for public business entities for fiscal years beginning after December 15, 2017. We are currently evaluating the impact of adopting the new guidance on the consolidated financial statements.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

2) Accumulated Other Comprehensive Income ("AOCI")

The following table reflects the changes in AOCI by component for the periods indicated:

	For the Years Ended December 31, 2015, 2014, and 2013			
	Unrealized Gains (Losses) on Available-for-Sale Securities and I/O Strips	Unamortized Unrealized Gain on Available-for-Sale Securities Reclassified to Held-to-Maturity	Defined Benefit Pension Plan Items	Total
	(Dollars in thousands)			
Beginning balance January 1, 2015, net of taxes	$ 3,666	$ 435	$ (5,952)	$ (1,851)
Other comprehensive (loss) before reclassification, net of taxes	(2,204)		(1,919)	(4,123)
Amounts reclassified from other comprehensive income (loss), net of taxes	(372)	(32)	158	(246)
Net current period other comprehensive income (loss), net of taxes	(2,576)	(32)	(1,761)	(4,369)
Ending balance December 31, 2015, net of taxes	$ 1,090	$ 403	$ (7,713)	$ (6,220)
Beginning balance January 1, 2014, net of taxes	$ (430)	$ 466	$ (4,065)	$ (4,029)
Other comprehensive (loss) before reclassification, net of taxes	4,152		(1,910)	2,242
Amounts reclassified from other comprehensive income (loss), net of taxes	(56)	(31)	23	(64)
Net current period other comprehensive income (loss), net of taxes	4,096	(31)	(1,887)	2,178
Ending balance December 31, 2014, net of taxes	$ 3,666	$ 435	$ (5,952)	$ (1,851)
Beginning balance January 1, 2013, net of taxes	$ 7,887	$ 497	$ (5,703)	$ 2,681
Other comprehensive (loss) before reclassification, net of taxes	(8,295)		1,518	(6,777)
Amounts reclassified from other comprehensive income (loss), net of taxes	(22)	(31)	120	67

Net current period other comprehensive income (loss), net of taxes		(8,317)		(31)	1,638		(6,710)
Ending balance December 31, 2013, net of taxes	$	(430)	$	466	$ (4,065)	$	(4,029)

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Details About AOCI Components	Amounts Reclassified from AOCI For the Year Ended December 31, 2015	2014	2013	Affected Line Item Where Net Income is Presented
	(Dollars in thousands)			
Unrealized gains on available-for-sale securities and I/O strips	$ 642	$ 97	$ 38	Realized gains on sale of securities
	(270)	(41)	(16)	Income tax expense
	372	56	22	Net of tax
Amortization of unrealized gain on securities available-for-sale that were reclassified to securities held-to-maturity	55	54	54	Interest income on taxable securities
	(23)	(23)	(23)	Income tax (expense) benefit
	32	31	31	Net of tax
Amortization of defined benefit pension plan items(1)				
Prior transition obligation	113	102	84	
Actuarial losses	(386)	(142)	(291)	
	(273)	(40)	(207)	Income before income tax
	115	17	87	Income tax benefit
	(158)	(23)	(120)	Net of tax
Total reclassification for the year	$ 246	$ 64	$ (67)	

(1) This AOCI component is included in the computation of net periodic benefit cost (see Note 14 Benefit Plans).

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

3) Securities

The amortized cost and estimated fair value of securities at year-end were as follows:

2015	Amortized Cost	Gross Unrealized Gains	Gross Unrealized (Losses)	Estimated Fair Value
		(Dollars in thousands)		
Securities available-for-sale:				
Agency mortgage-backed securities	$ 324,077	$ 2,457	$ (2,304)	$ 324,230
U.S. Treasury	30,047		(44)	30,003
Trust preferred securities	15,000	132		15,132
U.S. Government sponsored entities	9,042	13	(14)	9,041
Corporate bonds	6,412	261		6,673
Total	$ 384,578	$ 2,863	$ (2,362)	$ 385,079
Securities held-to-maturity:				
Municipals tax exempt	$ 93,518	$ 1,517	$ (863)	$ 94,172
Agency mortgage-backed securities	15,793	24	(168)	15,649
Total	$ 109,311	$ 1,541	$ (1,031)	$ 109,821

2014	Amortized Cost	Gross Unrealized Gains	Gross Unrealized (Losses)	Estimated Fair Value
		(Dollars in thousands)		
Securities available-for-sale:				
Agency mortgage-backed securities	$ 150,570	$ 3,867	$ (265)	$ 154,172
Corporate bonds	35,927	959	(23)	36,863
Trust preferred securities	15,000	300		15,300
Total	$ 201,497	$ 5,126	$ (288)	$ 206,335
Securities held-to-maturity:				
Municipals tax exempt	$ 79,882	$ 1,011	$ (1,346)	$ 79,547
Agency mortgage-backed securities	15,480	44	(118)	15,406
Total	$ 95,362	$ 1,055	$ (1,464)	$ 94,953

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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 an unrealized loss position, are as follows:

2015	Less Than 12 Months Fair Value	Less Than 12 Months Unrealized (Losses)	12 Months or More Fair Value	12 Months or More Unrealized (Losses)	Total Fair Value	Total Unrealized (Losses)
	(Dollars in thousands)					
Securities available-for-sale:						
Agency mortgage-backed securities	$ 241,067	$ (2,258)	$ 2,165	$ (46)	$ 243,232	$ (2,304)
U.S. Treasury	30,003	(44)			30,003	(44)
U.S. Government sponsored entities	4,980	(14)			4,980	(14)
Total	$ 276,050	$ (2,316)	$ 2,165	$ (46)	$ 278,215	$ (2,362)
Securities held-to-maturity:						
Municipals Tax Exempt	$ 9,920	$ (78)	$ 24,412	$ (785)	$ 34,332	$ (863)
Agency mortgage-backed securities	7,152	(89)	4,409	(79)	11,561	(168)
Total	$ 17,072	$ (167)	$ 28,821	$ (864)	$ 45,893	$ (1,031)

2014	Less Than 12 Months Fair Value	Less Than 12 Months Unrealized (Losses)	12 Months or More Fair Value	12 Months or More Unrealized (Losses)	Total Fair Value	Total Unrealized (Losses)
	(Dollars in thousands)					
Securities available-for-sale:						
Agency mortgage-backed securities	$ 12,491	$ (27)	$ 35,614	$ (238)	$ 48,105	$ (265)
Corporate bonds			5,148	(23)	5,148	(23)
Total	$ 12,491	$ (27)	$ 40,762	$ (261)	$ 53,253	$ (288)
Securities held-to-maturity:						
Municipals Tax Exempt	$ 1,884	$ (16)	$ 42,867	$ (1,330)	$ 44,751	$ (1,346)
Agency mortgage-backed securities	4,869	(29)	4,974	(89)	9,843	(118)
Total	$ 6,753	$ (45)	$ 47,841	$ (1,419)	$ 54,594	$ (1,464)

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. At December 31, 2015, the Company held 460 securities (193 available-for-sale and 267 held-to-maturity), of which 193 had fair values below amortized cost. At December 31, 2015, there were $2,165,000 of agency mortgage-backed securities available-for-sale, $4,409,000 of agency mortgage-backed securities held-to-maturity and $24,412,000 of municipals bonds held-to-maturity carried with an unrealized loss for 12 months or greater. The total unrealized loss for securities 12 months or greater was $910,000 at December 31, 2015. The 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 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, 2015.

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The proceeds from sales of securities and the resulting gains and losses are listed below:

	2015	2014	2013
	(Dollars in thousands)		
Proceeds	$ 71,832	$ 108,603	$ 26,944
Gross gains	751	1,008	310
Gross losses	(109)	(911)	(272)

The amortized cost and fair value of debt securities as of December 31, 2015, by contractual maturity, are shown below. The expected maturities will differ from contractual maturities if borrowers have the right to call or prepay obligations with or without call or prepayment penalties. Securities not due at a single maturity date are shown separately.

	Available-for-sale	
	Amortized Cost	Estimated Fair Value
	(Dollars in thousands)	
Due after 3 months through one year	$ 1,999	$ 1,996
Due after one through five years	39,454	39,659
Due after five through ten years	4,048	4,062
Due after ten years	15,000	15,132
Agency mortgage-backed securities	324,077	324,230
Total	$ 384,578	$ 385,079

	Held-to-maturity	
	Amortized Cost	Estimated Fair Value
	(Dollars in thousands)	
Due less than 3 months	$ 879	$ 882
Due after 3 months through one year	1,353	1,362
Due after one through five years	5,554	5,626
Due after five through ten years	13,990	14,608
Due after ten years	71,742	71,694
Agency mortgage-backed securities	15,793	15,649
Total	$ 109,311	$ 109,821

Securities with amortized cost of $134,235,000 and $147,497,000 as of December 31, 2015 and 2014 were pledged to secure public deposits and for other purposes as required or permitted by law or contract.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

4) Loans

Loans at year-end were as follows:

	2015	2014
	(Dollars in thousands)	
Loans held-for-investment:		
Commercial	$ 556,522	$ 462,403
Real estate:		
Commercial and residential	625,665	478,335
Land and construction	84,428	67,980
Home equity	76,833	61,644
Consumer	16,010	18,867
Loans	1,359,458	1,089,229
Deferred loan fees, net	(742)	(586)
Loans, net of deferred fees	1,358,716	1,088,643
Allowance for loan losses	(18,926)	(18,379)
Loans, net	$ 1,339,790	$ 1,070,264

At December 31, 2015, total net loans included in the table above include $141,343,000 of the non-PCI loans acquired in the Focus transaction.

Changes in the allowance for loan losses were as follows:

	For the Year Ended December 31, 2015			
	Commercial	Real Estate	Consumer	Total
	(Dollars in thousands)			
Balance, beginning of year	$ 11,187	$ 7,070	$ 122	$ 18,379
Charge-offs	(527)	(2)	(9)	(538)
Recoveries	877	146	30	1,053
Net recoveries	350	144	21	515
Provision (credit) for loan losses	(789)	862	(41)	32
Balance, end of year	$ 10,748	$ 8,076	$ 102	$ 18,926

	For the Year Ended December 31, 2014			
	Commercial	Real Estate	Consumer	Total
	(Dollars in thousands)			
Balance, beginning of year	$ 12,533	$ 6,548	$ 83	$ 19,164

Charge-offs	(815)	(87)	(25)	(927)
Recoveries	418	62		480
Net charge-offs	(397)	(25)	(25)	(447)
Provision (credit) for loan losses	(949)	547	64	(338)
Balance, end of year	$ 11,187	$ 7,070	$ 122	$ 18,379

HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

	For the Year Ended December 31, 2013			
	Commercial	Real Estate	Consumer	Total
	(Dollars in thousands)			
Balance, beginning of year	$ 12,866	$ 6,034	$ 127	$ 19,027
Charge-offs	(1,676)	(276)		(1,952)
Recoveries	2,621	283	1	2,905
Net recoveries	945	7	1	953
Provision (credit) for loan losses	(1,278)	507	(45)	(816)
Balance, end of year	$ 12,533	$ 6,548	$ 83	$ 19,164

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, 2015			
	Commercial	Real Estate	Consumer	Total
	(Dollars in thousands)			
Allowance for loan losses:				
Ending allowance balance attributable to loans:				
Individually evaluated for impairment	$ 174	$ 112	$	$ 286
Collectively evaluated for impairment	10,574	7,964	102	18,640
Acquired with deteriorated credit quality				
Total allowance balance	$ 10,748	$ 8,076	$ 102	$ 18,926
Loans:				
Individually evaluated for impairment	$ 2,014	$ 4,272	$ 4	$ 6,290
Collectively evaluated for impairment	554,271	782,654	16,006	1,352,931
Acquired with deteriorated credit quality	237			237
Total loan balance	$ 556,522	$ 786,926	$ 16,010	$ 1,359,458

	December 31, 2014			
	Commercial	Real Estate	Consumer	Total
	(Dollars in thousands)			

Allowance for loan losses:								
Ending allowance balance attributable to loans:								
Individually evaluated for impairment	$	404	$		$		$	404
Collectively evaluated for impairment		10,783		7,070		122		17,975
Total allowance balance	$	11,187	$	7,070	$	122	$	18,379
Loans:								
Individually evaluated for impairment	$	2,701	$	3,315	$	6	$	6,022
Collectively evaluated for impairment		459,702		604,644		18,861		1,083,207
Total loan balance	$	462,403	$	607,959	$	18,867	$	1,089,229

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Purchased Credit Impaired Loans:

The Company has purchased loans, for which there was, at acquisition, evidence of credit quality since origination and it was probable, at acquisition, that all contractually required payments would not be collected. The carrying amount of these loans is as follows:

		2015
		(Dollars in thousands)
Commercial	$	876
Outstanding balance		876
Carrying amount, net of discount of $639,000		237

For those purchased credit impaired loans discussed above, the Company increased the allowance for loan losses by $0 during 2015. No allowance for loan losses were reversed during 2015.

For these purchased credit impaired loans, the Company cannot reasonably estimate the cash flows expected to be collected on the loans and therefore has continued to account for those loans using the cost recovery method of income recognition. As such, no portion of a purchase discount adjustment has been determined to meet the definition of an accretable yield adjustment on those loans accounted for using the cost recovery method. If, in the future, cash flows from the borrowers can be reasonably estimated, a portion of the purchase discount would be allocated to an accretable yield adjustment based upon the present value of the future estimated cash flows versus the current carrying value of the loan and the accretable yield portion would be recognized as interest income over the remaining life of the loan. Until such accretable yield can be calculated, under the cost recovery method of income recognition, all payments will be used to reduce the carrying value of the loan and no income will be recognized on the loan until the carrying value is reduced to zero. Any loan accounted for under the cost recovery method is also still included as a nonaccrual loan.

The following table presents loans held-for-investment individually evaluated for impairment by class of loans as of December 31, 2015 and December 31, 2014. 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, 2015			December 31, 2014		
	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	$ 745	$ 745	$	$ 2,282	$ 1,872	$
Real estate:						
Commercial and residential	3,851	2,992		2,510	1,651	
Land and construction	237	219		1,808	1,319	
Home Equity	302	302		345	345	
Consumer	4	4		6	6	
Total with no related allowance recorded	5,139	4,262		6,951	5,193	
With an allowance recorded:						
Commercial	1,506	1,506	174	829	829	404
Real estate:						
Home Equity	759	759	112			
Total with an allowance recorded	2,265	2,265	286	829	829	404
Total	$ 7,404	$ 6,527	$ 286	$ 7,780	$ 6,022	$ 404

The following table presents interest recognized and cash-basis interest earned on impaired loans for the periods indicated:

	For the Year Ended December 31, 2015					
		Real Estate				
	Commercial	Commercial and Residential	Land and Construction	Home Equity	Consumer	Total
	(Dollars in thousands)					
Average of impaired loans during the period	$ 1,774	$ 3,006	$ 764	$ 475	$ 5	$ 6,024
Interest income during impairment	$ 14	$	$	$ 2	$	$ 16
Cash-basis interest earned	$	$	$	$	$	$

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

	For the Year Ended December 31, 2014					
		Real Estate				
	Commercial	Commercial and Residential	Land and Construction	Home Equity	Consumer	Total
	(Dollars in thousands)					
Average of impaired loans during the period	$ 4,069	$ 2,758	$ 1,628	$ 529	$ 56	$ 9,040
Interest income during impairment	$ 56	$	$	$	$	$ 56
Cash-basis interest earned	$	$	$	$	$	$

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:

	2015	2014
	(Dollars in thousands)	
Nonaccrual loans held-for-investment	$ 4,716	$ 5,855
Restructured and loans over 90 days past due and still accruing	1,662	
Total nonperforming loans	$ 6,378	$ 5,855
Other restructured loans	$ 149	$ 167
Impaired loans, excluding loans held-for-sale	$ 6,527	$ 6,022

The following table presents the nonperforming loans by class at year-end:

	2015			2014		
	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	$ 724	$ 1,378	$ 2,102	$ 2,534	$	$ 2,534
Real estate:						
Commercial and residential	2,992		2,992	1,651		1,651
Land and construction	219		219	1,320		1,320
Home equity	777	284	1,061	344		344
Consumer	4		4	6		6
Total	$ 4,716	$ 1,662	$ 6,378	$ 5,855	$	$ 5,855

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The following table presents the aging of past due loans as of December 31, 2015 by class of loans:

	30 - 59 Days Past Due	60 - 89 Days Past Due	90 Days or Greater Past Due	Total Past Due	Loans Not Past Due	Total
			(Dollars in thousands)			
Commercial	$ 3,285	$ 262	$ 1,704	$ 5,251	$ 551,271	$ 556,522
Real estate:						
Commercial and residential					625,665	625,665
Land and construction	219			219	84,209	84,428
Home equity			284	284	76,549	76,833
Consumer					16,010	16,010
Total	$ 3,504	$ 262	$ 1,988	$ 5,754	$ 1,353,704	$ 1,359,458

The following table presents the aging of past due loans as of December 31, 2014 by class of loans:

	30 - 59 Days Past Due	60 - 89 Days Past Due	90 Days or Greater Past Due	Total Past Due	Loans Not Past Due	Total
			(Dollars in thousands)			
Commercial	$ 3,002	$ 195	$ 1,978	$ 5,175	$ 457,228	$ 462,403
Real estate:						
Commercial and residential			1,065	1,065	477,270	478,335
Land and construction					67,980	67,980
Home equity					61,644	61,644
Consumer					18,867	18,867
Total	$ 3,002	$ 195	$ 3,043	$ 6,240	$ 1,082,989	$ 1,089,229

Past due loans 30 days or greater totaled $5,754,000 and $6,240,000 at December 31, 2015 and December 31, 2014, respectively, of which $591,000 and $3,130,000 were on nonaccrual. At December 31, 2015, there were also $4,125,000 loans less than 30 days past due included in nonaccrual loans held-for-investment. At December 31, 2014, there were also $2,725,000 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

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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, and it is probable that the Company will not receive payment of the full contractual principal and interest. 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, 2015 or 2014.

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The following table provides a summary of the loan portfolio by loan type and credit quality classification for the periods indicated:

	December 31, 2015			December 31, 2014		
	Nonclassified	Classified*	Total	Nonclassified	Classified*	Total
	(Dollars in thousands)					
Commercial	$ 547,536	$ 8,986	$ 556,522	$ 455,767	$ 6,636	$ 462,403
Real estate:						
Commercial and residential	617,865	7,800	625,665	472,061	6,274	478,335
Land and construction	84,209	219	84,428	66,660	1,320	67,980
Home equity	75,511	1,322	76,833	60,736	908	61,644
Consumer	15,705	305	16,010	18,518	349	18,867
Total	$ 1,340,826	$ 18,632	$ 1,359,458	$ 1,073,742	$ 15,487	$ 1,089,229

* Classified loans in the table above include SBA guarantees.

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, 2015, 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.

The book balance of troubled debt restructurings at December 31, 2015 was $153,000, which included $4,000 of nonaccrual loans and $149,000 of accruing loans. The book balance of troubled debt restructurings at December 31, 2014 was $1,083,000, which included $916,000 of nonaccrual loans and $167,000 of accruing loans. Approximately $3,000 and $113,000 in specific reserves were established with respect to these loans as of December 31, 2015 and December 31, 2014. As of December 31, 2015 and December 31, 2014, the Company had no additional amounts committed on any loan classified as a troubled debt restructuring.

There were no loans by class modified as troubled debt restructurings during the twelve month period ended December 31, 2015 and 2014.

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 years ended December 31, 2015 and 2014.

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HBC makes loans to executive officers, directors, and their affiliates. The following table presents the loans outstanding to these related parties for the periods indicated:

	2015	2014
	(Dollars in thousands)	
Balance, beginning of year	$ 576	$ 590
Advances on loans during the year	4,175	
Repayment on loans during the year	(4,189)	(14)
Balance, end of year	$ 562	$ 576

5) Loan Servicing

At December 31, 2015 and 2014, the Company serviced SBA loans sold to the secondary market of approximately $175,457,000 and $130,611,000, respectively.

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 1.16% and 1.20% at December 31, 2015 and 2014, respectively.

Servicing rights are included in "accrued interest receivable and other assets" on the consolidated balance sheets. Activity for loan servicing rights follows:

	2015	2014	2013
	(Dollars in thousands)		
Balance, beginning of year	$ 565	$ 525	$ 709
Additions	2,126	319	106
Amortization	(482)	(279)	(290)
Balance, end of year	$ 2,209	$ 565	$ 525

There was no valuation allowance for servicing rights at December 31, 2015 and 2014, because the estimated fair value of the servicing rights was greater than the carrying value. The increase in loan servicing rights for the year ended December 31, 2015, compared to the prior year was primarily due to the Focus acquisition of $1,976,000 at fair value. The estimated fair value of loan servicing rights was $3,650,000 and $2,426,000 at December 31, 2015 and 2014, respectively. The fair value of servicing rights at December 31, 2015, was estimated using a weighted average constant prepayment rate ("CPR") assumption of 7.42%, and a weighted average discount rate assumption of 12.52%. The fair value of servicing rights at December 31, 2014 was estimated using a weighted average constant prepayment rate ("CPR") assumption of 7.32%, and a weighted average discount rate assumption of 12.11%.

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.

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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:

	2015	2014	2013
	(Dollars in thousands)		
Balance, beginning of year	$ 1,481	$ 1,647	$ 1,786
Unrealized loss	(114)	(166)	(139)
Balance, end of year	$ 1,367	$ 1,481	$ 1,647

6) Premises and Equipment

Premises and equipment at year-end were as follows:

	2015	2014
	(Dollars in thousands)	
Building	$ 3,279	$ 3,256
Land	2,900	2,900
Furniture and equipment	8,468	8,082
Leasehold improvements	5,257	4,658
	19,904	18,896
Accumulated depreciation and amortization	(12,131)	(11,445)
Premises and equipment, net	$ 7,773	$ 7,451

Depreciation and amortization expense was $685,000, $725,000, and $729,000 in 2015, 2014, and 2013, respectively.

7) 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:

Year ending December 31,	(Dollars in thousands)
2016	3,434
2017	2,683
2018	2,172
2019	1,998
2020	956
Thereafter	232
Total	$ 11,475

Rent expense under operating leases was $2,997,000, $2,692,000, and $2,719,000 in 2015, 2014, and 2013, respectively.

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8) Business Combinations

Bay View Funding

On October 8, 2014, HBC entered into a Stock Purchase Agreement ("Purchase Agreement") with BVF/CSNK Acquisition Corp., a Delaware corporation ("BVF/CSNK") pursuant to which HBC agreed to acquire all of the outstanding common stock from the stockholders of BVF/CSNK for an aggregate purchase price of $22,520,000 ("Acquisition"). The Acquisition closed on November 1, 2014. At the closing, the Bank paid in cash $20,268,000 of the total purchase price to the BVF/CSNK shareholders, and $2,252,000, or 10% of the purchase price, was deposited into an 18 month escrow account. CSNK Working Capital Finance Corp. dba Bay View Funding ("Bay View Funding") its wholly-owned subsidiary provides business essential working capital factoring financing to various industries throughout the United States. BVF/CSNK was subsequently merged into Bay View Funding and Bay View Funding became a wholly owned subsidiary of HBC. Bay View Funding's results of operations have been included in the Company's results beginning November 1, 2014.

The fair values of assets acquired and liabilities assumed are subject to adjustment during the first twelve months after the acquisition date if additional information becomes available to indicate more accurate or appropriate values for the assets acquired and liabilities assumed, which may be reflective of conditions or events that existed at the acquisition date. As of December 31, 2015, adjustments to the fair value of assets acquired and liabilities assumed in the Bay View Funding transaction were complete.

The Acquisition purchase agreement contains customary representations and warranties by Bay View Funding and the Bay View Funding stockholders, covenants by Bay View Funding regarding the operation of its business between the date of signing of the purchase agreement and the closing date of the Acquisition, and indemnification provisions whereby the BVF/CSNK stockholders agreed to indemnify Bay View Funding and HBC and their affiliated parties for breaches of representations and warranties, breaches of covenants and certain other matters. Of the total purchase price, $2,252,000, or 10%, was deposited into an escrow account with an independent escrow agent to support the indemnification obligations, if any, of indemnification claims against the BVF/CSNK stockholders. Any amounts remaining in the escrow account will be released to the BVF/CSNK stockholders after 18 months following the closing date of the Acquisition, net of any indemnification payments made from the escrow or amounts reserved for pending claims pursuant to any indemnification claims under the purchase agreement. Because it is uncertain whether any claims will be made against the escrow account the Company has assumed the entire amount will be paid to the BVF/CSNK stockholders.

The following table presents pro forma financial information as if the acquisition had occurred on January 1, 2013, which includes the pre-acquisition period for BVF/CSNK. The historical unaudited pro forma financial information has been adjusted to reflect supportable items that are directly attributable to the acquisition and expected to have a continuing impact on consolidated results of operations, as such, one-time acquisition costs are not included. The unaudited pro forma financial information is provided for informational purposes only. The unaudited pro forma financial information is not necessarily, and should not be assumed to be, an indication of the results that would have been achieved had the acquisition been completed as of the dates indicated or that may be achieved in the future. The preparation of the

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unaudited pro forma combined consolidated financial statements and related adjustments required management to make certain assumptions and estimates.

UNAUDITED	2014	2013
	(Dollars in thousands, except per share amounts)	
Net interest income	$ 66,105	$ 59,998
Noninterest income	8,293	8,080
Total revenue	$ 74,398	$ 68,078
Net income	$ 15,141	$ 13,397
Net income per share basic	$ 0.47	$ 0.42
Net income per share diluted	$ 0.47	$ 0.42

Focus Business Bank

On April 23, 2015, the Company and Focus entered into a definitive agreement and plan of merger and reorganization whereby Focus would merge into HBC. The Company completed the merger of its wholly-owned bank subsidiary HBC with Focus on August 20, 2015 for an aggregate transaction value of $66,558,000. Shareholders of Focus received a fixed exchange ratio at closing of 1.8235 shares of the Company's common stock for each share of Focus common stock. Upon closing of the transaction, the Company issued 5,456,713 shares of the Company's common stock to Focus shareholders for a total value of $58,278,000, based on the Company's closing stock price of $10.68 on August 20, 2015. In addition, the Company paid cash to the Focus holders of in-the-money stock options on August 20, 2015 totaling $8,280,000.

Focus's results of operations have been included in the Company's results of operations beginning August 21, 2015. Pre-tax severance, retention, acquisition and integration costs totaled $6,398,000 for the year ended December 31, 2015.

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The following table summarizes the estimated fair values of the assets acquired and liabilities assumed at the date of acquisition. The Company is in the process of finalizing the purchase accounting for the acquisition.

		(Dollars in thousands)
Assets acquired:		
Cash and cash item	$	5,651
Federal funds sold and deposits in other financial institutions		168,415
Securities available-for-sale		53,940
Securities held-to-maturity		8,665
Loans held-for-sale		4,416
Net loans		170,353
Goodwill		32,620
Core deposit intangible asset		6,285
Corporate owned life insurance		7,067
Other assets, net		20,250
Total assets acquired		477,662
Liabilities asssumed:		
Deposits		405,123
Other liabilities		5,981
Total liabilities		411,104
Net assets acquired	$	66,558

The fair value of net assets acquired includes fair value adjustments to certain receivables of which some were considered impaired and some were not considered impaired as of the acquisition date. The fair value adjustments were determined using discounted contractual cash flows, adjusted for expected losses and prepayments, where appropriate. The gross contractual amount of four purchased credit impaired loans as of the acquisition date totaled $1,124,000. As of that date, contractual cash flows not expected to be collected on the purchased credit impaired loans totaled $819,000, which represents 72.9% of their gross outstanding principal balances. The receivables that were not considered impaired at the acquisition date were not subject to the guidance relating to purchased credit impaired loans, which have shown evidence of credit deterioration since origination. Receivables acquired that were not subject to these requirements include nonimpaired loans with a fair value and gross contractual amounts receivable of $170,048,000 and $174,660,000 respectively, on the date of acquisition. As of that date, the purchase discount on these nonimpaired loans totaled $4,612,000, which represents 2.6% of their gross outstanding principal balances.

Goodwill of $32,620,000 arising from the acquisition is largely attributable to synergies and cost savings resulting from combining the operations of the companies. As this transaction was structured as a taxfree exchange, the goodwill will not be deductible for tax purposes. The fair values of assets acquired and liabilities assumed are subject to adjustment during the first twelve months after the acquisition date if additional information becomes available to indicate a more accurate or appropriate value for an asset or liability. The loans with a fair value of $170,353,000 and $1,758,000 of income tax attributes, on the acquisition date, related to the purchase accounting adjustments and Focus' legacy deferred tax assets are subject to change pending receipt of the final valuations and analyses. Loan valuations may be adjusted based on new information obtained by the Company in future periods that may reflect conditions or events

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that existed on the acquisition date. Deferred tax assets may be adjusted for purchase accounting adjustments on open areas such as loans or upon filing Focus' final August 20, 2015 "stub" period tax returns.

The following table summarizes the consideration paid for Focus:

		August 20, 2015
		(Dollars in thousands)
Cash paid for Focus in-the-money stock options	$	8,280
Common stock issued to Focus shareholders at $10.68 per share		58,278
Total consideration	$	66,558

The following table presents pro forma financial information as if the acquisition had occurred on January 1, 2014, which includes the pre-acquisition period for Focus. The historical unaudited pro forma financial information has been adjusted to reflect supportable items that are directly attributable to the acquisition and expected to have a continuing impact on consolidated results of operations, as such, one-time acquisition costs are not included. The unaudited pro forma financial information is provided for informational purposes only. The unaudited pro forma financial information is not necessarily, and should not be assumed to be, an indication of the results that would have been achieved had the acquisition been completed as of the dates indicated or that may be achieved in the future. The preparation of the unaudited pro forma combined consolidated financial statements and related adjustments required management to make certain assumptions and estimates.

UNAUDITED		For the Year Ended December 31, 2015		For the Year Ended December 31, 2014
	(Dollars in thousands, except per share amounts)			
Net interest income	$	83,876	$	68,175
Provision (credit) for loan losses		82		(38)
Noninterest income		11,443		9,624
Noninterest expense		60,372		53,600
Income before income taxes		34,865		24,237
Income tax expense		13,941		8,784
Net income	$	20,924	$	15,453
Net income per share basic	$	0.56	$	0.41
Net income per share diluted	$	0.55	$	0.41

9) Goodwill and Other Intangible Assets

Goodwill

At December 31, 2015, the carrying value of goodwill was $45,664,000. The Company recognized $13,044,000 of goodwill upon its acquisition of Bay View Funding on November 1, 2014, and $32,620,000 from its acquisition of Focus on August 20, 2015. During the fourth quarter of 2015, adjustments were made to the purchase price allocations for the Focus transaction that affected the amounts allocated to goodwill and other assets.

Goodwill impairment exists when a reporting unit's carrying value exceeds its fair value, which is determined through a a qualitative assessment whether it is more likely than not that the fair value of equity of the reporting unit exceeds the carrying value ("Step Zero"). If the qualitative assessment

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indicates it is more likely than not that the fair value of equity of a reporting unit is less than book value, than a quantitative two-step impairment test is required. Step 1 includes the determination of the carrying value of the Company's single reporting unit, including the existing goodwill and intangible assets, and estimating the fair value of the reporting unit. If the carrying amount of a reporting unit exceeds its fair value, the Company is required to perform a second step to the impairment test. Step 2 requires that the implied fair value of the reporting unit goodwill be compared to the carrying amount of that goodwill. If the carrying amount of the reporting unit goodwill exceeds the implied fair value of that goodwill, an impairment loss shall be recognized in an amount equal to that excess.

The Company completed its annual impairment analysis on the goodwill from the Bay View Funding acquisition as of November 30, 2015 with the assistance of an independent valuation firm. Based on the Step Zero qualitative analysis performed, the Company determined that it is more likely than not that the fair value of the reporting unit exceeded its reported book value of equity at November 30, 2015. As such, no impairment was indicated and no further testing was required.

Other 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 of 10 years and 7 years, respectively. The customer relationship intangible asset was fully amortized at December 31, 2014. Accumulated amortization of these intangible assets was $4,703,000 and $4,257,000 at December 31, 2015 and December 31, 2014, respectfully.

The core deposit intangible asset acquired in the acquisition of Focus in August 2015 was $6,285,000. This asset is amortized over its estimated useful lives of 10 years. Accumulated amortization of this intangible asset was $288,000 at December 31, 2015.

Other intangible assets acquired in the acquisition of Bay View Funding in November 2014 included: a below market value lease intangible asset of $109,000 (amortized over 3 years), customer relationship and brokered relationship intangible assets of $1,900,000, (amortized over the 10 year estimated useful lives), and a non compete agreement intangible asset of $250,000 (amortized over 3 years). Accumulated amortization of these intangible assets was $360,000 and $51,000 at December 31, 2015 and December 31, 2014, respectfully.

Estimated amortization expense for each of the next five years follows:

			Bay View Funding			
Year	Diablo Valley Bank Core Deposit Intangible	Focus Core Deposit Intangible	Below Market Value Lease Intangible	Customer & Brokered Relationship Intangible	Non-Compete Agreement Intangible	Total Amortization Expense
	(Dollars in thousands)					
2016	$ 427	$ 831	$ 36	$ 190	$ 83	$ 1,567
2017	195	875	31	190	70	1,361
2018		775		190		965
2019		734		190		924
2020		716		190		906
	$ 622	$ 3,931	$ 67	$ 950	$ 153	$ 5,723

Impairment testing of the intangible assets is performed at the individual asset level. The Company's intangibles are tested for recoverability whenever events or changes in circumstances indicate that their

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carrying amounts may not be recoverable. If such events or changes in circumstances are identified, an impairment loss is recognized only if the carrying amount of the intangible asset is not recoverable and exceeds its fair value. 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 did not identify any events or changes in circumstances indicating that such intangible assets may not be recoverable at December 31, 2015 or 2014.

10) Deposits

Time deposits of $250,000 and over, including time deposits within the Certificate of Deposit Account Registry Service ("CDARS") and brokered deposits of $250,000 and over, were $178,640,000 and $193,068,000 at December 31, 2015 and 2014, respectively. The following table presents the scheduled maturities of all time deposits and brokered deposits for the next five years:

	(Dollars in thousands)	
2016	$	233,765
2017		7,986
2018		1,829
2019		1,056
2020		225
Total	$	244,861

At December 31, 2015, total CDARS deposits of $7,583,000 include money market deposits of $3,388,000, which have no scheduled maturity date, and therefore, are excluded from the table above.

At December 31, 2015, the Company had securities pledged with a fair value of $93,042,000 for $78,026,000 in certificates of deposits (including accrued interest) with the State of California. At December 31, 2014, the Company had securities pledged with a fair value of $109,764,000 for $98,019,000 in certificates of deposits (including accrued interest) with 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 $3,388,000 of money market accounts and $4,195,000 of time deposits at December 31, 2015. CDARS deposits were comprised of $4,036,000 of money market accounts and $7,212,000 of time deposits at December 31, 2014.

Deposits from executive officers, directors, and their affiliates were $13,426,000 and $2,593,000 at December 31, 2015 and 2014, respectively.

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11) Borrowing Arrangements

Federal Home Loan Bank Borrowings, Federal Reserve Bank Borrowings, and Available Lines of Credit

HBC 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, 2015, and December 31, 2014, HBC had no overnight borrowings from the FHLB. HBC had $245,607,000 of loans and no securities pledged to the FHLB as collateral on a line of credit of $141,875,000 at December 31, 2015. HBC had $246,635,000 of loans and no securities pledged to the FHLB as collateral on a line of credit of $139,990,000 at December 31, 2014.

HBC can also borrow from the FRB's discount window. HBC had approximately $395,006,000 of loans pledged to the FRB as collateral on an available line of credit of approximately $243,156,000 at December 31, 2015, none of which was outstanding. HBC had approximately $387,972,000 of loans pledged to the FRB as collateral on an available line of credit of approximately $260,439,000 at December 31, 2014, none of which was outstanding.

At December 31, 2015, HBC had Federal funds purchase arrangements available of $55.0 million. There were no Federal funds purchased outstanding at December 31, 2015 and 2014.

HCC has a $5.0 million line of credit with a correspondent bank, of which $3.0 million was outstanding at December 31, 2015.

HBC 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, 2015, and 2014.

Subordinated Debt

The Company supported its growth through the issuance of trust preferred securities from special purpose trusts and accompanying sales of subordinated debt to these trusts. The subordinated debt issued to the trusts was senior to the outstanding shares of common stock and Series C Preferred Stock. As a result, payments were required on the subordinated debt before any dividends could be paid on the common stock and Series C Preferred Stock. Under the terms of the subordinated debt, the Company could defer interest payments for up to five years. Interest payments on the subordinated notes payable to the Company's subsidiary grantor Trusts were deductible for tax purposes.

During the third quarter of 2013, the Company redeemed its Company's variable rate subordinated debentures in the amount of $5,000,000 issued to Heritage Statutory Trust II and the Company's variable rate subordinated debentures in the amount of $4,000,000 issued to Heritage Statutory Trust III. The related trust securities issued by Statutory Trust II and Statutory Trust III were also redeemed in connection with the subordinated debt redemption and the trusts were dissolved.

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12) Income Taxes

Income tax (benefit) consisted of the following for the year ended December 31, as follows:

	2015	2014	2013
	(Dollars in thousands)		
Currently payable tax:			
Federal	$ 5,445	$ 4,392	$ 5,015
State	2,544	818	63
Total currently payable	7,989	5,210	5,078
Deferred tax (benefit):			
Federal	2,029	1,114	(130)
State	86	1,214	1,258
Total deferred tax	2,115	2,328	1,128
Income tax expense	$ 10,104	$ 7,538	$ 6,206

The effective tax rate differs from the Federal statutory rate for the years ended December 31, as follows:

	2015	2014	2013
Statutory Federal income tax rate	35.0%	35.0%	35.0%
State income taxes, net of federal tax benefit	6.9%	6.5%	5.3%
Low income housing credits, net of investment losses	0.0%	0.8%	0.6%
Increase in cash surrender value of life insurance	2.2%	2.7%	3.5%
Non-taxable interest income	2.7%	3.2%	2.9%
Split-dollar term insurance	0.1%	0.1%	0.2%
Other, net	0.9%	0.5%	0.3%
Effective tax rate	38.0%	36.0%	35.0%

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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:

	2015	2014
	(Dollars in thousands)	
Deferred tax assets:		
Defined postretirement benefit obligation	$ 11,049	$ 10,327
Allowance for loan losses	7,815	7,728
Federal net operating loss carryforwards	2,397	
Stock compensation	2,008	1,693
Accrued expenses	1,689	1,446
State income taxes	889	213
Premises and equipment	945	702
California net operating loss carryforwards	591	
Split-dollar life insurance benefit plan	107	112
Tax credit carryforwards	57	2,441
Loans		2
Nonaccrual interest		25
Other	742	359
Total deferred tax assets	28,289	25,048
Deferred tax liabilities:		
Intangible assets	(2,101)	(1,334)
Loan fees	(1,331)	(1,131)
Prepaid expenses	(1,022)	(464)
I/O strips	(574)	(621)
Securities available-for-sale	(505)	(2,351)
FHLB stock	(245)	(245)
Other	(293)	(375)
Total deferred tax liabilities	(6,071)	(6,521)
Net deferred tax assets	$ 22,218	$ 18,527

At December 31, 2015, the Company's federal net operating loss carryforwards were $6,850,000 and the Company's California net operating loss carryforwards were $8,389,000. These amounts are attributable to the Focus transaction. The Company did not have any net operating loss carryforwards as of December 31, 2014. These Federal and State net operating loss carryforwards will expire in 2035. The realization of these net operating loss carryforwards for federal and state tax purposes is limited under current tax law with limitations placed on the amount of net operating losses that can be utilized annually. The Company does not, however, believe that these annual limitations will impact the ultimate deductibility of the net operating loss carry-forwards.

The State tax credit carryforwards, net of Federal tax effects, were $57,000 as of December 31, 2015, which will begin to expire in 2019. The Company has Federal and State net operating loss carryforwards that arose from the acquisition of Focus. There is an Internal Revenue Code Section 382 annual limit of $1,877,000. As the Company will be able to fully utilize the net operating loss carryforwards before they expire in 2035, no valuation allowance is required against the deferred tax assets.

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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. In accordance with Accounting Standards Codification (ASC) 740-10 Accounting for Uncertainty in Income Taxes, the Company estimated the need for a reserve for income taxes of $130,000, net of Federal benefit, for uncertain state income tax positions of Bay View Funding. The Company does not expect this amount to significantly increase or decrease in the next twelve months.

At December 31, 2015, and December 31, 2014, the Company had net deferred tax assets of $22,218,000 and $18,527,000, respectively. At December 31, 2015, 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 2012 and 2011, respectively.

The Company adopted the proportional amortization method of accounting for its low income housing investments in the third quarter of 2014. The Company quantified the impact of adopting the proportional amortization method compared to the equity method to its current year and prior period financial statements. The Company determined that the adoption of the proportional amortization method did not have a material impact to its financial statements. The low income housing investment losses, net of the tax benefits received, are included in income tax expense for all periods reflected on the consolidated income statements.

The following table reflects the carry amounts of the low income housing investments included in accrued interest receivable and other assets, and the future commitments as of December 31, 2015 and 2014:

	December 31, 2015	December 31, 2014
	(Dollars in thousands)	
Low income housing investments	$ 4,304	$ 5,268
Future commitments	$ 1,271	$ 1,827

The Company expects $550,000 of the future commitments to be paid in 2016, $14,000 in 2017, and $707,000 in 2018 through 2023.

For tax purposes, the Company had low income housing tax credits of $685,000 and $581,000 for the years ended December 31, 2015 and December 2014, respectively, and low income housing investment losses of $916,000 and $338,000, respectively. The Company recognized low income housing investment expense as a component of income tax expense.

13) Equity Plan

The Company maintained an Amended and Restated 2004 Equity Plan (the "2004 Plan") for directors, officers, and key employees. The 2004 Plan was terminated on May 23, 2013. On May 23, 2013, the Company's shareholders approved the 2013 Equity Incentive Plan (the "2013 Plan"). The equity plans provide for the grant of incentive and nonqualified stock options and restricted stock. The equity plans provide that the option price for both incentive and nonqualified 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

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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. Restricted stock is subject to time vesting. In 2015, the Company granted 243,000 shares of nonqualified stock options and 103,855 shares of restricted stock subject to time vesting requirements. There were 940,985 shares available for the issuance of equity awards under the 2013 Plan as of December 31, 2015.

Stock option activity under the equity plans is as follows:

Total Stock Options	Number of Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (Years)	Aggregate Intrinsic Value
Outstanding at January 1, 2015	1,726,106	$ 11.23		
Granted	243,000	$ 9.50		
Exercised	(54,406)	$ 5.79		
Forfeited or expired	(139,673)	$ 18.12		
Outstanding at December 31, 2015	1,775,027	$ 10.62	5.8	$ 6,381,061
Vested or expected to vest	1,686,276		5.8	$ 6,062,008
Exercisable at December 31, 2015	1,259,434		4.7	$ 4,527,179

Information related to the equity plans for each of the last three years:

	2015	2014	2013
Intrinsic value of options exercised	$ 216,681	$ 258,467	$ 51,000
Cash received from option exercise	$ 315,076	$ 262,035	$ 88,000
Tax benefit realized from option exercises	$ 85,411	$ 102,710	$ 17,245
Weighted average fair value of options granted	$ 3.15	$ 3.90	$ 3.84

As of December 31, 2015, there was $1,842,000 of total unrecognized compensation cost related to nonvested stock options granted under the equity plans. That cost is expected to be recognized over a weighted-average period of approximately 2.48 years.

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.

	2015	2014	2013
Expected life in months(1)	72	84	96
Volatility(1)	47%	57%	54%
Weighted average risk-free interest rate(2)	1.57%	2.09%	1.49%
Expected dividends(3)	3.37%	2.06%	0.12%

(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.

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(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.

Restricted stock activity under the equity plans is as follows:

Total Restricted Stock Award	Number of Shares	Weighted Average Grant Date Fair Value
Nonvested shares at January 1, 2015	100,000	$ 8.25
Granted	103,855	$ 9.80
Vested	(31,250)	$ 7.81
Forfeited or expired	(5,000)	$ 8.70
Nonvested shares at December 31, 2015	167,605	$ 9.28

As of December 31, 2015, there was $1,363,000 of total unrecognized compensation cost related to nonvested restricted stock awards granted under the 2004 Plan and 2013 Plan. The cost is expected to be recognized over a weighted-average period of approximately 3.16 years.

14) 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 $1,500 for each employee's contributions in 2015. The Company made a discretionary matching contribution of up to $1,000 for each employee's contributions in 2014 and 2013. Contribution expense was $342,000, $206,000, and $196,000 in 2015, 2014 and 2013, 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 suspended contributions to the ESOP since 2010. At December 31, 2015, the ESOP owned 123,707 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 $20,000 and $50,000 as of December 31, 2015 and 2014 is included in "Accrued interest payable and other liabilities."

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The Company has purchased life insurance policies on the life of one of its former directors who has a Deferral Agreement. 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 some current and some former 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, 2015. 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:

	2015	2014
	(Dollars in thousands)	
Change in projected benefit obligation:		
Projected benefit obligation at beginning of year	$ 24,570	$ 20,712
Service cost	862	714
Actuarial loss (gain)	805	3,059
Interest cost	883	911
Benefits paid	(833)	(826)
Projected benefit obligation at end of year	$ 26,287	$ 24,570
Amounts recognized in accumulated other comprehensive loss:		
Net actuarial loss	$ 7,149	$ 6,730

Weighted-average assumptions used to determine the benefit obligation at year-end:

	2015	2014
Discount rate	4.00%	3.65%
Rate of compensation increase	N/A	N/A

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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)
2016	$ 919
2017	1,413
2018	1,549
2019	1,585
2020	1,635
2021 to 2025	9,468

The components of pension cost for the SERP follow:

	2015	2014
	(Dollars in thousands)	
Components of net periodic benefit cost:		
Service cost	$ 862	$ 714
Interest cost	883	911
Amortization of net actuarial loss	386	142
Net periodic benefit cost	$ 2,131	$ 1,767

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 $239,000 and $386,000 as of December 31, 2015 and 2014, respectively.

Net periodic benefit cost was determined using the following assumption:

	2015	2014
Discount rate	3.65%	4.50%
Rate of compensation increase	N/A	N/A

Split-Dollar Life Insurance Benefit Plan

The Company maintains life insurance policies for some current and some 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.

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.

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The following sets forth the funded status of the split dollar life insurance benefits.

	2015	2014
	(Dollars in thousands)	
Change in projected benefit obligation:		
Projected benefit obligation at beginning of year	$ 4,641	$ 4,353
Interest cost	169	196
Actuarial loss.	1,405	92
Projected benefit obligation at end of year	$ 6,215	$ 4,641

Amounts recognized in accumulated other comprehensive loss at December 31 consist of:

	2015	2014
	(Dollars in thousands)	
Net actuarial loss	$ 2,147	$ 540
Prior transition obligation	1,418	1,507
Accumulated other comprehensive loss	$ 3,565	$ 2,047

Weighted-average assumption used to determine the benefit obligation at year-end follow:

	2015	2014
Discount rate	4.00%	3.65%

Components of net periodic benefit cost during the year are:

	2015	2014
	(Dollars in thousands)	
Amortization of prior transition obligation	$ (113)	$ (102)
Interest cost	169	196
Net periodic benefit cost	$ 56	$ 94

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 as of December 31, 2015 and 2014.

Weighted-average assumption used to determine the net periodic benefit cost:

	2015	2014
Discount rate	3.65%	4.50%

15) 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.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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 Company uses matrix pricing (Level 2 inputs) to establish the fair value of its securities available-for-sale.

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).

		Fair Value Measurements Using		
	Balance	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Obeservable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
		(Dollars in thousands)		
Assets at December 31, 2015:				
Available-for-sale securities:				
Agency mortgage-backed securities	$ 324,230		$ 324,230	
U.S. Treasury	$ 30,003	$ 30,003	$	
Trust preferred securities	$ 15,132		$ 15,132	
U.S. Government sponsored entities	$ 9,041		$ 9,041	
Corporate bonds	$ 6,673		$ 6,673	
I/O strip receivables	$ 1,367		$ 1,367	
Assets at December 31, 2014:				
Available-for-sale securities:				
Agency mortgage-backed securities	$ 154,172		$ 154,172	
Corporate bonds	$ 36,863		$ 36,863	
Trust preferred securities	$ 15,300		$ 15,300	
I/O strip receivables	$ 1,481		$ 1,481	

There were no transfers between Level 1 and Level 2 during the year for assets measured at fair value on a recurring basis.

Financial Assets and Liabilities Measured on a Non-Recurring Basis

The fair value of impaired loans with specific allocations of the allowance for loan losses is generally based on recent real estate appraisals. The appraisals may utilize a single valuation approach or a

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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.

		Fair Value Measurements Using		
	Balance	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, 2015:				
Impaired loans held-for-investment:				
Commercial	$ 1,333			$ 1,333
Real estate:				
Commercial and residential	503			503
Land and construction	219			219
Home equity	647			647
	$ 2,702			$ 2,702
Assets at December 31, 2014:				
Impaired loans held-for-investment:				
Commercial	$ 859			$ 859
Real estate:				
Commercial and residential	587			587
Land and construction	1,176			1,176
	$ 2,622			$ 2,622
Foreclosed assets:				
Land and construction	$ 31			$ 31
	$ 31			$ 31

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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:

	December 31, 2015	December 31, 2014
	(Dollars in thousands)	
Impaired loans held-for-investment:		
Book value of impaired loans held-for-investment carried at fair value	$ 2,988	$ 3,026
Book value of impaired loans held-for-investment carried at cost	3,539	2,996
Total impaired loans held-for-investment	$ 6,527	$ 6,022
Impaired loans held-for-investment carried at fair value:		
Book value of impaired loans held-for-investment carried at fair value	$ 2,988	$ 3,026
Specific valuation allowance	(286)	(404)
Impaired loans held-for-investment carried at fair value, net	$ 2,702	$ 2,622

Impaired loans held-for-investment were $6,527,000 at December 31, 2015. There were no partial charge-offs at December 31, 2015. In addition, these loans had a specific valuation allowance of $286,000 at December 31, 2015. Impaired loans held-for-investment totaling $2,988,000 at December 31, 2015 were carried at fair value as a result of the aforementioned partial charge-offs and specific valuation allowances at year-end. The remaining $3,539,000 of impaired loans were carried at cost at December 31, 2015, 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 2015 on impaired loans held-for-investment carried at fair value at December 31, 2015 resulted in an additional provision for loan losses of $156,000.

At December 31, 2015, foreclosed assets had a carrying amount of $364,000, with no valuation allowance at December 31, 2015.

Impaired loans held for investment of $6,022,000 at December 31, 2014, after partial charge offs of $107,000 in 2014, were analyzed for additional impairment primarily using the fair value of collateral. In addition, these loans had a specific valuation allowance of $404,000 at December 31, 2014. Impaired loans held for investment totaling $3,026,000 at December 31, 2014 were carried at fair value as a result of the aforementioned partial charge offs and specific valuation allowances at year end. The remaining $2,996,000 of impaired loans were carried at cost at December 31, 2014, 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 2014 on impaired loans held for investment carried at fair value at December 31, 2014 resulted in a credit to the provision for loan losses of $100,000.

At December 31, 2014, foreclosed assets had a carrying amount of $696,000, with no valuation allowance at December 31, 2014.

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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, except for consumer loans, at December 31, 2015 and 2014:

	December 31, 2015			
	Fair Value	Valuation Techniques	Unobservable Inputs	Range (Weighted Average)
	(Dollars in thousands)			
Impaired loans held-for-investment:				
Commercial	$ 1,333	Market Approach	Discount adjustment for differences between comparable sales	0% to 5% (5%)
Real estate:				
Commercial and residential	503	Market Approach	Discount adjustment for differences between comparable sales	0% to 3% (3%)
Land and construction	219	Market Approach	Discount adjustment for differences between comparable sales	Less than 1%
Home equity	647	Market Approach	Discount adjustment for differences between comparable sales	0% to 2% (2%)

	December 31, 2014			
	Fair Value	Valuation Techniques	Unobservable Inputs	Range (Weighted Average)
	(Dollars in thousands)			
Impaired loans held-for-investment:				
Commercial	$ 859	Market Approach	Discount adjustment for differences between comparable sales	0% to 3% (3%)
Real estate:				
Commercial and residential	587	Market Approach	Discount adjustment for differences between comparable sales	0% to 3% (3%)
Land and construction	1,176	Market Approach	Discount adjustment for differences between comparable sales	1% to 2% (2%)
Foreclosed assets:				
Land and construction	31	Market Approach	Discount adjustment for differences between comparable sales	Less than 1%

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.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The carrying amounts and estimated fair values of the Company's financial instruments, at year-end were as follows:

		December 31, 2015 Estimated Fair Value			
	Carrying Amounts	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total
	(Dollars in thousands)				
Assets:					
Cash and cash equivalents	$ 344,092	$ 344,092	$	$	$ 344,092
Securities available-for-sale	385,079	30,003	355,076		385,079
Securities held-to-maturity	109,311		109,821		109,821
Loans (including loans held-for-sale), net	1,347,087		7,297	1,337,939	1,345,236
FHLB stock, FRB stock, and other investments	12,694				N/A
Accrued interest receivable	5,043		1,654	3,389	5,043
I/O strips receivables	1,367		1,367		1,367
Liabilities:					
Time deposits	$ 244,861	$	$ 245,279	$	$ 245,279
Other deposits	1,817,914		1,817,914		1,817,914
Short-term borrowings	3,000		3,000		3,000
Accrued interest payable	195		195		195

		December 31, 2014 Estimated Fair Value			
	Carrying Amounts	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total
	(Dollars in thousands)				
Assets:					
Cash and cash equivalents	$ 122,403	$ 122,403	$	$	$ 122,403
Securities available-for-sale	206,335		206,335		206,335
Securities held-to-maturity	95,362		94,953		94,953
Loans (including loans held-for-sale), net	1,071,436		1,172	1,071,854	1,073,026
FHLB and FRB stock	10,598				N/A
Accrued interest receivable	5,044		1,435	3,609	5,044
I/O strips receivables	1,481		1,481		1,481
Liabilities:					
Time deposits	$ 256,223	$	$ 256,589	$	$ 256,589
Other deposits	1,132,163		1,132,163		1,132,163
Accrued interest payable	201		201		201

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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 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 reprice 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.

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.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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.

16) 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, 2015		December 31, 2014	
	Fixed Rate	Variable Rate	Fixed Rate	Variable Rate
	(Dollars in thousands)			
Unused lines of credit and commitments to make loans	$ 16,917	$ 539,897	$ 8,164	$ 415,146
Standby letters of credit	3,402	13,458	3,235	12,783
	$ 20,319	$ 553,355	$ 11,399	$ 427,929

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.

The Company is required to maintain interest-bearing reserves. Reserve requirements are based on a percentage of certain deposits. As of December 31, 2015, the Company maintained reserves of $29,015,000 in the form of vault cash and balances at the Federal Reserve Bank of San Francisco, which satisfied the regulatory requirements.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Loss Contingencies

The Company's policy is to accrue for legal costs associated with both asserted and unasserted claims when it is probable that such costs will be incurred and such costs can be reasonably estimated. A number of parties have filed complaints in the Superior Court of California for the County of Santa Clara asserting certain claims against the Company arising from the transfer of funds. One complaint composed of numerous claims has been set for trial in late 2016. Three of the remaining complaints are in the pleading stage and in mid-discovery. One other complaint is in mid-discovery. As to all claims, it is not possible to determine the amount of the loss, if any, arising from the claim in excess of the legal expenses expected to be incurred in defense of the litigation. The Company intends to vigorously defend the litigation.

17) Shareholders' Equity and Earnings Per Share

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.

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 was exercisable at any time on or before November 21, 2018. The warrant was transferable at any time. On June 12, 2013, the Company completed the repurchase of the common stock warrant for $140,000.

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 5,601,000 shares of 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 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. The holders of Series C Preferred Stock receive dividends on an as converted basis when dividends are also declared for 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.

Dividends On January 28, 2016, the Company announced that its Board of Directors declared a $0.09 per share quarterly cash dividend to holders of common stock and Series C preferred stock (on an as converted basis). The dividend was paid on February 25, 2016, to shareholders of record on February 10, 2016.

Earnings 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, 2013. The Company

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

repurchased the warrant for $140,000 in the second quarter of 2013. A reconciliation of these factors used in computing basic and diluted earnings per common share is as follows:

	Year ended December 31,		
	2015	2014	2013
	(Dollars in thousands, except per share amounts)		
Net income available to common shareholders	$ 14,705	$ 12,419	$ 11,204
Less: undistributed earnings allocated to Series C Preferred Stock	(912)	(1,342)	(1,687)
Distributed and undistributed earnings allocated to common shareholders	$ 13,793	$ 11,077	$ 9,517
Weighted average common shares outstanding for basic earnings per common share	28,567,213	26,390,615	26,338,161
Dilutive effect of stock options oustanding, using the treasury stock method	218,865	135,667	48,291
Shares used in computing diluted earnings per common share	28,786,078	26,526,282	26,386,452
Basic earnings per share	$ 0.48	$ 0.42	$ 0.36
Diluted earnings per share	$ 0.48	$ 0.42	$ 0.36

18) 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.

As of January 1, 2015, HCC and HBC along with other community banking organizations became subject to new capital requirements on January 1, 2015 and certain provisions of the new rules will be phased in from 2015 through 2019. The Federal Banking regulators approved the new rules to implement the revised capital adequacy standards of the Basel Committee on Banking Supervision, commonly called Basel III, and address relevant provisions of The Dodd Frank Wall Street Reform and Consumer Protection Act of 2010, as amended. The Company's consolidated capital ratios and the Bank's capital ratios exceeded the regulatory guidelines for a well-capitalized financial institution under the Basel III regulatory requirements at December 31, 2015.

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 tables below) of total, Tier 1 capital, and common equity 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, 2015 and December 31, 2014, the Company and HBC met all capital adequacy guidelines to which they were subject.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The Company's consolidated capital amounts and ratios are presented in the following table, together with capital adequacy requirements, under the Basel III regulatory requirements as of December 31, 2015, and under the Basel I regulatory requirements as of December 31, 2014.

	Actual		Required For Capital Adequacy Purposes Under Basel III	
	Amount	Ratio	Amount	Ratio
	(Dollars in thousands)			
As of December 31, 2015:				
Total Capital (to risk-weighted assets)	$ 218,915	12.5%	$ 140,041	8.0%
Tier 1 Capital (to risk-weighted assets)	$ 199,299	11.4%	$ 105,031	6.0%
Common Equity Tier 1 Capital (to risk-weighted assets)	$ 181,221	10.4%	$ 78,773	4.5%
Tier 1 Capital (to average assets)	$ 199,299	8.6%	$ 92,918	4.0%

	Actual		To Be Well-Capitalized Under Basel I Regulatory Requirements		Required For Capital Adequacy Purposes Under Basel I	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
	(Dollars in thousands)					
As of December 31, 2014:						
Total Capital (to risk-weighted assets)	$ 186,068	13.9%	$ 134,109	10.0%	$ 107,287	8.0%
Tier 1 Capital (to risk-weighted assets)	$ 169,278	12.6%	$ 80,465	6.0%	$ 53,644	4.0%
Tier 1 Capital (to average assets)	$ 169,278	10.6%	N/A	N/A	$ 63,949	4.0%

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

HBC's actual capital amounts and ratios are presented in the following table, together with capital adequacy requirements, under the Basel III regulatory requirements as of December 31, 2015, and under the Basel I regulatory requirements as of December 31, 2014.

	Actual		To Be Well-Capitalized Under Basel III Regulatory Requirements		Required For Capital Adequacy Purposes Under Basel III	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
	(Dollars in thousands)					
As of December 31, 2015:						
Total Capital (to risk-weighted assets)	$ 219,943	12.6%	$ 175,022	10.0%	$ 140,018	8.0%
Tier 1 Capital (to risk-weighted assets)	$ 200,327	11.4%	$ 140,018	8.0%	$ 105,013	6.0%
Common Equity Tier 1 Capital (to risk-weighted assets)	$ 200,327	11.4%	$ 113,764	6.5%	$ 78,760	4.5%
Tier 1 Capital (to average assets)	$ 200,327	8.6%	$ 116,112	5.0%	$ 92,889	4.0%

	Actual		To Be Well-Capitalized Under Basel I Regulatory Requirements		Required For Capital Adequacy Purposes Under Basel I	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
	(Dollars in thousands)					
As of December 31, 2014:						
Total Capital (to risk-weighted assets)	$ 175,765	13.1%	$ 134,095	10.0%	$ 107,276	8.0%
Tier 1 Capital (to risk-weighted assets)	$ 158,976	11.9%	$ 80,457	6.0%	$ 53,638	4.0%
Tier 1 Capital (to average assets)	$ 158,976	9.9%	$ 79,959	5.0%	$ 63,967	4.0%

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 Business Oversight Division of Financial Institutions ("DBO") 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 DBO 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. As of December 31, 2015, HBC would be required to obtain regulatory approval from the DBO for a dividend or other distribution to HCC, however,

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

commencing January 1, 2016 HBC will not be required to obtain regulatory approval. The amount available for cash dividened is $22,361,000 as of January 1, 2016. Similar restrictions applied to the amount and sum of loan advances and other transfers of funds from HBC to the parent company.

19) Noninterest Expense

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

	Year Ended December 31,		
	2015	2014	2013
	(Dollars in thousands)		
Salaries and employee benefits	$ 35,146	$ 26,250	$ 23,450
Occupancy and equipment	4,300	4,053	4,043
Acquisition and integration related costs(1)	3,546	895	
Professional fees	1,828	1,891	2,588
Data processing	1,371	969	1,078
Software subscriptions	1,214	999	1,289
Insurance expense	1,127	1,126	1,032
FDIC deposit insurance premiums	1,092	892	894
Correspondent bank charges	1,021	760	684
Amortization on intangible assets	1,043	510	473
Foreclosed assets	(94)	53	(251)
Other	7,079	5,824	5,190
Total	$ 58,673	$ 44,222	$ 40,470

(1) Does not include pre-tax severance and retention cost of $2,887,000, which is included in salaries and employee benefits for the year ended December 31, 2015.

20) Business Segment Information

The following presents the Company's operating segments. The Company operates through two business segments: Banking segment and Factoring segment. Transactions between segments consist primarily of borrowed funds. Intersegment interest expense is allocated to the Factoring segment based on the Company's prime rate and funding costs. The provision for loan loss is allocated based on the segment's allowance for loan loss determination which considers the effects of charge-offs. Noninterest income and expense directly attributable to a segment are assigned to it. Taxes are paid on a consolidated basis and allocated for segment purposes. The Factoring segment includes only factoring originated by Bay

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HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

View Funding, which has been included in the results of operations since the acquisition on November 1, 2014.

	For the Twelve Months Ended Deember 31, 2015		
	Banking(1)	Factoring	Consolidated
	(Dollars in thousands)		
Interest income	$ 66,306	$ 12,437	$ 78,743
Intersegment interest allocations	1,087	(1,087)	
Total interest expense	2,422		2,422
Net interest income	64,971	11,350	76,321
Provision (credit) for loan losses	(156)	188	32
Net interest income after provision	65,127	11,162	76,289
Noninterest income	8,234	751	8,985
Noninterest expense	51,438	7,235	58,673
Intersegment expense allocations	386	(386)	
Income before income taxes	22,309	4,292	26,601
Income tax expense	8,301	1,803	10,104
Net income	$ 14,008	$ 2,489	$ 16,497
Total assets	$ 2,306,543	$ 55,036	$ 2,361,579
Loans, net of deferred fees	$ 1,318,657	$ 40,059	$ 1,358,716
Goodwill	$ 32,620	$ 13,044	$ 45,664

(1) Includes the holding company's results of operations

	For the Twelve Months Ended Deember 31, 2014		
	Banking(1)	Factoring(2)	Consolidated
	(Dollars in thousands)		
Interest income	$ 57,178	$ 2,078	$ 59,256
Intersegment interest allocations	31	(31)	
Total interest expense	2,033	120	2,153
Net interest income	55,176	1,927	57,103
Provision (credit) for loan losses	(338)		(338)
Net interest income after provision	55,514	1,927	57,441
Noninterest income	7,662	84	7,746
Noninterest expense	43,132	1,090	44,222
Income before income taxes	20,044	921	20,965

Income tax expense		7,151		387		7,538
Net income	$	12,893	$	534	$	13,427
Total assets	$	1,561,911	$	55,192	$	1,617,103
Loans, net of deferred fees	$	1,048,631	$	40,012	$	1,088,643
Goodwill	$		$	13,044	$	13,044

(1) Includes the holding company's results of operations

(2) Includes two months of Bay View Funding's results of operations

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HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

21) 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,	
	2015	2014
	(Dollars in thousands)	
Assets		
Cash and cash equivalents	$ 1,686	$ 10,159
Investment in subsidiary bank	246,357	173,453
Other assets	400	953
Total assets	$ 248,443	$ 184,565
Liabilities and Shareholder's Equity		
Short-term borrowings	3,000	
Other liabilities	7	207
Shareholder's equity	245,436	184,358
Total liabilities and shareholder's equity	$ 248,443	$ 184,565

Condensed Statements of Operations

	For the Year Ended December 31,		
	2015	2014	2013
	(Dollars in thousands)		
Dividend from subsidiary bank	$	$	$ 16,000
Interest expense	(18)		(229)
Other expenses	(2,705)	(2,033)	(2,080)
Income (loss) before income taxes and equity in net income of subsidiary bank	(2,723)	(2,033)	13,691
Equity in net income of subsidiary bank:			
Reduction in contributed capital and distribution from subsidiary bank			(16,000)
Net income of subsidiary bank	18,081	14,614	13,155
Income tax benefit	1,139	846	694
Net income	16,497	13,427	11,540
Dividends and discount accretion on preferred stock	(1,792)	(1,008)	(336)

Net income available to common shareholders	$	14,705	$	12,419	$	11,204

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Condensed Statements of Cash Flows

	For the Year Ended December 31,		
	2015	2014	2013
	(Dollars in thousands)		
Cash flows from operating activities:			
Net Income	$ 16,497	$ 13,427	$ 11,540
Adjustments to reconcile net income to net cash provided by (used in) operations:			
Amortization of restricted stock award, net of forfeitures and taxes	265	(9)	200
Equity in undistributed loss/(net income) of subsidiary bank	(18,081)	(14,614)	2,845
Net change in other assets and liabilities	269	(2,158)	4,478
Net cash (used in) provided by operating activities	(1,050)	(3,354)	19,063
Cash flows from financing activities:			
Repayment of subordinated debt			(9,279)
Net change in purchased funds and other short-term borrowings	3,000		
Payment of cash dividends	(10,738)	(5,758)	(1,916)
Proceeds from issuance of common stock, net of issuance costs	315	262	88
Payment of repurchase of common stock warrant			(140)
Net cash used in financing activities	(7,423)	(5,496)	(11,247)
Net (decrease) increase in cash and cash equivalents	(8,473)	(8,850)	7,816
Cash and cash equivalents, beginning of year	10,159	19,009	11,193
Cash and cash equivalents, end of year	$ 1,686	$ 10,159	$ 19,009

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HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

22) Quarterly Financial Data (Unaudited)

The following table discloses the Company's selected unaudited quarterly financial data:

	For the Quarter Ended(1)			
	12/31/15	09/30/15	06/30/15	03/31/15
	(Dollars in thousands, except per share amounts)			
Interest income	$ 22,896	$ 20,306	$ 18,175	$ 17,366
Interest expense	758	623	533	508
Net interest income	22,138	19,683	17,642	16,858
Provision (credit) for loan losses	371	(301)	22	(60)
Net interest income after provision for loan losses	21,767	19,984	17,620	16,918
Noninterest income	2,829	2,066	2,164	1,926
Noninterest expense	17,361	16,419	12,617	12,276
Income before income taxes	7,235	5,631	7,167	6,568
Income tax expense	2,812	2,172	2,690	2,430
Net income	4,423	3,459	4,477	4,138
Dividends on preferred stock	(448)	(448)	(448)	(448)
Net income available to common shareholders	3,975	3,011	4,029	3,690
Undistributed earnings allocated to Series C Preferred Stock	(209)	(111)	(331)	(274)
Distributed and undistributed earnings allocated to common shareholders	$ 3,766	$ 2,900	$ 3,698	$ 3,416
Earnings per common share				
Basic	$ 0.12	$ 0.10	$ 0.14	$ 0.13
Diluted	$ 0.12	$ 0.10	$ 0.14	$ 0.13

(1) Pre-tax severance, retention and acquisition and integration costs included in noninterest expense were $2,991,000, $2,865,000, $423,000, and $119,000, for the fourth, third, second, and first quarters of 2015, respectively.

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HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

	For the Quarter Ended			
	12/31/2014(1)	**9/30/2014(2)**	**06/30/14**	**03/31/14**
	(Dollars in thousands, except per share amounts)			
Interest income	$ 16,717	$ 14,492	$ 14,192	$ 13,855
Interest expense	625	500	507	521
Net interest income	16,092	13,992	13,685	13,334
Provision (credit) for loan losses	(106)	(24)	(198)	(10)
Net interest income after provision for loan losses	16,198	14,016	13,883	13,344
Noninterest income	1,812	1,870	2,047	2,017
Noninterest expense	12,415	10,492	10,769	10,546
Income before income taxes	5,595	5,394	5,161	4,815
Income tax expense	1,993	1,969	1,837	1,739
Net income	3,602	3,425	3,324	3,076
Dividends on preferred stock	(280)	(280)	(224)	(224)
Net income available to common shareholders	3,322	3,145	3,100	2,852
Undistributed earnings allocated to Series C Preferred Stock	(349)	(320)	(358)	(315)
Distributed and undistributed earnings allocated to common shareholders	$ 2,973	$ 2,825	$ 2,742	$ 2,537
Earnings per common share				
Basic	$ 0.11	$ 0.11	$ 0.10	$ 0.10
Diluted	$ 0.11	$ 0.11	$ 0.10	$ 0.10

(1) The Company's selected unaudited quarterly financial data for the quarter ended December 31, 2014 includes Bay View Funding acquisition and integration costs of $609,000, and the results of operations for Bay View Funding for the months of November and December 2014.

(2) The Company's selected unaudited quarterly financial data for the quarter ended September 30, 2014 includes Bay View Funding acquisition and integration costs of $234,000.

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EXHIBIT INDEX

Exhibit Number	Description
2.1	Agreement and Plan of Merger, dated April 23, 2015, by and among Heritage Commerce Corp, Heritage Bank of Commerce and Focus Business Bank (incorporated by reference from the Registrant's Current Report on Form 8-K filed on April 23, 2015)
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 4, 2010)
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 Registrant's Current Report Form 8-K filed June 28, 2013)
4.1	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 filed on June 22, 2010)
10.1	Real Property Lease for Registrant's Principle Office dated April 13, 2000 (incorporated by reference from Registrant's Annual Report on Form 10-K filed on March 6, 2015)
10.2	Sixth Amendment to Lease for Registrant's Principle Office dated November 17, 2014 (incorporated by reference from Registrant's Annual Report on Form 10-K filed on March 6, 2015)
*10.3	Heritage Commerce Corp Management Incentive Plan (incorporated herein by reference from the Registrant's Current Report on Form 8-K filed May 3, 2005)
*10.4	Amended and Restated 2004 Equity Plan (incorporated herein by reference from the Registrant's Current Report on Form 8-K filed June 2, 2009)
*10.5	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)
*10.6	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)
*10.7	Non-qualified Deferred Compensation Plan (incorporated herein by reference from the Registrant's Annual Report on Form 10-K filed March 31, 2005)
*10.8	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)
*10.9	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)
*10.10	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)

*10.11	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)

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Exhibit Number	Description
*10.12	Employment Agreement with Keith Wilton, dated February 18, 2014 (incorporated by reference from the Registrant's Current Report on Form 8-K filed February 20, 2014)
*10.13	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, 2012)
*10.14	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, 2012)
*10.15	2013 Equity Incentive Plan (incorporated by reference from the Registrant's Registration Statement in Form S-8 filed July 15, 2013)
*10.16	Form of Restricted Stock Agreement For 2013 Equity Incentive Plan (incorporated by reference from the Registrant's Registration Statement on Form S-8 filed July 15, 2013)
*10.17	Form of Stock Option Agreement for 2013 Equity Incentive Plan (incorporated by reference from the Registrant's Registration Statement on Form S-8 filed July 15, 2013)
*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)
*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)

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Exhibit Number	Description
10.28	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)
10.29	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)
10.30	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)
10.31	Stock Purchase Agreement, between Heritage Bank of Commerce, BVF Acquisition Corp and the stockholders named therein dated October 8, 2014 (incorporated herein from the Registrant's Current Report on Form 8-K, as filed October 9, 2014)
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 the Registrant
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
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
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.