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

# FORM 10-Q

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

**For the quarterly period ended March 31, 2006**

**OR**

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

**For the transition period from ________to _________**

**Commission file number 000-23877**

# Heritage Commerce Corp

(Exact name of Registrant as Specified in its Charter)

| **California** | **77-0469558** |
| --- | --- |
| (State or Other Jurisdiction of Incorporation or Organization) | (I.R.S. Employer Identification Number) |

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

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

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

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

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). YES [ ] NO [X]

The Registrant had 11,840,570 shares of Common Stock outstanding on May 4, 2006.

**Heritage Commerce Corp and Subsidiaries**
**Quarterly Report on Form 10-Q**
**Table of Contents**

**Part I -- FINANCIAL INFORMATION**

**ITEM 1 - CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)**

**Heritage Commerce Corp**

**Consolidated Balance Sheets (Unaudited)**

| (Dollars in thousands) | March 31, 2006 | December 31, 2005 |
|---|---|---|
| **Assets** | | |
| Cash and due from banks | $ 40,065 | $ 35,560 |
| Federal funds sold | 94,200 | 62,900 |
| Total cash and cash equivalents | 134,265 | 98,460 |
| Securities available-for-sale, at fair value | 186,168 | 198,495 |
| Loans held for sale, at lower of cost or market | 30,745 | 70,147 |
| Loans, net of deferred costs | 695,865 | 688,778 |
| Allowance for loan losses | (9,748) | (10,224) |
| Loans, net | 686,117 | 678,554 |
| Federal Home Loan Bank and Federal Reserve Bank stock, at cost | 5,918 | 5,859 |
| Company owned life insurance | 35,081 | 34,735 |
| Premises and equipment, net | 2,389 | 2,541 |
| Accrued interest receivable and other assets | 39,359 | 41,718 |
| Total assets | $ 1,120,042 | $ 1,130,509 |
| **Liabilities and Shareholders' Equity** | | |
| Liabilities: | | |
| Deposits | | |
| Demand, noninterest bearing | $ 243,816 | $ 248,009 |
| Demand, interest bearing | 154,277 | 157,330 |
| Savings and money market | 352,304 | 353,798 |
| Time deposits, under $100 | 33,003 | 35,209 |
| Time deposits, $100 and over | 115,293 | 109,373 |
| Brokered deposits, $100 and over | 36,040 | 36,040 |
| Total deposits | 934,733 | 939,759 |
| Notes payable to subsidiary grantor trusts | 23,702 | 23,702 |
| Securities sold under agreement to repurchase | 26,100 | 32,700 |
| Accrued interest payable and other liabilities | 20,310 | 22,731 |
| Total liabilities | 1,004,845 | 1,018,892 |
| Shareholders' equity: | | |
| Preferred stock, no par value; 10,000,000 shares authorized; none outstanding | - | - |
| Common Stock, no par value; 30,000,000 shares authorized; shares outstanding: 11,834,846 at March 31, 2006 and 11,807,649 at December 31, 2005 | 67,120 | 67,602 |
| Retained earnings | 51,324 | 47,539 |
| Unearned restricted stock award | - | (803) |
| Accumulated other comprehensive loss | (3,247) | (2,721) |
| Total shareholders' equity | 115,197 | 111,617 |
| Total liabilities and shareholders' equity | $ 1,120,042 | $ 1,130,509 |

See notes to consolidated financial statements

**Heritage Commerce Corp**

**Consolidated Income Statements (Unaudited)**

| **(Dollars in thousands, except per share data)** | **Three Months Ended March 31, 2006** | **2005** |
|---|---|---|
| Interest income: | | |
| Loans, including fees | $ 14,721 | $ 12,345 |
| Securities, taxable | 1,746 | 1,810 |
| Securities, non-taxable | 46 | 54 |
| Interest bearing deposits in other financial institutions | 18 | 14 |
| Federal funds sold | 729 | 177 |
| Total interest income | 17,260 | 14,400 |
| Interest expense: | | |
| Deposits | 4,319 | 2,411 |
| Notes payable to subsidiary grantor trusts | 562 | 512 |
| Repurchase agreements and other | 188 | 274 |
| Total interest expense | 5,069 | 3,197 |
| Net interest income | 12,191 | 11,203 |
| Provision for loan losses | (489) | 413 |
| Net interest income after provision for loan losses | 12,680 | 10,790 |
| Noninterest income: | | |
| Gain on sale of loans | 1,497 | 760 |
| Servicing income | 468 | 392 |
| Increase in cash surrender value of life insurance | 347 | 266 |
| Service charges and fees on deposit accounts | 327 | 393 |
| Equipment leasing | - | 79 |
| Other | 255 | 467 |
| Total noninterest income | 2,894 | 2,357 |
| Noninterest expense: | | |
| Salaries and employee benefits | 5,109 | 5,171 |
| Occupancy | 777 | 851 |
| Professional fees | 513 | 496 |
| Client services | 300 | 407 |
| Low income housing investment losses and writedowns | 264 | 252 |
| Advertising and promotion | 210 | 189 |
| Data processing | 181 | 172 |
| Furniture and equipment | 109 | 199 |
| Retirement plan expense | 88 | 102 |
| Amortization of leased equipment | - | 250 |
| Other | 1,210 | 1,221 |
| Total noninterest expense | 8,761 | 9,310 |
| Income before income taxes | 6,813 | 3,837 |
| Income tax expense | 2,437 | 1,184 |
| Net income | $ 4,376 | $ 2,653 |
| Earnings per share: | | |
| Basic | $ 0.37 | $ 0.23 |
| Diluted | $ 0.36 | $ 0.22 |

See notes to consolidated financial statements

**Heritage Commerce Corp**
**Consolidated Statements of Changes in Shareholders' Equity (Unaudited)**
**Three Months Ended March 31, 2006 and 2005**

| **(Dollars in thousands, except share data)** | **Common Stock Shares** | **Common Stock Amount** | **Unearned Restricted Stock Award** | **Unallocated ESOP Shares** | **Accumulated Other Comprehensive Loss** | **Retained Earnings** | **Total Shareholders' Equity** | **Comprehensive Income** |
|---|---|---|---|---|---|---|---|---|
| **Balance, January 1, 2005** | 11,669,837 | $ 67,409 | $ - | $ (193) | $ (1,730) | $ 33,093 | $ 33,093 | |
| Net Income | - | - | - | - | - | 2,653 | 2,653 | $ 2,653 |
| Net change in unrealized gain/loss on securities available-for-sale and Interest-Only strips, net of reclassification adjustment and deferred income taxes | - | - | - | - | (1,114) | - | (1,114) | (1,114) |
| Total comprehensive income | | | | | | | | $ 1,539 |
| ESOP shares released | - | 97 | - | 65 | - | - | 162 | |
| Restricted stock award | 51,000 | 926 | (926) | - | - | - | - | |
| Amortization of restricted stock award | - | - | 6 | - | - | - | 6 | |
| Redemption payment on commom stock | - | (12) | - | - | - | - | (12) | |
| Stock options exercised | 118,589 | 1,548 | - | - | - | - | 1,548 | |
| **Balance, March 31, 2005** | 11,839,426 | $ 69,968 | $ (920) | $ (128) | $ (2,844) | $ 35,746 | $ 101,822 | |
| | | | | | | | | |
| **Balance, January 1, 2006** | 11,807,649 | $ 67,602 | $ (803) | $ - | $ (2,721) | $ 47,539 | $ 111,617 | |
| Net Income | - | - | - | - | - | 4,376 | 4,376 | $ 4,376 |
| Net change in unrealized gain/loss on securities available-for-sale and Interest-Only strips, net of reclassification adjustment and deferred income taxes | - | - | - | - | (688) | - | (688) | (688) |
| Decrease in minimum pension liability, net of deferred income taxes | - | - | - | - | 162 | - | 162 | 162 |
| Total comprehensive income | | | | | | | | $ 3,850 |
| Reclassification of unearned restricted stock award upon adoption of Statement 123R | - | (803) | 803 | - | - | - | - | |
| Amortization of restricted stock award | - | 38 | - | - | - | - | 38 | |
| Dividend declared on commom stock, $0.05 per share | - | - | - | - | - | (591) | (591) | |
| Commom stock repurchased | (32,000) | (739) | - | - | - | - | (739) | |
| Stock option expense | - | 175 | - | - | - | - | 175 | |
| Stock options exercised | 59,197 | 847 | - | - | - | - | 847 | |
| **Balance, March 31, 2006** | 11,834,846 | $ 67,120 | $ - | $ - | $ (3,247) | $ 51,324 | $ 115,197 | |

See notes to consolidated financial statements

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

| (Dollars in thousands) | Three Months Ended March 31, 2006 | 2005 |
|---|---|---|
| CASH FLOWS FROM OPERATING ACTIVITIES: | | |
| Net income | $ 4,376 | $ 2,653 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 174 | 277 |
| Provision for loan losses | (489) | 413 |
| Non-cash compensation expense related to ESOP plan | 0 | 161 |
| Stock option expense | 175 | 0 |
| Amortization of restricted stock award | 38 | 6 |
| Amortization / accretion of discounts and premiums on securities | (303) | 298 |
| Gain on sale of loans | (1,497) | (760) |
| Proceeds from sales of loans held for sale | 47,767 | 13,172 |
| Originations of loans held for sale | (13,756) | (16,032) |
| Maturities of loans held for sale | 6,888 | 7,187 |
| Increase in cash surrender value of life insurance | (347) | (266) |
| Effect of changes in: | | |
| Accrued interest receivable and other assets | 2,169 | (974) |
| Accrued interest payable and other liabilities | (623) | 1,790 |
| Other | (17) | (13) |
| Net cash provided by operating activities | 44,555 | 7,912 |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | |
| Net increase in loans | (7,074) | (6,001) |
| Purchases of securities available-for-sale | (17,690) | 0 |
| Maturities/paydowns/calls of securities available-for-sale | 29,392 | 5,198 |
| Purchase of premises and equipment | (22) | (87) |
| Purchase of other investments | (42) | 13 |
| Net cash provided by (used in) investing activities | 4,564 | (877) |
| CASH FLOWS FROM FINANCING ACTIVITIES: | | |
| Net (decrease) increase in deposits | (5,026) | 43,988 |
| Payment of other liability | (1,205) | (942) |
| Exercise of stock options | 847 | 1,548 |
| Common stock repurchased | (739) | 0 |
| Redemption payment on common stock | 0 | (12) |
| Payment of cash dividend | (591) | 0 |
| Net change in repurchase agreements | (6,600) | 0 |
| Net cash provided by (used in) financing activities | (13,314) | 44,582 |
| Net increase (decrease) in cash and cash equivalents | 35,805 | 51,617 |
| Cash and cash equivalents, beginning of period | 98,460 | 57,746 |
| Cash and cash equivalents, end of period | $ 134,265 | $ 109,363 |
| Supplemental disclosures of cash flow information: | | |
| Cash paid during the period for: | | |
| Interest | $ 5,539 | $ 3,220 |
| Income taxes | $ 0 | $ 1,670 |

See notes to consolidated financial statements

**1) Basis of Presentation**

The unaudited consolidated financial statements of Heritage Commerce Corp (the "Company") and its wholly owned subsidiary, Heritage Bank of Commerce ("HBC"), have been prepared pursuant to the rules and regulations for reporting on Form 10-Q. Accordingly, certain information and notes required by accounting principles generally accepted in the United States of America ("GAAP") for annual financial statements are not included herein. The interim statements should be read in conjunction with the consolidated financial statements and notes thereto included in the Company's Form 10-K for the year ended December 31, 2005. The Company has also established the following unconsolidated subsidiary grantor trusts: Heritage Capital Trust I; Heritage Statutory Trust I; Heritage Statutory Trust II; and Heritage Commerce Corp Statutory Trust III which are Delaware Statutory business trusts formed for the exclusive purpose of issuing and selling trust preferred securities.

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

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

The results for the three months ended March 31, 2006 are not necessarily indicative of the results expected for any subsequent period or for the entire year ending December 31, 2006.

Certain amounts in the March 31, 2005 three month ended consolidated financial statements have been reclassified to conform to the 2006 presentation.

**2) Securities Available-for-Sale**

The following table shows the gross unrealized losses and fair value of the Company's securities with unrealized losses aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, at March 31, 2006:

| | Less Than 12 Months | | 12 Months or More | | Total | |
|---|---|---|---|---|---|---|
| **(Dollars in thousands)** | **Fair Value** | **Unrealized Losses** | **Fair Value** | **Unrealized Losses** | **Fair Value** | **Unrealized Losses** |
| U.S. Treasuries | $ 5,905 | $ (95) | $ - | $ - | $ 5,905 | $ (95) |
| U.S. Government Agencies | 25,683 | (138) | 48,111 | (508) | 73,794 | (646) |
| Mortgage-Backed Securities | 26,595 | (593) | 63,400 | (3,512) | 89,995 | (4,105) |
| Municipals - Tax Exempt | - | - | 8,117 | (205) | 8,117 | (205) |
| Collateralized Mortgage Obligations | - | - | 7,515 | (314) | 7,515 | (314) |
| Total | $ 58,183 | $ (826) | $ 127,143 | $ (4,539) | $ 185,326 | $ (5,365) |

As of March 31, 2006, the Company held 92 securities, of which 80 had fair values below amortized cost. Fifty-five securities have been carried with an unrealized loss for over 12 months. Higher interest rates at March 31, 2006 resulted in lower fair values for the period. Unrealized losses were primarily due to interest rates. No security sustained a downgrade in credit rating. The issuers are 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. Because the Company has the ability and intent to hold these securities until a recovery of fair value, which may be maturity, the Company does not consider these securities to be other-than-temporarily impaired at March 31, 2006.

Securities classified as U.S. Government Agencies as of March 31, 2006 were issued by the Federal National Mortgage Association, Federal Home Loan Mortgage Corporation, and the Federal Home Loan Bank.

The securities portfolio of the Company is also used as collateral to meet requirements imposed as a condition of deposit by some depositors such as political subdivisions (public funds) or bankruptcy trustees and other contractual obligations such as repurchase agreements. Securities with amortized cost of $61,981,000 and $88,278,000 as of March 31, 2006 and 2005 were pledged to secure public and certain other deposits as required by law or contract and other contractual obligations. A portion of these deposits can only be secured by U.S. Treasury securities. The Company has not used interest rate swaps or other derivative instruments to hedge fixed rate loans or to otherwise mitigate interest rate risk.

**3) Stock-Based Compensation**

The Company has a stock option plan (the Plan) for directors, officers, and key employees. The Plan provides for the grant of incentive and non-qualified stock options. The Plan provides that the option price for both incentive and non-qualified stock options will be determined by the Board of Directors at no less than the fair value at the date of grant. Options granted vest on a schedule determined by the Board of Directors at the time of grant. Generally, options vest over four years. All options expire no later than ten years from the date of grant. As of March 31, 2006, there are 56,000 shares available for future grants under the Plan. Option activity under the Plan is as follows:

| Total Stock Options | Number of Shares | Weighted Average Exercise Price | Weighted Average Remaining Contractual Life | Aggregate Intrinsic Value |
|---|---|---|---|---|
| Options Outstanding at January 1, 2006: | 753,978 | $ 12.92 | | |
| Granted | 23,000 | $ 22.78 | | |
| Exercised | (59,197) | $ 9.37 | | |
| Forfeited or expired | (19,422) | $ 16.23 | | |
| Options Outstanding at March 31, 2006: | 698,359 | $ 13.46 | $ 6.72 | $ 8,060,000 |
| Exercisable at March 31, 2006 | 430,755 | $ 11.00 | $ 5.43 | $ 6,033,000 |

The weighted average grant-date fair value of options granted during the quarter ended March 31, 2006 and 2005 was $8.56 and $6.01respectively. The total intrinsic value of options exercised during the three months ended March 31, 2006 and 2005 was $805,000 and $1,001,000, respectively.

Cash received from option exercise under all share-based payment arrangements for the three months ended March 31, 2006 and 2005 was $555,000 and $1,196,000, respectively. The actual tax benefit realized for the tax deductions from the option exercise of the share-based payment arrangements totaled $292,000 and $352,000, respectively, for the three months ended March 31, 2006 and 2005.

A summary of the status of the Company's nonvested shares as of March 31, 2006 and changes during the three months ended March 31, 2006, is presented below:

| Nonvested Options | Shares | Weighted-Average Grant Date Fair Value |
|---|---|---|
| Options Outstanding at January 1, 2006: | 289,806 | $ 5.47 |
| Granted | 22,342 | $ 8.56 |
| Vested | (31,622) | $ 6.72 |
| Forfeited or expired | (12,922) | $ 5.80 |
| Outstanding at March 31, 2006 | 267,604 | $ 5.78 |

As of March 31, 2006, there was $1,691,000 of total unrecognized compensation cost related to nonvested share-based compensation arrangements granted under the Company's stock plan. That cost is expected to be recognized over a weight-average period of 1.97 years. The total fair value of options vested during the three months ended March 31, 2006 and 2005 is $212,000.

Prior to 2006, the Company accounted for stock-based awards to employees using the intrinsic value method in accordance with Accounting Principles Board (APB) Opinion No. 25, "Accounting for Stock Issued to Employees." No compensation expense was recognized in the financial statements for employee stock option arrangements, as the Company's stock option plan provides for the issuance of options at a price of no less than the fair market value at the date of the grant.

Statement of Financial Accounting Standards ("Statement") No. 123, "Accounting for Stock-Based Compensation," requires the disclosure of pro forma net income and earnings per share had the Company adopted the fair value method at the grant date of all stock options. Under Statement No. 123, the fair value of stock-based awards to employees is calculated through the use of option pricing models, even though such models were developed to estimate the fair value of freely tradable, fully transferable options without vesting restrictions, which differ significantly from the Company's stock option awards. Those models also require subjective assumptions, which affect the calculated values.

In December 2004, the FASB issued Statement 123 (revised 2004), "Share-Based Payment." This Statement requires that compensation costs related to share-based payment transactions be recognized in the financial statements. Measurement of the cost of employee service is based on the grant-date fair value of the equity or liability instruments issued. That cost is recognized over the period during which an employee is required to provide service in exchange for the award. Additionally, liability awards will be remeasured each reporting period. Statement 123R replaces Statement No. 123, "Accounting for Stock-Based Compensation" and supersedes APB Opinion 25 "Accounting for Stock Issued to Employees". On April 14, 2005, the SEC issued rule 2005-57, which allowed companies to delay implementation of Statement 123R to the beginning of 2006.

The Company adopted Statement 123R on January 1, 2006, which has resulted in an increase in noninterest expense of $175,000 for the first quarter ended March 31, 2006. The total income tax benefit recognized in the income statement for share-based compensation was $2,000 for the first quarter ended March 31, 2006. The Company elected the modified prospective method, under which prior periods are not revised for comparative purposes. If compensation expense for the Company's stock-based awards had been determined under the requirements of Statement 123R, noninterest expense would have been increased by $101,000 for the first quarter ended March 31, 2005. The following table presents the Company's pro forma net income and earnings per common share for the three months ended March 31, 2005 as if the Company had applied the requirements of Statement 123R:

| **(Dollars in thousands, except per share data)** | **Three Months Ended March 31, 2005** | |
|---|---|---|
| Net income as reported | $ | 2,653 |
| Less: Compensation expense for stock options determined under fair value method | | (101) |
| Pro forma net income | $ | 2,552 |
| | | |
| Net income per common share - basic | | |
| As reported | $ | 0.23 |
| Pro forma | $ | 0.22 |
| Net income per common share - diluted | | |
| As reported | $ | 0.22 |
| Pro forma | $ | 0.21 |

The following table presents the assumptions used to estimate the fair value of options granted during the three months periods ending March 31, 2006 and 2005, respectively:

| | 2006 | 2005 |
|---|---|---|
| Expected life in months (1) | 84 | 84 |
| Volatility (1) | 24% | 19% |
| Risk-free interest rate (2) | 4.56% | 4.30% |
| Expected dividends (3) | 0.89% | 0% |

(1) Estimate based on historical experience. Volatility is based on the historical volatility of the stock over the most recent period that is generally commensurate with 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 options granted.
(3) The Company began paying cash dividends on common stock in 2006. 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.

Forfeitures for options granted prior to 2006 were recognized as they occurred. Beginning in 2006, the Company estimates the impact of forfeitures based on the Company's historical experience with previously granted stock options in determining stock option expense. The Company generally issues new shares of common stock to satisfy stock option exercises.

The Company awarded 51,000 restricted shares of common stock to Walter T. Kaczmarek, President and Chief Executive Officer of the Company, pursuant to the terms of a Restricted Stock Agreement dated March 17, 2005. The grant price was $18.15. Under the terms of the Restricted Stock Agreement, the restricted shares will vest 25% per year at the end of years three, four, five and six, provided Mr. Kaczmarek is still with the Company. Compensation cost associated with the restricted stock issued is measured based on the market price of the stock at the grant date and is expensed on a straight-line basis over the service period. Restricted stock compensation expense for the three months ended March 31, 2006 and 2005 was $38,000 and $6,000, respectively.

**4) Earnings Per Share**

Basic earnings per share is computed by dividing net income by the weighted average common shares outstanding. Diluted earnings per share reflects potential dilution from outstanding stock options, using the treasury stock method. There were 132,224 and 8,556 stock options for three months ended March 31, 2006 and 2005, respectively, considered to be antidilutive and excluded from the computation of diluted earnings per share. For each of the periods presented, net income is the same for basic and diluted earnings per share. Reconciliation of weighted average shares used in computing basic and diluted earnings per share is as follows:

| | Three Months Ended March 31, | |
|---|---|---|
| | 2006 | 2005 |
| Weighted average common shares outstanding - used in computing basic earnings per share | 11,821,817 | 11,753,371 |
| Dilutive effect of stock options outstanding using the treasury stock method | 217,721 | 409,375 |
| Shares used in computing diluted earnings per share | 12,039,538 | 12,162,746 |

**5) Comprehensive Income**

Comprehensive income includes net income and other comprehensive income, which represents the changes in net assets during the period from non-owner sources. The Company's sources of other comprehensive income are unrealized gains and losses on securities available-for-sale and I/O strips, which are treated like available-for-sale securities, and the additional minimum liability related to the Company's supplemental retirement plan. The items in other comprehensive income are presented net of deferred income tax effects. Reclassification adjustments result from gains or losses on securities that were realized and included in net income of the current period that also had been included in other comprehensive income as unrealized holding gains and losses.

The following is a summary of the components of other comprehensive income:

| (Dollars in thousands) | Three Months Ended March 31, 2006 | Three Months Ended March 31, 2005 |
|---|---|---|
| Net unrealized holding gains (losses) on available-for-sale securities and Interest-Only strips, net of deferred income tax of $498 and $807 for March 31, 2006 and 2005 | $ (688) | $ (1,114) |
| Less: reclassification adjustment for net realized gains, net of tax, on available-for-sale securities included in net income | 0 | 0 |
| Unrealized losses on available-for-sale securities and I/O strips, net of deferred income tax | (688) | (1,114) |
| Decrease in minimum pension liability, net of deferred income tax of $117 and $0 | 162 | 0 |
| Other comprehensive income (loss) | $ (526) | $ (1,114) |

**6) Supplemental Retirement Plan**

The Company has a supplemental retirement plan covering current and former key executives and directors (“Plan”). The Plan is a nonqualified defined benefit plan. Benefits are unsecured as there are no Plan assets. The following table presents the amount of periodic cost recognized for the three months ended March 31, 2006 and 2005:

| (Dollars in thousands) | Three Months Ended March 31, 2006 | Three Months Ended March 31, 2005 |
|---|---|---|
| Components of net periodic benefits cost | | |
| Service cost | $ 200 | $ 197 |
| Interest cost | 138 | 110 |
| Prior service cost | 9 | 3 |
| Amortization of loss | 36 | 51 |
| Net periodic cost | $ 383 | $ 361 |

Net periodic cost applicable to employee and director participants is included in salaries and employee benefits and retirement plan expense, respectively, on the income statement.

**7) Commitments and Contigencies**

***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 notional 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 as of March 31, 2006 and December 31, 2005 were as follows:

| (Dollars in thousands) | March 31, 2006 | December 31, 2005 |
|---|---|---|
| Commitments to extend credit | $ 314,178 | $ 328,031 |
| Standby letters of credit | 8,221 | 6,104 |
| | $ 322,399 | $ 334,135 |

Generally, commitments to extend credit as of March 31, 2006 are at variable rates, typically based on the prime rate (with a margin). Commitments generally expire within one year.

Commitments to extend credit are agreements to lend to a client as long as there is no violation of conditions established in the contract. Commitments generally have fixed expiration dates or other termination clauses. Since some of the commitments are expected to expire without being drawn upon, the total commitment amount does not necessarily represent future cash requirements. HBC evaluates each client's creditworthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by HBC upon the extension of credit, is based on management's credit evaluation of the borrower. Collateral held varies but may include cash, marketable securities, accounts receivable, inventory, property, plant and equipment, income-producing commercial properties, and/or residential properties. Fair value of these instruments is not material.

Standby letters of credit are written with conditional commitments issued by HBC to guaranty 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.

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

Discussions of certain matters in this Report on Form 10-Q may constitute forward looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), and as such, may involve risks and uncertainties. Forward-looking statements, which are based on certain assumptions and describe future plans, strategies, and expectations, are generally identifiable by the use of words such as "believe", "expect", "intend", "anticipate", "estimate", "project", “assume”, “plan”, “predict”, “forecast” or similar expressions. These forward-looking statements relate to, among other things, expectations of the business environment in which the Company operates, projections of future performance, potential future performance, potential future credit experience, perceived opportunities in the market, and statements regarding the Company's mission and vision. The Company's actual results, performance, and achievements may differ materially from the results, performance, and achievements expressed or implied in such forward-looking statements due to a wide range of factors. These factors include, but are not limited to, changes in interest rates, reducing interest margins or increasing interest rate risk, general economic conditions nationally or, in the State of California, legislative and regulatory changes adversely affecting the business in which the Company operates, monetary and fiscal policies of the US Government, real estate valuations, the availability of sources of liquidity at a reasonable cost, competition in the financial services industry, the occurrence of events such as the terrorist acts of September 11, 2001, and other risks. All of the Company's operations and most of its customers are located in California. In addition, acts and threats of terrorism or the impact of military conflicts have increased the uncertainty related to the national and California economic outlook and could have an effect on the future operations of the Company or its customers, including borrowers. The Company does not undertake, and specifically disclaims any obligation, to update any forward-looking statements to reflect occurrences or unanticipated events or circumstances after the date of such statements.

**EXECUTIVE SUMMARY**

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

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

When evaluating financial condition and performance, management looks at certain key metrics and measures. The Company's evaluation includes an analysis including comparisons with peer group financial institutions and with its own performance objectives established in the internal planning process.

Through its asset and liability management process, the Company monitors a number of ratios to analyze the Company's performance over time and also to compare the Company against similarly sized and situated companies in the banking industry. Management considers the following ratios to be important benchmarks for the Company's performance and financial conditions:

- Return on average assets: Net income as a percentage of average assets. Measures the earning power of the balance sheet.

- Return on average equity: Net income as a percentage of average shareholders' equity. Measures the return on invested capital.

- Net interest margin: Net interest income as a percentage of average interest earning assets. Measures the earning power of interest earning assets funded by interest bearing liabilities.

- Efficiency ratio: Noninterest expense divided by the sum of net interest income and noninterest income. Measures the cost of producing revenue as a percentage of total revenue.

There is no single ratio or metric that summarizes the performance of the Company. The ratios above each take an element of the Company's performance and quantify it so that it can be compared over time and benchmarked against other peer companies. Management uses these and other ratios and metrics in assessing and planning the Company's performance.

***Capital Management and Share Repurchases***

Heritage Commerce Corp and Heritage Bank of Commerce meet the regulatory definition of "well capitalized" at March 31, 2006. As part of its asset and liability process, the Company continually assesses its capital position to take into consideration growth, expected earnings, risk profile and potential corporate activities that it may choose to pursue.

On February 7, 2006, the Board of Directors authorized the repurchase of up to $10 million of common stock through June 30, 2007. Shares may be repurchased in open market purchases or in privately negotiated transactions as permitted under applicable rules and regulations. The repurchase program may be modified, suspended or terminated by the Board of Directors at any time without notice. The extent to which the Company repurchases its shares and the timing of such repurchases will depend upon market conditions and other corporate considerations.

On February 7, 2006, the Company's Board of Directors declared a $0.05 per share quarterly cash dividend. The dividend was paid on March 15, 2006, to shareholders of record on February 20, 2006. The payment marks the Company's first cash dividend. The Company expects to pay a quarterly dividend each quarter through 2006.

***Danville Branch Office Reopened After Fire Damage***

The Danville branch office reopened on April 26, 2006 after an early morning fire that damaged the facility on April 13, 2006. The Company worked quickly to provide services to the customers while the branch was undergoing repairs. There were no injuries from the accidental fire. No client records or client property were damaged. The losses from this fire will not have a material effect on the financial statements of the Company.

**CRITICAL ACCOUNTING POLICIES**

***General***

HCC's consolidated financial statements are prepared in accordance with accounting principles generally accepted in the United States of America ("GAAP"). The financial information contained within our consolidated financial statements is, to a significant extent, based on approximate measures of the financial effects of transactions and events that have already occurred. A variety of factors could affect the ultimate value that is obtained either when earning income, recognizing an expense, recovering an asset or relieving a liability. In certain instances, we use a discount factor and prepayment assumptions to determine the present value of assets and liabilities. A change in the discount factor or prepayment speeds could increase or decrease the values of those assets and liabilities which would result in either a beneficial or adverse impact to our financial results. We use historical loss factors as one factor in determining the inherent loss that may be present in our loan portfolio. Actual losses could differ significantly from the historical factors that we use. The Company adopted Statement 123R on January 1, 2006, and elected the modified prospective method, under which prior periods are not revised for comparative purposes. Other estimates that we use are related to the expected useful lives of our depreciable assets. In addition, GAAP itself may change from one previously acceptable method to another method. Although the economics of our transactions would be the same, the timing of events that would impact our transactions could change.

***Allowance for Loan Losses***

The allowance for loan losses is an estimate of the losses in our loan portfolio. The allowance is based on two basic principles of accounting: (1) Statement of Financial Accounting Standards ("Statement") No. 5 "Accounting for Contingencies," which requires that losses be accrued when they are probable of occurring and estimable and (2) Statement No. 114, "Accounting by Creditors for Impairment of a Loan," which requires that losses be accrued based on the differences between the impaired loan balance and value of collateral, if the loan is collateral dependent, or present value of future cash flows or values that are observable in the secondary market.

The Company's allowance for loan losses primarily consists of a formula allowance for pools of loans and a specific allowance for individual impaired loans. Loan loss estimates can and do change when the actual events occur. The formula allowance uses a historical loss view as an indicator of future losses and, as a result, losses could differ from the loss incurred in the future. The specific allowance uses impairment measurement to arrive at an estimate of loss, primarily collateral shortfalls on individual impaired loans. The use of these values is inherently subjective and our actual losses could differ from the estimates.

***Loan Sales and Servicing***

The amounts of gains recorded on sales of loans and the initial recording of servicing assets and interest only strips are based on the estimated fair values of the respective components. In recording the initial value of the servicing assets and the fair value of the Interest-Only ("I/O") strips receivable, the Company uses estimates which are made based on management's expectations of future prepayment and discount rates. In evaluating the servicing assets, management used discounted cash flow modeling techniques, which require estimates regarding the amount and times of future cash flows, including assumptions about loan repayment rates, costs to service, as well as interest rate assumptions that contemplate the risks involved. For the three months ended March 31, 2006, management's estimate of constant prepayment rate ("CPR") was 15% and the weighted average discount rate assumption was 9%. These prepayment and discount rates were based on current market conditions and historical performance of the various pools. If actual prepayments with respect to sold loans occur more quickly than projected, the carrying value of the servicing assets may have to be adjusted through a charge to earnings. A corresponding decrease in the value of the I/O strip receivable would also be expected.

***Stock Based Compensation***

Prior to 2006, the Company accounted for stock-based awards to employees using the intrinsic value method in accordance with Accounting Principles Board (APB) Opinion No. 25, "Accounting for Stock Issued to Employees." No compensation expense was recognized in the financial statements for employee stock option arrangements, as the Company's stock option plan provides for the issuance of options at a price of no less than the fair market value at the date of the grant.

Statement of Financial Accounting Standards ("Statement") No. 123, "Accounting for Stock-Based Compensation," requires the disclosure of pro forma net income and earnings per share had the Company adopted the fair value method at the grant date of all stock options. Under Statement No. 123, the fair value of stock-based awards to employees is calculated through the use of option pricing models, even though such models were developed to estimate the fair value of freely tradable, fully transferable options without vesting restrictions, which differ significantly from the Company's stock option awards. Those models also require subjective assumptions, which affect the calculated values.

In December 2004, the FASB issued Statement 123 (revised 2004), "Share-Based Payment." This Statement requires that compensation costs related to share-based payment transactions be recognized in the financial statements. Measurement of the cost of employee service is based on the grant-date fair value of the equity or liability instruments issued. That cost is recognized over the period during which an employee is required to provide service in exchange for the award. Additionally, liability awards will be remeasured each reporting period. Statement 123R replaces Statement No. 123, "Accounting for Stock-Based Compensation" and supersedes APB Opinion 25 "Accounting for Stock Issued to Employees". On April 14, 2005, the SEC issued rule 2005-57, which allowed companies to delay implementation of Statement 123R to the beginning of 2006.

The Company adopted Statement 123R on January 1, 2006, which has resulted in an increase in noninterest expense of $175,000 for the first quarter ended March 31, 2006. The total income tax benefit recognized in the income statement for share-based compensation was $2,000 for the first quarter ended March 31, 2006. The Company elected the modified prospective method, under which prior periods are not revised for comparative purposes. If compensation expense for the Company's stock-based awards had been determined under the requirements of Statement 123R, noninterest expense would have been increased by $101,000 for the first quarter ended March 31, 2005,

The following table presents the assumptions used to estimate the fair value of options granted during the three months periods ending March 31, 2006 and 2005, respectively:

| | 2006 | 2005 |
|---|---|---|
| Expected life in months (1) | 84 | 84 |
| Volatility (1) | 24% | 19% |
| Risk-free interest rate (2) | 4.56% | 4.30% |
| Expected dividends (3) | 0.89% | 0% |

(1) Estimate based on historical experience. Volatility is based on the historical volatility of the stock over the most recent period that is generally commensurate with 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 options granted.
(3) The Company began paying cash dividends on common stock in 2006. 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.

Forfeitures for options granted prior to 2006 were recognized as they occurred. Beginning in 2006, the Company estimates the impact of forfeitures based on the Company’s historical experience with previously granted stock options in determining stock option expense. The Company generally issues new shares of common stock to satisfy stock option exercises.

**RESULTS OF OPERATIONS**

***Overview***

For the three months ended March 31, 2006, consolidated net income was $4,376,000, compared to $2,653,000 for the three months ended March 31, 2005, an increase of 65%. Earnings per diluted share was $0.36 for the three months ended March 31, 2006, compared to $0.22 for the three months ended March 31, 2005, an increase of 64%. The increase was primarily attributed to increases in key market interest rates in 2005 and the first quarter of 2006. In addition, improved loan quality, continued control of operating expenses, and a nonrecurring gain on sale of the Capital Group loan portfolio also contributed stronger earnings in 2006. Annualized return on average assets and return on average equity for the three months ended March 31, 2006 were 1.59% and 15.53%, respectively, compared to 0.96% and 10.66%, for the same period in 2005.

Net interest income increased $988,000, or 9%, for the three months ended March 31, 2006 compared to the same period in 2005. The Company's net interest margin was 4.90% for the three months ended March 31, 2006, an increase of 50 basis points from 4.40% for the three months ended March 31, 2005. The increase in net interest margin for the three months ended March 31, 2006 reflects an increase in the yield on earning assets of 128 basis points offset by a corresponding increase in the cost of interest bearing liabilities of 101 basis points.

The Company's shareholders' equity at March 31, 2006 was $115,197,000, compared to $101,822,000 at March 31, 2005 and $111,617,000 at December 31, 2005. The increase in shareholders’ equity from these prior periods was primarily attributable to net income and proceeds from the exercise of common stock options, partially offset by the repurchase of common stock. Book value per share increased to $9.73 at March 31, 2006, from $8.60 at March 31, 2005 and $9.45 at December 31, 2005. The Company's leverage capital ratio was 12.5% at March 31, 2006 compared to 11.2% at March 31, 2005 and 11.6% at December 31, 2005.

**Net Interest Income and Net Interest Margin**

Net interest income is the largest component of the Company's total revenue. Net interest income is the difference between the interest and fees earned on loans and investments and the interest paid on deposits and other liabilities. Net interest income depends on two factors: (1) the volume or balance of earning assets compared to the volume or balance of interest bearing deposits and liabilities, and (2) the interest rate earned on those interest earning assets compared with the interest rate paid on those interest bearing assets and liabilities. Net interest margin is net interest income expressed as a percentage of average earning assets. To maintain its net interest margin, the Company must manage the relationship between interest earned and paid.

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

| | For the Three Months Ended March 31, | | | | | |
|---|---|---|---|---|---|---|
| | 2006 | | | 2005 | | |
| (Dollars in thousands) | Average Balance | Interest Income / Expense | Average Yield / Rate | Average Balance | Interest Income / Expense | Average Yield / Rate |
| **Assets:** | | | | | | |
| Loans, gross | $ 740,397 | $ 14,721 | 8.06% | $ 767,724 | $ 12,345 | 6.52% |
| Securities | 201,074 | 1,792 | 3.61% | 234,463 | 1,864 | 3.22% |
| Interest bearing deposits in other financial institutions | 2,838 | 18 | 2.57% | 2,554 | 14 | 2.22% |
| Federal funds sold | 65,560 | 729 | 4.51% | 28,429 | 177 | 2.53% |
| Total interest earning assets | 1,009,869 | $ 17,260 | 6.93% | 1,033,170 | $ 14,400 | 5.65% |
| Cash and due from banks | 36,959 | | | 38,498 | | |
| Premises and equipment, net | 2,477 | | | 3,254 | | |
| Other assets | 64,943 | | | 46,790 | | |
| Total assets | $ 1,114,248 | | | $ 1,121,712 | | |
| **Liabilities and shareholders' equity:** | | | | | | |
| Deposits: | | | | | | |
| Demand, interest bearing | $ 157,993 | $ 838 | 2.15% | $ 127,009 | $ 293 | 0.94% |
| Savings and money market | 348,130 | 2,081 | 2.42% | 360,256 | 1,123 | 1.26% |
| Time deposits, under $100 | 34,210 | 274 | 3.25% | 37,860 | 184 | 1.97% |
| Time deposits, $100 and over | 108,273 | 793 | 2.97% | 109,647 | 550 | 2.03% |
| Brokered time deposits, $100 and over | 36,050 | 333 | 3.75% | 29,750 | 261 | 3.56% |
| Notes payable to subsidiary grantor trusts | 23,702 | 562 | 9.62% | 23,702 | 512 | 8.76% |
| Securities sold under agreement to repurchase | 32,553 | 188 | 2.34% | 50,167 | 274 | 2.22% |
| Total interest bearing liabilities | 740,911 | $ 5,069 | 2.77% | 738,391 | $ 3,197 | 1.76% |
| Demand, noninterest bearing | 235,288 | | | 261,471 | | |
| Other liabilities | 23,781 | | | 20,928 | | |
| Total liabilities | 999,980 | | | 1,020,790 | | |
| Shareholders' equity | 114,268 | | | 100,922 | | |
| Total liabilities and shareholders' equity | $ 1,114,248 | | | $ 1,121,712 | | |
| Net interest income / margin | | $ 12,191 | 4.90% | | $ 11,203 | 4.40% |

Note: Yields and amounts earned on loans include loan fees of $261,000 and $330,000 for the three month periods ended March 31, 2006 and 2005, respectively. Nonaccrual loans are included in the average balance calculation above.

The Company sold its Capital Group loan portfolio, which consisted primarily of “factoring” type loans, during the first quarter of 2006, resulting in a gain on sale of $671,000. The sale of the Capital Group loan portfolio will negatively impact the Bank’s net interest margin going forward.

The following table sets forth an analysis of the changes in net interest income resulting from changes in the average volume of interest earning assets and liabilities and changes in the average rates earned and paid. The total change is shown in the column designated “Net Change” and is allocated in the columns to the left, for the portions attributable to volume changes and rate changes that occurred during the period indicated. Changes due to both volume and rate have been allocated to the change in volume. Overall, the effect of the changes in rates contributed $1,419,000, offsetting negative changes in volume of $431,000, resulting in the overall increase of $988,000 at March 31, 2006 from March 31, 2005.

| | Three Months Ended March 31, 2006 vs. 2005 Increase (Decrease) Due to Change In: | | |
|---|---|---|---|
| (Dollars in thousands) | Average Volume | Average Rate | Net Change |
| Interest earning assets | | | |
| Loans, gross | $ (537) | $ 2,913 | $ 2,376 |
| Securities | (295) | 223 | (72) |
| Interest bearing deposits in other financial institutions | 2 | 2 | 4 |
| Federal funds sold | 413 | 139 | 552 |
| Total interest earnings assets | $ (417) | $ 3,277 | $ 2,860 |
| | | | |
| Interest bearing liabilities | | | |
| Demand, interest bearing | $ 165 | $ 380 | $ 545 |
| Savings and money market | (69) | 1,027 | 958 |
| Time deposits, under $100 | (29) | 119 | 90 |
| Time deposits, $100 and over | (10) | 253 | 243 |
| Brokered time deposits, $100 and over | 58 | 14 | 72 |
| Notes payable to subsidiary grantor trusts | - | 50 | 50 |
| Securities sold under agreement to repurchase | (101) | 15 | (86) |
| Total interest bearing liabilities | $ 14 | $ 1,858 | $ 1,872 |
| Net interest income | $ (431) | $ 1,419 | $ 988 |

**Provision for Loan Losses**

The provision for loan losses represents the current period expense associated with maintaining an appropriate allowance for credit losses. The loan loss provision and level of allowance for each period are dependent upon many factors, including loan growth, net charge-offs, changes in the composition of the loan portfolio, delinquencies, management's assessment of the quality of the loan portfolio, the valuation of problem loans and the general economic conditions in the Company's market area. Periodic fluctuations in the provision for loan losses result from management's assessment of the adequacy of the allowance for loan losses; however, actual loan losses may vary from current estimates.

The Company reduced the allowance for loan losses by $489,000 during the first quarter of 2006. This reduction reflects sound credit quality as demonstrated by net recoveries of $13,000 for the first quarter of 2006 and a decrease in nonperforming loans to $2,530,000 at March 31, 2006 from $3,672,000 at December 31, 2005. The Company's provision for loan losses was $413,000 for the three months ended March 31, 2005. See additional discussion under the caption "Allowance for loan losses."

**Noninterest Income**

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

| (Dollars in thousands) | For the Three Months Ended March 31, 2006 | For the Three Months Ended March 31, 2005 | Increase (decrease) 2006 versus 2005 Amount | Increase (decrease) 2006 versus 2005 Percent |
|---|---|---|---|---|
| Gain on sale of loans | $ 1,497 | $ 760 | $ 737 | 97% |
| Servicing income | 468 | 392 | 76 | 19% |
| Increase in cash surrender value of life insurance | 347 | 266 | 81 | 30% |
| Service charges and fees on deposit accounts | 327 | 393 | (66) | -17% |
| Equipment leasing | - | 79 | (79) | N/A |
| Other | 255 | 467 | (212) | -45% |
| Total noninterest income | $ 2,894 | $ 2,357 | $ 537 | 23% |

Noninterest income for the three months ended March 31, 2006 was $2,894,000, an increase of 23% from $2,357,000 for the same period in 2005.

Noninterest income was primarily comprised of the gain on sale of Small Business Administration ("SBA") and other guaranteed loans, SBA loan-servicing income, and the gain on sale of the Capital Group loan portfolio. The Company has an ongoing program of originating SBA loans and selling the government guaranteed portion in the secondary market, while retaining the servicing of the whole loans. Gain on sale of SBA loans contributed $826,000 during the first quarter of 2006, compared to $760,000 for the three months ended March 31, 2005. The Company sold its Capital Group loan portfolio, which consisted primarily of "factoring" type loans, during the first quarter of 2006, resulting in a gain on sale of $671,000. The increase in the cash surrender value of life insurance was primarily the result of additional policies purchased during 2005. The decrease in deposit service charges and fees on deposit accounts was primarily because higher interest rates applied to collected balances created a waiver of (or credit against) service charges for many business customers. The Company sold all leased equipment during the second quarter of 2005.

**Noninterest Expense**

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

| (Dollars in thousands) | For the Three Months Ended March 31, 2006 | For the Three Months Ended March 31, 2005 | Increase (decrease) 2006 versus 2005 Amount | Increase (decrease) 2006 versus 2005 Percent |
|---|---|---|---|---|
| Salaries and employee benefits | $ 5,109 | $ 5,171 | $ (62) | -1% |
| Occupancy | 777 | 851 | (74) | -9% |
| Professional fees | 513 | 496 | 17 | 3% |
| Client services | 300 | 407 | (107) | -26% |
| Low income housing investment losses and writedowns | 264 | 252 | 12 | 5% |
| Advertising and promotion | 210 | 189 | 21 | 11% |
| Data processing | 181 | 172 | 9 | 5% |
| Furniture and equipment | 109 | 199 | (90) | -45% |
| Retirement plan expense | 88 | 102 | (14) | -14% |
| Amortization of leased equipment | - | 250 | (250) | -100% |
| Other | 1,210 | 1,221 | (11) | -1% |
| Total noninterest expense | $ 8,761 | $ 9,310 | $ (549) | -6% |

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

| | For The Three Months Ended March 31, | | | |
|---|---|---|---|---|
| **(Dollars in thousands)** | **2006** | **Percent of Total** | **2005** | **Percent of Total** |
| Salaries and employee benefits | $ 5,109 | 58% | $ 5,171 | 56% |
| Occupancy | 777 | 9% | 851 | 9% |
| Professional fees | 513 | 6% | 496 | 5% |
| Client services | 300 | 3% | 407 | 4% |
| Low income housing investment losses and writedowns | 264 | 3% | 252 | 3% |
| Advertising and promotion | 210 | 3% | 189 | 2% |
| Data processing | 181 | 2% | 172 | 2% |
| Furniture and equipment | 109 | 1% | 199 | 2% |
| Retirement plan expense | 88 | 1% | 102 | 1% |
| Amortization of leased equipment | 0 | 0% | 250 | 3% |
| Other | 1,210 | 14% | 1,221 | 13% |
| Total noninterest expense | $ 8,761 | 100% | $ 9,310 | 100% |

For the three months ended March 31, 2006, noninterest expense decreased $549,000, or 6%, from the same period in 2005. The efficiency ratio was 58.08% for the three months ended March 31, 2006, compared to 68.66% for the three months ended March 31, 2005.

Salaries and employee benefits, the single largest component of noninterest expenses decreased $62,000 for the three months ended March 31, 2006 from the same period in 2005. The decrease was primarily attributable to a decrease in the number of employees. The Company employed 183 people at March 31, 2006, down from 197 at March 31, 2005. Salaries and employee benefits as a percentage of total noninterest expense increased to 58% for the three months ended March 31, 2006 from 56% for the three months ended March 31, 2005.

Occupancy decreased $74,000 for the three months ended March 31, 2006 from same period in 2005. The decrease was primarily a result of lower depreciation on leasehold improvements for the three months ended March 31, 2006. In addition, the Company amended two of its existing lease contracts to reduce monthly rent by extending the terms of the leases during the third quarter of 2005. Occupancy cost as a percentage of total noninterest expense remained fairly constant at 9% for the three months ended March 31, 2006 and 2005.

Professional fees increased $17,000 for the three months ended March 31, 2006 from the same period in 2005. The increase was primarily attributable to increases in consulting expenses. Professional fees as a percentage of total noninterest expense increased to 6% for the three months ended March 31, 2006 from 5% for the three months ended March 31, 2005.

Client services decreased $107,000 for the three months ended March 31, 2006 from the same period in 2005. The decrease was primarily attributable to the decrease in service fees charged to the Company from third party vendors who have certain deposit accounts. Client services as a percentage of total noninterest expense decreased to 3% for the three months ended March 31, 2006 from 4% for the three months ended March 31, 2005.

Low income housing investment losses and writedowns increased $12,000 for the three months ended March 31, 2006 from the same period in 2005. The increase was primarily attributable to the increased losses from three fully active funds. Low income housing investment losses and writedowns as a percentage of total expense remained fairly constant at 3% for the three months ended March 31, 2006 and 2005.

Advertising and promotion costs increased $21,000 for the three months ended March 31, 2006 from the same period in 2005. The increase was primarily attributable to certain new sponsorships and promotions in 2006. Advertising and promotion as a percentage of total expense increased to 3% for the three months ended March 31, 2006 from 2% for the three months ended March 31, 2005.

Data processing expense increased $9,000 for the three months ended March 31, 2006 from the same period in 2005. Data processing expense as a percentage of total noninterest expense remained fairly constant at 2% for the three months ended March 31, 2006 and 2005.

Furniture and equipment expense decreased $90,000 for the three months ended March 31, 2006 from the same period in 2005. The decrease was primarily due to fewer equipment repairs and lower depreciation on furniture and equipment. Furniture and equipment expense as a percentage of total noninterest expense decreased to 1% for the three months ended March 31, 2006 from 2% for the three months ended March 31, 2005.

Retirement plan expense decreased $14,000 for the three months ended March 31, 2006 from the same period in 2005. Retirement plan expense as a percentage of total noninterest expense remained fairly constant at 1% for the three months ended March 31, 2006 and 2005.

Amortization of leased equipment decreased $250,000 for the three months ended March 31, 2006 from the same period in 2005. All of the leased equipment was sold in the second half of 2005.

Other noninterest expenses decreased $11,000 for the three months ended March 31, 2006 from the same period in 2005. Other noninterest expense as a percentage of total noninterest expense increased to 14% for the three months ended March 31, 2006 from 13% for the three months ended March 31, 2005.

**Income Taxes**

Income tax expense for the three months ended March 31, 2006 was $2,437,000, compared to $1,184,000 for the same period in 2005. The following table shows the effective income tax rate for each period indicated.

| | **For the Three Months Ended March 31,** | |
|---|---|---|
| | **2006** | **2005** |
| Effective income tax rate | 35.77% | 30.86% |

The difference in the effective tax rate compared to the combined federal and state statutory tax rate of 42% is primarily the result of the Company's investment in life insurance policies whose earnings are not subject to taxes, tax credits related to investments in low income housing and investments in tax-free municipal securities. The effective tax rate in 2006 is higher compared to 2005 because pre-tax income increased more than the savings from tax advantaged investments.

## FINANCIAL CONDITION

As of March 31, 2006, total assets were $1.1 billion, compared to $1.2 billion as of March 31, 2005. Total securities available-for-sale were $186 million, a decrease of 17% from $225 million for 2005. The total loan portfolio was $696 million, a decrease of 5% from $730 million for 2005. Total deposits were $935 million, a decrease of 3% from $963 million for 2005. Securities sold under agreement to repurchase decreased $22 million, or 45%, to $26 million at March 31, 2006, from $48 million at March 31, 2005.

### Securities Portfolio

A major component of the Company's earning assets is its securities portfolio. The following table sets forth the estimated fair value of securities at the dates indicated:

| | March 31, | | December 31, |
|---|---|---|---|
| **(Dollars in thousands)** | **2006** | **2005** | **2005** |
| Securities available-for-sale (at fair value) | | | |
| U.S. Treasuries | $ 5,905 | $ 5,941 | $ 6,920 |
| U.S. Government Agencies | 73,794 | 89,734 | 82,041 |
| Municipals - Tax Exempt | 8,117 | 8,923 | 8,268 |
| Mortgage-Backed Securities | 90,837 | 101,162 | 91,868 |
| Collateralized Mortgage Obligations | 7,515 | 19,322 | 9,398 |
| Total | $ 186,168 | $ 225,082 | $ 198,495 |

Securities classified as U.S. Government Agencies as of March 31, 2006 were issued by the Federal National Mortgage Association, Federal Home Loan Mortgage Corporation, and the Federal Home Loan Bank.

The following table summarizes the composition of the Company's securities available-for-sale and the weighted average yields at March 31, 2006:

| | March 31, 2006 Maturity | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | Within One Year | | After One and Within Five Years | | After Five and Within TenYears | | After Ten Years | | Total | |
| **(Dollars in thousands)** | **Amount** | **Yield** | **Amount** | **Yield** | **Amount** | **Yield** | **Amount** | **Yield** | **Amount** | **Yield** |
| Securities available-for-sale (at fair value): | | | | | | | | | | |
| U.S. Treasuries | $ - | - | $ 5,905 | 3.50% | $ - | - | $ - | - | $ 5,905 | 3.50% |
| U.S. Government Agencies | 49,180 | 2.68% | 24,614 | 4.53% | - | - | - | - | 73,794 | 3.30% |
| Mortgage Backed Securities | - | - | 2,367 | 3.48% | 7,891 | 4.30% | 80,579 | 4.28% | 90,837 | 4.26% |
| Municipals - non-taxable | 317 | 2.22% | 7,800 | 2.98% | - | - | - | - | 8,117 | 2.95% |
| Collateralized Mortgage Obligations | - | - | - | - | - | - | 7,515 | 3.10% | 7,515 | 3.10% |
| Total | $ 49,497 | 2.68% | $ 40,686 | 4.02% | $ 7,891 | 4.30% | $ 88,094 | 4.18% | $ 186,168 | 3.75% |

Securities that are classified as available for sale are carried at their fair value. This means that the carrying amount will increase or decrease based on changes in interest rates or, very rarely, changes in credit rating.

As of March 31, 2006, the only securities held by the Company where the aggregate carrying value of the Company's investment in securities of a single issuer exceeded 10% of the Company's shareholders' equity were direct obligations of the U.S. government or U.S. government agencies.

The securities portfolio of the Company is also used as collateral to meet requirements imposed as a condition of deposit by some depositors such as political subdivisions (public funds) or bankruptcy trustees and other contractual obligations such as repurchase agreements. Securities with amortized cost of $61,981,000 and $88,278,000 as of March 31, 2006 and 2005 were pledged to secure public and certain other deposits as required by law or contract and other contractual obligations. A portion of these deposits can only be secured by U.S. Treasury securities. The Company has not used interest rate swaps or other derivative instruments to hedge fixed rate loans or to otherwise mitigate interest rate risk.

**Loans and Loan Servicing**

Total loans (exclusive of loans held of sale) were $696 million for the three months ended March 31, 2006, compared to $730 million for the three months ended March 31, 2005. The Company's allowance for loan losses was $9.7 million, or 1.40% of total loans, at March 31, 2006, as compared to $11.2 million, or 1.54% of total loans, at March 31, 2005. As of March 31, 2006 and 2005, the Company had $2.5 million and $3.7 million, respectively, in nonperforming assets.

The loan portfolio is primarily comprised of commercial loans to companies principally engaged in manufacturing, wholesale and service businesses and real estate lending, with the balance in land development and construction, home equity and consumer loans.

The following table summarizes the composition of the Company's loan portfolio at the dates indicated:

| | March 31, | | March 31, | | December 31, 2005 | |
|---|---|---|---|---|---|---|
| **(Dollars in thousands)** | **2006** | **% to Total** | **2005** | **% to Total** | **2005** | **% to Total** |
| Commercial | $ 262,625 | 38% | $ 293,488 | 40% | $ 256,713 | 37% |
| Real estate - mortgage | 232,790 | 34% | 250,005 | 34% | 237,566 | 35% |
| Real estate - land and construction | 156,468 | 22% | 129,881 | 18% | 149,851 | 22% |
| Home equity | 41,429 | 6% | 53,595 | 8% | 41,772 | 6% |
| Consumer | 1,495 | 0% | 2,147 | 0% | 1,721 | 0% |
| Total loans | 694,807 | 100% | 729,116 | 100% | 687,623 | 100% |
| Deferred loan costs | 1,058 | | 754 | | 1,155 | |
| Allowance for loan losses | (9,748) | | (11,249) | | (10,224) | |
| Loans, net | $ 686,117 | | $ 718,621 | | $ 678,554 | |

The change in the Company's loan portfolio for the three months ended March 31, 2006 compared to the three months ended March 31, 2005 is primarily due to the decrease in the commercial and real estate mortgage loan portfolios, partially offset by an increase in the real estate land and construction loan portfolio. In the fourth quarter of 2005, the Company entered into negotiations for the sale of its Capital Group loan portfolio consisting primarily of "factoring" type loans. In contemplation of the sale, $32 million, net of the respective allowance for loan losses, was moved from commercial loans into loans held-for-sale at December 31, 2005. The sale of the Capital Group loan portfolio was completed in 2006, resulting in a gain of $671,000.

The following table presents the maturity distribution of the Company's loans as of March 31, 2006. The table shows the distribution of such loans between those loans with predetermined (fixed) interest rates and those with variable (floating) interest rates. Floating rates generally fluctuate with changes in the prime rate as reflected in the western edition of The Wall Street Journal. As of March 31, 2006, approximately 81% of the Company's loan portfolio consisted of floating interest rate loans.

| (Dollars in thousands) | Due in One Year or Less | Over One Year But Less than Five Years | Over Five Years | Total |
|---|---|---|---|---|
| Commercial | $ 247,630 | $ 12,346 | $ 2,649 | $ 262,625 |
| Real estate - mortgage | 117,768 | 57,639 | 57,383 | 232,790 |
| Real estate - land and construction | 156,316 | 152 | - | 156,468 |
| Home equity | 41,235 | 194 | - | 41,429 |
| Consumer | 1,407 | 88 | - | 1,495 |
| Total loans | $ 564,356 | $ 70,419 | $ 60,032 | $ 694,807 |
| | | | | |
| Loans with variable interest rates | $ 536,647 | $ 23,633 | $ 131 | $ 560,411 |
| Loans with fixed interest rates | 27,709 | 46,786 | 59,901 | 134,396 |
| Total loans | $ 564,356 | $ 70,419 | $ 60,032 | $ 694,807 |

At March 31, 2006 and 2005, the Company serviced Small Business Administration and other guaranteed loans which it had sold to the secondary market of approximately $180,823,000 and $169,357,000, respectively.

Activity for loan servicing rights follows:

| (Dollars in thousands) | For the Three Months Ended March 31, 2006 | 2005 |
|---|---|---|
| Beginning of period balance at January 1, | $ 2,171 | $ 2,213 |
| Additions | 289 | 264 |
| Amortization | (299) | (276) |
| End of period balance at March 31, | $ 2,161 | $ 2,201 |

Loan servicing income is reported net of amortization. There was no valuation allowance as of March 31, 2006 and 2005, as the fair market value of the assets was greater than the carrying value.

Activity for I/O strip receivables follows:

| (Dollars in thousands) | For the Three Months Ended March 31, 2006 | 2005 |
|---|---|---|
| Beginning of period balance at January 1, | $ 4,679 | $ 3,954 |
| Additions | 312 | 770 |
| Amortization | (321) | (398) |
| Unrealized holding gain (loss) | (119) | 271 |
| End of period balance at March 31, | $ 4,551 | $ 4,597 |

**Nonperforming Assets**

Nonperforming assets consist of nonaccrual loans, loans past due 90 days and still accruing, and other real estate owned. Management generally places loans on nonaccrual status when they become 90 days past due, unless they are well secured and in the process of collection. When a loan is placed on nonaccrual status, any interest previously accrued but not collected is revered against income, and the amortization of deferred fees and costs is discontinued. Loans are charged off when management determines that collection has become unlikely. Other real estate owned ("OREO") consists of real property acquired through foreclosure on the related underlying defaulted loans.

The following table shows nonperforming assets at the dates indicated:

| (Dollars in thousands) | March 31, 2006 | March 31, 2005 | December 31, 2005 |
|---|---|---|---|
| Nonaccrual loans | $ 2,292 | $ 3,450 | $ 3,672 |
| Loans 90 days past due and still accruing | 238 | 287 | - |
| Total nonperforming loans | 2,530 | 3,737 | 3,672 |
| Other real estate owned | - | - | - |
| Total nonperforming assets | $ 2,530 | $ 3,737 | $ 3,672 |
| Nonperforming assets as a percentage of loans plus other real estate owned | 0.36% | 0.51% | 0.53 |

**Allowance for Loan Losses**

The Company assigns to all of its loans a risk grade consistent with the system recommended by regulatory agencies. Grades range from "Pass" to "Loss" depending on credit quality, with "Pass" representing loans that involve an acceptable degree of risk. Management conducts a critical evaluation of the loan portfolio monthly. This evaluation includes periodic loan by loan review for certain loans to evaluate the level of impairment, as well as detailed reviews of other loans (either individually or in pools) based on an assessment of the following factors: past loan loss experience, known and inherent risks in the portfolio, adverse situations that may affect the borrower's ability to repay, collateral values, loan volumes and concentrations, size and complexity of the loans, recent loss experience in particular segments of the portfolio, bank regulatory examination results, and current economic conditions in the Company's marketplace, in particular the state of the technology industry and the real estate market.

This process attempts to assess the risk of loss inherent in the portfolio by segregating loans into four components for purposes of determining an appropriate level of the allowance: "watch," "special mention," "substandard" and "doubtful." Additionally, the Company maintains a program for regularly scheduled reviews of certain new and renewed loans by an outside loan review consultant. Any loans identified during an external review process that expose the Company to increased risk are appropriately downgraded and an increase in the allowance for loan losses is established for such loans. Further, the Company is examined periodically by the Board of Governors of the Federal Reserve System (“FRB”) and the California Department of Financial Institutions (“DFI”), at which time a further review of loan quality is conducted.

Loans that demonstrate a weakness, for which there is a possibility of loss if the weakness is not corrected, are categorized as "classified." Classified loans include all loans considered as substandard, doubtful, and loss and may result from problems specific to a borrower's business or from economic downturns that affect the borrower's ability to repay or that cause a decline in the value of the underlying collateral (particularly real estate).

The principal balance of classified loans, which include all loans internally graded as substandard, doubtful, and loss, was $13,708,000 and $25,587,000, respectively, at March 31, 2006 and 2005.

It is the policy of management to maintain the allowance for loan losses at a level adequate for risks inherent in the loan portfolio. Based on information currently available to analyze loan loss delinquency and a history of actual charge-offs, management believes that the loan loss allowance 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. Loans are charged against the allowance when management believes that the collectibility of the principal is unlikely.

The following table summarizes the Company’s loan loss experience as well as provisions, charge-offs and recoveries to the allowance for loan and lease losses and certain pertinent ratios for the periods indicated:

| | For the Three Months Ended March 31, | | For the Year Ended December 31, |
|---|---|---|---|
| (Dollars in thousands) | 2006 | 2005 | 2005 |
| Balance, beginning of period / year | $ 10,224 | $ 12,497 | $ 12,497 |
| Net recoveries (charge-offs) | 13 | (1,661) | (1,915) |
| Provision for loan losses | (489) | 413 | 313 |
| Reclassification to loans held for sale | - | - | (671) |
| Balance, end of period/ year | $ 9,748 | $ 11,249 | $ 10,224 |
| | | | |
| RATIOS: | | | |
| Net charge-offs to average loans outstanding | -0.01% | 0.93% | 0.26% |
| Allowance for loan losses to average loans | 1.41% | 1.55% | 1.41% |
| Allowance for loan losses to total loans at end of period | 1.40% | 1.54% | 1.48% |
| Allowance for loan losses to nonperforming loans | 385% | 301% | 278% |

Charge-offs reflect the realization of losses in the portfolio that were recognized previously through provisions for loan losses. Historical net charge-offs are not necessarily indicative of the amount of net charge-offs that the Company will realize in the future.

Loans are charged against the allowance when management believes that the uncollectibility of the loan balance is confirmed. The Company's methodology for assessing the appropriateness of the allowance consists of several key elements, which include specific allowances, the formula allowance and the unallocated allowance.

Specific allowances are established for individual impaired loans. The formula allowance is calculated by applying estimated loss factors to pools of similar loans. Loss factors are based on historical experience, adjusted for significant factors that, in management's judgment, may affect the collectibility of the portfolio as of the evaluation date.

In adjusting the historical loss factors applied to the respective segments of the loan portfolio, management considered the following factors:

- Levels and trends in delinquencies, non-accruals, charge offs and recoveries
- Trends in volume and loan terms
- Lending policy or procedural changes
- Experience, ability, and depth of lending management and staff
- National and local economic trends and conditions
- Concentrations of credit

There can be no assurance that the adverse impact of any of these conditions on the Bank will not be in excess of the current level of estimated losses.

In an effort to improve its analysis of risk factors associated with its loan portfolio, the Company continues to monitor and to make appropriate changes to its internal loan policies. These efforts better enable the Company to assess risk factors prior to granting new loans and to assess the sufficiency of the allowance for loan losses.

Management believes that it has adequately provided an allowance for estimated probable losses in the credit portfolio. Significant deterioration in Northern California real property values or economic downturns could impact future operating results, liquidity or capital resources and require additional provisions to the allowance or cause losses in excess of the allowance.

**Deposits**

Total deposits were $934,733,000 at March 31, 2006, compared to $962,523,000 at March 31, 2005. At March 31, 2006, compared to March 31, 2005, noninterest bearing demand deposits decreased $30,920,000, or 11%, primarily due to decreases in title and escrow companies’ accounts. Interest bearing demand deposits increased $24,238,000, or 19%, primarily impacted by the increasing rate environment; savings and money market deposits decreased $8,756,000, or 2%; time deposits decreased $8,306,000, or 5%; and brokered deposits decreased $4,046,000, or 10%.

The following table summarizes the distribution of average deposits and the average rates paid for the periods indicated:

| (Dollars in thousands) | Three Months Ended March 31, 2006 | | Three Months Ended March 31, 2005 | | For the Year Ended December 31, 2005 | |
|---|---|---|---|---|---|---|
| | Average Balance | Average Rate Paid | Average Balance | Average Rate Paid | Average Balance | Average Rate Paid |
| Demand, noninterest bearing | $ 235,288 | 0% | $ 261,471 | 0% | $ 259,881 | 0% |
| Demand, interest bearing | 157,993 | 2.15% | 127,009 | 0.94% | 134,412 | 1.30% |
| Savings and money market | 348,130 | 2.42% | 360,256 | 1.26% | 363,570 | 1.67% |
| Time deposits, under $100 | 34,210 | 3.25% | 37,860 | 1.97% | 37,260 | 2.47% |
| Time deposits, $100 and over | 108,273 | 2.97% | 109,647 | 2.03% | 115,104 | 2.44% |
| Brokered deposits, $100 and over | 36,050 | 3.75% | 29,750 | 3.56% | 35,764 | 3.67% |
| Total average deposits | $ 919,944 | 1.90% | $ 925,993 | 1.06% | $ 945,991 | 1.36% |

As of March 31, 2006, the Company had a deposit mix of 38% in savings and money market accounts, 20% in time deposits, 16% in interest bearing demand accounts, and 26% in noninterest bearing demand deposits. As of March 31, 2006, approximately $2,400,000, or less than 1%, of deposits were from public sources, and approximately $39,228,000, or 4%, of deposits were from title and escrow companies. As of March 31, 2005, the Company had a deposit mix of 38% in savings and money market accounts, 20% in time deposits, 14% in interest bearing demand accounts, and 28% in noninterest bearing demand deposits. As of March 31, 2006, approximately $6,515,000, or less than 1%, of deposits were from public sources, and approximately $125,171,000, or 14%, of deposits were from title and escrow companies.

The Company obtains deposits from a cross-section of the communities it serves. The Company's business is not seasonal in nature. The Company had brokered deposits totaling $36,040,000 and $40,086,000 at March 31, 2006 and 2005, respectively. These brokered deposits generally mature within one to three years. The Company is not dependent upon funds from sources outside the United States.

The following table indicates the maturity schedule of the Company’s time deposits of $100,000 or more as of March 31, 2006:

| (Dollars in thousands) | Balance | % of Total |
|---|---|---|
| Three months or less | $ 58,316 | 39% |
| Over three months through six months | 26,338 | 17% |
| Over six months through twelve months | 29,004 | 19% |
| Over twelve months | 37,675 | 25% |
| Total | $ 151,333 | 100% |

The Company focuses primarily on providing and servicing business deposit accounts that are frequently over $100,000 in average balance per account. As a result, certain types of business clients whom the Company serves typically carry average deposits in excess of $100,000. The account activity for some account types and client types necessitates appropriate liquidity management practices by the Company to ensure its ability to fund deposit withdrawals.

**Liquidity and Asset/Liability Management**

To meet liquidity needs, the Company maintains a portion of its funds in cash deposits in other banks, in Federal funds sold, and in securities. At March 31, 2006, the Company's primary liquidity ratio was 23.13%, comprised of $90,183,000 in securities available-for-sale with maturities (or probable calls) of up to five years, less $10,767,000 of securities that were pledged to secure public and certain other deposits as required by law and contract; Federal funds sold of $94,200,000, and $40,065,000 in cash and due from banks, as a percentage of total unsecured deposits of $923,966,000. At December 31, 2005 and March 31, 2005, the Company's primary liquidity ratio was 20.16% and 20.96%, respectively.

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

| | March 31, | |
|---|---|---|
| **(Dollars in thousands)** | **2006** | **2005** |
| YTD average balance | $ 32,553 | $ 50,167 |
| YTD average interest rate | 2.34% | 2.22% |
| Maximum month-end balance | $ 26,100 | $ 47,800 |
| Average rate at March 31, | 2.34% | 2.20% |

The Company has Federal funds purchase and lines of credit arrangements totaling $73,000,000 with correspondent banks. As of March 31, 2006, the Company had borrowing capacity of approximately $89,000,000 under a borrowing arrangement with the Federal Home Loan Bank secured by certain loans and securities.

**Capital Resources**

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

| | March 31, | | December 31, | |
|---|---|---|---|---|
| **(Dollars in thousands)** | **2006** | **2005** | **2005** | |
| Capital components: | | | | |
| Tier 1 Capital | $ 139,704 | $ 125,465 | $ 133,715 | |
| Tier 2 Capital | 9,921 | 11,249 | 10,427 | |
| Total risk-based capital | $ 149,625 | $ 136,714 | $ 144,142 | |
| Risk-weighted assets | $ 835,679 | $ 948,932 | $ 941,567 | |
| Average assets for capital purposes | $ 1,118,272 | $ 1,122,671 | $ 1,157,704 | |
| Capital ratios | | | | Minimum Regulatory Requirements |
| Total risk-based capital | 17.9% | 14.4% | 15.3% | 8.00% |
| Tier 1 risk-based capital | 16.7% | 13.2% | 14.2% | 4.00% |
| Leverage (1) | 12.5% | 11.2% | 11.6% | 4.00% |

(1) Tier 1 capital divided by average assets (excluding goodwill).

The table above presents the capital ratios of the Company computed in accordance with applicable regulatory guidelines and compared to the standards for minimum capital adequacy requirements under the FDIC's prompt corrective action authority as of March 31, 2006.

The Company's Tier 1 capital consists primarily of shareholders' equity (excluding unrealized gains and losses on securities) plus notes payable to subsidiary grantor trusts, less intangible assets. Tier 2 capital consists primarily of the allowance for loan losses.

At March 31, 2006 and 2005, and December 31, 2005, the Company's capital met all minimum regulatory requirements. As of March 31, 2006, management believes that HBC was considered "Well Capitalized" under the Prompt Corrective Action Provisions.

To enhance regulatory capital and to provide liquidity the Company, through unconsolidated subsidiary grantor trusts, issued the following mandatorily redeemable cumulative trust preferred securities of subsidiary grantor trusts: In the first quarter of 2000, the Company issued $7,000,000 aggregate principal amount of 10.875% subordinated debentures due on March 8, 2030 to a subsidiary trust, which in turn issued a similar amount of trust preferred securities. In the third quarter of 2000, the Company issued $7,000,000 aggregate principal amount of 10.60% subordinated debentures due on September 7, 2030 to a subsidiary trust, which in turn issued a similar amount of trust preferred securities. In the third quarter of 2001, the Company issued $5,000,000 aggregate principal amount of Floating Rate Junior Subordinated Deferrable Interest Debentures due on July 31, 2031 to a subsidiary trust, which in turn issued a similar amount of trust preferred securities. In the third quarter of 2002, the Company issued $4,000,000 aggregate principal amount of Floating Rate Junior Subordinated Deferrable Interest Debentures due on September 26, 2032 to a subsidiary trust, which in turn issued a similar amount of trust preferred securities. Under applicable regulatory guidelines, the Trust Preferred securities currently qualify as Tier I capital. The subsidiary trusts are not consolidated in the Company's consolidated financial statements and the subordinated debt payable to the subsidiary grantor trusts is recorded as debt of the Company to the related trusts.

**Market Risk**

Market risk is the risk of loss to future earnings, to fair values, or to 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 Sensitivity**

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; 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.

The following table sets forth the interest rate sensitivity of the Company's interest-earning assets and interest-bearing liabilities at March 31, 2006, using the rate sensitivity gap ratio. For purposes of the following table, an asset or liability is considered rate-sensitive within a specified period when it can be repriced or when it is scheduled to mature within the specified time frame:

| (Dollars in thousands) | Within Three Months | Due in Three to Twelve Months | Due After One to Five Years | Due After Five Years | Not Rate Sensitive | Total |
|---|---|---|---|---|---|---|
| **Interest earning assets:** | | | | | | |
| Federal funds sold | $ 94,200 | $ - | $ - | $ - | $ - | $ 94,200 |
| Interest bearing deposits in other financial institutions | 3,120 | - | - | - | - | 3,120 |
| Securities | 19,468 | 30,029 | 40,686 | 95,985 | - | 186,168 |
| Total loans, including loans held for sale | 532,411 | 63,748 | 70,419 | 60,032 | - | 726,610 |
| Total interest earning assets | 649,199 | 93,777 | 111,105 | 156,017 | - | 1,010,098 |
| Cash and due from banks | - | - | - | - | 36,945 | 36,945 |
| Other assets | - | - | - | - | 72,999 | 72,999 |
| Total assets | $ 649,199 | $ 93,777 | $ 111,105 | $ 156,017 | $ 109,944 | $ 1,120,042 |
| **Interest bearing liabilities:** | | | | | | |
| Demand, interest bearing | $ 154,277 | $ - | $ - | $ - | $ - | $ 154,277 |
| Savings and money market | 352,304 | - | - | - | - | 352,304 |
| Time deposits | 71,417 | 72,734 | 40,185 | - | - | 184,336 |
| Securities sold under agreement to repurchase | 4,300 | 6,700 | 15,100 | - | - | 26,100 |
| Notes payable to subsidiary grantor trusts | 9,279 | - | - | 14,423 | - | 23,702 |
| Total interest bearing liabilities | 591,577 | 79,434 | 55,285 | 14,423 | - | 740,719 |
| Noninterest demand deposits | 14,131 | - | - | - | 229,685 | 243,816 |
| Accrual interest payable and other liabilities | - | - | - | - | 20,310 | 20,310 |
| Shareholders' equity | - | - | - | - | 115,197 | 115,197 |
| Total liabilities and shareholder's equity | $ 605,708 | $ 79,434 | $ 55,285 | $ 14,423 | $ 365,192 | $ 1,120,042 |
| Interest rate sensitivity GAP | $ 43,491 | $ 14,343 | $ 55,820 | $ 141,594 | $ (255,248) | $ - |
| Cumulative interest rate sensitivity GAP | $ 43,491 | $ 57,834 | $ 113,654 | $ 255,248 | $ - | $ - |
| Cumulative interest rate sensitivity GAP ratio | 4% | 5% | 10% | 23% | 0% | 0% |

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. To supplement traditional GAP analysis, the Company performs simulation modeling to estimate the potential effects of changing interest rate environments but there is no significant difference as of March 31, 2006, compared to December 31, 2005. The process allows the Company to explore the complex relationships within the GAP over time and various interest rate environments.

Liquidity risk represents the potential for loss as a result of limitations on the Company's ability to adjust for future cash flows to meet the needs of depositors and borrowers and to fund operations on a timely and cost-effective basis. The liquidity policy approved annually by the board of directors requires monthly review of the Company's liquidity by the Asset/Liability Committee, which is composed of senior executives, and the Finance and Investment Committee of the board of directors.

The Company's internal Asset/Liability Committee and the Finance and Investment Committee of the Board of Directors each meet monthly to monitor the Company's investments, liquidity needs and to oversee its asset/liability management. The Company evaluates the rates offered on its deposit products on a regular basis.

## ITEM 3 - QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

No material changes have occurred during the quarter to the Company’s market risk profile or information. For further information refer to the Company’s Form 10-K.

## ITEM 4 - CONTROLS AND PROCEDURES

### Disclosure Control and Procedures

The Company has carried out an evaluation, under the supervision and with the participation of the Company's management, including the Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures as of March 31, 2006. 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 Office, as appropriate, to allow timely decisions regarding required disclosure. Based upon their evaluation, our Chief Executive Officer and Chief Financial Officer concluded the Company’s disclosure controls were effective as of March 31, 2006, the period covered by this report on Form 10Q.

During the three months ended March 31, 2006, there were no changes in our internal controls over financial reporting that materially affected, or are reasonably likely to affect, our internal controls over financial reporting.

# Part II — OTHER INFORMATION

## ITEM 1 - LEGAL PROCEEDINGS

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

## ITEM 1A - RISK FACTORS

In addition to the information on the financial condition of the Company contained in this report, the following risks may affect the Company. If any of these risks occurs, our business, financial condition or operating results could be adversely affected.

***Changes in market interest rates may adversely affect the Company’s performance***

The Company’s earnings are impacted by changing interest rates. Changes in interest rates impact the demand for new loans, the credit profile of existing loans, the prepayment characteristics of loans sold to the secondary market, the rates received on loans, securities and rates paid on deposits and securities and borrowings. The Board of Governors of the Federal Reserve System increased short-term interest rates 200 basis points during 2005 and 50 basis points in the first quarter of 2006. Any further increases in 2006 should continue to have a positive effect on the Company’s net interest margin and net interest income.

***Business focus and economic and competitive conditions in the San Francisco Bay Area could adversely affect the Company’s operations***

All of the Company’s operations and a vast majority of its customers are located in the Bay Area of California. A deterioration in economic and business conditions in the Bay Area, particularly in the technology and real estate industries on which this area depends, could have a material adverse impact on the quality of the Company’s loan portfolio and the demand for the Company’s products and services. A downturn in the national economy might further exacerbate local economic conditions.

The banking and financial services business in California, generally, and in the Company's market areas, specifically, is highly competitive. The increasingly competitive environment is a result primarily of changes in regulation, changes in technology and product delivery systems, and the consolidation among financial service providers. The Company competes for loans, deposits and customers for financial services with other commercial banks, savings and loan associations, securities and brokerage companies, mortgage companies, insurance companies, finance companies, money market funds, credit unions, and other non-bank financial service providers. Many of these competitors are much larger in total assets and capitalization, have greater access to capital markets and offer a broader array of financial services than the Company. In order to compete with the other financial service providers, the Company principally relies upon local promotional activities, personal relationships established by officers, directors, and employees with its customers, and specialized services tailored to meet its customers' needs. In those instances where the Company is unable to accommodate a customer's needs, the Company seeks to arrange for such loans on a participation basis with other financial institutions or to have those services provided in whole or in part by its correspondent banks.

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

In February 2006, the Company’s Board of Directors authorized the purchase of up to $10 million of its common stock, which represents approximately 455,000 shares, or 4%, of its outstanding shares at current market price. The Share repurchase authorization is valid through June 30, 2007.

The Company intends to finance the purchase using its available cash. Shares may be repurchased by the Company in open market purchases or in privately negotiated transactions as permitted under applicable rules and regulations. The repurchase program may be modified, suspended or terminated by the Board of Directors at any time without notice. The extent to which the Company repurchases its shares and the timing of such repurchases will depend upon market conditions and other corporate considerations.

As of March 31, 2006, repurchases of equity securities are presented in the table below.

| Settlement Date | Total Number of Shares Purchased | Price Paid Per Share | Total Number of Shares Purchased as Part of Publicly Announced Plans | Approximate Dollar of Shares That May Yet Be Purchased Under the Plan |
|---|---|---|---|---|
| 3/2/2006 | 1,000 | $ 23.40 | 1,000 | $ 9,976,598.00 |
| 3/3/2006 | 1,000 | $ 23.36 | 1,000 | $ 9,953,243.00 |
| 3/6/2006 | 1,000 | $ 22.88 | 1,000 | $ 9,930,367.00 |
| 3/7/2006 | 1,000 | $ 22.62 | 1,000 | $ 9,907,747.10 |
| 3/8/2006 | 1,000 | $ 22.75 | 1,000 | $ 9,884,997.20 |
| 3/9/2006 | 1,000 | $ 22.84 | 1,000 | $ 9,862,157.30 |
| 3/10/2006 | 1,000 | $ 22.84 | 1,000 | $ 9,839,317.40 |
| 3/13/2006 | 1,000 | $ 22.86 | 1,000 | $ 9,816,457.40 |
| 3/14/2006 | 1,000 | $ 23.00 | 1,000 | $ 9,793,458.40 |
| 3/15/2006 | 20,000 | $ 23.10 | 20,000 | $ 9,331,458.40 |
| 3/16/2006 | 1,000 | $ 23.20 | 1,000 | $ 9,308,258.50 |
| 3/17/2006 | 1,000 | $ 23.50 | 1,000 | $ 9,284,758.50 |
| 3/20/2006 | 1,000 | $ 23.50 | 1,000 | $ 9,261,258.50 |
| | 32,000 | | 32,000 | |

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

There was no submission of matters to a vote of security holders during the three months ended March 31, 2006.

**ITEM 6 - EXHIBITS**

| Exhibit | Description |
|---|---|
| 31.1 | Certification of Registrant's Chief Executive Officer Pursuant To Section 302 of the Sarbanes-Oxley Act of 2003 |
| 31.2 | Certification of Registrant's Chief Financial Officer Pursuant To Section 302 of the Sarbanes-Oxley Act of 2003 |
| 32.1 | Certification of Registrant's Chief Executive Officer Pursuant To18 U.S.C. Section 1350 |
| 32.2 | Certification of Registrant's Chief Financial Officer Pursuant To 18 U.S.C. Section 1350 |

**SIGNATURES**

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

Heritage Commerce Corp
Registrant

| | |
|---|---|
| May 10, 2006<br>Date | /s/ Walter T. Kaczmarek<br>Walter T. Kaczmarek<br>Chief Executive Officer |
| May 10, 2006<br>Date | /s/ Lawrence D. McGovern<br>Lawrence D. McGovern<br>Chief Financial Officer |