Redwood Capital Bancorp

Audited Financial Statements

December 31, 2010

Redwood Capital Bancorp

April 6, 2011

Dear Shareholder,

We have a great deal to be proud of as we look at our 2010 financial results. Our 2010 performance represents our fifth consecutive year of annual profitability and substantiates our consistent ability to gain valuable market share. As many banks continue to struggle or fail, our results bolster our strategy of building a safe, strong and profitable financial institution that Humboldt County can bank on and with.

Redwood Capital Bank's 2010 performance achievements have been recognized by the industry. The Financial Management Consulting Group has ranked Redwood Capital Bank 9th in the State of California for overall performance out of the 243 California-based institutions. Redwood Capital Bank also earned the highest possible rating of Super Premier Performance by The Findley Company with only 19 California banks receiving this honorable distinction in 2010. Though the bank has received accolades for its above peer performance, the best news is the position and condition of the company's balance sheet which will continue to provide core earnings now and into the future.

In this economy asset quality is the key to survival. Redwood Capital Bank has a great deal to be proud of in the metrics of asset quality. At year end 2010, the bank's Texas ratio had declined to 3.26% which compares favorably to the national average of 31%. As of year end 2010, Redwood Capital Bank had no foreclosed properties and no foreclosures in process.

Redwood Capital Bank's milestones are a direct reflection of the breadth and depth of the company's knowledgeable and experienced leadership team, as well as our growing reputation in the community as the local bank of choice. Likewise, our accomplishments speak volumes about the performance of our most valuable asset: our front line employees who continue to consistently deliver a brand of personalized service that sets us apart from our competitors.

Since the time we opened our doors in March of 2004, we have never waivered from our commitment to be the best full-service bank on the North Coast. While we remain mindful of the uncertainties created by the current economic and financial landscape and its impact globally, nationally and locally, we believe we are in a unique position to sustain the growth of our company, thereby supporting the communities we serve.

If you have not yet made the transition to Redwood Capital Bank, we strongly encourage you to visit either of our full-service branches and discover an extremely friendly, unique and refreshing banking experience. Also, kindly continue to keep Redwood Capital Bank in mind as you hear about any opportunities for us to expand our services. Your referrals are a significant part of our marketing success so please keep them coming!

Sincerely,

REDWOOD CAPITAL BANK

John E. Dalby
President & CEO

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INDEPENDENT AUDITOR'S REPORT

The Shareholders and
Board of Directors
Redwood Capital Bancorp and Subsidiary
Eureka, California

We have audited the accompanying consolidated balance sheets of Redwood Capital Bancorp (the Company) and its wholly-owned subsidiary, Redwood Capital Bank as of December 31, 2010 and 2009, and the related consolidated statements of operations, changes in shareholders' equity and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Redwood Capital Bancorp and its wholly-owned subsidiary, Redwood Capital Bank as of December 31, 2010 and 2009, and the consolidated results of its operations and its consolidated cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

Richardson & Company

March 28, 2011

REDWOOD CAPITAL BANCORP
AND SUBSIDIARY

CONSOLIDATED BALANCE SHEETS

December 31, 2010 and 2009

	2010	2009
ASSETS		
Cash and due from banks	$ 6,339,042	$ 3,472,096
Federal funds sold	32,780,000	22,450,000
Interest bearing deposit in other financial institutions	1,002,468	
Cash and cash equivalents	40,121,510	25,922,096
Investment securities available-for-sale, at fair value	20,908,659	15,951,348
Loans, net	141,199,574	134,209,255
Premises and equipment, net	4,217,364	4,368,887
Foreclosed real estate		326,379
Cash surrender value of life insurance	2,498,720	2,398,504
Accrued interest receivable and other assets	4,484,331	3,124,079
TOTAL ASSETS	$ 213,430,158	$ 186,300,548
LIABILITIES AND SHAREHOLDERS' EQUITY		
LIABILITIES		
Deposits		
Non interest-bearing	$ 32,515,730	$ 24,943,739
Interest-bearing	160,934,175	144,182,414
Total deposits	193,449,905	169,126,153
Borrowings	3,097,860	1,500,250
Accrued interest payable and other liabilities	1,118,797	629,329
TOTAL LIABILITIES	197,666,562	171,255,732
Commitments and contingencies (see accompanying notes)		
SHAREHOLDERS' EQUITY		
Preferred stock, Series A and B, no par value; 10,000,000 shares authorized; 3,800 shares of Series A and 190 shares of Series B issued and outstanding in 2010 and 2009	3,862,206	3,824,214
Common stock, no par value; 30,000,000 shares authorized; 1,746,799 and 1,733,034 shares issued and outstanding in 2010 and 2009	11,791,633	11,699,908
Additional paid-in capital	581,230	562,054
Accumulated deficit	(539,358)	(1,300,755)
Accumulated other comprehensive income	67,885	259,395
TOTAL SHAREHOLDERS' EQUITY	15,763,596	15,044,816
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	$ 213,430,158	$ 186,300,548

The accompanying notes are an integral part of these financial statements.

REDWOOD CAPITAL BANCORP
AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF OPERATIONS

For the Years Ended December 31, 2010 and 2009

	2010	2009
INTEREST INCOME		
Interest and fees on loans	$ 8,560,395	$ 8,273,211
Interest on taxable investment securities	549,194	502,208
Dividend income	2,609	6,404
Interest on federal funds sold	45,199	39,485
Interest on deposits in banks	6,916	9,178
Total interest income	9,164,313	8,830,486
INTEREST EXPENSE		
Interest on deposits	1,745,881	2,183,150
Interest on other borrowings	74,335	25,338
Total interest expense	1,820,216	2,208,488
NET INTEREST INCOME	7,344,097	6,621,998
Provision for loan losses	2,050,250	1,558,000
NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES	5,293,847	5,063,998
OTHER INCOME		
Service charges and fees	469,690	450,569
Other income	575,447	575,996
Total other income	1,045,137	1,026,565
OTHER EXPENSES		
Salaries and employee benefits	2,864,231	2,566,146
Foreclosed real estate	23,707	589,078
Occupancy and equipment	558,058	573,373
Other	2,150,407	1,934,690
Total other expenses	5,596,403	5,663,287
Income before provision for income taxes	742,581	427,276
(Benefit) provision for income taxes	(263,908)	1,600
NET INCOME	$ 1,006,489	$ 425,676
NET INCOME PER SHARE	$ 0.58	$ 0.25
NET INCOME PER SHARE – ASSUMING DILUTION	$ 0.57	$ 0.24

The accompanying notes are an integral part of these financial statements.

REDWOOD CAPITAL BANCORP
AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY

For the Years Ended December 31, 2010 and 2009

	Comprehensive Income	Preferred Stock	Common Stock		Additional Paid-In Capital	Accumulated Deficit	Accumulated Other Comprehensive (Loss) Income	Total Shareholders' Equity
			Shares	Amount				
Balance at January 1, 2009			1,728,494	$ 11,611,403	$ 455,759	$ (1,502,338)	$ 267,299	$ 10,832,123
Preferred stock issuance		$ 3,789,388						3,789,388
Dividends on preferred stock						(189,267)		(189,267)
Amortization/Accretion of preferred stock, net		34,826				(34,826)		
Stock options exercised			840	6,880	(1,277)			5,603
Stock option and restricted stock expense					152,797			152,797
Restricted stock vested			3,700	81,625	(45,225)			36,400
Comprehensive income:								
Net income	$ 425,676					425,676		425,676
Other comprehensive income:								
Unrealized holding losses on securities available-for-sale arising during the year	(7,904)						(7,904)	(7,904)
Total comprehensive income	$ 417,772							
Balance at December 31, 2009		3,824,214	1,733,034	11,699,908	562,054	(1,300,755)	259,395	15,044,816
2010 activity:								
Dividends on preferred stock						(207,100)		(207,100)
Amortization/Accretion of preferred stock, net		37,992				(37,992)		-
Redemption and retirement of stock			(2,351)	(16,428)				- (16,428)
Stock option and restricted stock expense					163,729			163,729
Restricted stock vested			16,116	108,153	(144,553)			(36,400)
Comprehensive income:								
Net income	$ 1,006,489					1,006,489		1,006,489
Other comprehensive income:								
Unrealized holding losses on securities available-for-sale arising during the year, net of tax of $47,477	(191,510)						(191,510)	(191,510)
Total comprehensive income	$ 814,979							
BALANCE AT DECEMBER 31, 2010		$ 3,862,206	1,746,799	$ 11,791,633	$ 581,230	$ (539,358)	$ 67,885	$ 15,763,596

The accompanying notes are an integral part of these financial statements.

REDWOOD CAPITAL BANCORP
AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF CASH FLOWS

For the Years Ended December 31, 2010 and 2009

	2010	2009
OPERATING ACTIVITIES		
Net income	$ 1,006,489	$ 425,676
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	2,050,250	1,558,000
Deferred loan origination fees and costs, net	13,274	(62,493)
Realized loss on sale of foreclosed real estate	8,879	156,912
Provision for losses on foreclosed real estate	15,000	439,050
Depreciation and amortization	491,125	275,064
Stock-based compensation expense	163,729	152,797
Restricted stock awarded	(36,400)	36,400
Net increase in cash surrender value of life insurance	(100,216)	(99,964)
Net change in accrued interest receivable and other assets	(1,211,329)	(1,291,137)
Net change in accrued interest payable and other liabilities	472,210	99,944
NET CASH PROVIDED BY OPERATING ACTIVITIES	2,873,011	1,690,249
INVESTING ACTIVITIES		
Purchase of available-for-sale investment securities	(10,852,764)	(11,117,030)
Proceeds from maturity of available-for-sale investment securities	3,000,000	3,025,000
Proceeds from paydowns on mortgage-backed securities	2,553,483	2,414,082
Proceeds from sale of foreclosed real estate	302,500	918,107
Purchase of Federal Home Loan Bank stock	(196,400)	(143,800)
Net increase in loans	(9,053,843)	(9,704,087)
Purchases of premises and equipment	(141,665)	(171,117)
NET CASH USED BY INVESTING ACTIVITIES	(14,388,689)	(14,778,845)
FINANCING ACTIVITIES		
Net increase in deposits	24,323,752	21,690,135
Repurchase of restricted stock	(16,428)	
Proceeds from exercise of stock options		5,603
Proceeds from other borrowings	3,097,860	1,500,250
Repayments of other borrowings	(1,500,250)	(3,000,000)
Proceeds from the issuance of preferred stock		3,789,388
Dividends paid on preferred stock	(189,842)	(172,109)
NET CASH PROVIDED BY FINANCING ACTIVITIES	25,715,092	23,813,267
INCREASE IN CASH AND CASH EQUIVALENTS	14,199,414	10,724,671
Cash and cash equivalents at beginning of year	25,922,096	15,197,425
CASH AND CASH EQUIVALENTS AT END OF YEAR	$ 40,121,510	$ 25,922,096
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION		
Cash paid during the year for:		
Interest	$ 1,850,764	$ 2,239,089
Income taxes	$ 1,130,000	$ 281,600
SUPPLEMENTAL DISCLOSURES OF NONCASH ACTIVITIES		
Net change in unrealized gains/losses on available-for-sale investment securities	$ (191,510)	$ (7,904)
Net change in deferred income taxes on unrealized gains and losses on securities available-for-sale	$ (47,477)	
Loans transferred to foreclosed real estate		$ 1,840,448

The accompanying notes are an integral part of these financial statements.

NOTE A – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Business: Redwood Capital Bancorp (the Company), formed in 2007, is a bank holding company whose principal activity is the ownership and management of its wholly-owned subsidiary, Redwood Capital Bank (the Bank). The Bank was incorporated on November 3, 2003 and commenced operations on March 24, 2004. The Bank is subject to regulation, supervision, and regular examination by the California Department of Financial Institutions (CDFI) and the Federal Deposit Insurance Corporation (FDIC). The regulations of these agencies govern most aspects of the Bank's business.

Principles of Consolidation: The consolidated financial statements include the accounts of the Company and the Bank. All material intercompany accounts and transactions have been eliminated.

Nature of Operations: The Bank provides commercial, industrial, agricultural and personal credit and other banking services through its branches located in Eureka and Fortuna, California.

Use of Estimates: The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

The determination of the adequacy of the allowance for loan losses is based on estimates that are particularly susceptible to significant changes in the economic environment and market conditions. In connection with the determination of the estimated losses on loans, management obtains independent appraisals for significant collateral. The Company's loans are generally secured by specific items of collateral including real property, consumer assets, and business assets. Although the Company has a diversified loan portfolio, a substantial portion of its debtors' ability to honor their contracts is dependent on local economic conditions. While management uses available information to recognize losses on loans, further reductions in the carrying amounts of loans may be necessary based on changes in local economic conditions. Because of these factors, it is reasonably possible that the estimated losses on loans may change materially in the near term. However, the amount of the change that is reasonably possible cannot be estimated.

Investment Securities: Securities are classified as held-to-maturity if the Company has both the intent and ability to hold those debt securities to maturity regardless of changes in market conditions, liquidity needs or changes in general economic conditions. These securities are carried at cost, adjusted for amortization of premium and accretion of discount, computed by the interest method over their contractual lives.

Securities are classified as available-for-sale if the Company intends to hold those debt securities for an indefinite period of time, but not necessarily to maturity. Any decision to sell a security classified as available-for-sale would be based on various factors, including significant movements in interest rates, changes in the maturity mix of the Company's assets and liabilities, liquidity needs, regulatory capital considerations and other similar factors. Securities held as available-for-sale are carried at fair value. Unrealized holding gains or losses are reported as increases or decreases in shareholders' equity, net of the related deferred tax effect. Realized gains or losses, determined on the basis of the cost of specific securities sold, are included in earnings.

Loans: Loans are stated at the amount of unpaid principal reduced by net deferred loan fees. Loan origination fees, net of direct origination costs, are deferred and recognized as an adjustment of the yield on the related loan. Amortization of net deferred loan fees is discontinued when the loan is placed on nonaccrual status. Interest on loans is accrued and credited to income based on the principal amount outstanding.

NOTE A – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Allowance for Loan Losses: The allowance is maintained at a level which, in the opinion of management, is adequate to absorb probable losses inherent in the loan portfolio. Credit losses related to off-balance-sheet instruments are included in the allowance for loan losses. Management determines the adequacy of the allowance based upon reviews of individual loans, recent loss experience, current economic conditions, the risk characteristics of the various categories of loans and other pertinent factors. The allowance is based on estimates, and ultimate losses may vary from the current estimates. These estimates are reviewed monthly and, as adjustments become necessary, they are reported in earnings in the periods in which they become known. Loans deemed uncollectible are charged to the allowance. Provisions for loan losses and recoveries on loans previously charged off are added to the allowance.

All loans, except those to individuals, are considered impaired, based on current information and events, if it is probable that the Company will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Allowances on impaired loans are established based on the present value of expected future cash flows discounted at the loan's historical effective interest rate or, for collateral-dependent loans, on the fair value of the collateral. Cash receipts on impaired loans are used to reduce principal.

Income Recognition on Impaired and Nonaccrual Loans: Loans, including those considered impaired, are generally classified as nonaccrual if they are past due as to maturity or payment of principal or interest for a period of more than 90 days, unless such loans are well-secured and in the process of collection. If a loan or a portion of a loan is classified as doubtful or is partially charged off, the loan is classified as nonaccrual. Loans that are on a current payment status or past due less than 90 days may also be classified as nonaccrual if repayment in full of principal and/or interest is in doubt.

Loans may be returned to accrual status when all principal and interest amounts contractually due (including arrearages) are reasonably assured of repayment within an acceptable period of time, and there is a sustained period of repayment performance by the borrower, in accordance with the contractual terms of interest and principal.

While a loan is classified as nonaccrual and the future collectibility of the recorded balance is doubtful, collections of interest and principal are generally applied as a reduction to the principal outstanding. When the future collectibility of the recorded balance is expected, interest income may be recognized on a cash basis. In the case where a nonaccrual loan had been partially charged off, recognition of interest on a cash basis is limited to that which would have been recognized on the recorded balance at the contractual interest rate. Cash interest receipts in excess of that amount are recorded as recoveries to the allowance for loan losses until prior charge-offs have been fully recovered.

Premises and Equipment: Premises and equipment are stated at cost, less accumulated depreciation and amortization. The provision for depreciation and amortization is computed principally by the straight-line method over estimated useful lives of the related assets.

Foreclosed Real Estate: Foreclosed real estate includes both formally foreclosed property and in-substance foreclosed property. In-substance foreclosed properties are those properties for which the Company has taken physical possession, regardless of whether formal foreclosure proceedings have taken place. At the time of foreclosure, foreclosed real estate is recorded at the lower of the carrying amount or fair value less cost to sell, which becomes the property's new basis. Any write-downs based on the asset's fair value at date of acquisition are charged to the allowance for loan losses. After foreclosure, valuations are periodically performed by management and the real estate is carried at the lower of their new cost basis or fair value minus estimated costs to sell. Revenue and expenses from operations and subsequent adjustments to the carrying amount are included in other non-interest expenses.

NOTE A – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Investment in Federal Home Loan Bank Stock: As a member of the Federal Home Loan Bank (FHLB) System, the Bank is required to maintain an investment in capital stock of the FHLB. The investment exceeds the minimum requirement at December 31, 2010 and 2009. The investment is stated at cost in the accompanying balance sheets and is reported as part of other assets.

Income Taxes: Provisions for income taxes are based on amounts reported in the statements of operations (after exclusion of non-taxable income such as interest on state and municipal securities) and include deferred taxes on temporary differences in the recognition of income and expense for tax and financial statement purposes. Deferred taxes are computed using the asset and liability method. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of assets and liabilities and their respective tax basis. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. Deferred tax assets are recognized for deductible temporary differences and tax credit carryforwards, and then a valuation allowance is established to reduce that deferred tax asset if it is "more likely than not" that the related tax benefits may not be realized.

Net Income Per Share of Common Stock: Net income per share of common stock is computed by dividing net income by the weighted average number of shares of common stock outstanding during the year, after giving retroactive effect to stock dividends and splits. Net income per share assuming dilution is computed similar to net income per share except that the denominator is increased to include the number of additional common shares that would have been outstanding if the dilutive potential common shares had been issued. Included in the denominator is the dilutive effect of stock options computed under the treasury method.

Advertising: Advertising costs are charged to operations in the year incurred.

Off-Balance-Sheet Financial Instruments: In the ordinary course of business the Company has entered into off-balance sheet financial instruments consisting of commitments to extend credit and standby letters of credit. Such financial instruments are recorded in the financial statements when they become payable.

Stock Option Accounting: The Company has a stock-based employee and director compensation plan which is described more fully in Note L. The Company applies the fair value recognition provisions of FASB ASC 718, *Accounting for Stock-Based Compensation*. Accordingly, compensation cost for stock options is measured based on the grant-date fair value and is recognized in the income statement. Awards under the Company's plan generally vest over five years.

Operating Segments: Reportable segments are based on products and services, geography, legal structure, management structure and any other manner in which management desegregates a company for making operating decisions and assessing performance. The Company has determined that its business is comprised of a single operating segment.

Cash and Cash Equivalents: For the purpose of presentation in the Statement of Cash Flows, cash and cash equivalents are defined as those amounts included in the balance sheet caption "Cash and due from banks" and "Federal funds sold."

Subsequent events: The Company evaluated all events or transactions that occurred after December 31, 2010 and up to March 28, 2011, the date the financial statements were issued. During this period, the Company did not have any recognizable or nonrecognizable subsequent events.

NOTE B – INVESTMENT SECURITIES

The amortized cost and approximate fair value of investment securities are summarized as follows:

	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
December 31, 2010				
Securities Available-for-Sale				
U.S. government agency securities	$ 8,220,246	$ 25,292	$ (329,740)	$ 7,915,798
Mortgage-backed securities	2,152,927	133,903		2,286,830
Collateralized mortgage obligations	10,420,125	301,418	(15,512)	10,706,031
Total	$ 20,793,298	$ 460,613	$ (345,252)	$ 20,908,659
December 31, 2009				
Securities Available-for-Sale				
U.S. government agency securities	$ 4,159,724	$ 33,806		$ 4,193,530
Mortgage-backed securities	3,332,309	179,737		3,512,046
Collateralized mortgage obligations	8,199,919	126,734	$ (80,881)	8,245,772
Total	$ 15,691,952	$ 340,277	$ (80,881)	$ 15,951,348

The maturities of investment securities at December 31, 2010 were as follows:

	Available-for-Sale	
	Amortized Cost	Fair Value
Due from one year to five years	$ 605,453	$ 623,580
Due from five years to ten years	4,685,105	4,658,452
Due after ten years	15,502,740	15,626,627
	$ 20,793,298	$ 20,908,659

The amortized cost and fair value of mortgage-backed securities and collateralized mortgage obligations are presented by contractual maturity in the preceding table. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations without call or prepayment penalties.

Investment securities with an amortized cost of $11,626,329 and a fair value of $11,877,304 at December 31, 2010 were pledged to secure public deposits. Investment securities with an amortized cost of $5,745,304 and a fair value of $5,839,958 at December 31, 2009 were pledged to secure public deposits.

NOTE B – INVESTMENT SECURITIES (Continued)

The following table shows the investments' gross unrealized losses and fair value, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, at December 31, 2010 and 2009.

	2010		2009	
	Less than 12 Months		Less than 12 Months	
Description of Securities	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
U.S. government agency securities	$ 6,727,770	$ (329,740)		
Collateralized mortgage obligations	1,534,078	(15,512)	$ 4,306,047	$ (80,881)
	$ 8,261,848	$ (345,252)	$ 4,306,047	$ (80,881)

There were four U.S. government agency securities and one collateralized mortgage obligation that were in a loss position as of December 31, 2010. There were three collateralized mortgage obligations that were in an unrealized loss position as of December 31, 2009. The unrealized losses on these securities were caused by interest rate increases. The contractual terms of these investments do not permit the issuer to settle the securities at a price less than the par value of the investment. Because the Company has the ability and intent to hold these investments until a recovery of fair value, which may be maturity, the Company does not consider these investments to be other-than-temporarily impaired at December 31, 2010 and 2009.

NOTE C – LOANS, NET

Major classifications of loans at December 31 are summarized as follows:

	2010	2009
Real estate – mortgage	$ 26,871,751	$ 23,495,001
Real estate – commercial	57,614,669	58,580,412
Construction loans	7,396,864	5,189,932
Commercial	23,793,015	21,997,703
Agricultural	358,209	429,254
Installment and other loans to individuals	27,951,487	26,989,921
	143,985,995	136,682,223
Net deferred loan fees and costs	(18,194)	(4,645)
Allowance for loan losses	(2,768,227)	(2,468,323)
	$ 141,199,574	$ 134,209,255

The Company receives fees for servicing retained on loans sold. Loans being serviced by the Company for others totaled approximately $8,768,104 and $4,089,445 for the years ended December 31, 2010 and 2009, respectively.

NOTE C – LOANS, NET (continued)

The maturity and repricing of the loan portfolio is as follows at December 31:

	2010	2009
Fixed rate loan maturities		
Three months or less	$ 808,592	$ 1,033,526
Over three months to twelve months	4,020,492	2,342,044
Over one year to five years	9,983,310	10,726,459
Over five years to fifteen years	5,594,489	5,879,919
Over fifteen years	3,637,265	1,780,803
Floating rate loans repricing		
Quarterly or more frequently	55,039,813	47,482,999
Quarterly to annual frequency	14,968,746	14,488,981
One to five years frequency	45,522,188	47,495,153
Five to fifteen years frequency	3,761,941	4,730,699
Non-accrual loans	649,159	721,640
	$ 143,985,995	$ 136,682,223

NOTE D – ALLOWANCE FOR LOAN LOSSES AND CREDIT QUALITY

The Company's methodology for assessing the appropriateness of the allowance consists of three key elements, which include the general allowance, the specific allowance and an allowance for changing environmental factors. These various components are factored into a single allowance analysis.

General Allowance: The determination of general allowance is based on estimates made by management, including but not limited to, consideration of historical losses by portfolio segment, peer bank losses, analysis of the economy, market, rate environment, underwriting standards and other criteria as identified by the credit administrator. The portfolio segments include commercial real estate, construction, single family residential, home equity lines of credit, agricultural land, commercial, agricultural loans/lines and consumer. In addition, the Company segregates each of these segments into local and out-of-area loans. Local refers to properties located in Humboldt, Del Norte and Trinity counties, and out-of-area refers to properties located outside of the tri-county area. Peer bank loss information is used for loans that are out-of-area. The general allowance consists of reserve factors that are based on charge-off history and management's assessment of each portfolio segment. These reserve factors are inherently subjective and are driven by the repayment risk associated with each portfolio segment described below:

Real estate commercial—These loan generally possess a higher inherent risk of loss than other real estate portfolio segments, except construction loans. Adverse economic developments or an overbuilt market impact commercial real estate projects and may result in troubled loans. Trends in vacancy rates of commercial properties impact the credit quality of these loans. High vacancy rates reduce operating revenues and the ability for properties to produce sufficient cash flow to service debt obligations.

Real estate mortgage—The loans consist of single family residential loans and home equity lines of credit. The degree of risk in residential real estate lending depends primarily on the loan amount in relation to collateral value, the interest rate and the borrower's ability to repay in an orderly fashion. These loans generally possess a lower inherent risk of loss than other real estate portfolio segments. Economic trends determined by unemployment rates and other key economic indicators are closely correlated to the credit quality of these loans. Weak economic trends indicate that the borrowers' capacity to repay their obligations may be deteriorating.

NOTE D – ALLOWANCE FOR LOAN LOSSES AND CREDIT QUALITY (Continued)

Construction—Construction loans generally possess a higher inherent risk of loss than other real estate portfolio segments. A major risk arises from the necessity to complete projects within specified cost and time lines. Trends in the construction industry significantly impact the credit quality of these loans, as demand drives construction activity. In addition, trends in real estate values significantly impact the credit quality of these loans, as property values determine the economic viability of construction projects.

Commercial—Commercial loans generally possess a lower inherent risk of loss than real estate portfolio segments because these loans are generally underwritten to existing cash flows of operating businesses. Debt coverage is provided by business cash flows and economic trends influenced by unemployment rates and other key economic indicators are closely correlated to the credit quality of these loans.

Agriculture—Loans secured by agricultural land and production are especially vulnerable to two risk factors that are largely outside the control of the Company and borrowers, commodity prices and weather conditions.

Installment and other loans to individuals—The installment loan portfolio is comprised of a large number of small loans scheduled to be amortized over a specific period. Most installment loans are made directly for consumer purchases, but business loans granted for purchase of heavy equipment or industrial vehicles may also be included.

Specific Allowance: Regular credit reviews of the portfolio also identify loans that are considered potentially impaired. A loan is considered impaired when, based on current information and events, the Company determines that they will probably not be able to collect all amounts due according to the loan contract, including scheduled interest payments. When the Company identifies a loan as impaired, they measure the impairment using discounted cash flows, except when the sole remaining source of repayment for the loans is the liquidation of the collateral. In these cases, they use the current fair value of the collateral, less selling costs. If the Company determines that the value of the impaired loan is less than the recorded investment in the loan, they either recognize an impairment reserve as a specific allowance to be provided for in the allowance or charge-off the impaired balance on collateral dependent loans if it is determined that such amount represents a confirmed loss. Loans determined to be impaired with a specific allowance are excluded from the general allowance so as not to double-count the loss exposure.

Qualitative factors: This component of the allowance is management's best estimate of the probable impact that various qualitative factors may have on the loan portfolio. It is not allocated to specific loans or groups of loans, but rather is intended to absorb losses caused by several factors, including changes in the nature and volume of the portfolio, changes in the terms of loans, changes in lending policies and procedures, underwriting collection practices, changes in international, national, regional, and local economic and business conditions, changes in the experience and ability of lending management and staff, changes in the volume and severity of past due loans, changes in the volume of non-accrual loans, changes in the volume and severity of adversely classified or graded loans, changes in the quality of the Company's loan review system, changes in the value of underlying collateral, the existence and effect of any concentrations of credit, changes in the level of concentrations of credit and the effect of other external factors such as competition and legal and regulatory requirements.

Although management believes the allowance to be adequate, ultimate losses may vary from its estimates. The Board of Directors review the adequacy of the allowance quarterly, including consideration of current economic conditions, known and inherent risks in the portfolio, adverse situations that may affect the borrower's ability to repay, the estimated value of any underlying collateral, or past loan experience and other factors. If the Board of Directors and management determine that changes are warranted based on those reviews, the allowance is adjusted. In addition, the Company's primary regulators, the FDIC and the DFI, review the adequacy of the allowance as an integral part of their examination process. These regulatory agencies may require additions to the allowance based on their judgment about information available at the time of their examinations.

NOTE D – ALLOWANCE FOR LOAN LOSSES AND CREDIT QUALITY (Continued)

The following table summarizes activity related to the allowance for loan losses by loan portfolio segment and the allocation of the allowance for loan losses by loan portfolio segment and by impairment methodology for the year ended December 31, 2010:

	Real estate - mortgage	Real estate - commercial	Construction loans	Commercial	Agricultural	Installment and Other loans to individuals	Unallocated and Qualitative Factors	Total
Allowance for credit losses:								
Beginning balance	$ 436,696	$ 120,340	$ 88,757	$ 283,808	$ 11,746	$ 91,371	$ 1,435,605	$ 2,468,323
Charge-offs	(198,055)	-	-	(1,610,250)	-	(24,801)	-	(1,833,106)
Recoveries	594	28,186	31,268	22,712	-	-	-	82,760
Provision	(45,091)	219,137	(49,009)	1,402,811	(11,746)	11,351	522,798	2,050,251
Ending balance	$ 194,144	$ 367,663	$ 71,016	$ 99,081	$ -	$ 77,921	$ 1,958,403	$ 2,768,228
Ending balance: Individually evaluated for impairment	$ 149,767	$ 290,639	$ -	$ 82,772	$ -	$ 75,000	$ -	$ 598,178
Ending balance: Collectively evaluated for impairment	$ 44,377	$ 77,024	$ 71,016	$ 16,309	$ -	$ 2,921	$ 1,958,403	$ 2,170,050
Loans:								
Ending balance	$ 26,871,751	$ 57,614,669	$ 7,396,864	$ 23,793,015	$ 358,209	$ 27,951,487		$ 143,985,995
Ending balance: Individually evaluated for impairment	$ 289,260	$ 921,140		$ 390,302		$ 74,971		$ 1,675,672
Ending balance: Collectively evaluated for impairment	$ 26,582,491	$ 921,140	$ 7,396,864	$ 23,402,713	$ 358,209	$ 27,876,516	$	$ 142,310,323

Changes in the allowance for loan losses were as follows for the year ended December 31, 2009:

	2009
Beginning balance	$ 1,542,216
Provision for loan losses	1,558,000
Loans charged off	(653,071)
Loan recoveries	21,178
Ending balance	$ 2,468,323

Credit Quality of Loans

The Company assigns a risk rating to loans over a certain threshold and periodically performs detailed reviews of all such loans to identify credit risks and to assess the overall collectability of the portfolio. During these internal reviews, management monitors and analyzes the financial condition of borrowers and guarantors, trends in the industries in which borrowers operate and the fair values of collateral securing these loans. These credit quality indicators are used to assign a risk rating to each individual loan. These risk ratings can be grouped into the following major categories, defined as follows:

Pass: A pass loan is a strong credit with no existing or known potential weaknesses deserving of management's close attention.

Watch List: A watch list loan has significant weaknesses resulting from performance trends or management concerns.

NOTE D – ALLOWANCE FOR LOAN LOSSES AND CREDIT QUALITY (Continued)

Special Mention: A substandard loan is currently protected, but is weak due to negative trends in the financial statements of the borrower and current cash flow problems, among other criteria. Special mention loans are not adversely classified and do not expose the Company to sufficient risk to warrant adverse classification.

Substandard: A substandard loan has well-defined weaknesses where a payment default and/or a loss is possible, but not yet probable. Cash flow is insufficient to service the debt, with prospects that the condition is permanent. Loans classified as substandard are inadequately protected by the current net worth and paying capacity of the borrower and there is a likelihood that collateral will have to be liquidated and/or guarantor called upon to repay the debt.

Doubtful: Loans classified as doubtful have characteristics of those classified as substandard but available information suggests it is unlikely that the loan will be repaid in its entirety. Cash flow is insufficient to service the debt. If the current material adverse trends continue, it is unlikely the borrower will have the ability to meet the terms of the loan agreement. It may be difficult to project the exact amount of loss, but the probability of some loss is greater than 50%.

Loss: Loans classified as loss have characteristics those classified as of doubtful but the loan will not be repaid in full. Debt service coverage clearly reflects the borrower's inability to service the debt. The borrower cannot generate sufficient cash flow to cover fixed charges. All near-term and long-term trends concerning cash flow and earnings are negative. Collateral and guarantees provide no support.

The following table shows the loan portfolio allocated by management's internal risk ratings at December 31, 2010:

	Real estate - mortgage	Real estate - commercial	Construction loans	Commercial	Agricultural	Installment and other loans to individuals	Total
Grade:							
Pass	$ 22,917,850	$ 49,325,276	$ 6,603,826	$ 18,520,471	$ 358,209	$ 27,836,708	$ 125,562,340
Watch	2,898,899	3,808,335		1,994,931			8,702,165
Special Mention	189,466	2,611,277		916,549			3,717,292
Substandard	865,536	1,869,781	793,038	2,170,986		114,779	5,814,120
Doubtful				190,078			190,078
Total	$ 26,871,751	$ 57,614,669	$ 7,396,864	$ 23,793,015	$ 358,209	$ 27,951,487	$ 143,985,995

The following table summarizes the Company's past due loans and non-accrual loans by loan portfolio segment as of December 31, 2010:

	30-59 Days Past Due	60-89 Days Past Due	Greater than 90 Days	Total Past Due	Nonaccrual	Current	Total Loans
Real Estate - Mortgage	$ 75,451	$ 226,033	$ 22,767	$ 324,251	$ 289,260	$ 26,258,240	$ 26,871,751
Real Estate - Commercial					190,078	57,424,591	57,614,669
Construction Loans						7,396,864	7,396,864
Commercial	87,099			87,099	169,821	23,536,095	23,793,015
Agricultural						358,209	358,209
Installment and other loans to Individuals						27,951,487	27,951,487
Total	$ 162,550	$ 226,033	$ 22,767	$ 411,350	$ 649,159	$ 142,925,486	$ 143,985,995

There were no accruing loans past due 90 days or more at December 31, 2010 or 2009.

NOTE D – ALLOWANCE FOR LOAN LOSSES AND CREDIT QUALITY (Continued)

The following table shows information related to impaired loans by loan portfolio segment as of December 31, 2010 and 2009:

	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
2010					
With no related allowance recorded:					
Real Estate - Commercial	$ 557,706	$ 553,248		$ 467,358	$ 46,813
Commercial	248,367	194,854		132,325	1,540
With an allowance recorded:					
Real Estate - Mortgage	345,364	289,260	$ 149,767	17,934	
Real Estate - Commercial	398,372	367,892	290,639	400,292	21,421
Commercial	194,318	195,448	82,772	216,559	19,638
Installment	74,798	74,971	75,000	43,683	4,067
Total:					
Real Estate - Mortgage	345,364	289,260	149,767	17,934	
Real Estate - Commercial	956,078	921,140	290,639	867,650	68,234
Commercial	442,685	390,302	82,772	348,884	21,178
Installment	74,798	74,971	75,000	43,683	4,067
Total	$ 1,818,925	$ 1,675,673	$ 598,178	$ 1,278,151	$ 93,479
2009					
With no related allowance recorded:					
Real Estate - Mortgage	$ 31,855	$ 32,784		$ 193,201	$ 3,548
Real Estate - Commercial	184,915	186,491		1,367,283	19,803
Commercial	113,102	100,309		76,226	
Installment				19,959	
With an allowance recorded:					
Real Estate - Mortgage	659,455	654,104	$ 25,000	328,578	19,269
Real Estate - Commercial	217,296	198,805	54,400	105,074	
Commercial	155,061	156,463	107,564	99,953	12,986
Total:					
Real Estate - Mortgage	691,310	686,888	25,000	521,779	22,817
Real Estate - Commercial	402,211	385,296	54,400	1,472,357	19,803
Commercial	268,163	256,772	107,564	176,179	12,986
Installment	-	-	-	19,959	
Total	$ 1,361,684	$ 1,328,956	$ 186,964	$ 2,190,274	$ 55,606

NOTE E – PREMISES AND EQUIPMENT

Premises and equipment consisted of the following at December 31:

	2010	2009
Land	$ 800,000	$ 800,000
Building and improvements	3,959,218	3,934,839
Furniture, fixtures and equipment	1,191,722	1,074,437
	5,950,940	5,809,276
Less: Accumulated depreciation	(1,733,576)	(1,440,389)
	$ 4,217,364	$ 4,368,887

Depreciation and amortization included in occupancy expense totaled $293,187 and $303,297 in 2010 and 2009, respectively.

NOTE F – INTEREST-BEARING DEPOSITS

Interest-bearing deposits consisted of the following at December 31:

	2010	2009
Negotiable order of withdrawal (NOW)	$ 37,486,085	$ 38,188,848
Savings and money markets	67,413,139	56,461,880
Time, $100,000 and over	26,790,716	19,074,828
Other time	29,244,235	30,456,858
	$ 160,934,175	$ 144,182,414

Interest expense on these deposits for the years ended December 31 is as follows:

	2010	2009
Negotiable order of withdrawal (NOW)	$ 331,211	$ 440,526
Savings and money markets	688,303	660,517
Time, $100,000 and over	372,957	482,738
Other time	353,410	599,369
	$ 1,745,881	$ 2,183,150

The maturities of time deposits at December 31 are as follows:

	2010	2009
Three months or less	$ 19,810,973	$ 21,638,180
Over three months through twelve months	27,387,989	24,022,415
Over one year through three years	8,481,167	3,545,911
Over three years	354,822	325,180
	$ 56,034,951	$ 49,531,686

NOTE G – LENDING AGREEMENTS

The Company has federal funds line of credit agreements with other banks. The maximum borrowings available under these lines amount to $9,000,000 at December 31, 2010 and 2009. There were no borrowings outstanding under these agreements at December 31, 2010 and 2009.

The Company has an agreement to borrow from the Federal Home Loan Bank to the extent of pledged assets, up to 15% of total assets. Assets pledged under the agreement at December 31, 2010 totaled $212,917,387, resulting in a limit on borrowings of $31,937,608. Assets pledged under the agreement at December 31, 2009 totaled $186,294,277, resulting in a limit on borrowings of $27,944,142. The Company also maintains a letter of credit with the Federal Home Loan Bank of $7,000,000 and $1,300,000, as of December 31, 2010 and 2009, respectively, which serves as collateral for public and other deposits and is collateralized by a portion of the loans discussed above. No amounts were outstanding under this agreement as of December 31, 2010 and 2009.

The Company has an agreement to borrow from the Federal Reserve Bank by obtaining advances or discounting eligible paper to the extent of pledged collateral. Promissory notes and deeds of trust on the Bank's loans totaling $6,697,821 were held by the Federal Reserve Bank as collateral. There were no borrowings outstanding under this agreement at December 31, 2010 and 2009.

The Company has an agreement to borrow from another financial institution for $3,100,000. Interest on the outstanding balance is calculated at a variable rate equal to the prime rate. The interest rate at December 31, 2010 and 2009 was 3.25%. Consecutive interest payments are required for 24 months beginning February 5, 2009 through February 5, 2011, after which principal and interest payments are due through January 5, 2021. The outstanding principal balance at December 31, 2010 was $3,097,860 and at December 31, 2009 was $1,500,250.

NOTE H – OTHER EXPENSES

Other expenses consisted of the following for the years ended December 31:

	2010	2009
Data processing	$ 442,013	$ 447,613
Insurance expense	508,050	431,036
Professional fees	301,171	313,023
Director and shareholder	192,641	85,008
Marketing and promotion	185,631	148,257
Operating expense	143,321	173,040
Loan and collection expense	80,490	102,536
Miscellaneous employee expense	80,086	33,990
Stationary and forms	60,630	54,817
Postage and delivery	56,962	54,109
Telephone expense	44,132	48,483
Dues and memberships	31,669	31,181
Operational losses	14,079	3,144
Subscriptions	6,665	4,096
Security expense	2,642	3,256
Other non-interest expense	225	1,101
	$ 2,150,407	$ 1,934,690

NOTE I – PREFERRED STOCK

On January 16, 2009, the Company completed the issuance of $3,800,000 of Series A preferred stock and related warrant for Series B preferred stock under the U.S. Department of Treasury's Capital Purchase Program and issued 3,800 shares of Series A preferred stock and a warrant to acquire 190 shares of Series B preferred stock for the aggregate purchase price (collectively the "Preferred Stock"). The warrant was exercised immediately and the 190 shares issued. The Series A preferred stock has a cumulative dividend of 5% per annum for five years and, unless redeemed, 9% thereafter. The liquidation amount is $1,000 per share. The Series B preferred stock pay a dividend of 9%. The Preferred Stock has no maturity date and ranks senior to the Company's common stock with respect to the payment of dividends and distributions and amounts payable upon liquidation, dissolution and winding up of the Company. The Preferred Stock is generally non-voting, other than class voting on certain matters that could adversely affect the Preferred Stock. Preferred stock dividends totaled $207,100 and $189,267 in 2010 and 2009, respectively.

NOTE J – RETIREMENT PLANS

The Company has a defined contribution retirement plan covering substantially all of the Company's employees. Employees may elect to have a portion of their compensation contributed to the plan in conformity with the requirements of Section 401(k) of the Internal Revenue Code. The Company will make contributions equal to 100% of the effective deferral made by the employees, up to a maximum of 4% of the employees' eligible earnings. Salaries and employee benefits expense includes the Company's contributions to the plan of $79,000 and $84,000 during 2010 and 2009, respectively.

The Company purchased single premium life insurance policies in 2006 in connection with the implementation of retirement plans for two key officers. The policies provide protection against the adverse financial effects from the death of key officers and to provide income to offset expenses associated with the plan. The officers are insured under the policies, but the Company is the owner and beneficiary. At December 31, 2010 and 2009, the cash surrender value of these policies totaled $2,498,720 and $2,398,504, respectively.

The Company has a retirement plan that is unfunded, which provides for the Company to pay the officers specified amounts for specified periods after retirement and allow them to defer a portion of current compensation in exchange for the Company's commitment to pay a deferred benefit at retirement. Directors are also eligible to participate in the deferred compensation plan. If death occurs prior to or during retirement, the Company will pay the officer's beneficiary or estate the benefits set forth in the plan. Deferred compensation is vested as to the amounts deferred. Liabilities are recorded for the estimated present value of future salary continuation benefits. At December 31, 2010 and 2009, the liability recorded for the executive officer supplemental retirement plan totaled $112,421 and $94,718, respectively. The amount of expense related to this plan for 2010 and 2009 was $17,703 and $35,505, respectively. At December 31, 2010, the liability recorded for the deferred compensation plan totaled $34,300.

NOTE K – INCOME TAXES

The provision for income taxes for 2010 and 2009 is comprised of the following:

	2010	2009
Current		
Federal	$ (58,313)	$ 436,216
State	443,088	40,042
	384,775	476,258
Deferred		
Federal	(9,192)	(268,285)
State	(49,556)	(140,204)
	(58,748)	(408,489)
Change in valuation allowance	(589,935)	(66,169)
(Benefit) provision for income taxes	$ (263,908)	$ 1,600

The following is a reconciliation of income taxes computed at the Federal statutory rate of 34% to the effective rate used for the provision for income taxes for the years ended December 31:

	2010	2009
Income benefit at the Federal statutory rate	$ 257,464	$ 145,274
State franchise tax benefit, less Federal income tax effect	54,177	30,569
Incentive stock option expense	2,387	2,183
Valuation allowance change	(589,935)	(66,169)
Interest on enterprise zone loans exempt from State tax	(77,355)	(77,355)
Earnings on cash surrender value of life insurance	(37,776)	(46,422)
Nondeductible expenses and other	127,130	13,520
Net (benefit) provision for income taxes	$ (263,908)	$ 1,600

NOTE K– INCOME TAXES (Continued)

The expected tax expense shown above that would result from applying Federal and State statutory rates to the pretax loss differs from amounts reported in the financial statements primarily because the valuation allowance increased to offset the impact of operating loss carryforwards and other temporary differences until such time as realization becomes more likely than not. The tax effects of temporary differences that give rise to the components of the net deferred tax assets as of December 31 were as follows:

	2010	2009
Deferred tax assets:		
Allowance for loan losses	$ 770,689	$ 735,025
Net operating loss carryforwards	189,733	170,536
Nonstatutory stock option expense	155,864	121,533
Deferred tax on AFS securities	47,477	106,752
Non-qualified restricted stock	76,775	51,290
Salary continuation accrual	45,803	38,981
Allowance for loan commitments	24,693	24,693
Accrued vacation	13,534	13,534
Organizational costs	9,452	10,286
Enterprise zone credits	5,280	
Non-accrual interest	1,233	1,233
Other	544	13,612
Foreclosed real estate		101,672
Total deferred tax assets	1,341,077	1,389,147
Valuation allowance for deferred tax assets	(242,363)	(832,298)
Deferred tax assets recognized	1,098,714	556,849
Deferred tax liabilities:		
Adjustment to cash basis		(48,895)
Federal Home Loan Bank dividends	(24,940)	(24,940)
Depreciation	(6,722)	(6,723)
Discount accretion	(6,177)	(4,826)
Total deferred tax liabilities	(37,839)	(85,384)
Net deferred tax assets	$ 1,060,875	$ 471,465

Amounts presented for the tax effects of temporary differences are based upon estimates and assumptions and could vary from amounts ultimately reflected on the Company's tax returns. Accordingly, the variances from amounts reported in prior years are primarily adjustments to conform to the tax returns as filed. The Company had income tax receivable at $660,512 at December 31, 2010 and an income taxes payable of $196,119 at December 31, 2009.

The Company and its subsidiary file an income tax return in the U.S. federal jurisdiction and a franchise tax return in the State of California jurisdiction. The Company is no longer subject to U.S. federal income tax examinations and State franchise tax examinations by taxing authorities for years prior to 2007 and 2006, respectively.

FASB ASC 740-10 clarifies the accounting for income taxes, by prescribing a minimum recognition threshold a tax position taken or expected to be taken in a tax return is required to meet before being recognized in the financial statements. The Company adopted provisions of FASB ASC 740-10, on January 1, 2007. There have been no adjustments identified for unrecognized tax benefits requiring an adjustment to the income statement since this pronouncement was implemented. The Company recognizes interest accrued and penalties related to unrecognized tax benefits in tax expense. The Company has recognized no interest or penalties since this pronouncement was implemented.

NOTE K– INCOME TAXES (Continued)

The Company recognizes interest accrued and penalties related to unrecognized tax benefits in tax expense. During the years ended December 31, 2010 and 2009, the Company recognized no interest and penalties.

As of December 31, 2010, the Company had federal and state net operating loss carryforwards available to reduce future taxable income as follows:

	Net Operating Loss Carryforward	Expiration Date
State	$ 1,716,804	2014
	520,003	2015
	120,860	2016
	257,772	2021
	$ 2,615,439	

As of December 31, 2010 and 2009, the Company also had state contribution carryforwards of $36,533 and $25,979, respectively, which expire in 2011 through 2012.

NOTE L– EARNINGS PER SHARE

The following is a computation of basic and diluted earnings per share for the years ended December 31, 2010 and 2009.

	2010	2009
Basic:		
Net income	$ 1,006,489	$ 425,676
Weighted-average common shares outstanding	1,744,010	1,732,399
Earnings per share	$ 0.58	$ 0.25
Diluted:		
Net income	$ 1,006,489	$ 425,676
Weighted-average common shares outstanding	1,744,010	1,732,399
Net effect of dilutive stock options - based on the Treasury stock method using average market price	10,503	27,602
Weighted-average common shares outstanding and common stock equivalents	1,754,513	1,760,001
Earnings per share - assuming dilution	$ 0.57	$ 0.24

NOTE L– EARNINGS PER SHARE (Continued)

Options to purchase 24,000 shares of common stock at $13.33 to $14.67 per share and 81,722 shares of restricted stock were outstanding during 2010 but were not included in the computation of diluted earnings per share because the options' exercise price and stock issuance price was greater than the average market price of the common shares. Options to purchase 24,000 shares of common stock at $13.33 to $14.67 per share and 95,230 shares of restricted stock were outstanding during 2009 but were not included in the computation of diluted earnings per share because the options' exercise price and stock issuance price was greater than the average market price of the common shares.

NOTE M – STOCK OPTION PLAN

The Company has a stock option plan established in 2004 under which incentive and nonstatutory stock options and restricted stock may be granted. The Company's Stock Option Plan provides for the granting of a maximum of 495,000 shares of the Company's common stock to directors, key employees and consultants at an exercise price not less than the fair market value of the shares on the date of grant and for a term of no more than 10 years. Options granted vest at a rate of 20% per year over five years from the date the option is granted. Generally, if an optionee's continuous status as a director, employee or consultant is terminated for various reasons, the nonvested options expire.

A summary of stock option activity follows for the years ended December 31:

	Stock Options			
	2010		2009	
	Weighted-Average Exercise Price	Shares	Weighted-Average Exercise Price	Shares
Shares under option at beginning of year	$ 7.37	249,080	$ 7.37	249,920
Options exercised			6.67	(840)
Shares under option at end of year	7.37	249,080	7.37	249,080
Options exercisable at end of year		248,503		244,719

Following is the intrinsic value and weighted-average contractual term of stock options outstanding for the years ended December 31:

	Stock Options	
	2010	2009
Intrinsic value:		
Outstanding shares	-	$ 70,518
Exercisable shares	-	70,518
Weighted-average remaining contractual term:		
Outstanding shares	3.29 years	4.29 years
Exercisable shares	3.28 years	4.26 years

Upon the exercise of stock options, new shares are issued. No stock options were exercised in 2010 and the total amount of cash received from the exercise of stock options during 2009 was $5,603. There were no tax benefits realized from the stock options exercised during 2009.

NOTE M – STOCK OPTION PLAN

A summary of the status of the Company's nonvested shares as of December 31, and changes during the years ended December 31, is presented below:

Nonvested Shares	2010 Weighted-Average Grant Date Fair Value	2010 Shares	2009 Weighted-Average Grant Date Fair Value	2009 Shares
Nonvested at beginning of year	$ 4.07	4,361	$ 2.78	17,672
Vested	3.99	(3,784)	2.33	(13,311)
Nonvested at end of year	4.57	577	4.07	4,361

As of December 31, 2010 and 2009, there was $3,052 and $23,381 of total unrecognized compensation cost related to nonvested stock options granted under the Plan. That cost is expected to be recognized over a weighted-average period of 0.20 years and 1.05 years, respectively. The total fair value of shares vested during the years ended December 31, 2010 and 2009, was $15,100 and $31,081, respectively.

A summary of restricted stock activity follows for the years ended December 31:

	Restricted Stock					
	2010			2009		
	Shares	Weighted-Average Grant Date Fair Value	Aggregate Intrinsic Value	Shares	Weighted-Average Grant Date Fair Value	Aggregate Intrinsic Value
Nonvested at beginning of year	95,230	$ 8.58		16,850	$ 12.20	
Granted	2,608	6.99		82,080	8.00	
Shares vested and issued	(16,116)	8.97		(3,700)	12.22	
Nonvested at end of year	81,722	8.45	$ 449,471	95,230	8.58	$ 664,705

As of December 31, 2010 and 2009, there was $567,481 and $700,273 of total unrecognized compensation cost related to nonvested restricted stock. That cost is expected to be recognized over a weighted-average period of 5.22 and 5.94 years, respectively.

Total compensation cost for all share-based payments recognized in net income for 2010 and 2009 totaled $163,729 and $152,797, respectively. A tax benefit of $67,374 was recognized during 2010 related to this compensation cost.

NOTE N – RELATED PARTY TRANSACTIONS

During the normal course of business, the Company has entered into transactions with its directors, executive officers, significant shareholders and their affiliates (related parties). The aggregate amount of loans to such related parties totaled $4,880,236 and $4,018,205 at December 31, 2010 and 2009, respectively. At December 31, 2010 and 2009, commitments to related parties of $2,702,019 and $2,397,910, respectively, were undisbursed. The Company has received deposits from directors and officers and their related interests totaling $5,344,529 and $3,654,961 at December 31, 2010 and 2009, respectively.

In addition, during 2009, the Company contracted with one of its directors to remodel the basement of their building. The total cost of this remodel was $79,622. The Company also entered into a lease agreement with another director's business late in 2009 as the landlord for two office spaces. The total rent received for 2010 was $29,174 and for 2009 was $3,802.

NOTE O – CONTINGENT LIABILITIES AND COMMITMENTS

Financial Instruments with Off-Balance-Sheet Risk: The Company's financial statements do not reflect various commitments and contingent liabilities which arise in the normal course of business and which involve elements of credit risk, interest rate risk and liquidity risk. These commitments and contingent liabilities are commitments to extend credit and standby letters of credit. A summary of the Company's commitments and contingent liabilities at December 31, 2010 and 2009 are as follows:

	Contractual Amounts	
	2010	2009
Commitments to extend credit	$ 36,348,571	$ 38,381,030
Standby letters of credit	28,500	210,385

Commitments to extend credit and standby letters of credit include exposure to some credit loss in the event of nonperformance of the customer. The Company's credit policies and procedures for credit commitments and financial guarantees are the same as those for extension of credit that are recorded on the balance sheet. Because most of these instruments have fixed maturity dates, and because many of them expire without being drawn upon, they do not generally present any significant liquidity risk to the Company.

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. The Company evaluates each customer's credit worthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Company upon extension of credit, is based on management's credit evaluation of the customer. Collateral held varies but may include accounts receivable, inventory, deeds of trust on residential real estate and income-producing commercial properties.

Standby letters of credit are conditional commitments issued by the Company to guarantee the performance of a customer to a third party. Those guarantees are primarily issued to support public and private borrowing arrangements. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending facilities to customers.

The Company did not incur any losses on its commitments in 2010 and 2009.

NOTE P – CONCENTRATIONS OF CREDIT RISK

Most of the Company's business activity is with customers located within the State of California, primarily in and around the City of Eureka. Most of the Company's loans have been granted to customers in the Company's market area. General economic conditions or natural disasters affecting the primary market area could affect the ability of customers to repay loans and the value of real property used as collateral. The loans are expected to be repaid from

NOTE P – CONCENTRATIONS OF CREDIT RISK (Continued)

cash flow or proceeds from the sale of selected assets of the borrowers. The Company requires that all loans have adequate collateral to secure the loan or that the borrower has evidence of sufficient cash flows to repay loans when the loans are made. All collateral must have an appraisal, if applicable, and collateral is generally secured by liens. The Company's access to this collateral is through judicial procedures.

The concentrations of credit by type of loan are set forth in Note C. Approximately 76% of the Company's loans are collateralized by real estate in the Company's service area. The National Banking Laws, Title 12 of the United States Code, generally restricts loans to a single borrower or group of related borrowers and investments by the Company to 15% of the sum of the Company's equity capital plus the allowance for loan losses, subject to certain adjustments. The Company evaluates each customer's credit worthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Company, upon extension of credit, is based on management's credit evaluation of the customer. Collateral held varies but may include residential and commercial real property, marketable securities, accounts receivable, inventory, equipment and savings accounts.

The concentrations by type of investment security are set forth in Note B. The Company places its investments primarily in financial instruments backed by the U.S. Government and its agencies. At December 31, 2010, the Bank has $32,780,000 in federal funds sold to five correspondent banks, which represents 190% of the Bank's net worth. Deposits with two correspondent banks were in excess of federally insured limits of $3,523,172 at December 31, 2010. While management recognizes the inherent risks involved in such concentrations, this concentration provides the Bank with an effective and cost efficient means of managing its liquidity position and item processing needs. Management closely monitors the financial condition of their correspondent banks on a continuous basis. The Bank also maintains additional deposit accounts with other correspondent banks should management determine that a change in its correspondent banking relationship would be appropriate.

NOTE Q – REGULATORY MATTERS

The Bank is subject to the dividend restrictions set forth by the FDIC. Under such restrictions, the Bank may not, without the prior approval of the FDIC, declare dividends in excess of the sum of the current year's net income plus the retained earnings from the prior two years. As of December 31, 2010, $3,709,941 was available for cash dividend distribution without prior approval.

The Company is subject to various regulatory capital requirements administered by its primary federal regulator, the FDIC. Failure to meet minimum capital requirements can initiate certain mandatory – and possibly additional discretionary – actions by regulators that, if undertaken, could have a direct material effect on the Company's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Company must meet specific capital guidelines that involve quantitative measures of the Company's assets, liabilities, and certain off-balance-sheet items as calculated under regulatory accounting practices. The Company's capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors.

Quantitative measures established by regulation to ensure capital adequacy require the Company to maintain minimum amounts and ratios (set forth in the table below) of total and Tier I capital (as defined in the regulations) to risk-weighted assets (as defined), and of Tier I capital (as defined) to average assets (as defined). Management believes, as of December 31, 2010, that the Company meets all capital adequacy requirements to which it is subject.

As of December 31, 2010, the most recent notification from the FDIC categorized the Company as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized the Company must maintain minimum total risk-based, Tier I risk-based and Tier I leverage ratios as set forth in the table. There are no conditions or events since that notification that management believes have changed the Company's category. The Company's actual capital amounts and ratios are also presented in the table.

NOTE Q – REGULATORY MATTERS (Continued)

	Actual		For Capital Adequacy Purposes		To Be Well Capitalized Under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
			(in thousands)			
As of December 31, 2010						
Total Capital						
(to Risk Weighted Assets)	$ 19,064	13.04%	≥ $ 11,696	≥ 8.00%	≥ $ 14,620	≥ 10.00%
Tier I Capital						
(to Risk Weighted Assets)	$ 17,225	11.78%	≥ $ 5,848	≥ 4.00%	≥ $ 8,772	≥ 6.00%
Tier I Capital						
(to Average Assets)	$ 17,225	8.08%	≥ $ 8,523	≥ 4.00%	≥ $ 10,653	≥ 5.00%
As of December 31, 2009						
Total Capital						
(to Risk Weighted Assets)	$ 16,342	11.76%	≥ $ 11,114	≥ 8.00%	≥ $ 13,893	≥ 10.00%
Tier I Capital						
(to Risk Weighted Assets)	$ 14,598	10.51%	≥ $ 5,557	≥ 4.00%	≥ $ 8,336	≥ 6.00%
Tier I Capital						
(to Average Assets)	$ 14,598	7.69%	≥ $ 7,592	≥ 4.00%	≥ $ 9,489	≥ 5.00%

NOTE R – FAIR VALUES OF FINANCIAL INSTRUMENTS

FASB ASC 825 requires disclosure of fair value information about financial instruments, whether or not recognized in the balance sheet. In cases where quoted market prices are not available, fair values are based on estimates using present value or other valuation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. In that regard, the derived fair value estimates cannot be substantiated by comparison to independent markets and, in many cases, could not be realized in immediate settlement of the instruments. FASB ASC 825 excludes certain financial instruments and all nonfinancial instruments from its disclosure requirements. Accordingly, the aggregate fair value amounts presented do not represent the underlying value of the Company as a whole. The estimated fair values of the Company's financial instruments are as follows at December 31:

	2010		2009	
	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
Financial assets:				
Cash and due from banks	$ 6,339,042	$ 6,339,042	$ 3,472,096	$ 3,472,096
Interest-bearing deposits in other banks	1,002,468	1,002,468		
Federal funds sold	32,780,000	32,780,000	22,450,000	22,450,000
Investment securities available-for-sale	20,908,659	20,908,659	15,951,348	15,951,348
Loans, net	141,199,574	145,708,291	134,209,255	134,179,037
Cash surrender value of life insurance	2,498,720	2,498,720	2,398,540	2,398,540
Accrued interest receivable	736,759	736,759	667,778	667,778
Financial liabilities:				
Deposits	193,449,905	193,440,451	169,126,153	169,119,096
Borrowings	3,097,860	3,097,860	1,500,250	1,500,250
Accrued interest payable	54,256	54,256	84,804	84,804

NOTE R – FAIR VALUES OF FINANCIAL INSTRUMENTS (Continued)

The carrying amounts in the preceding table are included in the balance sheet under the applicable captions. The following methods and assumptions were used by the Company in estimating its fair value disclosures for financial instruments:

Cash and due from banks, federal funds sold and interest-bearing deposits in other financial institutions: The carrying amount is a reasonable estimate of fair value.

Investment securities: Fair values for investment securities are based on quoted market prices, where available. If quoted market prices are not available, fair values are based on quoted market prices of comparable instruments. The carrying amount of accrued interest receivable approximates its fair value.

Loans, net: For variable-rate loans that reprice frequently and fixed rate loans that mature in the near future, with no significant change in credit risk, fair values are based on carrying amounts. The fair values for other fixed rate loans are estimated using discounted cash flow analysis, based on interest rates currently being offered for loans with similar terms to borrowers of similar credit quality. Loan fair value estimates include judgments regarding future expected loss experience and risk characteristics and are adjusted for the allowance for loan losses. The carrying amount of accrued interest receivable approximates its fair value.

Cash surrender value of life insurance: The carrying amount approximates fair value.

Deposits: The fair values disclosed for demand deposits (for example, interest-bearing checking, money market and savings accounts) are, by definition, equal to the amount payable on demand at the reporting date (that is, their carrying amounts). The fair values for certificates of deposit are estimated using a discounted cash flow calculation that applies interest rates currently being offered on the certificates to a schedule of aggregated contractual maturities on such time deposits. The carrying amount of accrued interest payable approximates fair value.

Borrowings: The carrying amount approximates fair value.

Fair value is a market-based measure considered from the perspective of a market participant who holds the asset or owes the liability rather than an entity-specific measure. Therefore, even when market assumptions are not readily available, the Company's own assumptions are set to reflect those that market participants would use in pricing the asset or liability at the measurement date. The Company uses prices and inputs that are current as of the measurement date, including during periods of market dislocation, the observability of prices and inputs may be reduced for many instruments. This condition could cause an instrument to be reclassified from Level 1 to Level 2 or Level 2 to Level 3.

In general, fair values are determined by:

Level 1 inputs utilize quoted prices (unadjusted) in active markets for identical assets or liabilities that the Company has the ability to access.

Level 2 inputs include quoted prices for similar assets and liabilities in active markets, and inputs other than quoted prices that are observable for the asset or liability, such as interest rates and yield curves that are observable at commonly quoted intervals. Fair values determined by Level 2 inputs utilize inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly or indirectly.

Level 3 inputs are unobservable inputs for the asset or liability, and include situations where there is little, if any market activity for the asset or liability.

The following table presents information about the Company's assets and liabilities measured at fair value on a recurring basis as of December 31, 2010 and 2009, and indicate the fair value hierarchy of the valuation techniques utilized by the Company to determine such fair value.

NOTE R – FAIR VALUES OF FINANCIAL INSTRUMENTS (Continued)

	Total	Level 1	Level 2	Level 3
December 31, 2010:				
Investment securities	$ 20,908,659			$ 20,908,659
Impaired loans	$ 1,077,494		$ 1,077,494	
December 31, 2009:				
Investment securities	$ 15,951,348			$ 15,951,348
Impaired loans	$ 1,151,987		$ 1,151,987	

The following methods were used to estimate the fair value of each class of financial instrument above:

Securities Available-for-Sale: To value securities available-for-sale, the Company obtains fair value measurements from an independent pricing service. The fair value measurement considers observable data that may include dealer quotes, market spreads, cash flows, the U.S. Treasury yield curve, live trading levels, trade execution data, market consensus prepayment speeds, credit information and the bond's terms and conditions among other things.

Impaired Loans: The fair value of impaired loans is estimated using one of several methods, including collateral value, market value of similar debt, enterprise value, liquidation value and discounted cash flows. Those impaired loans not requiring an allowance represent loans for which the fair value of the expected repayments or collateral exceed the recorded investments in such loans. At December 31, 2010 and 2009, all of the impaired loans were evaluated based on the fair value of the collateral. Impaired loans where an allowance is established based on the fair value of collateral require classification in the fair value hierarchy. When the fair value of the collateral is based on an observable market price or a current appraisal value, the Company records the impaired loan as nonrecurring Level 2. When an appraised value is not available or management determines the fair value of the collateral is further impaired below the appraised value and there is no observable market price, the Company records the impaired loan as nonrecurring Level 3.

NOTE S – CONDENSED FINANCIAL INFORMATION OF THE PARENT COMPANY

Condensed balance sheets as of December 31, 2010 and 2009 and the related condensed statement of operations and cash flows for the years then ended for Redwood Capital Bancorp (parent company only) are presented as follows:

Condensed Balance Sheets
December 31, 2010 and 2009

	2010	2009
Assets		
Cash	$ 877,735	$ 1,764,941
Other assets	275	8,350
Intercompany receivable	755,298	1,600
Investment in subsidiary	17,293,247	14,856,973
	$ 18,926,555	$ 16,631,864
Liabilities and shareholders' equity		
Accrued interest payable and other liabilities	$ 65,099	$ 86,798
Borrowings	3,097,860	1,500,250
Preferred stock	3,862,206	3,824,214
Common stock	11,791,633	11,699,908
Additional paid-in capital	581,230	562,054
Retained earnings (deficit)	(471,473)	(1,041,360)
	$ 18,926,555	$ 16,631,864

Condensed Statements of Operations
For the years ended December 31, 2010 and 2009

	2010	2009
Dividends from subsidiary	$ 150,000	
Interest expense	(73,213)	$ (24,697)
Provision for loan losses	(1,610,250)	
Other expenses	(341,529)	(342,128)
Loss before equity in undistributed income of subsidiary and income taxes	(1,874,992)	(366,825)
Equity in undistributed net income of subsidiary	2,126,183	793,301
Income tax expense	755,298	(800)
	$ 1,006,489	$ 425,676

NOTE S – CONDENSED FINANCIAL INFORMATION OF THE PARENT COMPANY (Continued)

Condensed Statements of Cash Flows
For the years ended December 31, 2010 and 2009

	2010	2009
Cash flows from operating activities:		
Net income	$ 1,006,489	$ 425,676
Adjustments to reconcile net income to net cash used by operating activities:		
Equity in undistributed income of subsidiary	(2,126,183)	(793,301)
Dividends from subsidiary	(150,000)	
Stock-based compensation expense	163,729	152,797
Restricted stock awarded	(36,400)	36,400
Change in other assets	8,075	(8,350)
Change in intercompany receivable	(753,698)	(800)
Change in interest payable and other liabilities	(40,558)	(24,298)
Net cash used by operating activities	(1,928,546)	(211,876)
Cash flows from investing activities:		
Dividends from subsidiary	150,000	
Capital infusion	(500,000)	(600,000)
Net cash used by investing activities	(350,000)	(600,000)
Cash flows from financing activities:		
Repayments of borrowings	(1,500,250)	(3,000,000)
Proceeds from other borrowings	3,097,860	1,500,250
Proceeds from issuance of preferred stock		3,789,388
Proceeds from exercise of stock options		5,603
Repurchase of restricted stock	(16,428)	
Dividends paid on preferred stock	(189,842)	(172,109)
Net cash provided by financing activities	1,391,340	2,123,132
Net (decrease) increase in cash	(887,206)	1,311,256
Cash at beginning of year	1,764,941	453,685
CASH AT END OF YEAR	$ 877,735	$ 1,764,941

NOTE T – SUBSEQUENT EVENTS

In January 2011, the Company applied for $7,310,000 of funding under the Small Business Lending Fund through the U.S. Department of the Treasury, in which nonvoting Senior Preferred Stock will be issued. The dividend rate will depend on the Company’s increase in qualified small business lending from an established baseline level. The dividend rates are determined on a sliding scale with rates ranging from 5% the first nine quarters to 9% after 4 ½ years, assuming no increase in qualified small business lending, to a range of 1% the first nine quarters to 9% after 4 ½ years, assuming a 10% increase in qualified small business lending. The Senior Preferred Stock may be redeemed at any time at the option of the Company.

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