

Lender Processing Services, Inc.

Form 10-K

March 01, 2011

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

**Form 10-K**

- p**      **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES  
EXCHANGE ACT OF 1934  
For the fiscal year ended December 31, 2010**
- or**
- o**      **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES  
EXCHANGE ACT OF 1934  
For the transition period from      to**

**Commission File No. 001-34005**

**Lender Processing Services, Inc.**  
*(Exact name of registrant as specified in its charter)*

**Delaware**  
*(State or other jurisdiction  
of incorporation or organization)*

**26-1547801**  
*(I.R.S. Employer  
Identification No.)*

**601 Riverside Avenue  
Jacksonville, Florida**  
*(Address of principal executive offices)*

**32204**  
*(Zip Code)*

**(904) 854-5100**  
*(Registrant's telephone number, including area code)*

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

**Title of Each Class:**

**Name of Each Exchange on Which Registered:**

Common Stock, par value \$0.0001 per share

New York Stock Exchange

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

None

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

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

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

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

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

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

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

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act) Yes  No

The aggregate market value of the registrant's common stock held by non-affiliates was \$2,914,909,057 based on the closing sale price of \$31.31 on June 30, 2010 as reported by the New York Stock Exchange. For the purposes of the foregoing sentence only, all directors and executive officers of the registrant were assumed to be affiliates. The number of shares outstanding of the registrant's common stock, \$0.0001 par value per share, was 88,861,779 as of January 31, 2011.

The information in Part III hereof is incorporated herein by reference to the registrant's Proxy Statement on Schedule 14A for its 2011 annual meeting of shareholders, to be filed within 120 days after the close of the fiscal year that is the subject of this Report.

**LENDER PROCESSING SERVICES, INC.  
2010 FORM 10-K ANNUAL REPORT**

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*Except as otherwise indicated or unless the context otherwise requires, all references to LPS, we, the Company, or the registrant are to Lender Processing Services, Inc., a Delaware corporation that was incorporated in December 2007 as a wholly-owned subsidiary of FIS, and its subsidiaries; all references to FIS, the former parent, or the holding company are to Fidelity National Information Services, Inc., a Georgia corporation formerly known as Certegy Inc., and its subsidiaries, that owned all of LPS's shares until July 2, 2008; all references to former FIS are to Fidelity National Information Services, Inc., a Delaware corporation, and its subsidiaries, prior to the merger of Certegy, Inc. and former FIS; all references to old FNF are to Fidelity National Financial, Inc., a Delaware corporation that owned a majority of former FIS's shares through November 9, 2006; and all references to FNF are to Fidelity National Financial, Inc. (formerly known as Fidelity National Title Group, Inc.), formerly a subsidiary of old FNF but now a stand-alone company.*

## **PART I**

### **Item 1. Business.**

#### **Overview**

We are a provider of integrated technology and services to the mortgage lending industry, with market leading positions in mortgage processing and default management services in the U.S. We conduct our operations through two reporting segments, Technology, Data and Analytics and Loan Transaction Services, which produced approximately 31% and 69%, respectively, of our revenues for the year ended December 31, 2010. A large number of financial institutions use our solutions. Our technology solutions include our mortgage processing system, which automates all areas of loan servicing, from loan setup and ongoing processing to customer service, accounting and reporting. Our technology solutions also include our Desktop system, which is a middleware enterprise workflow management application designed to streamline and automate business processes. Our loan transaction services include our default management services, which are used by mortgage lenders, servicers and other real estate professionals to reduce the expense of managing defaulted loans, and our loan facilitation services, which support most aspects of the closing of mortgage loan transactions by national lenders and loan servicers.

Prior to July 2, 2008, the Company was a wholly-owned subsidiary of FIS. In October 2007, the board of directors of FIS approved a plan of restructuring pursuant to which FIS would spin off its lender processing services segment to its shareholders in a tax free distribution. Pursuant to this plan of restructuring, on June 16, 2008, FIS contributed to us all of its interest in the assets, liabilities, businesses and employees related to FIS's lender processing services operations in exchange for shares of our common stock and \$1,585.0 million aggregate principal amount of our debt obligations. On July 2, 2008, FIS distributed to its shareholders a dividend of one-half share of our common stock, par value \$0.0001 per share, for each issued and outstanding share of FIS common stock held on June 24, 2008, which we refer to as the spin-off. Also on July 2, 2008, FIS exchanged 100% of our debt obligations for a like amount of FIS's existing Tranche B Term Loans issued under its Credit Agreement dated as of January 18, 2007. The spin-off was tax-free to FIS and its shareholders, and the debt-for-debt exchange undertaken in connection with the spin-off was tax-free to FIS.

#### **Information about Reporting Segments**

We offer a suite of solutions across the mortgage continuum, including technology applications, data, analytics, loan facilitation services and default management services. Our two reporting segments are Technology, Data and Analytics and Loan Transaction Services. We provide our solutions to many of the top 50 U.S. banks, as well as a number of other financial institutions, mortgage lenders, mortgage loan servicers, and other real estate professionals.

In our Technology, Data and Analytics segment, our principal technology solutions are software applications provided to mortgage lenders and other lending institutions, together with related support and services. Our technology solutions primarily consist of mortgage processing and workflow management software applications. The long term nature of most of our contracts in this business provides us with substantial recurring revenues. Our revenues from mortgage processing are generally based on the number of active mortgages on our mortgage servicing platform in a given period. Our other technology solutions include our Desktop application, which at

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present is deployed primarily to customers utilizing our default management services. We generally earn revenues from our Desktop application on a per transaction basis. Our data and analytics offerings primarily consist of our alternative valuation services, real estate and mortgage data, fraud detection solutions, modeling and forecasting and analytical tools. For 2010, the Technology, Data and Analytics segment generated \$762.6 million, or approximately 31%, of our consolidated revenues.

Our Loan Transaction Services segment consists principally of our loan facilitation services and our default management services. Our loan facilitation services consist primarily of settlement services, such as title agency and closing services, traditional appraisals and appraisal management services and other origination and real estate-related services. Each of these services is provided through a centralized delivery channel in accordance with a lender's specific requirements, regardless of the geographic location of the borrower or property. Our default management services, including title, posting and publication, property preservation, asset management and REO auction services and administrative support, are provided to national lenders, loan servicers and other real estate professionals to enable them to better manage some or all of the business processes necessary to take a loan and the underlying property through the default, foreclosure and disposition process. Our revenues from our Loan Transaction Services segment in 2010 were \$1,701.5 million, or approximately 69%, of our consolidated revenues.

In 2010, 2009 and 2008, all of our revenues were from sources within the U.S. and Puerto Rico.

### ***Technology, Data and Analytics***

Our Technology, Data and Analytics segment offers leading software systems and information solutions that facilitate and automate many of the business processes across the life cycle of a mortgage. Our customers use our technology and services to reduce their operating costs, improve their customer service and enhance the quality and consistency of various aspects of their mortgage servicing. We continually work with our customers to customize and integrate our software and services in order to assist them in achieving the value proposition that we offer to them.

*Technology.* We build all of our technology platforms to be scalable, highly secure, flexible, standards-based, and web connected. The primary applications and services of our technology businesses include:

*MSP.* Our mortgage servicing platform, or MSP, is an application that automates loan servicing, including loan setup and ongoing processing, customer service, accounting and reporting to the secondary mortgage market, and federal regulatory reporting. MSP serves as the core application through which our customers keep the primary records of their mortgage loans. MSP processes a wide range of loan products, including fixed-rate mortgages, adjustable-rate mortgages, construction loans and daily simple interest loans. Our capabilities on our MSP platform also include processing home equity lines of credit, or *HELOCs*. We believe MSP provides a more robust system for addressing *HELOCs* in areas such as loss mitigation, escrow tracking and regulatory reporting than the software systems that many banks have historically used to process these loans, which are based on credit card systems.

When a bank hires us to process its mortgage portfolio, we provide the hardware and the skilled personnel whose role is to keep the system up and running 24 hours a day, seven days a week; to keep the programs and interfaces running smoothly; and to make the system and application changes needed to upgrade the processes and ensure compliance with regulatory changes. We also undertake to perform the processing securely. The bank customer is responsible for all external communications and all keying or other data input, such as reflecting when checks or other payments are received from its loan customers.

*Desktop.* We have developed a web-based workflow information system, which we refer to as Desktop. The Desktop application can be used for managing and automating a wide range of different workflow processes. It



can also be used to organize images of paper documents within a particular file, to capture information from imaged documents, to manage invoices and to provide multiple users access to key data needed for various types of monitoring and process management.

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**Other software applications.** We offer various software applications and services that facilitate the origination of mortgage loans in the U.S. For example, we offer a loan origination software system, known as *Empower!*, which is used by banks, savings & loans and mortgage bankers to automate the loan origination process. *Empower!* provides credit bureau access and interfaces with MSP, automated underwriting systems used by Freddie Mac and Fannie Mae and various vendors providing settlement services. We also offer a software system, known as *SoftPro*, which is a real estate closing and title insurance production application used to create forms used in the closing of residential and commercial real estate transactions in the U.S. We also offer *RealEC*, a collaborative vendor network for the mortgage industry. The RealEC network enables lenders and their business partners to electronically connect, collaborate and automate their business processes and to electronically order and route settlement services.

We build all of our technology platforms to be scalable, highly secure, flexible, standards-based, and web connected. Standards and web connectivity ensure that our products are easy to use for our customers. Further, we can bring solutions to market quickly due to investments that we have made in integrating our technology.

**Data and analytics.** In addition to our technology applications, this segment provides data and analytics solutions that are used in different steps in the life cycle of a mortgage. Our primary data and analytics services are:

**Alternative valuation services.** We offer a broad range of property valuation services that allow our customers to match their risk of loss with alternative forms of property valuations, depending upon their needs and regulatory requirements. These include, among others, automated valuation models, broker price opinions, collateral risk scores, appraisal review services and valuation reconciliation services. To deliver these services, we utilize artificial intelligence software, detailed real estate statistical analysis, and modified physical property inspections.

**Data and information.** We acquire and aggregate real estate property and loan data on a national level and make such data available to our customers in a single database with a standard, normalized format. We also offer a number of value added services that enable our customers to utilize this data to assess risk, determine property values, track market performance, generate leads and mitigate risk.

**Fraud detection.** We also provide our customers with automated verification solutions. These services assist our customers to combat mortgage fraud and manage risk by quickly verifying applicant income and identity against Internal Revenue Service and Social Security Administration databases. We also provide employment verification services.

The following table sets forth our revenues for the last three years from our mortgage processing services and other services in this segment (in millions):

	<b>2010</b>	<b>2009</b>	<b>2008</b>
Mortgage processing	\$ 402.7	\$ 387.9	\$ 334.2
Other Technology, Data and Analytics	359.9	319.6	231.5
Total segment revenues	\$ 762.6	\$ 707.5	\$ 565.7

***Loan Transaction Services***

Our Loan Transaction Services segment offers customized outsourced business process and information solutions. We work with our customers to set specific parameters regarding the services they require, and where practicable, provide a single point of contact with us for these services.

*Loan facilitation services.* This segment includes the following services:

*Settlement services.* We offer centralized title agency and closing services to our customers. Our title agency services include conducting title searches and preparing an abstract of title, reviewing the status of title in a title commitment, resolving any title exceptions, verifying the payment of existing loans secured by a subject property, verifying the amount of prorated expenses and either arranging for or issuing a title insurance policy by a title insurance underwriter. Our closing management services include preparing many of the documents used in connection with the closing. We work with independent closing agents that are

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trained to close loans in accordance with the lender's instructions, and independent notaries who are available to promptly assist with the closing. Due to the centralized nature of our title and closing operations, our settlement services are typically utilized in connection with refinancing transactions.

Appraisal services. We operate an appraisal management company, which contracts with independent appraisers to provide traditional appraisals. Traditional property appraisal services involve labor intensive inspections of the real property in question and of comparable properties in the same and similar neighborhoods, and typically take weeks to complete. These services are typically provided in connection with first mortgages.

Other origination services. We offer lenders real estate tax information and federal flood zone certifications in connection with the origination of new mortgage loans. We also offer monitoring services that will notify a lender of any change in flood zone status during the life of a loan.

Default management services. In addition to loan facilitation services, our Loan Transaction Services segment offers default management services. These services allow our customers to efficiently manage the business processes necessary to take a loan and the underlying real estate securing the loan through the default and foreclosure process. We offer a full spectrum of services relating to the management of defaulted loans, from initial property inspection through the eventual disposition of our customer's asset. Based on a customer's needs, our default management services can be provided individually or, more commonly, as part of a solution that integrates one or more of those services with our technology applications, such as the Desktop application. Our default management services include:

Foreclosure services. We offer lenders, servicers and their attorneys certain administrative and support services in connection with managing foreclosures. We also offer comprehensive posting and publication of foreclosure and auction notices, and conduct mandatory title searches, in each case as necessary to meet state statutory requirements for foreclosure.

Property inspection and preservation services. At the onset of a loan default, our services are designed to assess and preserve the value of the property securing the loan. For example, through independent inspectors we provide inspection services, including daily reports on vacant properties, occupancy inspections and disaster and insurance inspections. We also offer property preservation and maintenance services, such as lock changes, window replacement, lawn service and debris removal, through independent contractors.

Asset management, default title and settlement services. After a property has been foreclosed, we provide services that aid our customers in managing their real estate owned, or REO, properties, including property preservation field services. We also offer a variety of title and settlement services relating to the lender's ownership and eventual sale of REO properties. Finally, we offer advisory and management services, as well as a comprehensive REO auction solution, to facilitate a lender's REO sales.

The following table sets forth our revenues for the last three years from our loan facilitation and default management services in this segment (in millions):

	2010	2009	2008
Loan facilitation services	\$ 640.9	\$ 547.3	\$ 431.7
Default management services	1,060.6	1,137.3	851.8
Total segment revenues	\$ 1,701.5	\$ 1,684.6	\$ 1,283.5

***Corporate***

In addition to our two reporting segments, we also have a corporate segment, which includes costs and expenses not allocated to our two reporting segments as well as certain smaller investments and operations.

**Customers**

We have numerous customers in each category of service that we offer across the mortgage continuum. A significant focus of our marketing efforts is on the top 50 U.S. banks, although we also provide our services to a

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number of other financial institutions, mortgage lenders, mortgage loan servicers, attorneys, trustees and real estate professionals.

Our most significant customer relationships tend to be long-term in nature and we typically provide an extensive number of services to each customer. Because of the depth of these relationships, we derive a significant portion of our aggregate revenue from our largest customers. For example, in 2010, our largest customer, Wells Fargo Bank, N.A. ( Wells Fargo ), accounted for approximately 20.0% of our aggregate revenue and approximately 12.2% and 23.3% of the revenue from our Technology, Data and Analytics and Loan Transaction Services segments, respectively. JPMorgan Chase Bank, N.A. ( JPMorgan Chase ), our second largest customer, accounted for approximately 11.1% of our consolidated revenues and approximately 10.3% and 11.3% of the revenues of our Technology, Data and Analytics and Loan Transaction Services segments, respectively. Our five largest customers accounted for approximately 47.7% of our aggregate revenue and approximately 31.4% and 54.7% of the revenue of our Technology, Data and Analytics and Loan Transaction Services segments, respectively. However, these revenues in each case are spread across a range of services, and are subject to multiple separate contracts. Although the diversity of the services we provide to each of these customers reduces the risk that we would lose all of the revenues associated with any of these customers, a significant deterioration in our relationships with or the loss of any one or more of these customers could have a significant impact on our results of operations. See Risk Factors Our results of operations may be affected by the nature of our relationships with our largest customers or by our customers relationships with the government-sponsored enterprises.

## **Sales and Marketing**

### ***Sales Force***

We have teams of experienced sales personnel with subject matter expertise in particular services or in the needs of particular types of customers. A significant portion of our potential customers in each of our business lines is targeted via direct and/or indirect field sales, as well as inbound and outbound telemarketing efforts. Marketing activities include direct marketing, print advertising, media relations, public relations, tradeshow and convention activities, seminars and other targeted activities. As many of our customers use a single service, or a combination of services, our direct sales force also targets existing customers to promote cross-selling opportunities. These individuals also support the efforts of our Office of the Enterprise, discussed below.

### ***Office of the Enterprise***

The broad range of services we offer provides us with the opportunity to expand our sales to our existing customer base through cross-selling efforts. We have established a core team of senior managers to lead account management and cross-selling of the full range of our services to existing and potential customers at the top 50 U.S. lending institutions. The individuals who participate in this effort, which we coordinate through our Office of the Enterprise, spend a significant amount of their time on sales and marketing efforts.

As part of the Office of the Enterprise operations, we engage in strategic account reviews, during which our executives share their knowledge of clients and the market in order to determine the best sales approach on a client-by-client basis. The Office of the Enterprise provides us with a more cohesive sales force and reduces confusion over client responsibility. As a result, we have created an effective cross-sell culture within our organization.

## **Patents, Trademarks and Other Intellectual Property**

We rely on a combination of contractual restrictions, internal security practices, and copyright and trade secret law to establish and protect our software, technology, and expertise. Further, we have developed a number of brands that

have accumulated goodwill in the marketplace, and we rely on trademark law to protect our rights in that area. We intend to continue our policy of taking all measures we deem necessary to protect our copyright, trade secret and trademark rights.

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### **Competition**

A number of the businesses in which we engage are highly competitive. The businesses that make up our Technology, Data and Analytics segment compete with internal technology departments within financial institutions and with third party data processing or software development companies and data and analytics companies. Competitive factors in processing businesses include the quality of the technology-based application or service, application features and functions, ease of delivery and integration, ability of the provider to maintain, enhance and support the applications or services, and pricing. We believe that due to our integrated technology and economies of scale in the mortgage processing business, we have a competitive advantage in each of these categories.

With respect to our mortgage servicing platform, we compete with our customers' internal technology departments and other providers of similar systems. MSP is a leading mortgage processing software in the U.S.

Our Desktop application, which is a workflow information system that can be used to manage a range of different workflow processes, is currently the leading mortgage default management application in the U.S. We compete primarily with our customers' in-house technology departments for this type of business.

In our Data and Analytics businesses, we primarily compete with Corelogic, Inc., in-house capabilities and certain niche providers. Recently, the national credit bureaus have also begun providing competitive fraud detection offerings.

For the businesses that comprise our Loan Transaction Services segment, key competitive factors include quality of the service, convenience, speed of delivery, customer service and price. Our title and closing services businesses principally compete with large national title insurance underwriters. Our appraisal services businesses principally compete with First American Corporation, Fidelity National Financial, Inc. and small independent appraisal providers, as well as our customers' in-house appraisers. Due to a lack of publicly available information as to the national market for these services, we are unable to determine our overall competitive position in the national marketplace with respect to our loan facilitation services businesses. Our default management services businesses principally compete with in-house services performed directly by our customers and, to a lesser extent, other third party vendors that offer similar applications and services. Based in part on the range and quality of default management services we offer and our focus on technology and customer service, our default management business has grown significantly and we believe we are now one of the largest mortgage default management services providers in the U.S.

### **Research and Development**

Our research and development activities have related primarily to the design and development of our processing systems and related software applications. We expect to continue our practice of investing an appropriate level of resources to maintain, enhance and extend the functionality of our proprietary systems and existing software applications, to develop new and innovative software applications and systems in response to the needs of our customers, and to enhance the capabilities surrounding our infrastructure. We work with our customers to determine the appropriate timing and approach to introducing technology or infrastructure changes to our applications and services.

### **Government Regulation**

Various aspects of our businesses are subject to federal and state regulation. Our failure to comply with any applicable laws and regulations could result in restrictions on our ability to provide certain services, as well as the possible imposition of civil fines and criminal penalties.



As a provider of electronic data processing to financial institutions, such as banks and credit unions, we are subject to regulatory oversight and examination by the Federal Financial Institutions Examination Council, an interagency body of the Federal Reserve Board, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation and various other federal and state regulatory authorities. In addition, independent auditors annually review several of our operations to provide reports on internal controls for our customers' auditors and regulators. We also may be subject to possible review by state agencies that regulate banks in each state in which we conduct our electronic processing activities.

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Our financial institution clients are required to comply with various privacy regulations imposed under state and federal law, including the Gramm-Leach-Bliley Act. These regulations place restrictions on the use of non-public personal information. All financial institutions must disclose detailed privacy policies to their customers and offer them the opportunity to direct the financial institution not to share information with third parties. The regulations, however, permit financial institutions to share information with non-affiliated parties who perform services for the financial institutions. As a provider of services to financial institutions, we are required to comply with the privacy regulations and are generally bound by the same limitations on disclosure of the information received from our customers as apply to the financial institutions themselves.

The Real Estate Settlement Procedures Act, or RESPA, and related regulations generally prohibit the payment or receipt of fees or any other item of value for the referral of real estate-related settlement services. RESPA also prohibits fee shares or splits or unearned fees in connection with the provision of residential real estate settlement services, such as mortgage brokerage and real estate brokerage. Notwithstanding these prohibitions, RESPA permits payments for goods furnished or for services actually performed, so long as those payments bear a reasonable relationship to the market value of the goods or services provided. RESPA and related regulations may to some extent restrict our real estate-related businesses from entering into certain preferred alliance arrangements. The U.S. Department of Housing and Urban Development is responsible for enforcing RESPA.

Real estate appraisers are subject to regulation in most states, and some state appraisal boards have sought to prohibit our automated valuation applications. Courts have limited such prohibitions, in part on the ground of preemption by the federal Financial Institutions Reform, Recovery, and Enforcement Act of 1989, but we cannot assure you that our valuation and appraisal services business will not be subject to further regulation. In July 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Wall Street Reform Act), which contains broad changes for many sectors of the financial services and lending industries, was signed into law. Among other things, the Wall Street Reform Act includes new requirements for appraisals and appraisal management companies. In addition, some states have enacted legislation requiring the registration of appraisal management companies, and numerous states have similar proposals pending. We monitor these proposals carefully, and we believe that our appraisal management operations will be able to comply with any new requirements.

The title agency and related services we provide are conducted through an affiliated group of underwritten title agencies. Our underwritten title agencies are generally required by various state laws to maintain specified levels of net worth and working capital, and are also required to obtain and maintain a license in each state in which they operate. The title agencies are also subject to regulation by the insurance or banking regulators in many jurisdictions. These regulators generally require, among other items, that our agents and certain employees maintain state licenses as well, and be appointed by a title insurer. We also own a title insurer which issues policies generated by our agency operations. This insurer is domiciled in New York and is therefore subject to regulation by the insurance regulatory authorities of that state. Among other things, the laws of New York require that (1) certain amounts of premiums earned by our insurance company be set aside as reserves, (2) only limited, defined amounts of any earnings of our insurance company are available as potential dividends, and (3) no one person may acquire 10% or more of our common stock without the approval of the New York insurance regulators.

The current economic downturn and troubled housing market have resulted in increased scrutiny of all parties involved in the mortgage industry by governmental authorities with the most recent focus being on those involved in the foreclosure process. This scrutiny has included federal and state governmental review of all aspects of the mortgage lending business, including an increased legislative and regulatory focus on consumer protection practices. The Wall Street Reform Act is one example of such legislation. It is too early to predict the final form that regulations or other rule-makings to implement the various requirements of the Wall Street Reform Act may take, what additional legislative or regulatory changes may be approved in the future, or whether those changes may require us to change our business practices, incur increased costs of compliance or adversely affect our results of operations.



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### **Employees**

As of December 31, 2010, we had approximately 8,700 employees, all of which were principally employed in the U.S. None of our workforce currently is unionized. We have not experienced any work stoppages, and we consider our relations with employees to be good.

### **Available Information**

We file Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q, and Current Reports on Form 8-K with the Securities and Exchange Commission (the "SEC"). The public may read and copy any materials we file with the SEC at the SEC's Public Reference Room at 100 F Street, N.E., Washington, DC 20549. The public may obtain information on the operation of the Public Reference Room by calling the SEC at 1-800-SEC-0330. We are an electronic filer, and the SEC maintains an Internet site at [www.sec.gov](http://www.sec.gov) that contains the reports, proxy and information statements and other information we file electronically. We make available, free of charge, through our website our Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q, and Current Reports on Form 8-K, and amendments to those reports, as soon as reasonably practicable after we file them with, or furnish them to, the SEC. Our Internet website address is <http://www.lpsvcs.com>. Our Corporate Governance Guidelines and Code of Business Conduct and Ethics are also available on our website and are available in print, free of charge, to any stockholder who mails a request to the Corporate Secretary, Lender Processing Services, Inc., 601 Riverside Avenue, Jacksonville, Florida 32204. Other corporate governance-related documents can be found on our website as well. However, the information found on our website is not part of this or any other report.

### **Item 1A. Risk Factors.**

In addition to the normal risks of business, we are subject to significant risks and uncertainties, including those listed below and others described elsewhere in this Annual Report on Form 10-K. Any of the risks described in this report could result in a significant adverse effect on our results of operations and financial condition.

#### ***The strength of the economy and the housing market affect demand for certain of our services.***

The level of real estate activity is primarily affected by real estate prices, the availability of funds for mortgage loans, mortgage interest rates and the overall state of the U.S. economy. The Mortgage Brokers Association ("MBA") estimates that the level of U.S. mortgage originations, by dollar volume, was \$1.5 trillion and \$2.0 trillion in 2010 and 2009, respectively. Of these total origination markets in 2010 and 2009, approximately 69% and 65%, respectively, were refinancing transactions. The revenues for our loan facilitation business are linked to the volume of origination transactions, and refinancing transactions in particular. There can be no assurance that the relative strength of the refinancing market will continue, especially in light of current market conditions, rising interest rates and tightened loan requirements, such as higher credit score and down payment requirements and additional fees. In the event that the level of origination transactions, particularly refinancing transactions, decreases, the results of our loan facilitation operations could be adversely affected. Further, in the event that the difficult economy or other factors lead to a decline in levels of home ownership and a reduction in the aggregate number of U.S. mortgage loans outstanding, our revenues from mortgage processing could be adversely affected.

In contrast, the weaker economy and housing market have tended to increase the volume of consumer mortgage defaults, which can favorably affect our default management operations, in which we service residential mortgage loans in default. It can also increase revenues from our Desktop solution, which is currently primarily used in connection with default management. As a result, our default management services have historically provided a natural hedge against the volatility of the real estate origination business and its resulting impact on our loan facilitation services. However, government legislation aimed at mitigating the current downturn in the housing market

by providing a loan modification program targeted at borrowers who are at risk of foreclosure because their incomes are not sufficient to make their mortgage payments, and lenders' efforts to comply with the requirements of that legislation and other foreclosure requirements, has adversely affected foreclosure volumes and the results of our default management operations. Although we believe that the reduction in foreclosure volumes is temporary, it is impossible to predict whether additional legislative or regulatory changes will be implemented or other actions may be taken by regulators or lenders that might cause a continuation of or further slow the current level of

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foreclosure volumes and adversely affect our future results. In the event that foreclosure volumes remain slow without a corresponding increase in the level of mortgage originations to increase revenues from our loan facilitation businesses, our revenues could be adversely affected.

***Our results of operations may be affected by the nature of our relationships with our largest customers or by our customers' relationships with the government-sponsored enterprises.***

A small number of customers have accounted for a significant portion of our revenues, and we expect that a limited number of customers will continue to represent a significant portion of our revenues for the foreseeable future. In 2010, our largest customer, Wells Fargo, accounted for approximately 20.0% of our aggregate revenue, and our second largest customer, JPMorgan Chase, accounted for approximately 11.1% of our aggregate revenue. Wells Fargo accounted for approximately 12.2% of the revenue from our Technology, Data and Analytics segment and approximately 23.3% of the revenue from our Loan Transaction Services segments in 2010, and JPMorgan Chase accounted for approximately 10.3% of the revenue from our Technology, Data and Analytics segment and approximately 11.3% of the revenue from our Loan Transaction Services segment in 2010. Our five largest customers accounted for approximately 47.7% of our aggregate revenue and approximately 31.4% and 54.7% of the revenue of our Technology, Data and Analytics and Loan Transaction Services segments, respectively. See Business Customers. The revenues of our five largest customers are spread across a range of services, and we protect ourselves by utilizing separate contracts for different services. However, our relationships with these and other large customers are important to our future operating results, and deterioration in any of those relationships could significantly reduce our revenues. In addition, by virtue of their significant relationships with us, these customers may be able to exert pressure on us with respect to the pricing of our services.

Our customers also have significant relationships with the Federal National Mortgage Association, or Fannie Mae, and the Federal Home Loan Mortgage Corporation, or Freddie Mac, which are government-sponsored enterprises ( GSE ) tasked with working with financial institutions to provide liquidity to the mortgage market. They do this by purchasing loans from the lenders either for cash or in exchange for a mortgage-backed security that comprises those loans and that, for a fee, carries the GSE's guarantee of timely payment of interest and principal. Because our customers service the loans owned by the GSEs, we provide services on many of those loans. As a result of these relationships, the GSEs have been able to implement changes to our pricing structure on certain services we provide related to default and foreclosure servicing. The GSEs or other governmental agencies may be able to exert similar pressure on the pricing of our services in the future, which could have a negative impact on our results of operations.

***Participants in the mortgage industry are under increased scrutiny, and efforts by the government to reform the mortgage industry or address the troubled mortgage market and the current economic environment could affect us.***

The current economic downturn and troubled housing market have resulted in increased scrutiny of all parties involved in the mortgage industry by governmental authorities, judges and the news media, among others, with the most recent focus being on those involved in the foreclosure process. This scrutiny has included federal and state governmental review of all aspects of the mortgage lending business, including an increased legislative and regulatory focus on consumer protection practices. An example of such legislation is the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Wall Street Reform Act ), which was signed into law in July 2010 and contains broad changes for many sectors of the financial services and lending industries. Among other things, the Wall Street Reform Act includes new requirements for appraisals and appraisal management companies. In addition, some states have enacted legislation requiring the registration of appraisal management companies, and numerous states have similar proposals pending. While we believe that we will be able to comply with the new federal and any new state requirements relating to appraisals going forward, it is too early to predict with certainty what impact those requirements may have on our business or the results of our operations. It is also too early to predict the final form that regulations and rule-makings to implement other requirements of the Wall Street Reform Act may take, what

additional legislative or regulatory changes may be approved in the future, or whether those changes may require us to change our business practices, incur increased costs of compliance and/or adversely affect our results of operations.

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Several pieces of legislation have been enacted to address the struggling mortgage market and the current economic downturn. For example, under the Homeowner Affordability and Stability Plan (the HASP ), many homeowners with an existing mortgage owned by Fannie Mae or Freddie Mac who would otherwise be unable to get a refinancing loan because of a loss in home value have been able to get a refinancing loan. In addition, the Home Affordable Modification Program ( HAMP ) under the HASP provides mortgage loan servicers with a set of standardized qualification guidelines for loan modifications aimed at reducing borrower monthly payments to affordable levels. Although HAMP has produced a large number of trial modifications, only a small portion of those modifications have been converted to permanent modifications to date. We cannot predict the ultimate impact that the government's initiatives under the HASP or other foreclosure relief and loan modification initiatives may have, or whether the government may take additional action to address the current housing market.

Notwithstanding the effects of existing government programs, we believe that the inventory of delinquent mortgage loans and loans in foreclosure continues to grow. We believe this growth is due in part to continued high delinquency rates and lenders focusing their resources on trying to make modifications under the HAMP program in compliance with its requirements and new government directives intended to increase its success, which slowed the pace of foreclosure starts in the first half of 2010. The timing for foreclosure starts and the pace of foreclosure proceedings further slowed in the fourth quarter of 2010 as a number of lenders once again slowed or in some cases temporarily halted foreclosures in order to confirm the compliance of their foreclosure procedures with applicable laws. We cannot predict whether any legislative or regulatory changes will be implemented as a result of recent issues reported by banks and servicers in connection with foreclosure actions, or whether the government may implement additional directives to increase the success of HAMP. Any such actions could cause a continuation of or further slow the current level of foreclosure volumes and adversely affect our future results.

***We may incur additional costs and expenses due to investigations or other actions relating to default procedures.***

As described in Item 3. Legal Proceedings, a number of governmental agencies have been conducting separate inquiries concerning various current and past business practices in our default operations, and others may do so in the future. These inquiries range from grand jury subpoenas for documents and/or testimony to informal requests for information. We have been cooperating and we have expressed our willingness to continue to fully cooperate with these inquiries. Due to the current scrutiny being placed on participants in the foreclosure process and the early stage of certain of these inquiries, it is difficult to predict the final outcome of these matters. There can be no assurance that we will not incur additional material costs and expenses, including but not limited to fines or penalties and legal costs, or be subject to other remedies, as a result of regulatory, legislative or administrative investigations or actions relating to default procedures. Also as described in Item 3. Legal Proceedings, we are a defendant in civil litigation relating to default matters, and could become subject to additional civil litigation. There can be no assurance that we will not incur material costs and expenses as a result of such litigation.

***If we fail to adapt our services to changes in technology or in the marketplace, or if our ongoing efforts to upgrade our technology are not successful, we could lose customers and have difficulty attracting new customers for our services.***

The markets for our services are characterized by constant technological changes, frequent introductions of new services and evolving industry standards. Our future success will be significantly affected by our ability to enhance our current services, and develop and introduce new services that address the increasingly sophisticated needs of our customers and their customers. These initiatives carry the risks associated with any new service development effort, including cost overruns, delays in delivery and performance issues. There can be no assurance that we will be successful in developing, marketing and selling new services that meet these changing demands, that we will not experience difficulties that could delay or prevent the successful development, introduction, and marketing of these services, or that our new services and their enhancements will adequately meet the demands of the marketplace and



achieve market acceptance.

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***We operate in a competitive business environment, and if we are unable to compete effectively our results of operations and financial condition may be adversely affected.***

The markets for our services are intensely competitive. Our competitors vary in size and in the scope and breadth of the services they offer. We compete for existing and new customers against both third parties and the in-house capabilities of our customers. Some of our competitors have substantial resources. In addition, we expect that the markets in which we compete will continue to attract new competitors and new technologies. There can be no assurance that we will be able to compete successfully against current or future competitors or that competitive pressures we face in the markets in which we operate will not materially adversely affect our business, financial condition and results of operations.

Further, because many of our larger potential customers have historically developed their key processing applications in-house and therefore view their system requirements from a make-versus-buy perspective, we often compete against our potential customers' in-house capacities. As a result, gaining new customers in our mortgage processing business can be difficult. For banks and other potential customers, switching from an internally designed system to an outside vendor, or from one vendor of mortgage processing services to a new vendor, is a significant undertaking. Many potential customers worry about potential disadvantages such as loss of accustomed functionality, increased costs and business disruption. As a result, potential customers often resist change. There can be no assurance that our strategies for overcoming potential customers' reluctance to change will be successful, and this resistance may adversely affect our growth.

***We have substantial indebtedness, which could have a negative impact on our financing options and liquidity position.***

We have approximately \$1,249.4 million of total debt outstanding, consisting of (i) a senior secured credit agreement divided into two tranches, a \$700 million Term Loan A under which \$385.0 million was outstanding at December 31, 2010, and a \$510 million Term Loan B under which \$497.3 million was outstanding at December 31, 2010, and (ii) \$367.0 million of senior unsecured notes outstanding at December 31, 2010. As of December 31, 2010, we also had additional borrowing capacity of approximately \$138.5 million available under our revolving credit facility. We also have other contractual commitments and contingent obligations. See Management's discussion and analysis of results of operations and financial condition - Contractual obligations.

This high level of debt could have important consequences to us, including the following:

this debt level makes us more vulnerable to economic downturns and adverse developments in our business, may cause us to have difficulty borrowing money in the future in excess of amounts available under our credit facility for working capital, capital expenditures, acquisitions or other purposes and may limit our ability to pursue other business opportunities and implement certain business strategies;

we will need to use a large portion of the money we earn to pay principal and interest on our debt, which will reduce the amount of money available to finance operations, acquisitions and other business activities and pay stockholder dividends;

approximately \$657.2 million of the debt currently bears interest at a floating rate, which exposes us to the risk of increased interest rates (for example, a one percent increase in interest rates would result in a

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\$1 million increase in our annual interest expense for every \$100 million of floating rate debt we incur, which may make it more difficult for us to service our debt);

6.1

William J. Pasenelli	31,377	20,039	1.1
Mary Todd Peterson	6,529	—	*
James R. Shepherd	8,000	12,375	*
Austin J. Slater, Jr.	17,419	10,375	*
H. Beaman Smith	104,037	15,750	2.6
Joseph V. Stone, Jr.	28,625	(5) 500	*
Named Executive Officer Who is Not Also a Director			
Gregory C. Cockerham	115,590	14,175	2.8
All Directors, Executive Officers and Nominees as a Group (15 persons)	634,314(6)	125,225	15.8
Community Bank of the Chesapeake Employee Stock Ownership Plan	246,983(7)	—	5.3
Basswood Capital Management, L.L.C.	250,065(8)	—	5.3
Matthew Lindenbaum			

Bennett  
Lindenbaum

645 Madison  
Avenue, 10<sup>th</sup>  
Floor

New York,  
New York  
10022

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\*Less than 1% of the shares outstanding

Includes shares allocated to the account of the individuals under the Community Bank of the Chesapeake Employee (1) Stock Ownership Plan, with respect to which the individual has voting but not investment power as follows: Mr. Cockerham – 27,827 shares; Mr. Middleton – 43,790 shares; and Mr. Pasenelli – 3,622 shares.

Includes shares of unvested restricted stock, with respect to which the individual has voting but no investment (2) power as follows: Mr. Goldstein – 800 shares; Mr. Javaid – 400 shares; Mr. Jenkins – 800 shares; Mr. Middleton – 1,684 shares; Mr. Pasenelli – 4,789 shares; Ms. Peterson – 800 shares; Mr. Shepherd – 800 shares; Mr. Slater – 800 shares; Mr. Smith – 800 shares; Mr. Stone – 800 shares; and Mr. Cockerham – 3,370 shares

Based upon 4,688,159 shares of Company common stock outstanding, plus, for each individual or group, the (3) number of shares of Company common stock that each individual or group may acquire through the exercise of options within 60 days of March 7, 2014.

(4) Includes 69,351 shares owned by Mr. Middleton's wife and 4,877 shares owned by the individual retirement account of Mr. Middleton's wife.

(5) Includes 2,000 shares owned by the individual retirement account of Mr. Stone's wife.

(6) Amount includes an aggregate of 25,835 unvested shares of restricted stock over which certain officers of the Company have voting but no dispositive power.

Includes 40,281 shares held in a suspense account for future allocation and/or distribution among participants as the (7) loan used to purchase the shares is repaid. The ESOP trustees, which are Company directors Joseph V. Stone, Jr., and H. Beaman Smith, vote all allocated shares in accordance with the instructions of the participating employees.

Unallocated shares and shares for which no instructions have been received are voted by the trustees in the same proportion as shares for which the trustees have received timely voting instructions.

(8) Based on information contained in a Schedule 13G filed with the U.S. Securities and Exchange Commission on February 12, 2014.

## ITEMS TO BE VOTED ON BY STOCKHOLDERS

### Item 1 – Election of Directors.

The Community Financial's Board of Directors currently consists of nine members. H. Beaman Smith's term as a director will expire at the annual meeting. The Board is divided into three classes, each with terms of three years, one-third of whom are elected annually. The Board of Directors has nominated Philip T. Goldstein, James R. Shepherd and M. Arshed Javaid to serve for an additional three-year term and until their successors are elected and qualified. Messrs. Goldstein and Shepherd are currently directors of the Company and the Bank. Mr. Javaid is currently a director of the Bank.

It is intended that the persons named in the proxies solicited by the Board will vote for the election of the named nominees. If any nominee is unable to serve, the shares represented by all valid proxies will be voted for the election of such substitute nominee as the Board of Directors may recommend. At this time, the Board knows of no reason why any nominee might be unable to serve.

**The Board of Directors recommends a vote "FOR" the election of each of the nominees.**

Information regarding the nominees and the directors continuing in office is provided below. Unless otherwise stated, each individual has held his or her current occupation for the last five years. The age indicated in each biography is as of December 31, 2013. There are no family relationships among the directors or executive officers. The indicated period for service as a director includes service as a director of Community Bank of the Chesapeake.

### **Board Nominees with Terms Ending in 2017**

**Philip T. Goldstein** has owned and operated Philip T. Goldstein Real Estate Appraisals, a full-service real estate appraisal and consulting firm, located in Prince Frederick, Maryland, since 1975. He currently serves as a director of Asbury Communities, Inc., a non-profit continuing care retirement community headquartered in Gaithersburg, Maryland and Calvert County Nursing Center, Prince Frederick, Maryland. Age 65. Director since 2006.

Mr. Goldstein provides the Board with significant management, strategic and operational knowledge through his experience as owner of a real estate appraisal and consulting firm. Mr. Goldstein's background in commercial and

residential appraisal practice also provides a valuable perspective to the credit function of the Bank. Mr. Goldstein provides local community insight through his position as a director on various local non-profit organizations.

**James R. Shepherd** is a retired businessman and former local government executive. Mr. Shepherd holds an MS degree in Management from the University of Maryland and a BA from Roanoke College in Economics and Business Administration. Mr. Shepherd serves on numerous civic and charitable organizations. Age 68. Director since 2003.

Mr. Shepherd's background in economic development and management adds strength to the market intelligence required to direct strategic initiatives on franchise expansion. Mr. Shepherd also brings critical insight regarding the economic development of the communities in which the Bank operates.

**M. Arshed Javaid** is President of Smartronix, Inc., an information technology and engineering solutions provider. Mr. Javaid founded Smartronix, Inc. in 1995, and has extensive experience in business management and community relations. Currently, he serves on the Historic Sotterley Inc. Board of Trustees and is actively involved with the St. Mary's Chamber of Commerce and the Southern Maryland Navy Alliance. Age 58. Director since 2013.

Mr. Javaid provides the Board with significant management, strategic and operational knowledge through his experience as founder and president of an information technology and engineering solutions provider that has evolved from a start-up company to a company with over 550 employees. Mr. Javaid's experience in the information technology industry provides the Board with valuable insight into the data security and reputational risk issues facing businesses.

### **Directors with Terms Ending in 2015**

**William J. Pasenelli** is President and Chief Financial Officer of the Company and the Bank. Mr. Pasenelli joined the Bank as Chief Financial Officer in 2000 and was named President of the Bank in 2010 and President of the Company in May 2012. Before joining the Bank, Mr. Pasenelli had been Chief Financial Officer of Acacia Federal Savings Bank, Annandale, Virginia, since 1987. Mr. Pasenelli is a member of the American Institute of Certified Public Accountants, the Greater Washington Society of Certified Public Accountants and other civic groups. Age 55. Director since 2010.

Mr. Pasenelli's extensive experience in the local banking industry affords the Board valuable insight regarding the business and operations of the Bank. Mr. Pasenelli's financial acumen and knowledge of the Company's and the Bank's business and history position him well to serve as President and Chief Financial Officer and as a Director.

**Austin J. Slater, Jr.** is the President and Chief Executive Officer of the Southern Maryland Electric Cooperative, which is one of the ten largest electrical distribution cooperatives in the country. Mr. Slater also serves as the immediate past Chairman of the Board of the Maryland Chamber of Commerce and numerous other industry and civic organizations. He also serves as the Chairman of the Board of Trustees for the College of Southern Maryland. Mr. Slater holds a MBA in Finance from George Washington University and a BS in Accounting from Shepherd University. Age 60. Director since 2003.

Mr. Slater has extensive management level experience in a large company setting outside of the financial services industry. Mr. Slater's financial acumen and operational experience allow him to understand the complexities of the Company and the Bank. His experience in a regulated industry has exposed Mr. Slater to many of the issues facing companies today, particularly regulated entities, making Mr. Slater a valued component of a well-rounded board.

**Joseph V. Stone, Jr.** has owned and operated Joe Stone Insurance Agency, which provides multi-line insurance services to clients in Maryland and Virginia, since 1981. He has served as a director for the Southern Maryland Electric Cooperative since 1996 and currently serves as Chairman of the Board. Age 59. Director since 2006.

Mr. Stone provides the Board with significant marketing and operational knowledge through his experience as owner of an insurance agency and various director positions with companies outside of the financial services industry. Mr. Stone also has considerable experience in the insurance industry, corporate governance and risk assessment practices necessary in banking operations.

#### **Directors with Terms Ending in 2016**

**Louis P. Jenkins, Jr.** is the principal of Jenkins Law Firm, LLC, located in LaPlata, Maryland. Before entering private practice, Mr. Jenkins served as an Assistant State's Attorney in Charles County, Maryland from 1997 to 1999. In addition to his private practice, Mr. Jenkins serves as Court Auditor for the Circuit Court for Charles County, Maryland and attorney for the Charles County Board of Elections. Mr. Jenkins currently serves as Chairman of the Board of Directors of Civista Medical Center, a member hospital of the University of Maryland Medical System, and has served as a board member of several other public service organizations including the Southern Maryland Chapter of the American Red Cross, Charles County Chamber of Commerce and the Charles County Bar Association. Age 42. Director since 2000.



As an attorney, Mr. Jenkins provides the Board with substantial knowledge regarding issues facing the Company and the Bank. In addition, Mr. Jenkins brings a critical perspective to the lending and governance function of the Company and the Bank. Mr. Jenkins' experience in the public sector adds valuable expertise regarding local issues and provides first-hand understanding of the local political and business environment in which the Bank operates.

**Michael L. Middleton** is Chairman and Chief Executive Officer of the Company and the Bank. Mr. Middleton joined the Bank in 1973 and served in various management positions until 1979 when he became President of the Bank, which he served as until 2010. He remained President of the Company until May 2012. Mr. Middleton is a Certified Public Accountant and holds a Masters of Business Administration. From 1996 to 2004, Mr. Middleton served on the Board of Directors of the Federal Home Loan Bank of Atlanta, serving as Chairman of the Board in 2004. Mr. Middleton served on the Board of Directors of the Federal Reserve Bank, Baltimore Branch, from 2004 to 2009. He completed his term as Chairman of the Maryland Bankers Association in June 2013 and is currently the Chairman of the Board for the College of Southern Maryland, serves on the Advisory Board of the Robert H. Smith School of Business Center for Financial Policy and serves on the Federal Reserve's Community Depository Advisory Council. He also serves on several philanthropic and civic boards. Age 66. Director since 1979.

Mr. Middleton's extensive experience in the local banking industry and involvement in the communities in which the Bank serves affords the Board valuable insight regarding the business and operations of the Bank. In addition to Mr. Middleton's extensive background in finance and corporate management, Mr. Middleton also has significant expertise in large financial institution governance providing a unique and broad-based decision-making capability for the Company and the Bank. Mr. Middleton's knowledge of the Company's and the Bank's business and history, combined with his success and strategic vision, position him well to serve as our Chairman and Chief Executive Officer.

**Mary Todd Peterson** is the President and Chief Executive Officer of Medmarc Insurance Group and a Director of Medmarc Casualty Insurance Company and each of its subsidiaries. Ms. Peterson has been associated with Medmarc since 2001 where she has also held the positions of Chief Financial Officer and Chief Operating Officer. From 1993 to 2001, Ms. Peterson was a Partner with Johnson Lambert & Co., a certified public accounting firm. Ms. Peterson has also held positions with Acacia Life Insurance Company, Oxford Development Corporation and Ernst & Whinney (now Ernst & Young). Ms. Peterson currently serves as a member of the Property Casualty Insurers Association of America ("PCI") Board of Governors, Chair of PCI's Investment Committee and a member of PCI's Executive and Finance Committees. Ms. Peterson is a member of the American Institute of Certified Public Accountants. Age 59. Director since 2010.

Ms. Peterson has extensive management level experience in a mid-size company setting within the financial services industry. As a Virginia resident, Ms. Peterson provides valuable insight regarding local markets in Virginia. Ms. Peterson's financial and operational expertise within the insurance industry, including her corporate governance and risk assessment skills, provide the Board with a skill set critical to operating the Company and Bank in an efficient manner.



## **Item 2 – Ratification of the Independent Registered Public Accounting Firm.**

Stegman & Company, which was the Company’s independent registered public accounting firm for 2013, has been retained by the Audit Committee of the Board of Directors to be the Company’s independent registered public accounting firm for 2014, subject to ratification by the Company’s stockholders. A representative of Stegman & Company is expected to be present at the annual meeting and will have the opportunity to make a statement if he or she desires to do so and will be available to respond to appropriate questions.

If the ratification of the appointment of the independent registered public accounting firm is not approved by a majority of the votes cast by stockholders at the annual meeting, the Audit Committee may consider other independent registered public accounting firms.

**The Board of Directors recommends that stockholders vote “FOR” the ratification of the appointment of Stegman & Company as the Company’s independent registered public accounting firm.**

## **Item 3 – Advisory Vote on Executive Compensation**

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the “Dodd-Frank Act”) requires that we provide our stockholders with the opportunity to express their views, on a non-binding basis, on the compensation of our named executive officers as disclosed in this proxy statement. This vote, which is often referred to as the “say-on-pay” vote, provides stockholders with the opportunity to endorse or not endorse the following resolution:

“Resolved, that the stockholders approve the compensation of the named executive officers, as described in the tabular disclosure regarding named executive officer compensation and the accompanying narrative disclosure in this proxy statement.”

Because your vote is advisory, it will not be binding upon the Compensation Committee or the Board of Directors. However, the Compensation Committee will take into account the outcome of the vote when considering future executive compensation arrangements.

**The Board of Directors unanimously recommends a vote “FOR” approval of the compensation of the named executive officers.**



**EXECUTIVE COMPENSATION**

**Summary Compensation Table.** The following table provides information concerning total compensation earned or paid to the Chief Executive Officer and the two most highly compensated executive officers of the Company who served in such capacity as of December 31, 2013. These three officers are referred to as the named executive officers in this proxy statement.

Name and Principal Position	Year	Salary (\$)	Bonus (\$)	Stock Awards (\$)	Non-qualified		Total (\$)
					Deferred Compensation Earnings (\$) (1)	All Other Compensation (\$) (2)	
Michael L. Middleton Chief Executive Officer	2013	\$478,899	\$–	\$–	\$ 36,509	\$ 56,565	\$571,973
	2012	454,960	–	65,508	22,720	48,865	592,053
William J. Pasenelli President and Chief Financial Officer	2013	355,131	56,497	32,652(3)	–	50,431	494,711
	2012	341,200	56,298	79,346	–	43,066	519,910
Gregory C. Cockerham Executive Vice President and Chief Lending Officer	2013	274,782	43,657	22,122(4)	–	13,419	353,980
	2012	263,670	43,506	53,764	–	12,036	372,976

Represents the portion of non-qualified deferred compensation earnings under the Community Bank of the Chesapeake Retirement Plan for Directors and the Community Bank of the Chesapeake Executive Deferred Compensation Plan that were above the applicable federal long-term rate. Under the plan, interest is credited quarterly at a rate equal to the Company's annualized return on equity.

(1) Details of the amounts reported in the "All Other Compensation" column for 2013 are provided in the table below.

(2) The table excludes perquisites, which did not exceed \$10,000 in the aggregate for each named executive officer.

Item	Mr. Middleton	Mr. Pasenelli	Mr. Cockerham
Directors' fees	\$ 36,925	\$ 36,925	\$ –
Market value of allocations under the employee stock ownership plan	2,150	2,150	2,150
Employer contribution to 401(k) Plan	9,359	9,359	9,359
Imputed income under split-dollar life insurance arrangement	8,015	1,968	1,883
Reimbursement of payroll taxes for supplemental retirement benefits	116	29	27

Represents the aggregate grant date fair value of the granting of 1,814 shares of restricted stock awards computed in accordance with FASB ASC Topic 718 based on a per share price of \$18.00, on the date of grant for awards in 2013.

Represents the aggregate grant date fair value of the granting of 1,229 shares of restricted stock awards computed in accordance with FASB ASC Topic 718 based on a per share price of \$18.00, on the date of grant for awards in 2013.

**Employment Agreements.** The Community Financial and Community Bank of the Chesapeake maintain employment agreements with each of the named executive officers. The term of Mr. Middleton's employment agreement is automatically extended by one day each day so that the term remains at five years. The term of the employment agreements with Mr. Pasenelli and Mr. Cockerham are automatically extended by one day each day so that the term remains at three years, until either party gives notice to the other of its intent to stop the renewal of the term of the agreement. Among other things, the agreements provide for an annual salary, for participation in an equitable manner in any stock option plan or incentive plan to the extent authorized by the Bank's Board of Directors for its key management employees and for participation in pension, group life insurance, medical coverage and in other employee benefits applicable to executive personnel.

See “*Retirement Benefits*” and “*Other Potential Post-Termination Benefits*” for a discussion of benefits and payments the named executive officers may receive under the employment agreements upon their retirement or termination of their employment.

**Outstanding Equity Awards at Fiscal Year End.** The following table provides information concerning unexercised options for each of the named executive officers outstanding as of December 31, 2013.

Name	Option Awards		Option Exercise Price (\$)	Option Expiration Date	Restricted Stock Awards	
	Number of Securities Underlying Unexercised Options (#) Exercisable	Number of Securities Underlying Unexercised Options (#) Unexercisable			Number of Shares or Units of Stock That Have Not Vested (#)	Market Value of Shares or Units of Stock That Have Not Vested (\$)(1)
Michael L. Middleton	5,830	—	\$27.70	07/17/2017	4,210	\$87,189
	6,036	—	22.29	12/19/2015		
	20,164	—	15.89	12/27/2014		
	4,344	—	27.70			
William J. Pasenelli	5,397	—	22.29	07/17/2017	2,868	\$59,396
	10,298	—	15.89	12/19/2015		
	4,407	—	27.70	12/27/2014		
Gregory C. Cockerham	5,476	—	22.29	07/17/2017	1,947	\$40,322
	7,582	—	15.89	12/19/2015		
				12/27/2014		

(1) Based upon the Company’s closing stock price of \$20.71 at December 31, 2013.

## **RETIREMENT BENEFITS**

The Bank maintains salary continuation agreements with each of the named executive officers to provide the executives with additional compensation at retirement or upon termination of employment due to death, disability or a change in control. Messrs. Middleton, Pasenelli and Cockerham are entitled to a total annual benefit for a period of 15 years of \$128,048, \$92,212 and \$77,035, respectively, upon normal retirement at or after age 62 for Mr. Middleton and 65 for Messrs. Pasenelli and Cockerham. A reduced benefit is payable if the executive retires before normal retirement age. The annual benefits are payable on a monthly basis to the executives or their designated beneficiaries.

The Bank also maintains a supplemental executive retirement plan (“SERP”) with Messrs. Middleton, Pasenelli and Cockerham to provide the executives with additional compensation at retirement or upon termination of employment due to death, disability or a change in control. Messrs. Middleton, Pasenelli and Cockerham are entitled to a total annual benefit for a period of 15 years of \$28,348, \$66,373 and \$10,484, respectively, upon normal retirement at or after age 65 for Messrs. Pasenelli and Cockerham and age 67 in the case of Mr. Middleton. A reduced benefit is payable if the executive retires before normal retirement age. The annual benefits are payable on an annual basis to the executives or their designated beneficiaries.

The Bank maintains an Executive Deferred Compensation Plan under which Messrs. Middleton, Pasenelli and Cockerham may defer all or any portion of their base salary. Deferred amounts will be credited annually with interest at a rate equal to the Company’s return on equity for the calendar year. The executive’s account balance under the plan will be distributed to the executive following the executive’s termination of service in either a lump sum or over a period of one to five years, as elected by the executive.



## **OTHER POTENTIAL POST-TERMINATION BENEFITS**

**Payments Made Upon Termination with Cause.** Each of the named executive officer's employment agreements contain a definition of cause for which we may terminate the executive's employment. If we terminate the executive's employment for cause, he will receive only his base salary or other compensation earned through the date of termination and retain the rights to any vested benefits subject to the terms of the plan or agreement under which those benefits are provided.

The SERPs for Messrs. Middleton, Pasenelli and Cockerham contain a definition of cause for which we may terminate the executive's employment. If the executive's employment is terminated for cause, they will not be entitled to any benefits under the terms of the SERPs.

Under the 1995 Stock Option and Incentive Plan, if we terminate an executive for just cause (as defined in the plan), any stock option granted under the plan and held by the terminated employee is cancelled upon the date of termination.

Pursuant to the 2005 Equity Compensation Plan, if an executive is terminated for cause, all rights to any restricted stock and long-term restricted stock units award granted under the plan and held by the terminated employee will expire as of the effective date of termination.

**Payments Made Upon Termination Without Cause.** If we terminate Mr. Middleton's employment without cause, he will receive (1) his base salary or other compensation earned through the date of termination, a pro rata share of the average bonus or other cash compensation for the three years preceding the termination and retain the rights to any vested benefits subject to the terms of the plan or agreement under which those benefits are provided, and (2) a lump sum payment equal to his base salary for the remaining term of the agreement and five times his most recent annual incentive compensation payment. We would also continue Mr. Middleton's medical, dental and life insurance benefits for 60 months.

Under his employment agreement, if we terminate the employment of Mr. Pasenelli without cause, he would receive a lump sum payment equal to three times his base salary and three times his most recent annual incentive compensation payment. Under Mr. Cockerham's employment agreement, if we terminate his employment without cause, he would receive a lump sum payment equal to two times his base salary and two times his most recent annual incentive compensation payment. We would also continue both executives' medical, dental and life insurance benefits for 36 months.

Pursuant to the 2005 Equity Compensation Plan, if we terminate an executive without cause and unless otherwise determined by the Compensation Committee, all unvested shares of restricted stock and interests under long-term restricted stock units are forfeited as of the termination date of the executive.

**Payments Made Upon Termination by Executive with Good Reason.** If Mr. Middleton voluntarily terminates his employment under circumstances that would constitute good reason (as defined in his employment agreement), he will receive (1) his base salary or other compensation earned through the date of termination, a pro rata share of the average bonus or other cash compensation for the three years preceding the termination and retain the rights to any vested benefits subject to the terms of the plan or agreement under which those benefits are provided, and (2) a lump sum payment equal to his base salary for the remaining term of the agreement and five times his most recent annual incentive compensation payment. We would also continue Mr. Middleton's medical, dental and life insurance benefits for 60 months.

Pursuant to the 2005 Equity Compensation Plan, if an executive voluntarily terminates his or her employment and unless otherwise determined by the Compensation Committee, all unvested shares of common stock and interests under long-term restricted stock units are forfeited as of the termination date of the executive.

**Payments Made Upon Disability.** Under Mr. Middleton's employment agreement, if he becomes disabled and we terminate his employment pursuant to the terms of the agreement, he will receive his base salary or other compensation earned through the date of termination and retain the rights to any vested benefits subject to the terms of the plan or agreement under which those benefits are provided. In addition, Mr. Middleton will be entitled to disability pay equal to 100% of his base salary in effect at the date of termination. He would continue to receive disability payments until the earlier of (1) 180 days after his termination of employment, (2) the date on which long-term disability insurance benefits are first paid to him, (3) his death, or (4) the date his employment agreement would have terminated had his employment not terminated because of disability. If the disability benefits terminate because 180 days have lapsed or because the date his employment agreement would have terminated had his employment not terminated because of disability is reached, Mr. Middleton will receive disability pay equal to 60% of his base salary during an additional period ending on the earliest of (1) the date on which long-term disability insurance benefits are first paid to him, (2) his death, or (3) the date his employment agreement would have terminated had his employment not terminated because of disability. While receiving benefits under any long-term disability insurance plan, the Company will supplement any disability benefits received by Mr. Middleton to ensure that the aggregate amount received by Mr. Middleton equals 60% of his base salary. Mr. Middleton would continue to participate in our benefit plans until the date his employment agreement would have terminated had his employment not terminated because of disability.

Under Mr. Pasenelli's and Mr. Cockerham's employment agreements, if we terminate an executive due to disability pursuant to the terms of the agreement, the executive will receive the compensation and benefits provided for under the agreement for (1) any period during the term of the agreement and before the establishment of the executive's disability; or (2) any period of disability before the executive's termination of employment due to disability.

The SERPs for Messrs. Middleton, Pasenelli and Cockerham provide for a disability benefit equal to the executive's accrued benefit, calculated as of the date of determination of disability. Payment of the disability benefit will commence on the first day of the month following the earlier of the executive's 65<sup>th</sup> birthday or death and shall be paid in 15 equal annual installments.

Under the salary continuation agreements dated September 6, 2003, as amended, upon termination of employment as a result of disability, Messrs. Middleton, Pasenelli and Cockerham are entitled to an annual benefit for a period of 15 years of \$128,048, \$74,112 and \$72,235, respectively, commencing with the month following the executive attaining age 65, or in Mr. Middleton's case, age 62. Under the salary continuation agreements dated August 21, 2006, as amended, Messrs. Pasenelli and Cockerham are entitled to an annual disability benefit ranging from \$10,637 to \$18,100 and \$3,282 to \$4,800, respectively, depending on the date of termination, commencing with the month following the executive attaining age 65.

Under the 1995 Stock Option and Incentive Plan, if we terminate an executive's employment due to a disability, outstanding stock options will vest and remain exercisable until the earlier of one year from the date of termination or the expiration date of the stock options.

Pursuant to the 2005 Equity Compensation Plan, if we terminate an executive's employment due to a disability, outstanding restricted stock and long-term restricted stock unit awards will immediately vest as of the date of termination.

**Payments Made Upon Death.** Under Mr. Middleton's employment agreement, upon Mr. Middleton's death, Mr. Middleton's beneficiary will receive any base salary compensation earned through the date of death, plus any other compensation or benefits to be provided in accordance with the terms and provisions of the Company's benefit plans and programs.

Under Mr. Pasenelli's and Mr. Cockerham's employment agreements, upon the executive's death, the Company will pay his or her beneficiary or estate any compensation due to the executive through the end of the month in which death occurred, plus any other compensation or benefits to be provided in accordance with the terms and provisions of the Company's benefit plans and programs.

Mr. Middleton's, Mr. Pasenelli's and Mr. Cockerham's SERPs provide for a death benefit equal to the executive's accrued benefit, payable to the executive's beneficiary in 15 equal annual installments beginning the second month following the death of the executive if the executive dies before reaching normal retirement age. If the executive dies after the commencement of the SERP benefit payments, the executive's beneficiary is entitled to the unpaid balance of the executive's 15 annual benefit payments.

Under their salary continuation agreements, if the executive dies while in active service with the Bank, Mr. Middleton's, Mr. Pasenelli's and Mr. Cockerham's designated beneficiaries will receive an annual benefit, for a period of 15 years, of \$128,048, \$92,212 and \$77,035, respectively, commencing with the month following the executive's death. If the executive dies after his employment has terminated but before payments under the agreement have commenced, their designated beneficiary will be entitled to the same payments beginning on the first day of the month after the executive's death.

Under the 1995 Stock Option and Incentive Plan, if an executive dies, outstanding stock options will vest and remain exercisable until the earlier of two years from the date of death or the expiration date of the stock options.

Pursuant to the 2005 Equity Compensation Plan, if an executive dies, outstanding awards vest immediately.

**Payments Made Upon a Change in Control.** Mr. Middleton's employment agreement provides that if during the two-year period following a change in control (as defined in the agreement), Mr. Middleton terminates employment

for any reason, he will be entitled to (1) his base salary or other compensation earned through the date of termination, a pro rata share of the average bonus or other cash compensation for the three years preceding the termination and retain the rights to any vested benefits subject to the terms of the plan or agreement under which those benefits are provided, and (2) a lump sum payment equal to his base salary for the remaining term of the agreement and five times his most recent annual incentive compensation payment. We would also continue Mr. Middleton's medical, dental and life insurance benefits for 60 months. Mr. Middleton would also be entitled to these payments and benefits if Mr. Middleton's employment is terminated due to death or disability and (1) the termination occurs within one year after a change in control, or (2) the termination occurs within one year after a preliminary change in control (as defined in the agreement) and a change in control occurs within two years after such termination. Section 280G of the Internal Revenue Code provides that payments related to a change in control that equal or exceed three times the individual's "base amount" (defined as average annual taxable compensation over the five preceding calendar years) constitute "excess parachute payments." Individuals who receive excess parachute payments are subject to a 20% excise tax on the amount that exceeds the base amount, and the employer may not deduct such amounts. Mr. Middleton's employment agreement provides for an additional tax indemnification payment if payments under the agreement exceed three times his base amount ("280G Limit"). The indemnification payment provides the executive with a net amount sufficient to pay the excise tax and related taxes to place Mr. Middleton in the same economic position in which he would have been had the 280G Limit not applied.

Mr. Pasenelli's employment agreement provides that if (1) the executive's employment is terminated without cause or without the executive's consent and for a reason other than cause in connection with or within 12 months after a change in control (as defined in the agreement); or (2) the executive voluntarily terminates employment within 12 months following a change in control upon the occurrence of events described in the agreement, he will receive a lump sum payment equal to three times his annual base salary and three times his most recent annual incentive compensation payment, plus continued health and welfare benefits for 36 months following termination. Under Mr. Cockerham's employment agreement, he will receive a lump sum payment equal to two times his annual base salary and two times his most recent annual incentive compensation payment, plus continued health and welfare benefits for 36 months following termination. Mr. Pasenelli's and Mr. Cockerham's employment agreements provide that if the value of the benefits provided under the agreements in connection with a change in control exceed his 280G Limit, his payment will be reduced or revised so that the aggregate payments do not exceed his 280G Limit.

Mr. Middleton's, Mr. Pasenelli's and Mr. Cockerham's SERPs provide that if the executives experience a separation from service within 24 months following a change in control, the executives are entitled to an annual benefit for a period of 15 years of \$28,348, \$66,373 and \$10,484, respectively. The executives will receive the benefit payment in the form of (1) a lump sum, (2) equal annual installments over two years, or (3) equal annual installments over five years, as previously elected by each executive.

Under the salary continuation agreements dated September 6, 2003, as amended, upon the termination of employment within 12 months (24 months in the case of Mr. Middleton) subsequent to a change in control and before age 65 (62 in the case of Mr. Middleton), Mr. Middleton, Mr. Pasenelli and Mr. Cockerham are entitled to an annual benefit for a period of 15 years of \$128,048, \$74,112 and \$72,235, respectively, commencing with the month following the executive attaining age 65 (62 in the case of Mr. Middleton). As with his employment agreement, Mr. Middleton's salary continuation agreement provides for an additional tax indemnification payment if payments under the agreement exceed his 280G Limit. Each of Mr. Pasenelli's and Mr. Cockerham's salary continuation agreements dated September 6, 2003, as amended, provide that if the value of the benefits provided in connection with a change in control exceed his 280G Limit, his payment will be reduced or revised so that the aggregate payments do not exceed his 280G Limit. Under the salary continuation agreement dated August 21, 2006, as amended, Mr. Pasenelli is entitled to an additional annual benefit ranging from \$11,314 to \$18,100 (based on the date of termination) if his employment is terminated within 12 months subsequent to a change in control and before age 65. Under the salary continuation agreement dated August 21, 2006, as amended, Mr. Cockerham is entitled to an additional annual benefit equal to the present value of \$4,800 using an interest factor of 5% upon the termination of employment within 12 months subsequent to a change in control and before age 65.

In the event of a change in control of The Community Financial or Community Bank of the Chesapeake, outstanding stock options granted pursuant to our 1995 Stock Option and Incentive Plan automatically vest and, unless otherwise provided for by the committee administering the plan, the option holder will receive in cash an amount equal to the difference between the fair market price of the securities and the exercise price of the option for each option held. Under the Company's 2005 Equity Compensation Plan, a change in control accelerates the vesting of all outstanding stock options, restricted stock awards and long-term restricted stock units. The value of the accelerated options count toward the executive's 280G Limit.





## OTHER INFORMATION RELATING TO

### DIRECTORS AND EXECUTIVE OFFICERS

**Section 16(a) Beneficial Ownership Reporting Compliance.** Pursuant to federal securities laws, the Company's officers, directors and persons who own more than 10% of the outstanding common stock are required to file reports detailing their ownership and changes of ownership in such common stock, and to furnish the Company with copies of all such reports. Based solely on its review of the copies of such reports received during the past fiscal year and written representations from such persons that no additional reports of changes in beneficial ownership were required, the Company believes that during 2013, all of its officers, directors and all of its stockholders owning in excess of 10% of the outstanding common stock of the Company, have complied with the reporting requirements, except for two late reports filed by Todd L. Capitani, Executive Vice President and Senior Financial Officer of the Company, with regard to awards of restricted stock and one late report filed by Mr. Pasenelli with regard to the exercise of stock options and the tendering of shares for tax withholding purposes.

**Policies and Procedures for Approval of Related Persons Transactions.** We maintain a Policy and Procedures Governing Related Person Transactions, which is a written policy and set of procedures for the review and approval or ratification of transactions involving related persons. Under the policy, related persons consist of directors, director nominees, executive officers, persons or entities known to us to be the beneficial owner of more than five percent of any outstanding class of the voting securities of the Company, or immediate family members or certain affiliated entities of any of the foregoing persons.

Transactions covered by the policy consist of any financial transaction, arrangement or relationship or series of similar transactions, arrangements or relationships, in which:

- the aggregate amount involved will or may be expected to exceed \$50,000 in any calendar year;
- the Company is, will or may be expected to be a participant; and
- any related person has or will have a direct or indirect material interest.

The policy excludes certain transactions, including:

- any compensation paid to an executive officer of the Company if the Governance Committee of the Board approved (or recommended that the Board approve) such compensation;
- any compensation paid to a director of the Company if the Board or an authorized committee of the Board approved such compensation; and
- any transaction with a related person involving consumer and investor financial products and services provided in the ordinary course of the Company's business and on substantially the same terms as those prevailing at the time for

comparable services provided to unrelated third parties or to the Company's employees on a broad basis (and, in the case of loans, in compliance with the Sarbanes-Oxley Act of 2002).

Related person transactions will be approved or ratified by the Audit Committee. In determining whether to approve or ratify a related person transaction, the Audit Committee will consider all relevant factors, including:

- whether the terms of the proposed transaction are at least as favorable to the Company as those that might be achieved with an unaffiliated third party;
- the size of the transaction and the amount of consideration payable to the related person;
- the nature of the interest of the related person;
- whether the transaction may involve a conflict of interest; and
- whether the transaction involves the provision of goods and services to the Company that are available from unaffiliated third parties.

A member of the Audit Committee who has an interest in the transaction will abstain from voting on approval of the transaction, but may, if so requested by the chair of the Audit Committee, participate in some or all of the discussion.

**Relationships and Transactions with the Company and the Bank.** The Sarbanes-Oxley Act of 2002 generally prohibits loans by the Company to its executive officers and directors. However, the Sarbanes-Oxley Act contains a specific exemption from such prohibition for loans by the Bank to its executive officers and directors in compliance with federal banking regulations. Federal regulations require that all loans or extensions of credit to executive officers and directors of insured financial institutions must be made on substantially the same terms, including interest rates and collateral, as those prevailing at the time for comparable transactions with other persons not related to the Bank and must not involve more than the normal risk of repayment or present other unfavorable features. The Bank is therefore prohibited from making any new loans or extensions of credit to executive officers and directors at different rates or terms than those offered to the general public. Notwithstanding this rule, federal regulations permit the Bank to make loans to executive officers and directors at reduced interest rates if the loan is made under a benefit program generally available to all other employees and does not give preference to any executive officer or director over any other employee. The Bank does not currently have such a program in place. From time to time, the Bank makes loans and extensions of credit to its executive officers and directors, and members of their immediate families. The outstanding loans made to our directors and executive officers, and members of their immediate families, were made in the ordinary course of business, were made on substantially the same terms, including interest rates and collateral, as those prevailing at the time for comparable loans with persons not related to the Bank, and did not involve more than the normal risk of collectibility or present other unfavorable features. As of December 31, 2013, these loans were performing according to their original terms.

In accordance with banking regulations, the Board of Directors reviews all loans made to a director or executive officer in an amount that, when aggregated with the amount of all other loans to such person and his or her related interests, exceed the greater of \$25,000 or 5% of the Company's capital and surplus (up to a maximum of \$500,000), and such loan must be approved in advance by a majority of the disinterested members of the Board of Directors.

## **STOCKHOLDER PROPOSALS AND NOMINATIONS**

To be eligible for inclusion in the Company's proxy materials for next year's annual meeting of stockholders, any stockholder proposal to take action at such meeting must be received at the Company's main office at 3035 Leonardtown Road, Waldorf, Maryland 20601 no later than November 25, 2014. If next year's annual meeting is held on a date more than 30 calendar days from May 5, 2015, a stockholder proposal must be received by a reasonable time before the Company begins to print and mail its proxy solicitation materials. Any stockholder proposals will be subject to the requirements of the proxy rules adopted by the Securities and Exchange Commission.

Stockholder proposals, other than those submitted above, and nominations must be submitted in writing, delivered or mailed by first class United States mail, postage pre-paid, to the Secretary of the Company not fewer than 30 days nor

more than 60 days before any such meeting; provided, however, that if notice or public disclosure of the meeting is given fewer than 40 days before the meeting, such written notice shall be delivered or mailed to the Secretary of the Company not later than the close of the 10<sup>th</sup> day following the day on which notice of the meeting was mailed to stockholders.

## **BOARD POLICIES REGARDING COMMUNICATIONS**

### **WITH THE BOARD OF DIRECTORS**

The Board of Directors maintains a process for stockholders to communicate with the Board of Directors. Stockholders wishing to communicate with the Board of Directors should send any communication to the Secretary, The Community Financial Corporation, 3035 Leonardtown Road, Waldorf, Maryland 20601. Any communication must state the number of shares beneficially owned by the stockholder making the communication. The Secretary will forward such communication to the full Board of Directors or to any individual director or directors to whom the communication is addressed unless the communication is unduly hostile, threatening, illegal or similarly inappropriate, in which case the Secretary has the authority to discard the communication or take appropriate legal action regarding the communication.

### **MISCELLANEOUS**

The Company will pay the cost of this proxy solicitation. The Company will reimburse brokerage firms and other custodians, nominees and fiduciaries for reasonable expenses incurred by them in sending proxy materials to the beneficial owners of the common stock. In addition to conducting solicitations by mail, directors, officers and regular employees of the Company may solicit proxies personally or by telephone without additional compensation.

The Company's 2013 Annual Report to Stockholders, including financial statements, accompanies this proxy statement. Such Annual Report is not to be treated as a part of the proxy solicitation material nor as having been incorporated herein by reference. **A copy of the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2013, as filed with the Securities and Exchange Commission, will be furnished without charge to stockholders as of March 7, 2014, upon written request to the Secretary, The Community Financial Corporation, 3035 Leonardtown Road, Waldorf, Maryland 20601.**

[The Community Financial Corporation Letterhead]

Dear ESOP Participant:

On behalf of the Board of Directors, I am forwarding to you the attached vote authorization form to convey your voting instructions to Joseph V. Stone, Jr. and H. Beaman Smith, Trustees for the Community Bank of the Chesapeake Employee Stock Ownership Plan and Trust (the "ESOP") on the proposals presented at the Annual Meeting of Stockholders of The Community Financial Corporation (the "Company") on May 5, 2014. Also enclosed is a Notice of Annual Meeting and Proxy Statement for the Company's Annual Meeting of Stockholders and a The Community Financial Corporation 2013 Annual Report to Stockholders.

As an ESOP participant, you are entitled to instruct the ESOP Trustees how to vote the shares of Company common stock allocated to your ESOP account as of March 7, 2014, the record date for the Annual Meeting. The Trustees will vote all allocated shares of Company common stock as directed by ESOP participants. The Trustees will vote unallocated shares of common stock held in the ESOP Trust and the shares for which timely instructions are not received in a manner calculated to most accurately reflect the instructions received from ESOP participants, subject to the exercise of their fiduciary duties.

To direct the ESOP Trustees how to vote the shares of common stock allocated to your ESOP account, please complete and sign the enclosed vote authorization form and return it to the attention of Marlene Smith at the address indicated on the vote authorization form no later than **April 28, 2014**.

Sincerely,

/s/ Michael L. Middleton  
Michael L. Middleton  
*Chairman of the Board and Chief Executive Officer*

**VOTE AUTHORIZATION FORM**

**COMMUNITY BANK OF THE CHESAPEAKE**

**EMPLOYEE STOCK OWNERSHIP PLAN AND TRUST**

**THE COMMUNITY FINANCIAL CORPORATION**

**Annual Meeting of Stockholders – May 5, 2014**

With respect to all shares of common stock of The Community Financial Corporation (the “Company”) that are allocated to the account of the undersigned pursuant to the Community Bank of the Chesapeake Employee Stock Ownership Plan and Trust (the “ESOP”), the undersigned hereby directs Joseph V. Stone, Jr. and H. Beaman Smith, as Trustees of the Trust established under the ESOP, to vote such shares at the Annual Meeting of Stockholders (the “Meeting”) to be held at the Community Bank of the Chesapeake, Waldorf, Maryland, on Monday, May 5, 2014 at 10:00 a.m., local time, and at any and all adjournments thereof as follows:

**The Board of Directors recommends a vote “FOR” all of the nominees and “FOR” Proposals 2 and 3.**

You are to vote my shares as follows:

x PLEASE MARK VOTES AS IN THIS EXAMPLE

**1. ELECTION OF DIRECTORS**

**FOR** all nominees “ **WITHHOLD AUTHORITY** to vote “ **\*EXCEPTIONS** “  
listed below for all nominees listed below

Philip T. Goldstein, James R. Shepherd and M. Arshed Javaid

**(INSTRUCTIONS: To withhold authority to vote for any individual nominee, mark the “Exceptions” box and write that nominee’s name in the space provided below).**

\*Exceptions: \_\_\_\_\_

**2. THE RATIFICATION OF THE APPOINTMENT OF STEGMAN & COMPANY AS THE INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM FOR THE FISCAL YEAR ENDING DECEMBER 31, 2014**

FOR AGAINST ABSTAIN

.. .. .

**3. THE APPROVAL OF A NON-BINDING RESOLUTION ON THE COMPENSATION OF THE NAMED EXECUTIVE OFFICERS.**

FOR AGAINST ABSTAIN

.. .. .



The undersigned acknowledges receipt from the Company prior to the execution of this vote authorization form of the Notice of Annual Meeting, a Proxy Statement for the Annual Meeting and the Company's 2013 Annual Report.

PARTICIPANT'S NAME

Dated: \_\_\_\_\_, 2014

SIGNATURE OF PARTICIPANT

**Please complete this direction form, sign, date and return it to the Company, Attn: Marlene Smith, The Community Financial Corporation, 3035 Leonardtown Road, Waldorf, Maryland 20601 by April 28, 2014.**



