

FIRST UNITED CORP/MD/  
Form 10-K  
March 15, 2013

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, DC 20549

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**FORM 10-K**

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

**For the fiscal year ended December 31, 2012**

Commission file number 0-14237

**FIRST UNITED CORPORATION**

*(Exact name of registrant as specified in its charter)*

**Maryland**

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

**52-1380770**

*(I.R.S. Employer Identification Number)*

**19 South Second Street, Oakland, Maryland**

*(Address of principal executive offices)*

**21550-0009**

*(Zip Code)*

Registrant's telephone number, including area code: **(800) 470-4356**

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 \$.01 per share** **NASDAQ Global Select Market**

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

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

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

Indicate by check mark if disclosures of delinquent filers pursuant to Item 405 of Regulation S-K (Section 229.405 of this chapter) is not contained herein, and will not be contained, to the best of the 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 definition of "accelerated filer", "large 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

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

The aggregate market value of the registrant's outstanding voting and non-voting common equity held by non-affiliates as of June 30, 2012: **\$23,749,764.**

The number of shares of the registrant's common stock outstanding as of February 28, 2013: **6,199,283**

**Documents Incorporated by Reference**

Portions of the registrant's definitive proxy statement for the 2013 Annual Meeting of Shareholders to be filed with the SEC pursuant to Regulation 14A are incorporated by reference into Part III of this Annual Report on Form 10-K.

**First United Corporation**

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## Forward-Looking Statements

This Annual Report on Form 10-K of First United Corporation (“we”, “our” or “us” on a consolidated basis) contains forward-looking statements within the meaning of The Private Securities Litigation Reform Act of 1995. Such statements include projections, predictions, expectations or statements as to beliefs or future events or results or refer to other matters that are not historical facts. Forward-looking statements are subject to known and unknown risks, uncertainties and other factors that could cause the actual results to differ materially from those contemplated by the statements. The forward-looking statements contained in this annual report are based on various factors and were derived using numerous assumptions. In some cases, you can identify these forward-looking statements by words like “may”, “will”, “should”, “expect”, “plan”, “anticipate”, “intend”, “believe”, “estimate”, “predict”, “potential”, or “continue” or those words and other comparable words. You should be aware that those statements reflect only our predictions. If known or unknown risks or uncertainties should materialize, or if underlying assumptions should prove inaccurate, actual results could differ materially from past results and those anticipated, estimated or projected. You should bear this in mind when reading this annual report and not place undue reliance on these forward-looking statements. Factors that might cause such differences include, but are not limited to:

- the risk that the weak national and local economies and depressed real estate and credit markets caused by the recent global recession will continue to decrease the demand for loan, deposit and other financial services and/or increase loan delinquencies and defaults;

- changes in market rates and prices may adversely impact the value of securities, loans, deposits and other financial instruments and the interest rate sensitivity of our balance sheet;

- our liquidity requirements could be adversely affected by changes in our assets and liabilities;

- the effect of legislative or regulatory developments, including changes in laws concerning taxes, banking, securities, insurance and other aspects of the financial services industry;

- competitive factors among financial services organizations, including product and pricing pressures and our ability to attract, develop and retain qualified banking professionals;

- the effect of changes in accounting policies and practices, as may be adopted by the Financial Accounting Standards Board, the Securities and Exchange Commission (the “SEC”), the Public Company Accounting Oversight Board and other regulatory agencies; and

- the effect of fiscal and governmental policies of the United States federal government.

You should also consider carefully the risk factors discussed in Item 1A of Part I of this annual report, which address additional factors that could cause our actual results to differ from those set forth in the forward-looking statements and could materially and adversely affect our business, operating results and financial condition. The risks discussed in this annual report are factors that, individually or in the aggregate, management believes could cause our actual results to differ materially from expected and historical results. You should understand that it is not possible to predict or identify all such factors. Consequently, you should not consider such disclosures to be a complete discussion of all potential risks or uncertainties.

The forward-looking statements speak only as of the date on which they are made, and, except to the extent required by federal securities laws, we undertake no obligation to update any forward-looking statement to reflect events or circumstances after the date on which the statement is made or to reflect the occurrence of unanticipated events. In addition, we cannot assess the impact of each factor on our business or the extent to which any factor, or combination of factors, may cause actual results to differ materially from those contained in any forward-looking statements.

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## ITEM 1. BUSINESS

### General

First United Corporation is a Maryland corporation chartered in 1985 and a financial holding company registered under the federal Bank Holding Company Act of 1956, as amended. First United Corporation's primary business is serving as the parent company of First United Bank & Trust, a Maryland trust company (the "Bank"), First United Statutory Trust I ("Trust I") and First United Statutory Trust II ("Trust II"), both Connecticut statutory business trusts, and First United Statutory Trust III, a Delaware statutory business trust ("Trust III" and together with Trust I and Trust II, the "Trusts"). The Trusts were formed for the purpose of selling trust preferred securities that qualified as Tier 1 capital. First United Corporation is also the parent company of First United Insurance Group, LLC, a Maryland limited liability company (the "Insurance Agency") that, through the close of business on December 31, 2011, operated as a full service insurance agency. Effective on January 1, 2012, the Insurance Agency sold substantially all of its assets, net of cash, to a third-party and is no longer an active subsidiary. The Bank has three wholly-owned subsidiaries: OakFirst Loan Center, Inc., a West Virginia finance company; OakFirst Loan Center, LLC, a Maryland finance company (collectively, the "OakFirst Loan Centers"), and First OREO Trust, a Maryland statutory trust formed for the purposes of servicing and disposing of the real estate that the Bank acquires through foreclosure or by deed in lieu of foreclosure. The Bank owns a majority interest in Cumberland Liquidation Trust, a Maryland statutory trust formed for the purposes of servicing and disposing of real estate that secured a loan made by another bank and in which the Bank held a participation interest. The Bank also owns 99.9% of the limited partnership interests in Liberty Mews Limited Partnership, a Maryland limited partnership formed for the purpose of acquiring, developing and operating low-income housing units in Garrett County, Maryland.

At December 31, 2012, we had total assets of approximately \$1.32 billion, net loans of approximately \$858.8 million, and deposits of approximately \$ 976.9 million. Shareholders' equity at December 31, 2012 was approximately \$98.9 million.

First United Corporation maintains an Internet website at [www.mybank4.com](http://www.mybank4.com) on which it makes available, free of charge, its Annual Report on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K, and all amendments to the foregoing as soon as reasonably practicable after these reports are electronically filed with, or furnished to, the SEC.

### Banking Products and Services

The Bank operates 27 banking offices, one call center and 29 Automated Teller Machines ("ATMs") in Allegany County, Frederick County, Garrett County, and Washington County in Maryland, and in Berkeley County, Mineral County, Hardy County, and Monongalia County in West Virginia. The Bank is an independent community bank



providing a complete range of retail and commercial banking services to businesses and individuals in its market areas. Services offered are essentially the same as those offered by the regional institutions that compete with the Bank and include checking, savings, money market deposit accounts, and certificates of deposit, business loans, personal loans, mortgage loans, lines of credit, and consumer-oriented retirement accounts including individual retirement accounts (“IRAs”) and employee benefit accounts. In addition, the Bank provides full brokerage services through a networking arrangement with Cetera Investment Services, LLC., a full service broker-dealer. The Bank also provides safe deposit and night depository facilities, and insurance products and trust services. The Bank’s deposits are insured by the Federal Deposit Insurance Corporation (the “FDIC”).

***Lending Activities***— Our lending activities are conducted through the Bank. Since 2010, the Bank has not been originating any new loans through the OakFirst Loan Centers and their sole activity is servicing existing loans.

The Bank’s commercial loans are primarily secured by real estate, commercial equipment, vehicles or other assets of the borrower. Repayment is often dependent on the successful business operations of the borrower and may be affected by adverse conditions in the local economy or real estate market. The financial condition and cash flow of commercial borrowers is therefore carefully analyzed during the loan approval process, and continues to be monitored throughout the duration of the loan by obtaining business financial statements, personal financial statements and income tax returns. The frequency of this ongoing analysis depends upon the size and complexity of the credit and collateral that secures the loan. It is also the Bank’s general policy to obtain personal guarantees from the principals of the commercial loan borrowers.

Commercial real estate (“CRE”) loans are primarily those secured by land for residential and commercial development, agricultural purpose properties, service industry buildings such as restaurants and motels, retail buildings and general purpose business space. The Bank attempts to mitigate the risks associated with these loans through low loan to value ratio standards, thorough financial analyses, and management’s knowledge of the local economy in which the Bank lends.

The risk of loss associated with CRE construction lending is controlled through conservative underwriting procedures such as loan to value ratios of 80% or less, obtaining additional collateral when prudent, analysis of cash flows, and closely monitoring construction projects to control disbursement of funds on loans.

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The Bank's residential mortgage portfolio is distributed between variable and fixed rate loans. Many loans are booked at fixed rates in order to meet the Bank's requirements under the Community Reinvestment Act or to complement our asset liability mix. Other fixed rate residential mortgage loans are originated in a brokering capacity on behalf of other financial institutions, for which the Bank receives a fee. As with any consumer loan, repayment is dependent on the borrower's continuing financial stability, which can be adversely impacted by job loss, divorce, illness, or personal bankruptcy. Residential mortgage loans exceeding an internal loan-to-value ratio require private mortgage insurance. Title insurance protecting the Bank's lien priority, as well as fire and casualty insurance, is also required.

Home equity lines of credit, included within the residential mortgage portfolio, are secured by the borrower's home and can be drawn on at the discretion of the borrower. These lines of credit are at variable interest rates.

The Bank also provides residential real estate construction loans to builders and individuals for single family dwellings. Residential construction loans are usually granted based upon "as completed" appraisals and are secured by the property under construction. Site inspections are performed to determine pre-specified stages of completion before loan proceeds are disbursed. These loans typically have maturities of six to 12 months and may have a fixed or variable rate. Permanent financing for individuals offered by the Bank includes fixed and variable rate loans with three or five year adjustable rate mortgages.

A variety of other consumer loans are also offered to customers, including indirect and direct auto loans, and other secured and unsecured lines of credit and term loans. Careful analysis of an applicant's creditworthiness is performed before granting credit, and on-going monitoring of loans outstanding is performed in an effort to minimize risk of loss by identifying problem loans early.

An allowance for loan losses is maintained to provide for anticipated losses from our lending activities. A complete discussion of the factors considered in determination of the allowance for loan losses is included in Item 7 of Part II of this report.

**Deposit Activities**— The Bank offers a full array of deposit products including checking, savings and money market accounts, regular and IRA certificates of deposit, Christmas Savings accounts, College Savings accounts, and Health Savings accounts. The Bank also offers the Certificate of Deposit Account Registry Service<sup>®</sup>, or CDARS<sup>®</sup>, program to municipalities, businesses, and consumers through which the Bank provides access to multi-million-dollar certificates of deposit that are FDIC-insured. Since the termination of the Transaction Account Guarantee ("TAG") program as of December 31, 2012, the Bank offers Insured Cash Sweep, or ICS, program to municipalities, businesses, and consumers through which the Bank provides access to multi-million-dollar savings and demand deposits that are FDIC-insured. In addition, we offer our commercial customers packages which include Treasury Management, Cash Sweep and various checking opportunities.

Information about our income from and assets related to our banking business may be found in the Consolidated Statements of Financial Condition and the Consolidated Statements of Income and the related notes thereto included in Item 8 of Part II of this annual report.

***Trust Services***—The Bank’s Trust Department offers a full range of trust services, including personal trust, investment agency accounts, charitable trusts, retirement accounts including IRA roll-overs, 401(k) accounts and defined benefit plans, estate administration and estate planning.

At December 31, 2012 and 2011, the total market value of assets under the supervision of the Bank’s Trust Department was approximately \$637 million and \$595 million, respectively. Trust Department revenues for these years may be found in the Consolidated Statements of Income under the heading “Other operating income”, which is contained in Item 8 of Part II of this annual report.

***Insurance Activities***—Through December 31, 2011, we offered a full range of insurance products and services to customers in our market areas through the Insurance Agency. Information about income from insurance activities for each of the years ended December 31, 2011 and 2010 may be found under “Other Operating Income” in the Consolidated Statements of Income included in Item 8 of Part II of this annual report. The Insurance Agency sold substantially all of its assets, net of cash, effective on January 1, 2012.

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## COMPETITION

The banking business, in all of its phases, is highly competitive. Within our market areas, we compete with commercial banks, (including local banks and branches or affiliates of other larger banks), savings and loan associations and credit unions for loans and deposits, with consumer finance companies for loans, and with other financial institutions for various types of products and services. There is also competition for commercial and retail banking business from banks and financial institutions located outside our market areas and on the internet.

The primary factors in competing for deposits are interest rates, personalized services, the quality and range of financial services, convenience of office locations and office hours. The primary factors in competing for loans are interest rates, loan origination fees, the quality and range of lending services and personalized services.

To compete with other financial services providers, we rely principally upon local promotional activities, personal relationships established by officers, directors and employees with its customers, and specialized services tailored to meet its customers' needs. In those instances in which we are unable to accommodate a customer's needs, we attempt to arrange for those services to be provided by other financial services providers with which we have a relationship.

The following table sets forth deposit data for the Maryland and West Virginia Counties in which the Bank maintains offices as of June 30, 2012, the most recent date for which comparative information is available.

[6]

	Offices (in Market)	Deposits (in thousands)	Market Share	
Allegany County, Maryland:				
Susquehanna Bank	5	\$ 296,051	44.21	%
Manufacturers & Traders Trust Company	6	162,292	24.23	%
First United Bank & Trust	4	116,823	17.44	%
PNC Bank NA	3	50,131	7.48	%
Standard Bank	2	44,493	6.64	%

Source: FDIC Deposit Market Share Report

Frederick County, Maryland:				
PNC Bank NA	20	1,053,620	27.11	%
Branch Banking & Trust Co.	12	711,851	18.32	%
Bank Of America NA	6	313,184	8.06	%
Frederick County Bank	5	266,996	6.87	%
Manufacturers & Traders Trust Company	6	248,306	6.39	%
Capital One NA	6	205,053	5.28	%
Woodsboro Bank	7	197,956	5.10	%
BlueRidge Bank	2	150,954	3.89	%
First United Bank & Trust	4	144,687	3.72	%
Wells Fargo Bank NA	2	142,092	3.66	%
SunTrust Bank	3	131,566	3.39	%
Middletown Valley Bank	4	125,195	3.22	%
Sandy Spring Bank	4	91,989	2.37	%
Sovereign Bank	1	44,202	1.14	%
Columbia Bank	2	24,724	0.64	%
SONABANK	1	18,345	0.47	%
Damascus Community Bank	1	13,997	0.36	%
Woodforest National Bank	1	310	0.01	%

Source: FDIC Deposit Market Share Report

Garrett County, Maryland:				
First United Bank & Trust	6	350,052	60.36	%
Susquehanna Bank	2	101,043	17.42	%
Manufacturers & Traders Trust Company	5	92,607	15.97	%
Clear Mountain Bank	1	29,837	5.14	%
Miners & Merchants Bank	1	6,409	1.11	%

Source: FDIC Deposit Market Share Report

Washington County, Maryland:				
Susquehanna Bank	12	641,259	32.46	%
Columbia Bank	11	410,851	20.79	%
Manufacturers & Traders Trust Company	11	376,039	19.03	%
PNC Bank NA	5	167,257	8.47	%
United Bank	2	105,183	5.32	%

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First United Bank & Trust	3	79,185	4.01	%
Sovereign Bank	3	75,844	3.84	%
Capital One NA	2	41,139	2.08	%
Citizens National Bank of Berkeley Springs	1	38,206	1.93	%
Orrstown Bank	1	26,088	1.32	%
Jefferson Security Bank	1	7,833	0.40	%
Middletown Valley Bank	1	6,898	0.35	%

Source: FDIC Deposit Market Share Report

Berkeley County, West Virginia:

Branch Banking & Trust Company	5	324,690	28.61	%
United Bank	5	205,502	18.10	%
First United Bank & Trust	5	130,704	11.52	%
City National Bank of West Virginia	4	120,611	10.63	%
Susquehanna Bank	3	117,859	10.38	%
Jefferson Security Bank	2	69,756	6.15	%
MVB Bank Inc.	1	62,430	5.50	%
Bank of Charles Town	2	48,052	4.23	%
Citizens National Bank of Berkeley Springs	3	41,335	3.64	%
Summit Community Bank	1	13,412	1.18	%
Woodforest National Bank	1	724	0.06	%

Source: FDIC Deposit Market Share Report

Hardy County, West Virginia:

Summit Community Bank, Inc.	4	463,283	73.59	%
Capon Valley Bank	3	112,422	17.86	%
Pendleton Community Bank, Inc.	1	25,851	4.11	%
First United Bank & Trust	1	16,164	2.57	%
Grant County Bank	1	11,787	1.87	%

Source: FDIC Deposit Market Share Report

Mineral County, West Virginia:

First United Bank & Trust	2	75,822	35.21	%
Branch Banking & Trust Company	2	68,803	31.95	%
Manufacturers & Traders Trust Company	2	40,687	18.90	%
Grant County Bank	1	30,005	13.94	%

Source: FDIC Deposit Market Share Report

Monongalia County, West Virginia:

United Bank	7	657,372	32.36	%
Branch Banking & Trust Company	6	549,438	27.04	%
Huntington National Bank	6	378,620	18.64	%
Clear Mountain Bank	5	171,150	8.42	%
Wesbanco Bank, Inc.	5	104,931	5.16	%
First United Bank & Trust	3	89,599	4.41	%
First Exchange Bank	1	28,643	1.41	%
Citizens Bank of Morgantown, Inc.	1	21,716	1.07	%

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MVB Bank, Inc.	1	18,062	0.89	%
PNC Bank NA	2	12,208	0.60	%

Source: FDIC Deposit Market Share Report

[7]

For further information about competition in our market areas, see the Risk Factor entitled “**We operate in a competitive environment, and our inability to effectively compete could adversely and materially impact our financial condition and results of operations**” in Item 1A of Part I of this annual report.

## **SUPERVISION AND REGULATION**

The following is a summary of the material regulations and policies applicable to First United Corporation and its subsidiaries and is not intended to be a comprehensive discussion. Changes in applicable laws and regulations may have a material effect on our business.

### **General**

First United Corporation is a financial holding company registered with the Board of Governors of the Federal Reserve System (the “FRB”) under the BHC Act and, as such, is subject to the supervision, examination and reporting requirements of the BHC Act and the regulations of the FRB. As a publicly-traded company whose common stock is listed on The NASDAQ Global Select Market, First United Corporation is also subject to regulation and supervision by the SEC and The NASDAQ Stock Market, LLC (“NASDAQ”).

The Bank is a Maryland trust company subject to the banking laws of Maryland and to regulation by the Commissioner of Financial Regulation of Maryland (the “Maryland Commissioner”), who is required by statute to make at least one examination in each calendar year (or at 18-month intervals if the Maryland Commissioner determines that an examination is unnecessary in a particular calendar year). The Bank also has offices in West Virginia, and the operations of these offices are subject to West Virginia laws and to supervision and examination by the West Virginia Division of Banking. As a member of the FDIC, the Bank is also subject to certain provisions of federal law and regulations regarding deposit insurance and activities of insured state-chartered banks, including those that require examination by the FDIC. In addition to the foregoing, there are a myriad of other federal and state laws and regulations that affect, impact or govern the business of banking, including consumer lending, deposit-taking, and trust operations.

[8]



All non-bank subsidiaries of First United Corporation are subject to examination by the FRB, and, as affiliates of the Bank, are subject to examination by the FDIC and the Maryland Commissioner. In addition, OakFirst Loan Center, Inc. is subject to licensing and regulation by the West Virginia Division of Banking, OakFirst Loan Center, LLC is subject to licensing and regulation by the Maryland Commissioner, and the Insurance Group was subject to licensing and regulation by various state insurance authorities. Retail sales of insurance products by these insurance affiliates are also subject to the requirements of the Interagency Statement on Retail Sales of Nondeposit Investment Products promulgated in 1994 by the FDIC, the FRB, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision.

### **Regulation of Financial Holding Companies**

In November 1999, the federal Gramm-Leach-Bliley Act (the “GLB Act”) was signed into law. The GLB Act revised the BHC Act and repealed the affiliation provisions of the Glass-Steagall Act of 1933, which, taken together, limited the securities, insurance and other non-banking activities of any company that controls a FDIC insured financial institution. Under the GLB Act, a bank holding company can elect, subject to certain qualifications, to become a “financial holding company.” The GLB Act provides that a financial holding company may engage in a full range of financial activities, including insurance and securities sales and underwriting activities, and real estate development, with new expedited notice procedures. Maryland law generally permits state-chartered banks, including the Bank, to engage in the same activities, directly or through an affiliate, as national banking associations. The GLB Act permits certain qualified national banking associations to form financial subsidiaries, which have broad authority to engage in all financial activities except insurance underwriting, insurance investments, real estate investment or development, or merchant banking. Thus, the GLB Act has the effect of broadening the permitted activities of First United Corporation and the Bank.

First United Corporation and its affiliates are subject to the provisions of Section 23A and Section 23B of the Federal Reserve Act. Section 23A limits the amount of loans or extensions of credit to, and investments in, First United Corporation and its non-bank affiliates by the Bank. Section 23B requires that transactions between the Bank and First United Corporation and its non-bank affiliates be on terms and under circumstances that are substantially the same as with non-affiliates.

Under FRB policy, First United Corporation is expected to act as a source of strength to the Bank, and the FRB may charge First United Corporation with engaging in unsafe and unsound practices for failure to commit resources to a subsidiary bank when required. This support may be required at times when the bank holding company may not have the resources to provide the support. Under the prompt corrective action provisions, if a controlled bank is undercapitalized, then the regulators could require the bank holding company to guarantee the bank’s capital restoration plan. In addition, if the FRB believes that a bank holding company’s activities, assets or affiliates represent a significant risk to the financial safety, soundness or stability of a controlled bank, then the FRB could require the bank holding company to terminate the activities, liquidate the assets or divest the affiliates. The regulators may require these and other actions in support of controlled banks even if such actions are not in the best interests of the bank holding company or its stockholders. Because the Corporation is a bank holding company, it is viewed as a

source of financial and managerial strength for any controlled depository institutions, like the Bank.

On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”), which made sweeping changes to the financial regulatory landscape and will impact all financial institutions, including First United Corporation and the Bank. The Dodd-Frank Act also directs federal bank regulators to require that all companies that directly or indirectly control an insured depository institution serve as sources of financial strength for the institution. The term “source of financial strength” is defined under the Dodd-Frank Act as the ability of a company to provide financial assistance to its insured depository institution subsidiaries in the event of financial distress. The appropriate federal banking agency for such a depository institution may require reports from companies that control the insured depository institution to assess their abilities to serve as sources of strength and to enforce compliance with the source-of-strength requirements. The appropriate federal banking agency may also require a holding company to provide financial assistance to a bank with impaired capital. Under this requirement, in the future First United Corporation could be required to provide financial assistance to the Bank should it experience financial distress.

[9]

In addition, under the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (“FIRREA”), depository institutions insured by the FDIC can be held liable for any losses incurred by, or reasonably anticipated to be incurred by, the FDIC in connection with (i) the default of a commonly controlled FDIC-insured depository institution or (ii) any assistance provided by the FDIC to a commonly controlled FDIC-insured depository institution in danger of default. Accordingly, in the event that any insured subsidiary of First United Corporation causes a loss to the FDIC, other insured subsidiaries of First United Corporation could be required to compensate the FDIC by reimbursing it for the estimated amount of such loss. Such cross guaranty liabilities generally are superior in priority to obligations of a financial institution to its shareholders and obligations to other affiliates.

### **Federal Banking Regulation**

Federal banking regulators, such as the FRB and the FDIC, may prohibit the institutions over which they have supervisory authority from engaging in activities or investments that the agencies believe are unsafe or unsound banking practices. Federal banking regulators have extensive enforcement authority over the institutions they regulate to prohibit or correct activities that violate law, regulation or a regulatory agreement or which are deemed to be unsafe or unsound practices. Enforcement actions may include the appointment of a conservator or receiver, the issuance of a cease and desist order, the termination of deposit insurance, the imposition of civil money penalties on the institution, its directors, officers, employees and institution-affiliated parties, the issuance of directives to increase capital, the issuance of formal and informal agreements, the removal of or restrictions on directors, officers, employees and institution-affiliated parties, and the enforcement of any such mechanisms through restraining orders or other court actions.

The Bank is subject to certain restrictions on extensions of credit to executive officers, directors, and principal shareholders or any related interest of such persons, which generally require that such credit extensions be made on substantially the same terms as those available to persons who are not related to the Bank and not involve more than the normal risk of repayment. Other laws tie the maximum amount that may be loaned to any one customer and its related interests to capital levels.

As part of the Federal Deposit Insurance Corporation Improvement Act of 1991 (“FDICIA”), each federal banking regulator adopted non-capital safety and soundness standards for institutions under its authority. These standards include internal controls, information systems and internal audit systems, loan documentation, credit underwriting, interest rate exposure, asset growth, and compensation, fees and benefits. An institution that fails to meet those standards may be required by the agency to develop a plan acceptable to meet the standards. Failure to submit or implement such a plan may subject the institution to regulatory sanctions. We believe that the Bank meets substantially all standards that have been adopted. FDICIA also imposes capital standards on insured depository institutions.

The Dodd-Frank Act made sweeping changes to the financial regulatory landscape and will impact all financial institutions, including First United Corporation and the Bank. The Dodd-Frank Act is discussed below.

The Community Reinvestment Act (“CRA”) requires the FDIC, in connection with its examination of financial institutions within its jurisdiction, to evaluate the record of those financial institutions in meeting the credit needs of their communities, including low and moderate income neighborhoods, consistent with principles of safe and sound banking practices. These factors are also considered by all regulatory agencies in evaluating mergers, acquisitions and applications to open a branch or facility. As of the date of its most recent examination report, the Bank had a CRA rating of “Satisfactory”.

The Bank is also subject to a variety of other laws and regulations with respect to the operation of its business, including, but not limited to, the Truth in Lending Act, the Truth in Savings Act, the Equal Credit Opportunity Act, the Electronic Funds Transfer Act, the Fair Housing Act, the Home Mortgage Disclosure Act, the Fair Debt Collection Practices Act, the Fair Credit Reporting Act, Expedited Funds Availability (Regulation CC), Reserve Requirements (Regulation D), Privacy of Consumer Information (Regulation P), Margin Stock Loans (Regulation U), the Right To Financial Privacy Act, the Flood Disaster Protection Act, the Homeowners Protection Act, the Servicemembers Civil Relief Act, the Real Estate Settlement Procedures Act, the Telephone Consumer Protection Act, the CAN-SPAM Act, the Children’s Online Privacy Protection Act, and the John Warner National Defense Authorization Act.

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## **The Dodd-Frank Act**

The Dodd-Frank Act, enacted in July 2010, significantly changed the bank regulatory structure and affected the lending, investment, trading and operating activities of financial institutions and their holding companies. The Dodd-Frank Act requires the FRB to set minimum capital levels for bank holding companies that are as stringent as those required for insured depository institutions. The legislation also establishes a floor for capital of insured depository institutions that cannot be lower than the standards in effect today, and directs the federal banking regulators to implement new leverage and capital requirements. The new leverage and capital requirements must take into account off-balance sheet activities and other risks, including risks relating to securitized products and derivatives. Pursuant to the Dodd-Frank Act, the FDIC has backup enforcement authority over a depository institution holding company, such as First United Corporation, if the conduct or threatened conduct of such holding company poses a risk to the Deposit Insurance Fund (“DIF”), although such authority may not be used if the holding company is generally in sound condition and does not pose a foreseeable and material risk to the DIF. In addition, the Dodd-Frank Act contains a wide variety of provisions (many of which are not yet effective) affecting the regulation of depository institutions, including restrictions related to mortgage originations, risk retention requirements as to securitized loans and the establishment of the Consumer Financial Protection Bureau (“CFPB”).

The full impact of the Dodd-Frank Act on our business and operations will not be known for years until regulations implementing the statute are written and adopted. The Dodd-Frank Act will increase our regulatory compliance burden and costs and may restrict the financial products and services we offer to our customers. In particular, the Dodd-Frank Act will require us to invest significant management attention and resources so that we can evaluate the impact of this law and its regulations and make any necessary changes to our product offerings and operations. These impacts may be material.

## **Capital Requirements**

### ***General***

FDICIA established a system of prompt corrective action to resolve the problems of undercapitalized institutions. Under this system, the federal banking regulators are required to rate supervised institutions on the basis of five capital categories: “well capitalized,” “adequately capitalized,” “undercapitalized,” “significantly undercapitalized,” and “critically undercapitalized;” and to take certain mandatory actions (and are authorized to take other discretionary actions) with respect to institutions in the three undercapitalized categories. The severity of the actions will depend upon the category in which the institution is placed. A depository institution is “well capitalized” if it has a total risk based capital ratio of 10% or greater, a Tier 1 risk based capital ratio of 6% or greater, and a leverage ratio of 5% or greater and is not subject to any order, regulatory agreement, or written directive to meet and maintain a specific capital level for any capital measure. An “adequately capitalized” institution is defined as one that has a total risk based capital ratio of 8% or greater, a Tier 1 risk based capital ratio of 4% or greater and a leverage ratio of 4% or greater (or 3% or greater

in the case of a bank with a composite CAMEL rating of 1).

FDICIA generally prohibits a depository institution from making any capital distribution, including the payment of cash dividends, or paying a management fee to its holding company if the depository institution would thereafter be undercapitalized. Undercapitalized depository institutions are subject to growth limitations and are required to submit capital restoration plans. For a capital restoration plan to be acceptable, the depository institution's parent holding company must guarantee (subject to certain limitations) that the institution will comply with such capital restoration plan.

Significantly undercapitalized depository institutions may be subject to a number of other requirements and restrictions, including orders to sell sufficient voting stock to become adequately capitalized and requirements to reduce total assets and stop accepting deposits from correspondent banks. Critically undercapitalized depository institutions are subject to the appointment of a receiver or conservator; generally within 90 days of the date such institution is determined to be critically undercapitalized.

Further information about our capital resources is provided in Item 7 of Part II of this annual report under the heading "Capital Resources". Information about the capital ratios of First United Corporation and of the Bank as of December 31, 2012 is set forth in Note 4 to our audited consolidated financial statements, which are included in Item 8 of Part II of this annual report (the "Consolidated Financial Statements")

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### *The Collins Amendment provisions of the Dodd-Frank Act*

The Collins Amendment provision of the Dodd-Frank Act imposes increased capital requirements in the future. The Collins Amendment also requires federal banking regulators to establish minimum leverage and risk-based capital requirements to apply to insured depository institutions, bank and thrift holding companies, and systemically important nonbank financial companies. These capital requirements must not be less than the Generally Applicable Risk Based Capital Requirements and the Generally Applicable Leverage Capital Requirements as of July 21, 2010, and must not be quantitatively lower than the requirements that were in effect for insured depository institutions as of July 21, 2010. The Collins Amendment defines Generally Applicable Risk Based Capital Requirements and Generally Applicable Leverage Capital Requirements to mean the risk-based capital requirements and minimum ratios of Tier 1 risk-based capital to average total assets, respectively, established by the appropriate federal banking agencies to apply to insured depository institutions under the Prompt Corrective Action provisions, regardless of total consolidated asset size or foreign financial exposure. Over a three-year phase-out period, trust preferred securities will no longer qualify as Tier 1 risk-based capital for certain bank holding companies, including First United Corporation. At December 31, 2012, \$40.2 million in proceeds received from First United Corporation's junior subordinated debentures offerings were included in Tier 1 risk-based capital. The Collins Amendment stipulates that this phase out period begins in 2013. The Company continues to monitor the finalization of these requirements, including whether its junior subordinated debentures will continue to qualify for Tier 1 capital under the final rules.

### *Basel III — Capital, Liquidity and Stress Testing Requirements*

The Basel Committee on Banking Supervision ("Basel") has drafted frameworks for the regulation of capital and liquidity of internationally active banking organizations, generally referred to as "Basel III". On June 7, 2012, the FRB issued a notice of proposed rulemaking that would implement elements of Sections 165 and 166 of the Dodd-Frank Act that encompass certain aspects of Basel III with respect to capital and liquidity. On November 9, 2012, following a public comment period, the U.S. federal banking agencies issued a joint press release announcing that the January 1, 2013 effective date was being delayed so the agencies could consider operational and transitional issues identified in the large volume of public comments received. It is anticipated that the U.S. federal banking agencies will formalize the implementation of the Basel III framework applicable to domestic banks in the United States during 2013. As proposed, the new rules, when implemented and fully phased-in, will require U.S. bank holding companies to maintain higher levels of capital and liquidity than the minimums that currently apply under existing capital regulations.

### Capital Requirements

The Basel III final capital framework, among other things, (i) formalizes a capital measure called "Tier 1 Common Equity" ("T1CE"), (ii) specifies that Tier 1 capital consist only of T1CE and certain "Additional Tier 1 capital" instruments meeting specified requirements, and (iii) defines T1CE narrowly by requiring that most adjustments to regulatory

capital measures be made to T1CE and not to the other components of capital. Requirements to maintain higher levels of capital could adversely impact our return on equity. We are in the process of modeling our capital ratios under various scenarios in light of these proposed rules and intend to take appropriate steps to ensure that we meet the fully-phased in minimum capital requirements, including capital conservation buffers, if and when these proposal rules are finalized.

### Liquidity Requirements

Historically, regulation and monitoring of bank and bank holding company liquidity has been addressed as a supervisory matter, without required formulaic measures. The Basel III liquidity framework, however, requires banks and bank holding companies to measure their liquidity against specific liquidity tests that, although similar in some respects to liquidity measures historically applied by banks and regulators for management and supervisory purposes, going forward would be required by regulation. Current rules and proposals from the U.S. federal banking agencies do not specifically address the Basel III liquidity requirements.

See the section entitled “Capital Resources” in Item 7 of Part II of this annual report for further information.

### **Deposit Insurance**

The Bank is a member of the FDIC and pays an insurance premium to the FDIC based upon its assessable deposits on a quarterly basis. Deposits are insured up to applicable limits by the FDIC and such insurance is backed by the full faith and credit of the United States Government.

Under the Dodd-Frank Act, a permanent increase in deposit insurance was authorized to \$250,000. The coverage limit is per depositor, per insured depository institution for each account ownership category.

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The Dodd-Frank Act also set a new minimum DIF reserve ratio at 1.35% of estimated insured deposits. The FDIC is required to attain this ratio by September 30, 2020. The Dodd-Frank Act required the FDIC to redefine the deposit insurance assessment base for an insured depository institution. Prior to the Dodd-Frank Act, an institution's assessment base has historically been its domestic deposits, with some adjustments. As redefined pursuant to the Dodd-Frank Act, an institution's assessment base is now an amount equal to the institution's average consolidated total assets during the assessment period minus average tangible equity. Institutions with less \$1.0 billion or more in assets at the end of a fiscal quarter, like the Bank, must report their average consolidated total assets on a daily basis and report their average tangible equity on an end-of-month balance basis.

The Federal Deposit Insurance Reform Act of 2005, which created the DIF, gave the FDIC greater latitude in setting the assessment rates for insured depository institutions which could be used to impose minimum assessments. On May 22, 2009, the FDIC imposed an emergency insurance assessment of five basis points in an effort to restore the DIF to an acceptable level. On November 12, 2009, the FDIC adopted a final rule requiring insured depository institutions to prepay their estimated quarterly risk-based deposit assessments for the fourth quarter of 2009, and for all of 2010, 2011, and 2012, on December 30, 2009, along with each institution's risk based deposit insurance assessment for the third quarter of 2009. It was also announced that the assessment rate will increase by 3 basis points effective January 1, 2011. The prepayment is accounted for as a prepaid expense and is amortized quarterly. The prepaid assessment qualifies for a zero risk weight under the risk-based capital requirements. The Bank expensed \$2.0 million and \$2.4 million in FDIC premiums for 2012 and 2011, respectively. In December 2009, the Bank prepaid approximately \$11 million in FDIC premiums and the balance at December 31, 2012 was approximately \$3.2 million. The FDIC has the flexibility to adopt actual rates that are higher or lower than the total base assessment rates adopted without notice and comment, if certain conditions are met.

DIF-insured institutions pay a Financing Corporation ("FICO") assessment in order to fund the interest on bonds issued in the 1980s in connection with the failures in the thrift industry. For the fourth quarter of 2012, the FICO assessment was equal to 0.660 basis points computed on assets as required by the Dodd-Frank Act. These assessments will continue until the bonds mature in 2019.

The FDIC is authorized to conduct examinations of and require reporting by FDIC-insured institutions. It is also authorized to terminate a depository bank's deposit insurance upon a finding by the FDIC that the bank's financial condition is unsafe or unsound or that the institution has engaged in unsafe or unsound practices or has violated any applicable rule, regulation, order or condition enacted or imposed by the bank's regulatory agency. The termination of deposit insurance for our national bank subsidiary would have a material adverse effect on our earnings, operations and financial condition.

### **Bank Secrecy Act/Anti-Money Laundering**

The Bank Secrecy Act (“BSA”), which is intended to require financial institutions to develop policies, procedures, and practices to prevent and deter money laundering, mandates that every national bank have a written, board-approved program that is reasonably designed to assure and monitor compliance with the BSA.

The program must, at a minimum: (i) provide for a system of internal controls to assure ongoing compliance; (ii) provide for independent testing for compliance; (iii) designate an individual responsible for coordinating and monitoring day-to-day compliance; and (iv) provide training for appropriate personnel. In addition, state-chartered banks are required to adopt a customer identification program as part of its BSA compliance program. State-chartered banks are also required to file Suspicious Activity Reports when they detect certain known or suspected violations of federal law or suspicious transactions related to a money laundering activity or a violation of the BSA.

In addition to complying with the BSA, the Bank is subject to the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 (the “USA Patriot Act”). The USA Patriot Act is designed to deny terrorists and criminals the ability to obtain access to the United States’ financial system and has significant implications for depository institutions, brokers, dealers, and other businesses involved in the transfer of money. The Patriot Act mandates that financial service companies implement additional policies and procedures and take heightened measures designed to address any or all of the following matters: customer identification programs, money laundering, terrorist financing, identifying and reporting suspicious activities and currency transactions, currency crimes, and cooperation between financial institutions and law enforcement authorities.

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### **Ability-to-Repay and Qualified Mortgage Rule**

Pursuant to the Dodd Frank Act, the CFPB issued a final rule on January 10, 2013 (effective on January 10, 2014), amending Regulation Z, as implemented by the Truth in Lending Act, that requires mortgage lenders to make a reasonable and good faith determination based on verified and documented information that a consumer applying for a mortgage loan has a reasonable ability to repay the loan according to its terms. Mortgage lenders are required to determine consumers' ability to repay in one of two ways. The first alternative requires the mortgage lender to consider the following eight underwriting factors when making the credit decision: (i) current or reasonably expected income or assets; (ii) current employment status; (iii) the monthly payment on the covered transaction; (iv) the monthly payment on any simultaneous loan; (v) the monthly payment for mortgage-related obligations; (vi) current debt obligations, alimony, and child support; (vii) the monthly debt-to-income ratio or residual income; and (viii) credit history. Alternatively, the mortgage lender can originate "qualified mortgages," which are entitled to a presumption that the creditor making the loan satisfied the ability-to-repay requirements. In general, a "qualified mortgage" is a mortgage loan without negative amortization, interest-only payments, balloon payments, or terms exceeding 30 years. In addition, to be a qualified mortgage the points and fees paid by a consumer cannot exceed 3% of the total loan amount. Qualified mortgages that are "higher-priced" (e.g. subprime loans) garner a rebuttable presumption of compliance with the ability-to-repay rules, while qualified mortgages that are not "higher-priced" (e.g. prime loans) are given a safe harbor of compliance.

### **Volcker Rule**

The Dodd-Frank Act prohibits insured depository institutions and their holding companies from engaging in proprietary trading except in limited circumstances, and prohibits them from owning equity interests in excess of three percent (3%) of Tier 1 Capital in private equity and hedge funds (known as the "Volcker Rule"). The FRB released a final rule on February 9, 2011 (effective on April 1, 2011) which requires a "banking entity", a term that is defined to include bank holding companies like First United Corporation and banks like the Bank, to bring its proprietary trading activities and investments into compliance with the Dodd-Frank Act restrictions no later than two years after the earlier of: (i) July 21, 2012; or (ii) 12 months after the date on which interagency final rules are adopted. Pursuant to the compliance date final rule, banking entities are permitted to request an extension of this timeframe from the FRB. On October 11, 2011, the federal banking agencies released for comment proposed regulations implementing the Volcker Rule. The public comment period closed on February 13, 2012 and a final rule has not yet been published. The proposal has been criticized and there is no consensus as to what the provisions will ultimately include. First United Corporation intends to review the implications of the interagency rules on its investments once those rules are issued and will plan for any adjustments of its activities or its holdings so that it will be in compliance by the announced compliance date.

### **Federal Securities Laws and NASDAQ Rules**

The shares of common stock of First United Corporation are registered with the SEC under Section 12(b) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), and listed on the NASDAQ Global Select Market. First United Corporation is subject to information reporting requirements, proxy solicitation requirements, insider trading restrictions and other requirements of the Exchange Act, including the requirements imposed under the federal Sarbanes-Oxley Act of 2002, and rules adopted by NASDAQ. Among other things, loans to and other transactions with insiders are subject to restrictions and heightened disclosure, directors and certain committees of the Board must satisfy certain independence requirements, First United Corporation must comply with certain enhanced corporate governance requirements, and various issuances of securities by First United Corporation require shareholder approval.

### **Governmental Monetary and Credit Policies and Economic Controls**

The earnings and growth of the banking industry and ultimately of the Bank are affected by the monetary and credit policies of governmental authorities, including the FRB. An important function of the FRB is to regulate the national supply of bank credit in order to control recessionary and inflationary pressures. Among the instruments of monetary policy used by the FRB to implement these objectives are open market operations in U.S. Government securities, changes in the federal funds rate, changes in the discount rate of member bank borrowings, and changes in reserve requirements against member bank deposits. These means are used in varying combinations to influence overall growth of bank loans, investments and deposits and may also affect interest rates charged on loans or paid on deposits. The monetary policies of the FRB authorities have had a significant effect on the operating results of commercial banks in the past and are expected to continue to have such an effect in the future. In view of changing conditions in the national economy and in the money markets, as well as the effect of actions by monetary and fiscal authorities, including the FRB, no prediction can be made as to possible future changes in interest rates, deposit levels, loan demand or their effect on our businesses and earnings.

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## SEASONALITY

Management does not believe that our business activities are seasonal in nature. Deposit, loan, and insurance demand may vary depending on local and national economic conditions, but management believes that any variation will not have a material impact on our planning or policy-making strategies.

## EMPLOYEES

At December 31, 2012, we employed 398 individuals, of whom 316 were full-time employees.

## ITEM 1A. RISK FACTORS

The significant risks and uncertainties related to us, our business and our securities of which we are aware are discussed below. You should carefully consider these risks and uncertainties before making investment decisions in respect of our securities. Any of these factors could materially and adversely affect our business, financial condition, operating results and prospects and could negatively impact the market price of our securities. If any of these risks materialize, you could lose all or part of your investment in First United Corporation. Additional risks and uncertainties that we do not yet know of, or that we currently think are immaterial, may also impair our business operations. You should also consider the other information contained in this annual report, including our financial statements and the related notes, before making investment decisions in respect of our securities.

### *Risks Relating to First United Corporation and its Affiliates*

**First United Corporation's future success depends on the successful growth of its subsidiaries.**

First United Corporation's primary business activity for the foreseeable future will be to act as the holding company of the Bank and its other direct and indirect subsidiaries. Therefore, First United Corporation's future profitability will depend on the success and growth of these subsidiaries. In the future, part of our growth may come from buying other banks and buying or establishing other companies. Such entities may not be profitable after they are purchased or established, and they may lose money, particularly at first. A new bank or company may bring with it unexpected liabilities, bad loans, or bad employee relations, or the new bank or company may lose customers.

**Interest rates and other economic conditions will impact our results of operations.**

Our results of operations may be materially and adversely affected by changes in prevailing economic conditions, including declines in real estate values, rapid changes in interest rates and the monetary and fiscal policies of the federal government. Our profitability is in part a function of the spread between the interest rates earned on assets and the interest rates paid on deposits and other interest-bearing liabilities (*i.e.*, net interest income), including advances from the Federal Home Loan Bank of Atlanta (the “FHLB”). Interest rate risk arises from mismatches (*i.e.*, the interest sensitivity gap) between the dollar amount of repricing or maturing assets and liabilities. If more assets reprice or mature than liabilities during a falling interest rate environment, then our earnings could be negatively impacted. Conversely, if more liabilities reprice or mature than assets during a rising interest rate environment, then our earnings could be negatively impacted. Fluctuations in interest rates are not predictable or controllable. There can be no assurance that our attempts to structure our asset and liability management strategies to mitigate the impact on net interest income of changes in market interest rates will be successful in the event of such changes.

**The majority of our business is concentrated in Maryland and West Virginia, much of which involves real estate lending, so a decline in the real estate and credit markets could materially and adversely impact our financial condition and results of operations.**

Most of the Bank’s loans are made to borrowers located in Western Maryland and Northeastern West Virginia, and many of these loans, including construction and land development loans, are secured by real estate. Approximately 15%, or \$128 million, of total loans are real estate acquisition construction and development projects that are secured by real estate. Accordingly, a decline in local economic conditions would likely have an adverse impact on our financial condition and results of operations, and the impact on us would likely be greater than the impact felt by larger financial institutions whose loan portfolios are geographically diverse. We cannot guarantee that any risk management practices we implement to address our geographic and loan concentrations will be effective to prevent losses relating to our loan portfolio.

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The national and local economies were significantly and adversely impacted by the banking crisis and resulting economic recession that began around 2008, and these conditions have caused, and continue to cause, a host of challenges for financial institutions, including the Bank. For example, these conditions have made it more difficult for real estate owners and owners of loans secured by real estate to sell their assets at desirable times and prices. Not only has this impacted the demand for credit to finance the acquisition and development of real estate, but it has also impaired the ability of banks, including the Bank, to sell real estate acquired through foreclosure. In the case of real estate acquisition, construction and development projects that we have financed, these challenging economic conditions have caused some of our borrowers to default on their loans. Because of the deterioration in the market values of real estate collateral caused by the recession, banks, including the Bank, have been unable to recover the full amount due under their loans when forced to foreclose on and sell real estate collateral. As a result, we have realized significant impairments and losses in our loan portfolio, which have materially and adversely impacted our financial condition and results of operations. These conditions and their consequences are likely to continue until the nation fully recovers from the recent economic recession. Management cannot predict the extent to which these conditions will cause future impairments or losses, nor can it provide any assurances as to when, or if, economic conditions will improve.

**The Bank's concentrations of commercial real estate loans could subject it to increased regulatory scrutiny and directives, which could force us to preserve or raise capital and/or limit future commercial lending activities.**

The FRB, the FDIC, and the other federal banking regulators issued guidance in December 2006 entitled "Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices" directed at institutions who have particularly high concentrations of CRE loans within their lending portfolios. This guidance suggests that these institutions face a heightened risk of financial difficulties in the event of adverse changes in the economy and CRE markets. Accordingly, the guidance suggests that institutions whose concentrations exceed certain percentages of capital should implement heightened risk management practices appropriate to their concentration risk. The guidance provides that banking regulators may require such institutions to reduce their concentrations and/or maintain higher capital ratios than institutions with lower concentrations in CRE. All of the ratios for commercial real estate are within the guidance limits at December 31, 2012.

**The Bank may experience loan losses in excess of its allowance, which would reduce our earnings.**

The risk of credit losses on loans varies with, among other things, general economic conditions, the type of loan being made, the creditworthiness of the borrower over the term of the loan and, in the case of a collateralized loan, the value and marketability of the collateral for the loan. Management of the Bank maintains an allowance for loan losses based upon, among other things, historical experience, an evaluation of economic conditions and regular reviews of delinquencies and loan portfolio quality. Based upon such factors, management makes various assumptions and judgments about the ultimate collectability of the loan portfolio and provides an allowance for loan losses based upon a percentage of the outstanding balances and for specific loans when their ultimate collectability is considered questionable. If management's assumptions and judgments prove to be incorrect and the allowance for loan losses is inadequate to absorb future losses, or if the bank regulatory authorities require us to increase the allowance for loan

losses as a part of its examination process, our earnings and capital could be significantly and adversely affected. Although management continually monitors our loan portfolio and makes determinations with respect to the allowance for loan losses, future adjustments may be necessary if economic conditions differ substantially from the assumptions used or adverse developments arise with respect to our non-performing or performing loans. Material additions to the allowance for loan losses could result in a material decrease in our net income and capital, and could have a material adverse effect on our financial condition.

**The market value of our investments could decline.**

As of December 31, 2012, we had classified all but six of our investment securities as available-for-sale pursuant to FASB Accounting Standards Codification Topic 320, *Investments – Debt and Equity Securities*, relating to accounting for investments. Topic 320 requires that unrealized gains and losses in the estimated value of the available-for-sale portfolio be “marked to market” and reflected as a separate item in shareholders’ equity (net of tax) as accumulated other comprehensive loss. There can be no assurance that future market performance of our investment portfolio will enable us to realize income from sales of securities. Shareholders’ equity will continue to reflect the unrealized gains and losses (net of tax) of these investments. Moreover, there can be no assurance that the market value of our investment portfolio will not decline, causing a corresponding decline in shareholders’ equity.

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Management believes that several factors could affect the market value of our investment portfolio. These include, but are not limited to, changes in interest rates or expectations of changes, the degree of volatility in the securities markets, inflation rates or expectations of inflation and the slope of the interest rate yield curve (the yield curve refers to the differences between shorter-term and longer-term interest rates; a positively sloped yield curve means shorter-term rates are lower than longer-term rates). Also, the passage of time will affect the market values of our investment securities, in that the closer they are to maturing, the closer the market price should be to par value. These and other factors may impact specific categories of the portfolio differently, and management cannot predict the effect these factors may have on any specific category.

**Impairment of investment securities, goodwill, or deferred tax assets could require charges to earnings, which could result in a negative impact on our results of operations.**

In assessing whether the impairment of investment securities is other-than-temporary, management considers the length of time and extent to which the fair value has been less than cost, the financial condition and near-term prospects of the issuer, and the intent and ability to retain our investment in the security for a period of time sufficient to allow for any anticipated recovery in fair value in the near term. See the discussion under the heading “Estimates and Critical Accounting Policies – Other-Than-Temporary Impairment of Investment Securities” in Item 7 of Part II of this annual report for further information.

Under current accounting standards, goodwill is not amortized but, instead, is subject to impairment tests on at least an annual basis or more frequently if an event occurs or circumstances change that reduce the fair value of a reporting unit below its carrying amount. A decline in the price of First United Corporation’s common stock or occurrence of a triggering event following any of our quarterly earnings releases and prior to the filing of the periodic report for that period could, under certain circumstances, cause us to perform a goodwill impairment test and result in an impairment charge being recorded for that period which was not reflected in such earnings release. In the event that we conclude that all or a portion of our goodwill may be impaired, a non-cash charge for the amount of such impairment would be recorded to earnings. Such a charge would have no impact on tangible capital. At December 31, 2012, we had recorded goodwill of \$11.0 million, representing approximately 11% of shareholders’ equity. See the discussion under the heading “Estimates and Critical Accounting Policies – Goodwill” in Item 7 of Part II of this annual report for further information.

In assessing the realizability of deferred tax assets, management considers whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. Assessing the need for, or the sufficiency of, a valuation allowance requires management to evaluate all available evidence, both negative and positive, including the recent trend of quarterly earnings. Positive evidence necessary to overcome the negative evidence includes whether future taxable income in sufficient amounts and character within the carryback and carry forward periods is available under the tax law, including the use of tax planning strategies. When negative evidence (*e.g.*, cumulative losses in recent years, history of operating loss or tax credit carry forwards expiring unused) exists, more positive evidence than negative evidence will be necessary. At December 31, 2012, our net deferred tax assets were approximately \$28.9 million.

The impact of each of these impairment matters could have a material adverse effect on our business, results of operations, and financial condition.

**We operate in a competitive environment, and our inability to effectively compete could adversely and materially impact our financial condition and results of operations.**

We operate in a competitive environment, competing for loans, deposits, and customers with commercial banks, savings associations and other financial entities. Competition for deposits comes primarily from other commercial banks, savings associations, credit unions, money market and mutual funds and other investment alternatives. Competition for loans comes primarily from other commercial banks, savings associations, mortgage banking firms, credit unions and other financial intermediaries. Competition for other products, such as securities products, comes from other banks, securities and brokerage companies, and other non-bank financial service providers in our market area. Many of these competitors are much larger in terms of total assets and capitalization, have greater access to capital markets, and/or offer a broader range of financial services than those that we offer. In addition, banks with a larger capitalization and financial intermediaries not subject to bank regulatory restrictions have larger lending limits and are thereby able to serve the needs of larger customers.

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In addition, changes to the banking laws over the last several years have facilitated interstate branching, merger and expanded activities by banks and holding companies. For example, the GLB Act revised the BHC Act and repealed the affiliation provisions of the Glass-Steagall Act of 1933, which, taken together, limited the securities and other non-banking activities of any company that controls an FDIC insured financial institution. As a result, the ability of financial institutions to branch across state lines and the ability of these institutions to engage in previously-prohibited activities are now accepted elements of competition in the banking industry. These changes may bring us into competition with more and a wider array of institutions, which may reduce our ability to attract or retain customers. Management cannot predict the extent to which we will face such additional competition or the degree to which such competition will impact our financial conditions or results of operations.

**The banking industry is heavily regulated; significant regulatory changes could adversely affect our operations.**

Our operations will be impacted by current and future legislation and by the policies established from time to time by various federal and state regulatory authorities. First United Corporation is subject to supervision by the FRB. The Bank is subject to supervision and periodic examination by the Maryland Commissioner of Financial Regulation, the West Virginia Division of Banking, and the FDIC. Banking regulations, designed primarily for the safety of depositors, may limit a financial institution's growth and the return to its investors by restricting such activities as the payment of dividends, mergers with or acquisitions by other institutions, investments, loans and interest rates, interest rates paid on deposits, expansion of branch offices, and the offering of securities or trust services. First United Corporation and the Bank are also subject to capitalization guidelines established by federal law and could be subject to enforcement actions to the extent that either is found by regulatory examiners to be undercapitalized. It is not possible to predict what changes, if any, will be made to existing federal and state legislation and regulations or the effect that such changes may have on our future business and earnings prospects. Management also cannot predict the nature or the extent of the effect on our business and earnings of future fiscal or monetary policies, economic controls, or new federal or state legislation. Further, the cost of compliance with regulatory requirements may adversely affect our ability to operate profitably.

**The full impact of the recently enacted Dodd-Frank Act is currently unknown given that many of the details and substance of the new laws will be implemented through agency rulemakings, but it will likely materially increase our regulatory expenses.**

On July 21, 2010, the Dodd-Frank Act was signed into law. The Dodd-Frank Act represents a comprehensive overhaul of the financial services industry within the United States and requires federal agencies to adopt nearly 250 new rules and conduct more than 60 studies over the course of the next few years, ensuring that the federal regulations and implementing policies in these areas will continue to develop for the foreseeable future.

Significantly, the Dodd-Frank Act includes the following provisions which affect First United Corporation and/or the Bank:

It established the CFPB, which directly regulates and supervises the Bank for compliance with the CFPB's regulations and policies. The creation of the CFPB will directly impact the scope and cost of products and services offered to consumers by the Bank and may have a significant effect on its financial performance.

It revised the FDIC's insurance assessment methodology so that premiums are assessed based upon the average consolidated total assets of the Bank less tangible equity capital.

It permanently increased deposit insurance coverage to \$250,000.

It authorized the FRB to set debit interchange fees in an amount that is "reasonable and proportional" to the costs incurred by processors and card issuers. Under the final rule issued by the FRB, there is a cap of \$0.21 per transaction (with a maximum of \$.24 per transaction permitted if certain requirements are met). Implementation of these caps went into effect on October 1, 2011.

It imposes proprietary trading restrictions on insured depository institutions and their holding companies that prohibit them from engaging in proprietary trading except in limited circumstances, and prevents them from owning equity interests in excess of three percent (3%) of a bank's Tier 1 capital in private equity and hedge funds.

It requires a phased-in exclusion of trust preferred securities as a component of Tier 1 capital for certain bank holding companies.

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Depository institution holding companies must now act as a “source of strength” for their depository institution subsidiaries (previously, this had been limited to regulatory policy).

Pursuant to the Dodd-Frank Act, the CFPB recently issued a final rule requiring mortgage lenders to make a reasonable and good faith determination based on verified and documented information that a consumer applying for a mortgage loan has a reasonable ability to repay the loan according to its terms, or to originate “qualified mortgages” that meet specific requirements with respect to terms, pricing and fees. The new rule also contains new disclosure requirements at mortgage loan origination and in monthly statements. These requirements will likely require significant personnel resources and could have a material adverse effect on our operations.

Based on the text of the Dodd-Frank Act and the implementing regulations (both published and yet-to-be-published), it is anticipated that the costs to banks and their holding companies may increase or fee income may decrease significantly, which could adversely affect our results of operations, financial condition and/or liquidity. Moreover, compliance obligations will expose us to additional noncompliance risk and could divert management’s focus from the business of banking.

**The Consumer Financial Protection Bureau may reshape the consumer financial laws through rulemaking and enforcement of the prohibitions against unfair, deceptive and abusive business practices. Compliance with any such change may impact our business operations.**

The CFPB has broad rulemaking authority to administer and carry out the provisions of the Dodd-Frank Act with respect to financial institutions that offer covered financial products and services to consumers. The CFPB has also been directed to write rules identifying practices or acts that are unfair, deceptive or abusive in connection with any transaction with a consumer for a consumer financial product or service, or the offering of a consumer financial product or service. The concept of what may be considered to be an “abusive” practice is new under the law. The full scope of the impact of this authority has not yet been determined as the CFPB has not yet released significant supervisory guidance. Moreover, the Bank will be supervised and examined by the CFPB for compliance with the CFPB’s regulations and policies.

The costs and limitations related to this additional regulatory reporting regimen have yet to be fully determined, although they may be material and the limitations and restrictions that will be placed upon the Bank with respect to its consumer product offering and services may produce significant, material effects on our profitability. As of the date of this annual report, the CFPB has not examined the Bank.

**Bank regulators and other regulations, including proposed Basel III capital standards, may require higher capital levels, impacting our ability to pay dividends or repurchase our stock.**

In June 2012, the U.S. federal banking agencies issued three Notices of Proposed Rulemaking that would revise and replace the agencies' current capital rules to align with the BASEL III capital standards and meet certain requirements of the Dodd-Frank Act. Certain requirements of the proposed rules would establish more restrictive capital definitions, higher risk-weightings for certain asset classes, capital buffers, and higher minimum capital ratios. The proposed rules were in a comment period through October 22, 2012 and are subject to further modification by the agencies, as the release of the final rules has been deferred indefinitely. See the section entitled "Capital Resources" in Item 7 of Part II of this annual report for further information. If adopted, our ability to use our capital resources could be materially limited and/or we could be required to raise additional capital by issuing common stock. The issuance of additional shares of common stock may dilute existing shareholders.

**We may be adversely affected by other recent legislation.**

As discussed above, the GLB Act repealed restrictions on banks affiliating with securities firms and it also permitted certain bank holding companies to become financial holding companies. Financial holding companies are permitted to engage in a host of financial activities, and activities that are incidental to financial activities, that are not permitted for bank holding companies who have not elected to become financial holding companies, including insurance and securities underwriting and agency activities, merchant banking, and insurance company portfolio investment activities. Although we are a financial holding company, this law may increase the competition we face from larger banks and other companies, especially considering the fact that we have agreed with the FRB to not engage in additional financial holding company activities until the Bank is considered both "well capitalized" and "well managed". It is not possible to predict the full effect that the GLB Act will have on us.

[19]

The federal Sarbanes-Oxley Act of 2002 requires management of every publicly traded company to perform an annual assessment of the company's internal control over financial reporting and to report on whether the system is effective as of the end of the company's fiscal year. If our management were to discover and report significant deficiencies or material weaknesses in our internal control over financial reporting, then the market value of our securities and shareholder value could decline.

The Patriot Act requires certain financial institutions, such as the Bank, to maintain and prepare additional records and reports that are designed to assist the government's efforts to combat terrorism. This law includes sweeping anti-money laundering and financial transparency laws and required additional regulations, including, among other things, standards for verifying client identification when opening an account and rules to promote cooperation among financial institutions, regulators and law enforcement entities in identifying parties that may be involved in terrorism or money laundering. If we fail to comply with this law, we could be exposed to adverse publicity as well as fines and penalties assessed by regulatory agencies.

**Customer concern about deposit insurance may cause a decrease in deposits held at the Bank.**

With increased concerns about bank failures, customers increasingly are concerned about the extent to which their deposits are insured by the FDIC. Customers may withdraw deposits from the Bank in an effort to ensure that the amount they have on deposit with us is fully insured. Decreases in deposits may adversely affect our funding costs and net income.

**The Bank's funding sources may prove insufficient to replace deposits and support our future growth.**

The Bank relies on customer deposits, advances from the FHLB, lines of credit at other financial institutions and brokered funds to fund our operations. Although the Bank has historically been able to replace maturing deposits and advances if desired, no assurance can be given that the Bank would be able to replace such funds in the future if our financial condition or the financial condition of the FHLB or market conditions were to change. Our financial flexibility will be severely constrained and/or our cost of funds will increase if we are unable to maintain our access to funding or if financing necessary to accommodate future growth is not available at favorable interest rates. Finally, if we are required to rely more heavily on more expensive funding sources to support future growth, our revenues may not increase proportionately to cover our costs. In this case, our profitability would be adversely affected.

**Recent rulemaking efforts by the FRB may negatively impact our non-interest income.**

On November 12, 2009, the FRB announced the final rules amending Regulation E that prohibit financial institutions from charging fees to consumers for paying overdrafts on automated teller machine and one-time debit card transactions, unless a consumer consents, or opts-in, to the overdraft service for those types of transactions. Compliance with this regulation is effective July 1, 2010 for new consumer accounts and August 15, 2010 for existing consumer accounts. These new rules negatively impacted the Banks' non-interest income in 2011 and 2012 and may do the same in future periods.

In addition, the FRB has issued rules pursuant to the Dodd-Frank Act governing debit card interchange fees that apply to institutions with greater than \$10 billion in assets. Although we are not subject to these rules, market forces may effectively require all banks to adopt debit card interchange fee structures that comply with these rules, in which case our non-interest income for future periods could be materially and adversely affected.

**The loss of key personnel could disrupt our operations and result in reduced earnings.**

Our growth and profitability will depend upon our ability to attract and retain skilled managerial, marketing and technical personnel. Competition for qualified personnel in the financial services industry is intense, and there can be no assurance that we will be successful in attracting and retaining such personnel. Our current executive officers provide valuable services based on their many years of experience and in-depth knowledge of the banking industry and the market areas we serve. Due to the intense competition for financial professionals, these key personnel would be difficult to replace and an unexpected loss of their services could result in a disruption to the continuity of operations and a possible reduction in earnings.

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**The Bank's lending activities subject the Bank to the risk of environmental liabilities.**

A significant portion of the Bank's loan portfolio is secured by real property. During the ordinary course of business, the Bank may foreclose on and take title to properties securing certain loans. In doing so, there is a risk that hazardous or toxic substances could be found on these properties. If hazardous or toxic substances are found, the Bank may be liable for remediation costs, as well as for personal injury and property damage. Environmental laws may require the Bank to incur substantial expenses and may materially reduce the affected property's value or limit the Bank's ability to use or sell the affected property. In addition, future laws or more stringent interpretations or enforcement policies with respect to existing laws may increase the Bank's exposure to environmental liability. Although the Bank has policies and procedures to perform an environmental review before initiating any foreclosure action on real property, these reviews may not be sufficient to detect all potential environmental hazards. The remediation costs and any other financial liabilities associated with an environmental hazard could have a material adverse effect on our financial condition and results of operations.

**We may be subject to claims and the costs of defensive actions, and such claims and costs could materially and adversely impact our financial condition and results of operations.**

Our customers may sue us for losses due to alleged breaches of fiduciary duties, errors and omissions of employees, officers and agents, incomplete documentation, our failure to comply with applicable laws and regulations, or many other reasons. Also, our employees may knowingly or unknowingly violate laws and regulations. Management may not be aware of any violations until after their occurrence. This lack of knowledge may not insulate us from liability. Claims and legal actions will result in legal expenses and could subject us to liabilities that may reduce our profitability and hurt our financial condition.

**We may not be able to keep pace with developments in technology.**

We use various technologies in conducting our businesses, including telecommunication, data processing, computers, automation, internet-based banking, and debit cards. Technology changes rapidly. Our ability to compete successfully with other financial institutions may depend on whether we can exploit technological changes. We may not be able to exploit technological changes, and any investment we do make may not make us more profitable.

**Safeguarding our business and customer information increases our cost of operations. To the extent that we, or our third party vendors, are unable to prevent the theft of or unauthorized access to this information, our operations may become disrupted, we may be subject to claims, and our net income may be adversely affected.**

Our business depends heavily on the use of computer systems, the Internet and other means of electronic communication and recordkeeping. Accordingly, we must protect our computer systems and network from break-ins, security breaches, and other risks that could disrupt our operations or jeopardize the security of our business and customer information. Moreover, we use third party vendors to provide products and services necessary to conduct our day-to-day operations, which exposes us to risk that these vendors will not perform in accordance with the service arrangements, including by failing to protect the confidential information we entrust to them. Any security measures that we or our vendors implement, including encryption and authentication technology that we use to effect secure transmissions of confidential information, may not be effective to prevent the loss or theft of our information or to prevent risks associated with the Internet, such as cyber-fraud. Advances in computer capabilities, new discoveries in the field of cryptography, or other developments could permit unauthorized persons to gain access to our confidential information in spite of the use of security measures that we believe are adequate. Any compromise of our security measures or of the security measures employed by our vendors of our third party could disrupt our business and/or could subject us to claims from our customers, either of which could have a material adverse effect on our business, financial condition and results of operations.

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**We may lose key personnel because of our participation in the Troubled Asset Relief Program Capital Purchase Program.**

On January 30, 2009, First United Corporation participated in the Troubled Asset Relief Program (“TARP”) Capital Purchase Program (the “CPP”) adopted by the U.S. Department of Treasury (“Treasury”) by selling 30,000 shares of First United Corporation’s Fixed Rate Cumulative Perpetual Preferred Stock, Series A (the “Series A Preferred Stock”) to Treasury and issuing a 10-year common stock purchase warrant (the “Warrant”) to Treasury, for a total consideration of \$30 million. As part of these transactions, First United Corporation adopted the Treasury’s standards for executive compensation and corporate governance for the period during which the Treasury holds any shares of the Series A Preferred Stock and/or any shares of common stock acquired upon exercise of the warrant. On February 17, 2009, the American Reinvestment and Recovery Act of 2009 (the “Recovery Act”) was signed into law, which, among other things, imposed additional executive compensation restrictions on institutions that participate in the TARP CPP for so long as any TARP CPP assistance remains outstanding. Among these restrictions is a prohibition against making most severance payments to our “senior executive officers” (our Chairman and Chief Executive Officer and the two next most highly compensated executive officers) and to our next five most highly compensated employees. The restrictions also limit the type, timing and amount of bonuses, retention awards and incentive compensation that may be paid to certain employees. These restrictions, coupled with the competition we face from other institutions, including institutions that do not participate in TARP, may make it more difficult for us to attract and/or retain exceptional key employees.

**Because First United Corporation has failed to make six quarterly dividend payments on the Series A Preferred Stock, the holders thereof have the right to elect up to two additional directors to First United Corporation’s Board of Directors.**

Subject to the declaration thereof by First United Corporation’s Board of Directors, the terms of the Series A Preferred Stock provide for the payment of quarterly cash dividends on February 15th, May 15th, August 15th and November 15th of each year. Dividends will accrue regardless of whether the board declares a dividend on any such date. The terms further provide that whenever, at any time or times, dividends payable on the outstanding shares of the Series A Preferred Stock have not been paid for an aggregate of six quarterly dividend periods or more, whether or not consecutive, the authorized number of directors then constituting First United Corporation’s Board of Directors will automatically be increased by two, from 14 directors to 16 directors (based on the current board structure). Thereafter, holders of the Series A Preferred Stock, together with holders of any outstanding stock having voting rights similar to the Series A Preferred Stock, voting as a single class, will be entitled to fill the vacancies created by the automatic increase by electing up to two additional directors (the “Preferred Stock Directors”) at the next annual meeting (or at a special meeting called for the purpose of electing the Preferred Stock Directors prior to the next annual meeting) and at each subsequent annual meeting until all accrued and unpaid dividends for all past dividend periods have been paid in full. First United Corporation currently does not have any outstanding stock with voting rights on par with the Series A Preferred Stock. As discussed below, First United Corporation has deferred the payment of cash dividends on the Series A Preferred Stock for more than six quarterly dividend periods, since November 15, 2010. If the Treasury were to inform First United Corporation that it intends to elect Preferred Stock Directors, then the holders of the common stock would not be entitled to vote on the election of those Preferred Stock Directors.

*Risks Relating to First United Corporation's Securities*

**The shares of common stock, Series A Preferred Stock, and the Warrant are not insured.**

The shares of First United Corporation's common stock, including the shares underlying the Warrant, the shares of the Series A Preferred Stock, and the Warrant are not deposits and are not insured against loss by the FDIC or any other governmental or private agency.

**First United Corporation is prohibited from declaring or paying cash dividends on its outstanding capital securities and management cannot predict if or when First United Corporation will again have the ability to pay dividends.**

As discussed in the next three risk factors, First United Corporation has deferred the payment of cash dividends and interest under certain of its outstanding securities and is, therefore, currently prohibited from declaring or paying any cash dividends on any of its outstanding capital securities.

**First United Corporation and the Bank have entered into informal agreements with their regulators that limit their ability to pay dividends and make other distributions on outstanding securities.**

First United Corporation has entered into an informal agreement with the Federal Reserve Bank of Richmond (the "Reserve Bank") pursuant to which it agreed not to pay dividends on outstanding shares of its common stock or on outstanding shares of its Series A Preferred Stock or make interest payments under the junior subordinated debentures (the "TPS Debentures"), underlying the trust preferred securities issued by its trust subsidiaries, First United Statutory Trust I ("Trust I"), First United Statutory Trust II ("Trust II") and First United Statutory Trust III ("Trust III" and, together with Trust I and Trust II, the "Trusts"), or take any other action that reduces regulatory capital without the prior approval of the Reserve Bank. The Bank has entered into a similar agreement with the FDIC and the Maryland Commissioner. These agreements give our regulators the ability to prohibit a proposed dividend payment, or any other distribution with respect to outstanding securities, including the repurchase of stock, at a time or times when applicable banking and corporate laws would otherwise permit such a dividend or distribution. There is no requirement that our regulators take consistent approaches when exercising their powers under these agreements. For example, even though the Reserve Bank might approve the payment of a particular dividend, that dividend could be effectively prohibited by the FDIC and/or the Maryland Commissioner if First United Corporation intended to fund that dividend through a dividend by the Bank and the FDIC and/or the Maryland Commissioner were to deny the Bank's dividend request. Similarly, even though the FDIC and the Maryland Commissioner might approve a dividend by the Bank to First United Corporation, the Reserve Bank could prevent the Corporation from using that dividend to make a distribution to the holders of its outstanding common stock, Series A Preferred Stock, or outstanding TPS Debentures. These agreements increase the likelihood that we will realize the other risks discussed below related to our ability to pay dividends and make other distributions.

[22]

**The terms of the Series A Preferred Stock limit First United Corporation's ability to pay dividends and make other distributions on its capital securities, and First United Corporation's deferral of dividend payments under the Series A Preferred Stock has triggered additional dividend restrictions.**

In January 2009, First United Corporation issued and sold 30,000 shares of its Series A Preferred Stock to the U.S. Department of the Treasury (the "Treasury") pursuant to the Treasury's Troubled Asset Relief Program Capital Purchase Program. The terms of the Series A Preferred Stock permit First United Corporation to defer regular quarterly dividends. However, during any period that First United is in arrears on any quarterly cash dividend due on the outstanding shares of the Series A Preferred Stock, it will be prohibited from declaring or paying dividends on shares of its common stock, other stock ranking junior to the Series A Preferred Stock, or preferred stock ranking on a parity with the Series A Preferred Stock, or from repurchasing shares of such common stock, junior stock or parity stock. On November 15, 2010, at the request of the Reserve Bank pursuant to its agreement, First United Corporation elected to defer regularly scheduled quarterly cash dividend payments under the Series A Preferred Stock, starting with the dividend payment due November 15, 2010. As a result, First United Corporation is currently prohibited from declaring or paying dividends or making other distributions on, or repurchasing, redeeming or otherwise acquiring, shares of its common stock. First United Corporation cannot predict when, or if, it will be able to pay accrued and future dividends on the Series A Preferred Stock or, thus, the common stock.

**First United Corporation's ability to pay dividends on its capital securities is also subject to the terms of the outstanding TPS Debentures, and First United Corporation's deferral of interest payments under the TPS Debentures has also triggered dividend restrictions.**

In March 2004, First United Corporation issued approximately \$30.9 million of TPS Debentures to Trust I and Trust II in connection with the sales by those Trusts of \$30.0 in mandatorily redeemable preferred capital securities to third party investors. Between December 2009 and January 2010, First United Corporation issued approximately \$10.8 million of TPS Debentures to Trust III in connection with the sale by Trust III of approximately \$10.5 million in mandatorily redeemable preferred capital securities to third party investors. The terms of the TPS Debentures require First United Corporation to make quarterly payments of interest to the holders of the TPS Debentures, although it has the right to defer payments of interest for up to 20 consecutive quarterly periods. If First United Corporation elects to defer the payment of regularly scheduled interest payments under the TPS Debentures, the terms of the TPS Debentures will prohibit First United from declaring or paying dividends or making other distributions on, or repurchasing, redeeming or otherwise acquiring, any shares of the common stock or the Series A Preferred Stock. On December 15, 2010, at the request of the Reserve Bank pursuant to its agreement, First United Corporation elected to defer regularly scheduled quarterly interest payments under the TPS Debentures, starting with the interest payments due in March 2011, and this deferral requires the Trusts to defer regular quarterly dividend payments on their trust preferred securities. As a result, First United Corporation is currently prohibited from declaring or paying cash dividends or making other distributions on, or repurchasing, redeeming or otherwise acquiring, outstanding shares of its common stock or Series A Preferred Stock. First United Corporation cannot predict when, or if, it will be able to pay accrued and future interest due under the TPS Debentures.

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**Applicable banking and Maryland laws impose additional restrictions on the ability of First United Corporation and the Bank to pay dividends and make other distributions on their capital securities, and, in any event, the payment of dividends is at the discretion of the boards of directors of First United Corporation and the Bank.**

In the past, First United Corporation's ability to pay dividends to shareholders has been largely dependent upon the receipt of dividends from the Bank. Since December 2009, First United Corporation has used its cash to pay dividends. In December 2010, however, First United Corporation contributed substantially all of its excess cash to the Bank to strengthen the Bank's capital levels. Accordingly, in the event that First United Corporation desires to pay cash dividends on the common stock and/or the Series A Preferred Stock in the future, and assuming such dividends are then permitted under the terms of the Series A Preferred Stock and the TPS Debentures, First United Corporation will likely need to rely on dividends from the Bank to pay such dividends, and there can be no guarantee that the Bank will be able to pay such dividends. Both federal and state laws impose restrictions on the ability of the Bank to pay dividends. Under Maryland law, a state-chartered commercial bank may pay dividends only out of undivided profits or, with the prior approval of the Maryland Commissioner, from surplus in excess of 100% of required capital stock. If, however, the surplus of a Maryland bank is less than 100% of its required capital stock, cash dividends may not be paid in excess of 90% of net earnings. In addition to these specific restrictions, bank regulatory agencies have the ability to prohibit proposed dividends by a financial institution which would otherwise be permitted under applicable regulations if the regulatory body determines that such distribution would constitute an unsafe or unsound practice. Banks that are considered "troubled institution" are prohibited by federal law from paying dividends altogether. Notwithstanding the foregoing, shareholders must understand that the declaration and payment of dividends and the amounts thereof are at the discretion of First United Corporation's Board of Directors. Thus, even at times when First United Corporation is not prohibited from paying cash dividends on its capital securities, neither the payment of such dividends nor the amounts thereof can be guaranteed.

**There is no market for the Series A Preferred Stock or the Warrant, and the common stock is not heavily traded.**

There is no established trading market for the shares of the Series A Preferred Stock or the Warrant. First United Corporation does not intend to apply for listing of the Series A Preferred Stock on any securities exchange or for inclusion of the Series A Preferred Stock in any automated quotation system unless requested by the Treasury. The common stock is listed on the NASDAQ Global Select Market, but shares of the common stock are not heavily traded. Securities that are not heavily traded can be more volatile than stock trading in an active public market. Factors such as our financial results, the introduction of new products and services by us or our competitors, and various factors affecting the banking industry generally may have a significant impact on the market price of the shares the common stock. Management cannot predict the extent to which an active public market for any of First United Corporation's securities will develop or be sustained in the future. Accordingly, holders of First United Corporation's securities may not be able to sell such securities at the volumes, prices, or times that they desire.



**First United Corporation's Articles of Incorporation and Bylaws and Maryland law may discourage a corporate takeover.**

First United Corporation's Amended and Restated Articles of Incorporation (the "Charter") and its Amended and Restated Bylaws, as amended (the "Bylaws") contain certain provisions designed to enhance the ability of First United Corporation's Board of Directors to deal with attempts to acquire control of First United Corporation. First, the Board of Directors is classified into three classes. Directors of each class serve for staggered three-year periods, and no director may be removed except for cause, and then only by the affirmative vote of either a majority of the entire Board of Directors or a majority of the outstanding voting stock. Second, the board has the authority to classify and reclassify unissued shares of stock of any class or series of stock by setting, fixing, eliminating, or altering in any one or more respects the preferences, rights, voting powers, restrictions and qualifications of, dividends on, and redemption, conversion, exchange, and other rights of, such securities. The board could use this authority, along with its authority to authorize the issuance of securities of any class or series, to issue shares having terms favorable to management to a person or persons affiliated with or otherwise friendly to management. In addition, the Bylaws require any shareholder who desires to nominate a director to abide by strict notice requirements.

Maryland law also contains anti-takeover provisions that apply to First United Corporation. The Maryland Business Combination Act generally prohibits, subject to certain limited exceptions, corporations from being involved in any "business combination" (defined as a variety of transactions, including a merger, consolidation, share exchange, asset transfer or issuance or reclassification of equity securities) with any "interested shareholder" for a period of five years following the most recent date on which the interested shareholder became an interested shareholder. An interested shareholder is defined generally as a person who is the beneficial owner of 10% or more of the voting power of the outstanding voting stock of the corporation after the date on which the corporation had 100 or more beneficial owners of its stock or who is an affiliate or associate of the corporation and was the beneficial owner, directly or indirectly, of 10% percent or more of the voting power of the then outstanding stock of the corporation at any time within the two-year period immediately prior to the date in question and after the date on which the corporation had 100 or more beneficial owners of its stock. The Maryland Control Share Acquisition Act applies to acquisitions of "control shares", which, subject to certain exceptions, are shares the acquisition of which entitle the holder, directly or indirectly, to exercise or direct the exercise of the voting power of shares of stock of the corporation in the election of directors within any of the following ranges of voting power: one-tenth or more, but less than one-third of all voting power; one-third or more, but less than a majority of all voting power or a majority or more of all voting power. Control shares have limited voting rights.

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Although these provisions do not preclude a takeover, they may have the effect of discouraging, delaying or deferring a tender offer or takeover attempt that a shareholder might consider in his or her best interest, including those attempts that might result in a premium over the market price for the common stock. Such provisions will also render the removal of the Board of Directors and of management more difficult and, therefore, may serve to perpetuate current management. These provisions could potentially adversely affect the market prices of First United Corporation's securities.

#### **ITEM 1B. UNRESOLVED STAFF COMMENTS**

This Item 1B is not applicable because First United Corporation is a "smaller reporting company".

#### **ITEM 2. PROPERTIES**

The headquarters of First United Corporation and the Bank occupies approximately 29,000 square feet at 19 South Second Street, Oakland, Maryland, a 30,000 square feet operations center located at 12892 Garrett Highway, Oakland Maryland and 8,500 square feet at 102 South Second Street, Oakland, Maryland. These premises are owned by First United Corporation. The Bank owns 21 of its banking offices and leases six. The Bank also leases one office that is used for disaster recovery purposes and one specialty office. Total rent expense on the leased offices and properties was \$.5 million in 2012.

#### **ITEM 3. LEGAL PROCEEDINGS**

We are at times, in the ordinary course of business, subject to legal actions. Management, upon the advice of counsel, believes that losses, if any, resulting from current legal actions will not have a material adverse effect on our financial condition or results of operations.

#### **ITEM 4. MINE SAFETY DISCLOSURES**

Not applicable.

#### **PART II**

**ITEM MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS  
5. AND ISSUER PURCHASES OF EQUITY SECURITIES**

Shares of First United Corporation's common stock are listed on the NASDAQ Global Select Market under the symbol "FUNC". As of February 25, 2013, First United Corporation had 1,827 shareholders of record. The high and low sales prices for the shares of First United Corporation's common stock for each quarterly period of 2012 and 2011 are set forth below. On March 13, 2013, the closing sales price of the common stock as reported on the NASDAQ Global Select Market was \$8.75 per share. During 2012 and 2011, First United Corporation did not declare any dividends on its common stock.

	High	Low
2012		
1 <sup>st</sup> Quarter	\$6.48	\$3.16
2 <sup>nd</sup> Quarter	8.60	4.05
3 <sup>rd</sup> Quarter	7.25	4.31
4 <sup>th</sup> Quarter	7.80	6.02
2011		
1 <sup>st</sup> Quarter	\$4.93	\$2.76
2 <sup>nd</sup> Quarter	6.00	2.92
3 <sup>rd</sup> Quarter	5.50	3.38
4 <sup>th</sup> Quarter	4.81	2.93

[25]

The ability of the Bank to declare dividends is limited by federal and state banking laws and state corporate laws. Subject to the restrictions imposed on First United Corporation by these laws and the terms of its other securities, the payment of dividends on the shares of common stock and the amounts thereof are at the discretion of First United Corporation's Board of Directors. Prior to November 2010, cash dividends were typically declared on a quarterly basis. Historically, dividends to shareholders were generally dependent on the ability of First United Corporation's subsidiaries, especially the Bank, to declare dividends to the Corporation. As a result of First United Corporation's deferral of cash dividends under its Series A Preferred Stock in November 2010 and its December 2010 decision to defer interest payments under its TPS Debentures, the terms of these securities currently prohibit First United Corporation from declaring or paying cash dividends on outstanding shares of common stock. A complete discussion of these dividend restrictions is contained in Item 1A of Part I of this annual report under the heading "***Risks Relating to First United Corporation's Securities***" and in Note 21 to the Consolidated Financial Statements, both of which are incorporated herein by reference.

Because of these limitations and the fact that dividends are declared at the discretion of the Board, there can be no assurance that dividends will be declared in any future fiscal quarter. First United Corporation intends to periodically evaluate its dividend policy both internally and with the FRB, but it has no present intention of resuming dividend payments on its common stock in the foreseeable future.

### **Issuer Repurchases**

Neither First United Corporation nor any of its affiliates (as defined by Exchange Act Rule 10b-18) repurchased any shares of First United Corporation's common stock during 2012.

### **Equity Compensation Plan Information**

Pursuant to the SEC's Regulation S-K Compliance and Disclosure Interpretation 106.01, the information regarding First United Corporation's equity compensation plans required by this Item pursuant to Item 201(d) of Regulation S-K is located in Item 12 of Part III of this annual report and is incorporated herein by reference.

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**ITEM 6. SELECTED FINANCIAL DATA**

The following table sets forth certain selected financial data for the five years ended December 31, and is qualified in its entirety by the detailed information and financial statements, including notes thereto, included elsewhere or incorporated by reference in this annual report.

(Dollars in thousands, except for share data)	2012	2011	2010	2009	2008	
<b>Balance Sheet Data</b>						
Total Assets	\$1,320,783	\$1,390,865	\$1,696,445	\$1,743,796	\$1,639,104	
Net Loans	858,782	919,214	987,615	1,101,794	1,120,199	
Investment Securities	227,313	245,023	229,687	273,784	354,595	
Deposits	976,884	1,027,784	1,301,646	1,304,166	1,222,889	
Long-term Borrowings	182,735	207,044	243,100	270,544	277,403	
Shareholders' Equity	98,905	96,656	95,640	100,566	72,690	
<b>Operating Data</b>						
Interest Income	\$53,111	\$59,496	\$70,747	\$85,342	\$95,216	
Interest Expense	13,965	21,206	29,164	32,104	43,043	
Net Interest Income	39,146	38,290	41,583	53,238	52,173	
Provision for Loan Losses	9,390	9,157	15,726	15,588	12,925	
Other Operating Income	13,630	14,966	15,356	15,390	15,766	
Net Securities Impairment Losses	0	(19 )	(8,364 )	(26,693 )	(2,724 )	
Net Gains/(Losses) – Other	1,708	2,302	(6,014 )	411	727	
Other Operating Expense	39,518	43,410	45,049	46,578	40,573	
Income/(Loss) Before Taxes	5,576	2,991	(18,214 )	(19,820 )	12,444	
Income Tax expense/(benefit)	913	(635 )	(8,017 )	(8,496 )	3,573	
Net Income/(Loss)	\$4,663	\$3,626	\$(10,197 )	\$(11,324 )	\$8,871	
Accumulated preferred stock dividend and discount accretion	(1,691 )	(1,609 )	(1,559 )	(1,430 )	0	
Net income available to/(loss) attributable to common shareholders	\$2,972	\$2,017	\$(11,756 )	\$(12,754 )	\$8,871	
<b>Per Share Data</b>						
Basic and diluted net Income/(Loss) per common share	\$0.48	\$0.33	\$(1.91 )	\$(2.08 )	\$1.45	
Dividends Paid	0	0	0.13	0.80	0.80	
Book Value	11.14	10.80	10.68	11.49	11.89	
<b>Significant Ratios</b>						
Return on Average Assets	0.34	% 0.24	% (0.58 )%	(0.67 )%	0.55	%
Return on Average Equity	4.79	% 3.71	% (10.10 )%	(11.02 )%	9.31	%
Dividend Payout Ratio	0	% 0	% (7.85 )%	(43.21 )%	55.17	%
Average Equity to Average Assets	7.15	% 6.55	% 5.73	% 6.06	% 5.95	%
Total Risk-based Capital Ratio	14.13	% 13.05	% 11.57	% 11.20	% 12.18	%

Tier I Capital to Risk Weighted Assets	12.54	%	11.30	%	9.74	%	9.60	%	10.59	%
Tier I Capital to Average Assets	10.32	%	9.10	%	7.34	%	8.53	%	8.10	%

**ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

This discussion and analysis should be read in conjunction with the Consolidated Financial Statements and notes thereto for the year ended December 31, 2012, which are included in Item 8 of Part II of this annual report.

[27]

## Overview

First United Corporation is a financial holding company which, through the Bank and its non-bank subsidiaries, provides an array of financial products and services primarily to customers in four Western Maryland counties and four Northeastern West Virginia counties. Its principal operating subsidiary is the Bank, which consists of a community banking network of 27 branch offices located throughout its market areas. Our primary sources of revenue are interest income earned from our loan and investment securities portfolios and fees earned from financial services provided to customers.

Consolidated net income available to common shareholders was \$3.0 million for the year ended December 31, 2012, compared to net income available to common shareholders of \$2.0 million for the year ended December 31, 2011. Basic and diluted net income per common share for the year ended December 31, 2012 were \$.48, compared to net income per common share of \$.33 for the year ended December 31, 2011. The increase in net income for 2012 when compared to 2011 was attributable to a \$.6 million increase in net interest income after provision for loan losses, a reduction of \$3.9 million in other operating expenses due primarily to reductions in salaries and benefits, equipment expense and FDIC premiums. These increases were offset by a decrease in other operating income of \$1.3 million attributable to the sale of the insurance agency effective January 1, 2012, a decline in net gains of \$.6 million, and an increase in tax expense of \$1.6 million.

Net gains for 2012 were driven by net gains realized on sales of investment securities of \$1.5 million, gains on the sale of consumer mortgage loans of \$.2 million and a gain of \$.1 million from the sale of the assets of the Insurance Agency. The net interest margin for the year ended December 31, 2012, on a fully tax equivalent ("FTE") basis, increased to 3.30% from 2.96% for the year ended December 31, 2011.

The provision for loan losses increased to \$9.4 million for the year ended December 31, 2012, compared to \$9.2 million for the year ended December 31, 2011. The slightly higher provision expense was primarily due to a loan charge-off of \$9.0 million on a shared national credit for an ethanol plant in western Pennsylvania during the first quarter of 2012. In addition to this charge-off, we charged off \$1.1 million on a participation loan for a hotel located in Hazleton, Pennsylvania and \$.9 million on a motel located in Salisbury, Maryland. Other than these specific charge-offs, we saw an improvement in the credit quality of our loan portfolio as we experienced fewer loan downgrades and lower delinquency levels. Specific allocations were made for impaired loans where management determined that the collateral supporting the loans was not adequate to cover the loan balance, and the qualitative factors affecting the allowance for loan losses (the "ALL") were adjusted based on the current economic environment and the characteristics of the loan portfolio.

Other operating income decreased \$1.9 million during 2012 when compared to 2011. This decrease was attributable to a \$2.4 million decline in insurance commissions, as a result of the sale of the assets of the Insurance Agency effective January 1, 2012, a slight decline in debit card income of \$.1 million and a decrease of \$.6 million in net gains. These

declines were offset by the \$.7 million one-time, tax free death benefit that occurred in March 2012, a \$.2 million increase in trust department income, and an increase of \$.3 million in other income.

Operating expenses decreased \$3.9 million during 2012 when compared to 2011. This decrease was due to a \$.4 million decline in FDIC premiums attributable to the repayment of brokered deposits and a \$.7 million decline in salary expense due to the sale of the assets of the Insurance Agency. Equipment expense declined by \$.4 million in 2012 compared to 2011 primarily due to reduced depreciation expense. Other real estate expenses decreased \$1.5 million in 2012 when compared to 2011 primarily due to a \$.5 million decrease in write-downs, an increase of \$.7 in gains on sales of properties and an increase in other real estate owned ("OREO") rental income of \$.3 million. Professional services declined by \$.3 million and other expenses decreased by \$.4 million in 2012 when compared to 2011.

Comparing December 31, 2012 to December 31, 2011, outstanding loans decreased by \$63.9 million (6.8%). CRE loans decreased \$37.4 million as a result of payoffs of several large loans, charge-offs of loan balances and ongoing scheduled principal payments. Commercial and industrial ("C&I") loans decreased \$9.7 million and residential mortgages declined \$.3 million. Acquisition and development ("A&D") loans decreased \$14.5 million due to principal repayments and charge offs. The decrease in the residential mortgage portfolio was attributable to regularly scheduled principal payments on existing loans and management's decision to use secondary market outlets such as Fannie Mae for the majority of new, longer-term, fixed-rate residential loan originations. The consumer loan portfolio declined \$2.0 million due to repayment activity in the indirect auto portfolio which exceeded new production due to special financing offered by the automotive manufacturers, credit unions and certain large regional banks. At December 31, 2012, approximately 60% of the commercial loan portfolio was collateralized by real estate, compared to approximately 64% at December 31, 2011.

[28]



Interest income on loans in 2012 decreased by \$5.6 million (on a FTE basis) when compared to 2011 due to the continued low rate environment and the decline in loan balances during 2012. Interest income on the investment securities decreased by \$1.1 million (on a FTE basis) due to reinvesting sales and calls of securities at lower rates. (Additional information on the composition of interest income is available in Table 1 that appears on page 33).

Total deposits decreased \$50.9 million during 2012 when compared to deposits at December 31, 2011. The decline in deposits was due to a strategic decision to continue to use excess cash to repay wholesale deposits and FHLB advances at their stated maturities and to allow certificates of deposit for non-relationship customers to run off. Time deposits less than \$100,000 declined \$28.0 million while time deposits greater than \$100,000 decreased \$42.7 million. Retail money markets also declined by \$16.8 million during 2012. These decreases were offset by an increase of \$7.2 million in traditional savings accounts, \$17.8 million in interest-bearing demand deposits and \$11.6 million in non-interest bearing demand deposits.

Interest expense decreased \$7.2 million in 2012 when compared to 2011. The decline was due to our strategic focus to shift the mix of our portfolio from higher cost certificates of deposit to core deposits during 2012.

***Other Operating Income/Other Operating Expense*** – Other operating income, exclusive of gains, decreased \$1.3 million during 2012 when compared to 2011. Service charge income and debit card income both remained stable when comparing 2012 and 2011. Bank owned life insurance income increased due to the \$.7 million one-time, tax free death benefit that occurred in March 2012. Insurance commissions decreased \$2.4 million due to the sale of the assets of the Insurance Agency effective January 1, 2012. The sale did not have a material impact on our financial condition or results of operations. Other income increased \$.3 million in 2012 when compared to 2011 offset by a slight decline of \$.1 million in debit card income. Trust department income increased \$.2 million when comparing 2012 to 2011. Trust assets under management were \$637 million at December 31, 2012 and \$595 million at December 31, 2011.

Net gains of \$1.7 million were reported through other income during 2012, compared to net gains of \$2.3 million during 2011. The decrease in net gains in 2012 was primarily attributable to an increase of \$.7 million in net gains on sales of investment securities offset by the \$1.4 million gain on the sale of indirect auto loans in 2011.

Other operating expenses decreased \$3.9 million (9.0%) for the year ended December 31, 2012 when compared to the year ended December 31, 2011. The decrease was due to a decline of \$.7 million in salaries and benefits resulting primarily from a reduction of full-time equivalent employees through attrition within the Corporation and the sale of the assets of the Insurance Agency. A decline of \$.4 million in FDIC premiums attributable to the repayment of brokered deposits also impacted the reduced expenses. A decrease of \$.4 million in equipment expense was the result of normal depreciation during 2012 when compared to 2011. Other real estate expenses decreased \$1.5 million in 2012 when compared to 2011 primarily due to a \$.5 million decrease in write-downs, an increase of \$.7 in gains on sales of properties and an increase in OREO rental income of \$.3 million. Other miscellaneous expenses, such as legal and professional, marketing, consulting and postage, were also reduced when comparing 2012 to 2011.

**Dividends** – During 2012, First United Corporation did not declare or pay any dividends on the shares of its common stock due to the Board of Directors’ decision in November 2010 to defer quarterly cash dividends on the Series A Preferred Stock. There were no dividends paid on the Series A Preferred Stock in 2012.

**Looking Forward** – We will continue to face risks and challenges in the future, including, without limitation, changes in local economic conditions in our core geographic markets, potential yield compression on loan and deposit products from existing competitors and potential new entrants in our markets, fluctuations in interest rates, and changes to existing federal and state laws and regulations that apply to banks and financial holding companies. For a more complete discussion of these and other risk factors, see Item 1A of Part I of this annual report.

[29]

## **Estimates and Critical Accounting Policies**

This discussion and analysis of our financial condition and results of operations is based upon our Consolidated Financial Statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of these financial statements requires management to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent liabilities. (See Note 1 to the Consolidated Financial Statements.) On an on-going basis, management evaluates estimates and bases those estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions. Management believes the following critical accounting policies affect our more significant judgments and estimates used in the preparation of the Consolidated Financial Statements.

### *Allowance for Loan Losses, or ALL*

One of our most important accounting policies is that related to the monitoring of the loan portfolio. A variety of estimates impact the carrying value of the loan portfolio, including the calculation of the ALL, the valuation of underlying collateral, the timing of loan charge-offs and the placement of loans on non-accrual status. The allowance is established and maintained at a level that management believes is adequate to cover losses resulting from the inability of borrowers to make required payment on loans. Estimates for loan losses are arrived at by analyzing risks associated with specific loans and the loan portfolio, current and historical trends in delinquencies and charge-offs, and changes in the size and composition of the loan portfolio. The analysis also requires consideration of the economic climate and direction, changes in lending rates, political conditions, legislation impacting the banking industry and economic conditions specific to Western Maryland and Northeastern West Virginia. Because the calculation of the ALL relies on management's estimates and judgments relating to inherently uncertain events, actual results may differ from management's estimates.

The ALL is also discussed below in Item 7 under the heading "Allowance for Loan Losses" and in Note 7 to the Consolidated Financial Statements.

### *Goodwill*

Accounting Standards Codification ("ASC") Topic 350, *Intangibles – Goodwill and Other*, establishes standards for the amortization of acquired intangible assets and impairment assessment of goodwill. We have \$11.0 million in recorded goodwill at December 31, 2012 that is related to the acquisition of Huntington National Bank branches that occurred

in 2003 that is not subject to periodic amortization.

Goodwill arising from business combinations represents the value attributable to unidentifiable intangible elements in the business acquired. Goodwill is not amortized but is tested for impairment annually or more frequently if events or changes in circumstances indicate that the asset might be impaired. Impairment testing requires that the fair value of each of First United Corporation's reporting units be compared to the carrying amount of its net assets, including goodwill. If the estimated current fair value of the reporting unit exceeds its carrying value, no additional testing is required and an impairment loss is not recorded. Otherwise, additional testing is performed, and to the extent such additional testing results in a conclusion that the carrying value of goodwill exceeds its implied fair value, an impairment loss is recognized.

Our goodwill relates to the value inherent in the banking business, and that value is dependent upon our ability to provide quality, cost effective services in a highly competitive local market. This ability relies upon continuing investments in processing systems, the development of value-added service features and the ease of use of our services. As such, goodwill value is supported ultimately by revenue that is driven by the volume of business transacted. A decline in earnings as a result of a lack of growth or the inability to deliver cost effective services over sustained periods can lead to impairment of goodwill, which could adversely impact earnings in future periods. ASC Topic 350 requires an annual evaluation of goodwill for impairment. The determination of whether or not these assets are impaired involves significant judgments and estimates.

Throughout 2012, consistent with First United Corporation's peer group, the shares of First United Corporation common stock traded below its book value. At December 31, 2012, First United Corporation's stock price was below its tangible book value. Management believed that these circumstances could indicate the possibility of impairment. Accordingly, management consulted a third party valuation specialist to assist it with the determination of the fair value of First United Corporation, considering both the market approach (guideline public company method) and the income approach (discounted future benefits method). Due to the illiquidity in the common stock and the adverse conditions surrounding the banking industry, reliance was placed on the income approach in determining the fair value of First United Corporation. The income approach is a discounted cash flow analysis that is determined by adding (i) the present value, which is a representation of the current value of a sum that is to be received some time in the future, of the estimated net income, net of dividends paid out, that First United Corporation could generate over the next five years and (ii) the present value of a terminal value, which is a representation of the current value of an entity at a specified time in the future. The terminal value was calculated using both a price to tangible book multiple method and a capitalization method and the more conservative of the two was utilized in the fair value calculation.

[30]

Significant assumptions used in the above methods include:

Net income from First United Corporation's forward five-year operating budget, incorporating conservative growth and mix assumptions;

A discount rate of 10.0% based on the most recent [third quarter of 2012] Cost of Capital Report from Morningstar/Ibbotson Associates for the Commercial Banking Sector adjusted for a size and risk premium of 298 basis points;

A price to tangible book multiple of 1.16, which was the median multiple of commercial bank mergers and acquisitions during 2012 for selling banks and holding companies with non-performing assets to average assets between 2.0% and 4.0%, as provided by Sheshunoff & Co.; and

A capitalization rate of 7.0% (discount rate of 10.0% adjusted for a conservative growth rate of 3.0%).

The resulting fair value of the income approach resulted in the fair value of First United Corporation exceeding the carrying value by 68%. Management stressed the assumptions used in the analysis to provide additional support for the derived value. This stress testing showed that (i) the discount rate could increase to 27% before the excess would be eliminated in the tangible multiple method, and (ii) the assumption of the tangible book multiple could decline to 0.44 and still result in a fair value in excess of book value. Based on the results of the evaluation, management concluded that the recorded value of goodwill at December 31, 2012 was not impaired. However, future changes in strategy and/or market conditions could significantly impact these judgments and require adjustments to recorded asset balances. Management will continue to evaluate goodwill for impairment on an annual basis and as events occur or circumstances change.

#### *Accounting for Income Taxes*

First United Corporation accounts for income taxes in accordance with ASC Topic 740, "Income Taxes". Under this guidance, deferred taxes are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates that will apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized as income or expense in the period that includes the enactment date.

The Company regularly reviews the carrying amount of its net deferred tax assets to determine if the establishment of a valuation allowance is necessary. If based on the available evidence, it is more likely than not that all or a portion of the Company's net deferred tax assets will not be realized in future periods, a deferred tax valuation allowance would be established. Consideration is given to various positive and negative factors that could affect the realization of the deferred tax assets. In evaluating this available evidence, management considers, among other things, historical performance, expectations of future earnings, the ability to carry back losses to recoup taxes previously paid, length of statutory carry forward periods, experience with utilization of operating loss and tax credit carry forwards not expiring, tax planning strategies and timing of reversals of temporary differences. Significant judgment is required in

assessing future earnings trends and the timing of reversals of temporary differences. The Company's evaluation is based on current tax laws as well as management's expectations of future performance.

Management expects that First United Corporation's adherence to the required accounting guidance may result in increased volatility in quarterly and annual effective income tax rates because of changes in judgment or measurement including changes in actual and forecasted income before taxes, tax laws and regulations, and tax planning strategies.

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### *Other-Than-Temporary Impairment of Investment Securities*

Management systematically evaluates securities for impairment on a quarterly basis. Based upon application of accounting guidance for subsequent measurement in ASC Topic 320 (Section 320-10-35), management assesses whether (i) it has the intent to sell a security being evaluated and (ii) it is more likely than not that First United Corporation will be required to sell the security prior to its anticipated recovery. If neither applies, then declines in the fair values of securities below their cost that are considered other-than-temporary declines are split into two components. The first is the loss attributable to declining credit quality. Credit losses are recognized in earnings as realized losses in the period in which the impairment determination is made. The second component consists of all other losses, which are recognized in other comprehensive loss. In estimating other-than-temporary impairment (“OTTI”) losses, management considers (a) the length of time and the extent to which the fair value has been less than cost, (b) adverse conditions specifically related to the security, an industry, or a geographic area, (c) the historic and implied volatility of the fair value of the security, (d) changes in the rating of the security by a rating agency, (e) recoveries or additional declines in fair value subsequent to the balance sheet date, (f) failure of the issuer of the security to make scheduled interest or principal payments, and (g) the payment structure of the debt security and the likelihood of the issuer being able to make payments that increase in the future. Management also monitors cash flow projections for securities that are considered beneficial interests under the guidance of ASC Subtopic 325-40, *Investments – Other – Beneficial Interests in Securitized Financial Assets*, (ASC Section 325-40-35). This process is described more fully in the section of the Consolidated Balance Sheet Review entitled “Investment Securities”.

### *Fair Value of Investments*

We have determined the fair value of our investment securities in accordance with the requirements of ASC Topic 820, *Fair Value Measurements and Disclosures*, which defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements required under other accounting pronouncements. We measure the fair market values of our investments based on the fair value hierarchy established in Topic 820. The determination of fair value of investments and other assets is discussed further in Note 24 to the Consolidated Financial Statements.

### *Pension Plan Assumptions*

Our pension plan costs are calculated using actuarial concepts, as discussed within the requirements of ASC Topic 715, *Compensation – Retirement Benefits*. Pension expense and the determination of our projected pension liability are based upon two critical assumptions: the discount rate and the expected return on plan assets. We evaluate each of these critical assumptions annually. Other assumptions impact the determination of pension expense and the projected liability including the primary employee demographics, such as retirement patterns, employee turnover, mortality rates, and estimated employer compensation increases. These factors, along with the critical assumptions, are carefully reviewed by management each year in consultation with our pension plan consultants and actuaries. Further

information about our pension plan assumptions, the plan's funded status, and other plan information is included in Note 18 to the Consolidated Financial Statements.

Other than as discussed above, management does not believe that any material changes in our critical accounting policies have occurred since December 31, 2012.

*Adoption of New Accounting Standards and Effects of New Accounting Pronouncements*

Note 1 to the Consolidated Financial Statements discusses new accounting pronouncements that, when adopted, could affect our future consolidated financial statements.

**CONSOLIDATED STATEMENT OF INCOME REVIEW**

**Net Interest Income**

Net interest income is our largest source of operating revenue. Net interest income is the difference between the interest earned on interest-earning assets and the interest expense incurred on interest-bearing liabilities. For analytical and discussion purposes, net interest income is adjusted to a FTE basis to facilitate performance comparisons between taxable and tax-exempt assets by increasing tax-exempt income by an amount equal to the federal income taxes that would have been paid if this income were taxable at the statutorily applicable rate.

[32]



The table below summarizes net interest income (on a FTE basis) for the 2012 and 2011.

(Dollars in thousands)	2012	2011
Interest income	\$54,256	\$61,029
Interest expense	13,965	21,206
Net interest income	\$40,291	\$39,823
Net interest margin %	3.30 %	2.96 %

Net interest income on a FTE basis increased \$.5 million for the year ended December 31, 2012 over the year ended December 31, 2011 due to a \$7.2 million (34.1%) decrease in interest expense, which was partially offset by a \$6.8 million (11.1%) decrease in interest income. The increase in net interest income was primarily due to the reduction in the average balances of interest-bearing deposits and debt outstanding as well as the reduction in the average rate paid on interest-bearing liabilities. The slightly lower yield on both loans and investment securities, as funds were reinvested and the reduction in loan balances, contributed to the decline in interest income when comparing the two periods. The reduction in the average rates on interest-bearing liabilities was the primary driver of the increase in the net interest margin of 34 basis points, as it increased to 3.30% for the year ended December 31, 2012 from 2.96% for the year ended December 31, 2011.

There was an overall \$124.6 million decrease in average interest-earning assets, driven by the \$45.6 million reduction in loans and the \$61.5 million reduction in other interest earning assets, primarily cash, when comparing 2012 to 2011. The reduction in cash contributed to the relatively stable yield on our average earning assets.

Interest expense decreased for the year ended December 31, 2012 when compared to the year ended December 31, 2011 due to an overall reduction in interest rates on deposit products driven by our net-interest margin strategy implemented during 2011 and continuing through 2012 and our decision to only increase special rates on time deposits for full relationship customers. Management also strategically focused on shifting the mix of our deposits from higher cost certificates of deposit to core deposit products. The average balance of interest-bearing liabilities decreased by \$158.3 million as management continued its strategy to deploy excess cash to repay brokered deposits and wholesale long-term borrowings at their stated maturities during 2012. The overall effect was a 42 basis point decrease in the average rate paid on our average interest-bearing liabilities, from 1.71% for the year ended December 31, 2011 to 1.29% for the year ended December 31, 2012.

As shown below, the composition of total interest income between 2012 and 2011 remained constant between interest and fees on loans and investment securities.

	% of Total	
	Interest	
	Income	
	2012	2011
Interest and fees on loans	88 %	88 %
Interest on investment securities	11 %	11 %
Other	1 %	1 %

Table 1 sets forth the average balances, net interest income and expense, and average yields and rates for our interest-earning assets and interest-bearing liabilities for 2012, 2011 and 2010. Table 2 sets forth an analysis of volume and rate changes in interest income and interest expense of our average interest-earning assets and average interest-bearing liabilities for 2012, 2011 and 2010. Table 2 distinguishes between the changes related to average outstanding balances (changes in volume created by holding the interest rate constant) and the changes related to average interest rates (changes in interest income or expense attributed to average rates created by holding the outstanding balance constant).

[33]

**Distribution of Assets, Liabilities and Shareholders' Equity****Interest Rates and Interest Differential – Tax Equivalent Basis****Table 1**

(Dollars in thousands)	For the Years Ended December 31								
	2012			2011			2010		
	Average Balance	Interest	Average Yield/Rate	Average Balance	Interest	Average Yield/Rate	Average Balance	Interest	Average Yield/Rate
<b>Assets</b>									
Loans	\$908,213	\$46,742	5.15%	\$953,774	\$52,343	5.49%	\$1,074,080	\$61,115	5.69%
<b>Investment Securities:</b>									
Taxable	172,765	4,077	2.36	173,811	4,081	2.35	148,565	5,524	3.72
Non taxable	59,779	3,128	5.23	76,237	4,228	5.55	94,728	5,518	5.83
Total	232,544	7,205	3.1	250,048	8,309	3.32	243,293	11,042	4.54
Federal funds sold	58,645	138	0.24	109,287	265	0.24	190,878	422	0.22
<b>Interest-bearing deposits with other banks</b>									
	11,113	4	0.04	19,922	15	0.08	87,860	104	0.12
<b>Other interest earning assets</b>									
	9,762	167	1.71	11,797	97	0.82	13,453	47	0.35
Total earning assets	1,220,277	54,256	4.45%	1,344,828	61,029	4.54%	1,609,564	72,730	4.52%
Allowance for loan losses	(17,379 )			(21,495 )			(22,530 )		
Non-earning assets	157,979			167,896			176,265		
Total Assets	\$1,360,877			\$1,491,229			\$1,763,299		
<b>Liabilities and Shareholders' Equity</b>									
<b>Interest-bearing demand deposits</b>									
	\$120,616	\$180	0.15%	\$98,395	\$134	0.14%	\$115,478	\$387	0.34%
<b>Interest-bearing money markets</b>									
	203,497	424	0.21	224,303	748	0.33	286,639	2,418	0.84
<b>Savings deposits</b>									
	107,964	205	0.19	100,598	277	0.28	83,734	566	0.68
<b>Time deposits:</b>									
Less than \$100k	214,613	2,696	1.26	290,651	5,650	1.94	366,922	7,802	2.13
\$100k or more	198,051	3,054	1.54	267,648	5,090	1.9	388,945	6,910	1.78
<b>Short-term borrowings</b>									
	38,875	133	0.34	41,780	236	0.56	45,055	283	0.63
<b>Long-term borrowings</b>									
	198,541	7,273	3.66	217,112	9,071	4.18	252,889	10,798	4.27
Total interest-bearing liabilities	1,082,157	13,965	1.29%	1,240,487	21,206	1.71%	1,539,662	29,164	1.89%
<b>Non-interest-bearing deposits</b>									
	160,145			135,365			109,145		

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Other liabilities	21,258		17,662		13,507	
Shareholders' Equity	97,317		97,715		100,985	
Total Liabilities and Shareholders' Equity	\$1,360,877		\$1,491,229		\$1,763,299	
Net interest income and spread		\$40,291	3.16%		\$39,823	2.83%
Net interest margin			3.30%		\$43,566	2.63%
						2.71%

**Notes:**

The above table reflects the average rates earned or paid stated on a FTE basis assuming a tax rate of 35% for (1) 2012, 2011 and 2010. The FTE adjustments for the years ended December 31, 2012, 2011 and 2010 were \$1,145, \$1,533 and \$1,983, respectively.

(2) The average balances of non-accrual loans for the years ended December 31, 2012, 2011 and 2010, which were reported in the average loan balances for these years, were \$29,208, \$39,806 and \$42,506, respectively.

(3) Net interest margin is calculated as net interest income divided by average earning assets.

(4) The average yields on investments are based on amortized cost.

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**Interest Variance Analysis (1)****Table 2**

(In thousands and tax equivalent basis)	2012 Compared to 2011			2011 Compared to 2010		
	Volume	Rate	Net	Volume	Rate	Net
<b>Interest Income:</b>						
Loans	\$(2,345)	\$(3,256)	\$(5,601)	\$(6,605)	\$(2,167)	\$(8,772 )
Taxable Investments	(25 )	21	(4 )	593	(2,036)	(1,443 )
Non-taxable Investments	(861 )	(239 )	(1,100)	(1,026)	(264 )	(1,290 )
Federal funds sold	(119 )	(8 )	(127 )	(196 )	39	(157 )
Other interest earning assets	(189 )	248	59	(624 )	586	(38 )
Total interest income	(3,539)	(3,234)	(6,773)	(7,858)	(3,842)	(11,700)
<b>Interest Expense:</b>						
Interest-bearing demand deposits	33	13	46	(23 )	(230 )	(253 )
Interest-bearing money markets	(43 )	(281 )	(324 )	(206 )	(1,465)	(1,671 )
Savings deposits	14	(86 )	(72 )	47	(336 )	(289 )
Time deposits less than \$100	(955 )	(1,999)	(2,954)	(1,480)	(672 )	(2,152 )
Time deposits \$100 or more	(1,073)	(963 )	(2,036)	(2,305)	485	(1,820 )
Short-term borrowings	(10 )	(93 )	(103 )	(18 )	(29 )	(47 )
Long-term borrowings	(680 )	(1,118)	(1,798)	(1,495)	(232 )	(1,727 )
Total interest expense	(2,714)	(4,527)	(7,241)	(5,480)	(2,479)	(7,959 )
Net interest income	\$(825 )	\$1,293	\$468	\$(2,378)	\$(1,363)	\$(3,741 )

**Note:**

(1) The change in interest income/expense due to both volume and rate has been allocated to volume and rate changes in proportion to the relationship of the absolute dollar amounts of the change in each.

**Provision for Loan Losses**

The provision for loan losses was \$9.4 million for the year ended 2012, compared to \$9.2 million for the year ended December 31, 2011. The higher provision expense was primarily due to the aforementioned \$9.0 million charge-off of the shared national credit for an ethanol plant (included in C&I loans) during the first quarter of 2012. We also experienced a reduction in the level of classified assets (discussed below in the section entitled "FINANCIAL CONDITION" under the heading "Allowance and Provision for Loan Losses"). Management strives to ensure that the ALL reflects a level commensurate with the risk inherent in our loan portfolio.

**Other Operating Income**

The following table shows the major components of other operating income for the past two years, exclusive of net gains/(losses), and the percentage changes during these years:

(Dollars in thousands)	2012	2011	% Change	
Service charges on deposit accounts	\$2,851	\$3,019	-5.56	%
Other service charge income	788	652	20.86	%
Debit card income	2,010	2,125	-5.41	%
Trust department income	4,608	4,413	4.42	%
Insurance commissions	11	2,424	-99.55	%
Bank owned life insurance (BOLI)	1,778	1,030	72.62	%
Brokerage commissions	778	767	1.43	%
Other income	806	536	50.37	%
Total other operating income	\$13,630	\$14,966	-8.93	%

[35]

Other operating income, exclusive of gains, decreased \$1.3 million during 2012 when compared to 2011. Service charge income and debit card income both remained stable when comparing 2012 and 2011. Bank owned life insurance income increased due to the \$.7 million one-time, tax free death benefit that occurred in March 2012. Insurance commissions decreased \$2.4 million due to the sale of the assets of the Insurance Agency effective January 1, 2012. The sale did not have a material impact on our financial condition or results of operations. Other income increased \$.3 million in 2012 when compared to 2011 offset by a slight decline of \$.1 million in debit card income. Trust department income increased \$.2 million when comparing 2012 to 2011. Trust assets under management were \$637 million at December 31, 2012 and \$595 million at December 31, 2011.

Net gains of \$1.7 million were reported through other income during 2012, compared to net gains of \$2.3 million during 2011. The decrease in net gains in 2012 was primarily attributable to an increase of \$.7 million in net gains on sales of investment securities offset by the \$1.4 million gain on the sale of indirect auto loans in 2011.

### Other Operating Expense

The following table shows the major components of other operating expense for the past two years and the percentage changes during these years:

(Dollars in thousands)	2012	2011	% Change
Salaries and employee benefits	\$19,481	\$20,225	-3.68 %
Other expenses	7,061	7,426	-4.92 %
FDIC premiums	1,985	2,362	-15.96 %
Equipment	2,624	3,015	-12.97 %
Occupancy	2,719	2,804	-3.03 %
Data processing	2,886	2,744	5.17 %
Professional services	1,292	1,575	-17.97 %
Other real estate owned expense	890	2,410	-63.07 %
Miscellaneous loan fees	580	849	31.68 %
Total other operating expense	\$39,518	\$43,410	-8.97 %

Other operating expenses decreased \$3.9 million (9.0%) for the year ended December 31, 2012 when compared to the year ended December 31, 2011. The decrease was due to a decline of \$.7 million in salaries and benefits resulting primarily from a reduction of full-time equivalent employees as a result of the sale of the assets of the Insurance Agency on January 1, 2012. A decline of \$.4 million in FDIC premiums attributable to the repayment of brokered deposits also impacted the reduced expenses. Other real estate expenses decreased \$1.5 million in 2012 when compared to 2011 primarily due to a \$.5 million decrease in write-downs, an increase of \$.7 in gains on sales of properties and an increase in OREO rental income of \$.3 million. A decrease of \$.4 million in equipment expense was the result of reduced depreciation during 2012 when compared to 2011. Other miscellaneous expenses, such as legal

and professional, marketing, consulting and postage, were also reduced when comparing 2012 to 2011 as management continued its vigilance in maintaining and reducing operating expenses.

### **Applicable Income Taxes**

Due to improved operating results in 2012, we recognized a tax expense of \$.9 million in 2012, compared to a net tax benefit of \$.6 million in 2011. See Note 17 to the Consolidated Financial Statements under the heading "Income Taxes" for a detailed analysis of our deferred tax assets and liabilities. A valuation allowance has been provided for the \$1.5 million in state tax loss carry forwards included in deferred tax assets, which will expire commencing in 2030.

At December 31, 2012 the Corporation has federal net operating losses ("NOL") of approximately \$10.0 million and West Virginia NOLs of approximately \$5.3 million for which deferred tax assets of \$3.5 million and \$0.2 million, respectively, have been recorded at December 31, 2012. The federal and West Virginia NOLs were created in 2011 and 2010 and will begin expiring in 2030. Management has determined that a deferred tax valuation allowance is not required for 2012 on the Federal and West Virginia NOLs because we believe it is more likely than not that these deferred tax assets can be realized prior to expiration of their carry-forward period. This determination is based primarily on the ability of the Corporation to immediately generate approximately \$13.4 million of taxable income through tax planning strategies, irrespective of any additional future operating income. At December 31, 2012 these strategies include the ability to generate approximately \$4.1 million in taxable gains through the sale of investment securities, approximately \$8.0 million in taxable gains through the sale of its Bank Owned Life Insurance and approximately \$1.3 million in taxable gains through the sale of its fixed rate mortgage portfolio.

[36]



The Corporation has Maryland net operating loss carry-forwards of \$28.4 million for the NOL of the Parent Company for which a deferred tax asset of \$1.5 million has been recorded at December 31, 2012. There has been and continues to be a full valuation allowance on the Parent Company's NOL based on the fact that it is more likely than not that this deferred tax asset will not be realized because the Parent company files a separate tax return and has recurring tax losses and will not generate sufficient taxable income in the future to utilize them before they expire beginning in 2019. The valuation allowance of \$1.5 million at December 31, 2012 reflects an increase of \$.1 million from the level at December 31, 2011.

In addition, we have concluded that no valuation allowance is deemed necessary for the Corporation's remaining Federal and State deferred tax assets at December 31, 2012 as it is more likely than not (defined a level of likelihood that is more than 50 percent) that they will be realized based on the expected reversal of deferred tax liabilities, the generation of future income sufficient to realize the deferred tax assets as they reverse and the ability to implement tax planning strategies to prevent the expiration of any carry-forward periods. In making this determination, management considered the following:

the expected reversal of all but \$1.9 million of the total \$3.4 million of deferred tax liabilities at December 31, 2012 in such a manner so as to substantially utilize the dollar for dollar impact against the deferred tax assets at December 31, 2012;

for the remaining excess deferred tax assets that will not be utilized by the reversal of deferred tax liabilities, our expected future income will be sufficient to utilize the deferred tax assets as they reverse or before any net operating loss, if created, would expire; and

tax planning strategies that can provide both one-time increases to taxable income of up to approximately \$7.5 - \$8.5 million and recurring annual decreases in unfavorable permanent items.

We will need to generate future taxable income of approximately \$74 - \$76 million to fully utilize the net deferred tax assets in the years in which they are expected to reverse. Management estimates that we can fully utilize the deferred tax assets in approximately seven years based on the historical pre-tax income and forecasts of estimated future pre-tax income as adjusted for permanent book to tax differences.

## **CONSOLIDATED BALANCE SHEET REVIEW**

### **Overview**

Our total assets were \$1.32 billion at December 31, 2012, representing a decrease of \$70.1 million (5.0%) from assets at December 31, 2011. The decrease resulted from a reduction in loan balances due to payback, charge-off and scheduled principal amortization and a strategic decision to continue to deploy excess cash to repay wholesale borrowings and brokered certificates of deposit and invest in investment securities during 2012.

The total interest-earning asset mix at December 31, 2012 remained consistent when compared to 2011. The mix for each year is illustrated below:

	Year End Percentage of Total Assets			
	2012		2011	
Cash and cash equivalents	6	%	5	%
Net loans	65	%	66	%
Investments	17	%	18	%

[37]

The year-end total liability mix has remained consistent during the two-year period as illustrated below.

	Year End Percentage of Total Liabilities			
	2012		2011	
Total deposits	80	%	79	%
Total borrowings	18	%	19	%

### **Loan Portfolio**

The Bank is actively engaged in originating loans to customers primarily in Allegany County, Frederick County, Garrett County, and Washington County in Maryland, and in Berkeley County, Hardy County, Mineral County, and Monongalia County in West Virginia; and the surrounding regions of West Virginia and Pennsylvania. We have policies and procedures designed to mitigate credit risk and to maintain the quality of our loan portfolio. These policies include underwriting standards for new credits as well as continuous monitoring and reporting policies for asset quality and the adequacy of the allowance for loan losses. These policies, coupled with ongoing training efforts, have provided effective checks and balances for the risk associated with the lending process. Lending authority is based on the type of the loan, and the experience of the lending officer.

Commercial loans are collateralized primarily by real estate and, to a lesser extent, equipment and vehicles. Unsecured commercial loans represent an insignificant portion of total commercial loans. Residential mortgage loans are collateralized by the related property. Generally, a residential mortgage loan exceeding a specified internal loan-to-value ratio requires private mortgage insurance. Installment loans are typically collateralized, with loan-to-value ratios which are established based on the financial condition of the borrower. We will also make unsecured consumer loans to qualified borrowers meeting our underwriting standards. Additional information about our loans and underwriting policies can be found in Item 1 of Part I of this annual report under the heading “Banking Products and Services”.

Table 3 sets forth the composition of our loan portfolio. Historically, our policy has been to make the majority of our loan commitments in our market areas. We had no foreign loans in our portfolio as of December 31 for any of the years presented.

### **Summary of Loan Portfolio**

#### **Table 3**

The following table presents the composition of our loan portfolio for the past five years:

(In millions)	2012	2011	2010	2009	2008
Commercial real estate	\$298.8	\$336.2	\$348.6	\$326.8	\$322.4
Acquisition and development	128.4	142.9	156.9	231.7	227.0
Commercial and industrial	69.0	78.7	70.0	81.3	77.7
Residential mortgage	346.9	347.2	356.7	373.2	382.0
Consumer	31.7	33.7	77.6	108.9	125.4
Total Loans	\$874.8	\$938.7	\$1,009.8	\$1,121.9	\$1,134.5

Comparing December 31, 2012 to December 31, 2011, outstanding loans decreased by \$63.9 million (6.8%). CRE loans decreased \$37.4 million as a result of payoffs of several large loans, charge-offs of loan balances and ongoing scheduled principal payments. C&I loans decreased \$9.7 million due to the single \$9.0 million charge-off during the year, and residential mortgages declined \$.3 million. A&D loans decreased \$14.5 million due to principal repayments and charge offs. The residential mortgage portfolio remained stable as new production offset regularly scheduled principal payments on and refinancings of existing loans and due to management's decision to use secondary market outlets such as Fannie Mae for the majority of new, longer-term, fixed-rate residential loan originations. The consumer loan portfolio declined \$2.0 million due to repayment activity in the indirect auto portfolio which exceeded new production due to special financing offered by the automotive manufacturers, credit unions and certain large regional banks and management's decision to de-emphasize this line of business.

[38]

At December 31, 2012, approximately 60% of the commercial loan portfolio was collateralized by real estate, compared to approximately 64% at December 31, 2011.

At December 31, 2012, adjustable interest rate loans made up 64% of total loans, compared to 63% at December 31, 2011. Fixed-interest rate loans made up 36% of the total loan portfolio at December 31, 2012, compared to 37% of total loans at December 31, 2011.

Comparing December 31, 2011 to December 31, 2010, outstanding loans decreased by \$38.6 million (3.8%), net of the sale of \$32.5 million of the indirect auto portfolio. CRE loans decreased \$12.4 million as a result of the payoff of several large loans, charge-offs of loan balances and ongoing scheduled principal payments. C&I loans increased \$8.7 million and residential mortgages declined \$9.5 million. A&D loans decreased \$14.0 million due primarily to principal repayments and charge offs. The decrease in the residential mortgage portfolio was attributable to regularly scheduled principal payments on existing loans and management's decision to use secondary market outlets such as Fannie Mae for the majority of new, longer-term, fixed-rate residential loan originations. The consumer portfolio declined \$43.9 million due primarily to the sale of \$32.5 million of retail installment contracts in our indirect auto loan portfolio and \$11.4 million of repayment activity in the indirect auto portfolio exceeded new production due to special financing offered by the automotive manufacturers, credit unions and certain large regional banks. At December 31, 2011, approximately 64% of the commercial loan portfolio was collateralized by real estate, compared to approximately 71% at December 31, 2010.

The following table sets forth the maturities, based upon contractual dates, for selected loan categories as of December 31, 2012:

#### Maturities of Loan Portfolio at December 31, 2012

Table 4

(In thousands)	Maturing Within One Year	Maturing After One Year But Within Five Years	Maturing After Five Years	Total
Commercial Real Estate	\$26,606	\$61,644	\$210,601	\$298,851
Acquisition and Development	37,549	31,520	59,322	128,391
Commercial and Industrial	14,056	22,409	32,548	69,013
Residential Mortgage	14,899	6,432	325,588	346,919

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Consumer	8,826	19,347	3,482	31,655
Total Loans	\$ 101,936	\$ 141,352	\$ 631,541	\$ 874,829

Classified by Sensitivity to Change in Interest Rates

Fixed-Interest Rate Loans	39,922	98,860	174,803	313,585
Adjustable-Interest Rate Loans	62,014	42,492	456,738	561,244
Total Loans	\$ 101,936	\$ 141,352	\$ 631,541	\$ 874,829

Management monitors the performance and credit quality of the loan portfolio by analyzing the age of the portfolio as determined by the length of time a recorded payment is past due. A loan is considered to be past due when a payment has not been received for 30 days past its contractual due date. For all loan segments, the accrual of interest is discontinued when principal or interest is delinquent for 90 days or more unless the loan is well-secured and in the process of collection. All non-accrual loans are considered to be impaired. Interest payments received on non-accrual loans are applied as a reduction of the loan principal balance. Loans are returned to accrual status when all principal and interest amounts contractually due are brought current and future payments are reasonably assured. Our policy for recognizing interest income on impaired loans does not differ from our overall policy for interest recognition.

[39]

Table 5 sets forth the amounts of non-accrual, past-due and restructured loans for the past five years:

## Risk Elements of Loan Portfolio

**Table 5**

(In thousands)	At December 31,				
	2012	2011	2010	2009	2008
<b>Non-accrual loans:</b>					
Commercial real estate	\$6,194	\$10,069	\$11,893	\$4,046	\$2,175
Acquisition and development	10,778	14,938	16,269	37,244	16,520
Commercial and industrial	176	9,364	1,355	0	2,338
Residential mortgage	2,731	3,796	5,236	5,227	3,434
Consumer	36	21	152	67	86
Total non-accrual loans	\$19,915	\$38,188	\$34,905	\$46,584	\$24,553
<b>Accruing Loans Past Due 90 days or more:</b>					
Commercial real estate	\$0	\$0	\$0	\$0	\$513
Acquisition and development	200	128	128	0	430
Commercial and industrial	0	0	44	0	174
Residential mortgage	1,888	1,509	2,437	1,483	1,686
Consumer	58	142	183	287	673
Total accruing loans past due 90 days or more	\$2,146	\$1,779	\$2,792	\$1,770	\$3,476
	\$22,061	\$39,967	\$37,697	\$48,354	\$28,029
<b>Restructured Loans (TDRs):</b>					
Performing	\$12,134	\$10,657	\$5,506	\$22,160	\$349
Non-accrual (included above)	5,540	7,385	9,593	13,321	119
Total TDRs	\$17,674	\$18,042	\$15,099	\$35,481	\$468
Other Real Estate Owned	\$17,513	\$16,676	\$18,072	\$7,591	\$2,424
Impaired loans without a valuation allowance	\$39,361	\$41,778	\$42,890	\$102,553	\$66,816
Impaired loans with a valuation allowance	8,481	20,048	19,713	28,677	16,519
Total impaired loans	\$47,842	\$61,826	\$62,603	\$131,230	\$83,335
Valuation allowance related to impaired loans	\$1,632	\$3,951	\$4,366	\$7,624	\$4,759

Non-Accrual Loans as a % of Applicable Portfolio

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	2012	2011	2010	2009	2008
Commercial real estate	2.1 %	3.0 %	3.4 %	1.2 %	0.7 %
Acquisition and development	8.4 %	10.5%	10.4%	16.1%	7.3 %
Commercial and industrial	0.3 %	11.9%	1.9 %	0.0 %	3.0 %
Residential mortgage	0.8 %	1.1 %	1.5 %	1.4 %	0.9 %
Consumer	0.1 %	0.1 %	0.2 %	0.1 %	0.1 %

[40]



Interest income not recognized as a result of placing loans on non-accrual status was \$1.7 million for the year ended December 31, 2012, and there was \$94,000 of interest income recognized on a cash basis during 2012.

Performing loans considered to be impaired (including performing troubled debt restructurings, or TDRs), as defined and identified by management, amounted to \$28.2 million at December 31, 2012 and \$23.6 million at December 31, 2011. Loans are identified as impaired when, based on current information and events, management determines that we will be unable to collect all amounts due according to contractual terms. These loans consist primarily of A&D loans and CRE loans. The fair values are generally determined based upon independent third party appraisals of the collateral or discounted cash flows based upon the expected proceeds. Specific allocations have been made where management believes there is insufficient collateral to repay the loan balance if liquidated and there is no secondary source of repayment available.

The level of performing impaired loans (other than performing TDRs) increased \$3.1 million during the year ended December 31, 2012, due to the addition of \$4.8 million of loans added to performing accrued status, partially offset by \$1.7 million of net principal repayments received in the year. The new performing impaired balances were related to two relationships. Management will continue to monitor all loans that have been removed from an impaired status and take appropriate steps to ensure that satisfactory performance is sustained.

The following table presents the details of TDRs by loan class at December 31, 2012 and December 31, 2011:

(in thousands)	December 31, 2012		December 31, 2011	
	Number Contracts	Recorded Investment	Number Contracts	Recorded Investment
<b>Performing</b>				
Commercial real estate				
Non owner-occupied	2	\$ 273	2	\$ 287
All other CRE	5	5,676	1	3,162
Acquisition and development				
1-4 family residential construction	1	2,052	1	2,489
All other A&D	4	2,330	4	2,645
Commercial and industrial	2	557	1	693
Residential mortgage				
Residential mortgage – term	4	1,246	5	1,381
Residential mortgage – home equity	0	0	0	0
Consumer	0	0	0	0
Total performing	18	\$ 12,134	14	\$ 10,657
<b>Non-accrual</b>				
Commercial real estate				
Non owner-occupied	1	\$ 448	1	\$ 448

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All other CRE	0	0	0	0
Acquisition and development				
1-4 family residential construction	0	0	0	0
All other A&D	6	4,600	7	6,719
Commercial and industrial	0	0	0	0
Residential mortgage				
Residential mortgage – term	2	492	1	218
Residential mortgage – home equity	0	0	0	0
Consumer	0	0	0	0
Total non-accrual	9	5,540	9	7,385
Total TDRs	27	\$ 17,674	23	\$ 18,042

[41]

The level of TDRs decreased \$.4 million during 2012, reflecting the addition of eight loans totaling \$3.9 million to performing TDRs and one loan totaling \$.3 million to non-accrual TDRs, as well as the re-modification of five loans totaling \$7.6 million already in performing TDRs. Principal payments of \$1.3 million on performing TDRs and \$2.0 million on non-performing TDRs were received in 2012. Additionally, \$.8 million of performing TDRs and a \$.2 non-performing TDR were paid-off during 2012. Three loans totaling \$.3 million that had been modified at market rates prior to December 31, 2011 were removed from performing TDRs during 2012 because the borrowers had made at least six consecutive payments and were current at the time of reclassification.

At December 31, 2012, additional funds of up to \$2.1 million were committed to be advanced in connection with TDRs. Interest income not recognized due to rate modifications of TDRs was \$.1 million, and interest income recognized on all TDRs was \$.6 million in 2012.

### **Allowance for Loan Losses**

The ALL is maintained to absorb losses from the loan portfolio. The ALL is based on management's continuing evaluation of the quality of the loan portfolio, assessment of current economic conditions, diversification and size of the portfolio, adequacy of collateral, past and anticipated loss experience, and the amount of non-performing loans.

The ALL is also based on estimates, and actual losses will vary from current estimates. These estimates are reviewed quarterly, and as adjustments, either positive or negative, become necessary, a corresponding increase or decrease is made in the ALL. The methodology used to determine the adequacy of the ALL is consistent with prior years. An estimate for probable losses related to unfunded lending commitments, such as letters of credit and binding but unfunded loan commitments is also prepared. This estimate is computed in a manner similar to the methodology described above, adjusted for the probability of actually funding the commitment.

The ALL decreased to \$16.0 million at December 31, 2012, compared to \$19.5 million at December 31, 2011. The provision for loan losses for the year ended December 31, 2012 increased to \$9.4 million from \$9.2 million for the year ended December 31, 2011. Net charge-offs rose to \$12.8 million for the year ended December 31, 2012, compared to \$11.8 million for the year ended December 31, 2011. Included in the net charge-offs for the year ended December 31, 2012 were the aforementioned \$9.0 million charge-off on a shared national credit for an ethanol plant, a \$1.1 million charge-off for a participation loan, and a \$.9 million charge-off for a non owner-occupied commercial real estate loan. The increased provision expense was primarily due to these three large charge-offs. The ratio of the ALL to loans outstanding as of December 31, 2012 was 1.83%, which was lower than the 2.08% at December 31, 2011 due to the charge-off or removal of specific allocations as a result of changing circumstances.

The ratio of net charge-offs to average loans for the year ended December 31, 2012 was 1.41%, compared to 1.24% for the year ended December 31, 2011. Relative to December 31, 2011, all segments of loans, with the exception of C&I and residential mortgage loans, showed improvement. The net charge-off ratio for CRE loans as of December 31, 2012 was .67%, compared to 2.02% as of December 31, 2011. The net charge-off ratio for A&D loans as of December 31, 2012 was .29%, compared to 1.91% as of December 31, 2011. The ratios for C&I loans were 12.1% and .99% for December 31, 2012 and December 31, 2011, respectively, as a result of the \$9.0 million full charge-off described above. The residential mortgage ratios were .33% and .32% for December 31, 2012 and December 31, 2011, respectively, and the consumer loan ratios were .69% and 1.17%, for December 31, 2012 and December 31, 2011, respectively. Without the \$9.0 million C&I charge-off, the ratio of net charge-offs to average loans in 2012 would have been .41% and a net recovery rate of .18% for C&I loans.

Accruing loans past due 30 days or more declined to 2.39% of the loan portfolio at December 31, 2012, compared to 2.86% at December 31, 2011. The decrease for 2012 was primarily due to the full payoff of two past due CRE loans totaling \$5.2 million in 2012. Other improvements in the levels of past-due loans were attributable to a combination of a slowly improving economy and vigorous collection efforts by the Bank.

Non-accrual loans totaled \$19.9 million as of December 31, 2012, compared to \$38.2 million as of December 31, 2011. The \$18.3 million decline in non-accrual loans was due primarily to the \$9.0 million C&I charge-off as well as the payoff of one \$4.4 million CRE loan and payoffs/pay downs of \$7.4 million on three A&D loans during 2012. Non-accrual loans which have been subject to a partial charge-off totaled \$6.7 million as of December 31, 2012, compared to \$13.4 million as of December 31, 2011.

[42]

Management believes that the ALL at December 31, 2012 is adequate to provide for probable losses inherent in our loan portfolio. Amounts that will be recorded for the provision for loan losses in future periods will depend upon trends in the loan balances, including the composition of the loan portfolio, changes in loan quality and loss experience trends, potential recoveries on previously charged-off loans and changes in other qualitative factors. Management also applies interest rate risk, collateral value and debt service sensitivity analyses to the CRE loan portfolio and obtains new appraisals on specific loans under defined parameters to assist in the determination of the periodic provision for loan losses.

The ALL decreased to \$19.5 million at December 31, 2011 from \$22.1 million at December 31, 2010. The provision for loan losses for the year ended December 31, 2011 decreased to \$9.2 million from \$15.7 million for the year ended December 31, 2010. Net charge-offs declined to \$11.8 million at December 31, 2011 from \$13.7 million at December 31, 2010. Included in the net charge-offs for the year ended December 31, 2011 were partial charge-offs of \$5.1 million for two large CRE loans and \$1.5 million for one other A&D loan. The decrease in the provision for loan losses from 2010 to 2011 resulted from management's analysis of the adequacy of the loan loss reserve, declining loan balances, charge-offs and improving economic conditions as noted by the Federal Reserve. The sale of \$32.5 million of the indirect auto portfolio, which released \$.6 million in provision expense, was a contributing factor to the lower provision expense. The ratio of the ALL to loans outstanding as of December 31, 2011 was 2.08%, compared to 2.19% as of December 31, 2010. The decrease was due to a focused effort by management to recognize potential problem loans, charge-off potentially uncollectible balances, and record specific allocations and adjust qualitative factors to reflect the current quality of the loan portfolio.

Table 6 presents the activity in the allowance for loan losses by major loan category for the past five years.

### Analysis of Activity in the Allowance for Loan Losses

**Table 6**

(In thousands)	For the Years Ended December 31,				
	2012	2011	2010	2009	2008
Balance, January 1	\$19,480	\$22,138	\$20,090	\$14,347	\$7,304
Charge-offs:					
Commercial real estate	(2,289 )	(6,886 )	(543 )	(729 )	(109 )
Acquisition and development	(809 )	(3,055 )	(9,770 )	(3,902 )	(838 )
Commercial and industrial	(9,402 )	(840 )	(2,225 )	(2,246 )	(2,951 )
Residential mortgage	(1,314 )	(1,664 )	(2,008 )	(1,495 )	(672 )
Consumer	(650 )	(893 )	(1,791 )	(2,413 )	(2,025 )
Total charge-offs	(14,464)	(13,338)	(16,337)	(10,785)	(6,595)
Recoveries:					
Commercial real estate	156	95	94	103	0
Acquisition and development	420	322	1,097	40	23

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Commercial and industrial	464	57	538	201	33
Residential mortgage	177	550	391	80	120
Consumer	424	499	539	516	537
Total recoveries	1,641	1,523	2,659	940	713
Net credit losses	(12,823)	(11,815)	(13,678)	(9,845 )	(5,882 )
Provision for loan losses	9,390	9,157	15,726	15,588	12,925
Balance at end of period	\$16,047	\$19,480	\$22,138	\$20,090	\$14,347
Allowance for loan losses to loans outstanding (as %)	1.83	% 2.08	% 2.19	% 1.79	% 1.26
Net charge-offs to average loans outstanding during the period (as %)	1.41	% 1.24	% 1.28	% 0.87	% 0.54

Table 7 presents management's allocation of the ALL by major loan category in comparison to that loan category's percentage of total loans. Changes in the allocation over time reflect changes in the composition of the loan portfolio risk profile and refinements to the methodology of determining the ALL. Specific allocations in any particular category may be reallocated in the future as needed to reflect current conditions. Accordingly, the entire ALL is considered available to absorb losses in any category.

[43]

**Allocation of the Allowance for Loan Losses****Table 7**

(In thousands)	For the Years Ended December 31,														
	2012	% of Total Loans		2011	% of Total Loans		2010	% of Total Loans		2009	% of Total Loans		2008	% of Total Loans	
Commercial real estate	\$5,206	34	%	\$6,218	36	%	\$8,658	35	%	\$5,351	29	%	\$3,289	28	%
Acquisition and development	5,029	15	%	7,190	15	%	6,345	16	%	7,922	21	%	3,396	20	%
Commercial and industrial	906	8	%	2,190	8	%	1,345	7	%	1,945	7	%	2,318	7	%
Residential mortgage	4,507	39	%	3,430	37	%	4,211	35	%	3,061	33	%	3,437	34	%
Consumer	399	4	%	452	4	%	1,579	7	%	1,811	10	%	1,907	11	%
Total	\$16,047	100	%	\$19,480	100	%	\$22,138	100	%	\$20,090	100	%	\$14,347	100	%

**Investment Securities**

The following table sets forth the composition of our securities portfolio by major category as of the indicated dates:

**Table 8**

(In thousands)	At December 31,											
	2012			2011			2010					
	Amortized Cost	Fair Value (FV)	FV As % of Total	Amortized Cost	Fair Value (FV)	FV As % of Total	Amortized Cost	Fair Value (FV)	FV As % of Total	Amortized Cost	Fair Value (FV)	FV As % of Total
Securities Available-for-Sale:												
U.S. government agencies	\$40,334	\$40,320	18 %	\$25,490	\$25,580	11 %	\$24,813	\$24,850	11 %			
Residential mortgage-backed agencies	43,596	44,108	20 %	43,630	44,552	18 %	53,424	54,317	24 %			
Commercial mortgage-backed agencies	37,330	37,618	17 %	48,112	48,277	19 %	0	0	0			
Collateralized mortgage												

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obligations	31,836	31,731	14	%	48,120	48,351	20	%	45,448	45,958	20	%
Obligations of states and political subdivisions	55,212	58,054	26	%	65,424	68,816	28	%	94,250	94,724	41	%
Collateralized debt obligations	36,798	11,442	5	%	36,385	9,447	4	%	36,533	9,838	4	%
Total available for sale	\$245,106	\$223,273	100	%	\$267,161	\$245,023	100	%	\$254,468	\$229,687	100	%
Securities Held to Maturity:												
Obligations of states and political subdivisions	\$4,040	\$4,347	100	%	\$0	\$0	0	%	\$0	\$0	0	%

Total investment securities decreased \$17.4 million during 2012 when compared to the balance at December 31, 2011. At December 31, 2012, the securities classified as available-for-sale included a net unrealized loss of \$21.8 million, which represents the difference between the fair value and amortized cost of securities in the portfolio and is primarily attributable to the collateralized debt obligations (“CDOs”). Two tax increment fund bonds were moved to held to maturity during the first quarter of 2012 reflecting management’s intent to hold the securities until the earlier of their full repayment or maturity.

As discussed in Note 24 to the Consolidated Financial Statements, we measure fair market values based on the fair value hierarchy established in ASC Topic 820, *Fair Value Measurements and Disclosures*. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1 measurements) and the lowest priority to unobservable inputs (Level 3 measurements). Level 3 prices or valuation techniques require inputs that are both significant to the valuation assumptions and are not readily observable in the market (i.e. supported with little or no market activity). These Level 3 instruments are valued based on both observable and unobservable inputs derived from the best available data, some of which is internally developed, and considers risk premiums that a market participant would require.

[44]



Approximately \$211.8 million of the available-for-sale portfolio was valued using Level 2 pricing and had net unrealized gains of \$3.5 million at December 31, 2012. The remaining \$11.4 million of the securities available-for-sale represents the entire CDO portfolio, which was valued using significant unobservable inputs, or Level 3 pricing. The \$25.4 million in unrealized losses associated with this portfolio relates to 18 pooled trust preferred securities that comprise the CDO portfolio. Unrealized losses of \$16.9 million represent non-credit related OTTI charges on 13 of the securities, while \$8.5 million of unrealized losses relates to five securities which have no credit related OTTI. The unrealized losses on these securities are primarily attributable to continued depression in the marketability and liquidity associated with CDOs.

The following table provides a summary of the trust preferred securities in the CDO portfolio and the credit status of the securities as of December 31, 2012.

### Level 3 Investment Securities Available for Sale

(Dollars in Thousands)

Investment Description	First United Level 3 Investments					Security Credit Status					
	Deal	Class	Amortized Cost	Fair Market Value	Unrealized Gain (Loss)	Lowest Credit Rating	Original Collateral	Deferrals/ Defaults as % of Original Collateral	Performing Collateral	Collateral Support	Collateral as % of Performing Collateral
Preferred Term Security I	Mezz	672	511	(161 )	C	303,112	19.46%	118,000	(13,122 )	-11.12%	13 / 17
Preferred Term Security XI*	B-1	1,350	420	(930 )	C	635,775	28.67%	391,105	(117,044)	-29.93%	42 / 62
Preferred Term Security XVI*	C	237	209	(28 )	C	606,040	40.86%	324,060	(161,209)	-49.75%	34 / 56
Preferred Term Security XVIII	C	2,115	493	(1,622 )	C	676,565	28.57%	466,479	(97,549 )	-20.91%	49 / 75
Preferred Term Security	C	3,033	740	(2,293 )	C	676,565	28.57%	466,479	(97,549 )	-20.91%	49 / 75

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XVIII* Preferred Term Security	C	3,041	530	(2,511 )	C	700,535	23.86%	472,731	(135,846)	-28.74%	46 / 66
XIX* Preferred Term Security	C	1,316	227	(1,089 )	C	700,535	23.86%	472,731	(135,846)	-28.74%	46 / 66
XIX* Preferred Term Security	C	1,318	227	(1,091 )	C	700,535	23.86%	472,731	(135,846)	-28.74%	46 / 66
XIX* Preferred Term Security	C	2,210	380	(1,830 )	C	700,535	23.86%	472,731	(135,846)	-28.74%	46 / 66
XXII* Preferred Term Security	C-1	1,585	470	(1,115 )	C	1,386,600	26.54%	913,600	(162,436)	-17.78%	60 / 91
XXII* Preferred Term Security	C-1	3,963	1,175	(2,788 )	C	1,386,600	26.54%	913,600	(162,436)	-17.78%	60 / 91
XXIII* Preferred Term Security	C-1	2,082	646	(1,436 )	C	1,467,000	22.05%	907,258	(100,112)	-11.03%	86 / 112
XXIII* Preferred Term Security	D-1	2,210	516	(1,694 )	C	1,467,000	22.05%	907,258	(212,580)	-23.43%	86 / 112
XXIII* Preferred Term Security	D-1	737	172	(565 )	C	1,467,000	22.05%	907,258	(212,580)	-23.43%	86 / 112
XXIV* Preferred Term Security	C-1	929	147	(782 )	C	1,050,600	34.03%	640,494	(224,448)	-35.04%	54 / 86
I-P-I Preferred Term Security	B-2	2,000	1,085	(915 )	CCC-	351,000	4.27 %	173,500	27,200	15.68 %	15 / 16
I-P-IV Preferred Term Security	B-1	3,000	1,310	(1,690 )	CCC-	325,000	7.08 %	208,875	20,662	9.89 %	23 / 25
Term	B-1	5,000	2,184	(2,816 )	CCC-	325,000	7.08 %	208,875	20,662	9.89 %	23 / 25

Security  
I-P-IV

Total Level 3 Securities Available for Sale	36,798	11,442	(25,356)
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\* Security has been deemed other-than-temporarily impaired and loss has been recognized in accordance with ASC Section 320-10-35.

The terms of the debentures underlying trust preferred securities allow the issuer of the debentures to defer interest payments for up to 20 quarters, and, in such case, the terms of the related trust preferred securities require their issuers to contemporaneously defer dividend payments. The issuers of the trust preferred securities in our investment portfolio have defaulted and/or deferred payments, ranging from 4.27% to 40.86% of the total collateral balances underlying the securities. The securities were designed to include structural features that provide investors with credit enhancement or support to provide default protection by subordinated tranches. These features include over-collateralization of the notes or subordination, excess interest or spread which will redirect funds in situations where collateral is insufficient, and a specified order of principal payments. There are securities in our portfolio that are under-collateralized, which does represent additional stress on our tranche. However, in these cases, the terms of the securities require excess interest to be redirected from subordinate tranches as credit support, which provides additional support to our investment.

Management systematically evaluates securities for impairment on a quarterly basis. Based upon application of Topic 320 (ASC Section 320-10-35), management must assess whether (i) it has the intent to sell the security and (ii) it is more likely than not that First United Corporation will be required to sell the security prior to its anticipated recovery. If neither applies, then declines in the fair value of securities below their cost that are considered other-than-temporary declines are split into two components. The first is the loss attributable to declining credit quality. Credit losses are recognized in earnings as realized losses in the period in which the impairment determination is made. The second component consists of all other losses. The other losses are recognized in other comprehensive income. In estimating OTTI charges, management considers (a) the length of time and the extent to which the fair value has been less than cost, (b) adverse conditions specifically related to the security, an industry, or a geographic area, (c) the historic and implied volatility of the security, (d) changes in the rating of a security by a rating agency, (e) recoveries or additional declines in fair value subsequent to the balance sheet date, (f) failure of the issuer of the security to make scheduled interest payments, and (g) the payment structure of the debt security and the likelihood of the issuer being able to make payments that increase in the future. Due to the duration and the significant market value decline in the pooled trust preferred securities held in our portfolio, we performed more extensive testing on these securities for purposes of evaluating whether or not an OTTI has occurred.

[45]

The market for these securities as of December 31, 2012 is not active and markets for similar securities are also not active. The inactivity was evidenced in 2008 first by a significant widening of the bid-ask spread in the brokered markets in which these securities trade and then by a significant decrease in the volume of trades relative to historical levels. The new issue market is also inactive, as no new CDOs have been issued since 2007. There are currently very few market participants who are willing to transact for these securities. The market values for these securities, or any securities other than those issued or guaranteed by the Treasury, are very depressed relative to historical levels. Therefore, in the current market, a low market price for a particular bond may only provide evidence of stress in the credit markets in general rather than being an indicator of credit problems with a particular issue. Given the conditions in the current debt markets and the continued absence of observable transactions in the secondary and new issue markets, management has determined that (i) the few observable transactions and market quotations that are available are not reliable for the purpose of obtaining fair value at December 31, 2012, (ii) an income valuation approach technique (i.e. present value) that maximizes the use of relevant observable inputs and minimizes the use of observable inputs will be equally or more representative of fair value than a market approach, and (iii) the CDO segment is appropriately classified within Level 3 of the valuation hierarchy because management determined that significant adjustments were required to determine fair value at the measurement date.

Management utilizes an independent third party to assist the Corporation with both the evaluations of OTTI and the fair value determinations for our CDO portfolio. Management believes that there were no material differences in the impairment evaluations and pricing between December 31, 2011 and December 31, 2012.

The approach of the third party to determine fair value involved several steps, including detailed credit and structural evaluation of each piece of collateral in each bond, default, recovery and prepayment/amortization probabilities for each piece of collateral in the bond, and discounted cash flow modeling. The discount rate methodology used by the third party combines a baseline current market yield for comparable corporate and structured credit products with adjustments based on evaluations of the differences found in structure and risks associated with actual and projected credit performance of each CDO being valued. Currently, there is an active and liquid trading market only for stand-alone trust preferred securities. Therefore, adjustments to the baseline discount rate are also made to reflect the additional leverage found in structured instruments.

Based upon a review of credit quality and the cash flow tests performed by the independent third party, management determined that no securities had credit-related OTTI during 2012.

The risk-based capital regulations require banks to set aside additional capital for securities that are rated below investment grade. Securities rated one level below investment grade require a 200% risk weighting. Additional methods are applicable to securities rated more than one level below investment grade. Management believes that, as of December 31, 2012, we maintain sufficient capital and liquidity to cover the additional capital requirements of these securities and future operating expenses. Additionally, we do not anticipate any material commitments or expected outlays of capital in the near term.

Table 9 sets forth the contractual or estimated maturities of the components of our securities portfolio as of December 31, 2012 and the weighted average yields on a tax-equivalent basis.

[46]

**Investment Security Maturities, Yields, and Fair Values at December 31, 2012****Table 9**

(In thousands)	Within 1 Year	1 Year To 5 Years	5 Years To 10 Years	Over 10 Years	Total Fair Value
<b>Securities Available-for-Sale:</b>					
U.S. government agencies	\$ 0	\$ 0	\$ 22,100	\$ 18,220	\$40,320
Residential mortgage-backed agencies	181	17,364	17,863	8,700	44,108
Commercial mortgage-backed agencies	0	25,007	0	12,611	37,618
Collateralized mortgage obligations	14,818	4,554	12,359	0	31,731
Obligations of states and political subdivisions	0	0	22,835	35,219	58,054
Collateralized debt obligations	0	0	0	11,442	11,442
<b>Total</b>	<b>\$ 14,999</b>	<b>\$ 46,925</b>	<b>\$ 75,157</b>	<b>\$ 86,192</b>	<b>\$223,273</b>
Percentage of total	6.72	% 21.02	% 33.66	% 38.60	% 100.00
Weighted average yield	-1.15	% 2.16	% 2.69	% 3.28	% 2.55
<b>Held to Maturity:</b>					
Obligations of states and political subdivisions	\$ 0	\$ 0	\$ 0	\$ 4,347	\$4,347
Percentage of total	0.00	% 0.00	% 0.00	% 100.00	% 100.00
Weighted average yield	0.00	% 0.00	% 0.00	% 3.07	% 3.07

The weighted average yield was calculated using historical cost balances and does not give effect to changes in fair value. At December 31, 2012, the collateralized mortgage obligation portion of the portfolio briefly produced a negative yield of 1.23% due to the fact that prepayment speeds spiked, the underlying cash flows are extremely short and the securities are owned at a premium. The short cash flows were purchased to mitigate the possible extension in the mortgage backed securities portion of the portfolio and as a hedge against rising rates. However, the securities are paying much faster than anticipated. Management is reviewing this sector. At December 31, 2012, we did not hold any securities in the name of any one issuer exceeding 10% of shareholders' equity.

**Deposits**

Table 10 sets forth the actual and average deposit balances by major category for 2012, 2011 and 2010:

**Deposit Balances**

**Table 10**

(In thousands)	2012			2011			2010		
	Actual Balance	Average Balance	Average Yield	Actual Balance	Average Balance	Average Yield	Actual Balance	Average Balance	Average Yield
Non-interest-bearing demand deposits	\$161,500	\$160,145	0	\$149,888	\$135,365	0	\$121,142	\$109,145	
Interest-bearing deposits:									
Demand	119,306	120,616	0.15%	101,492	98,395	0.14%	100,472	115,478	
Money Market:									
Retail	202,678	203,497	0.21%	219,488	216,390	0.32%	217,401	218,571	
Brokered	0	0	0.00%	0	7,913	0.87%	55,545	68,068	
Savings deposits	109,740	107,964	0.19%	102,561	100,598	0.28%	93,543	83,734	
Time deposits less than \$100K	188,341	214,613	1.26%	216,324	290,651	1.94%	278,588	366,922	
Time deposits \$100K or more:									
Retail	164,085	158,298	1.72%	185,045	171,557	2.32%	221,564	127,590	
Brokered/CDARS	31,234	39,753	0.84%	52,986	96,091	1.01%	213,391	261,355	
Total Deposits	\$976,884	\$1,004,886		\$1,027,784	\$1,116,960		\$1,301,646	\$1,350,863	

[47]

Total deposits decreased \$50.9 million during 2012 when compared to deposits at December 31, 2011. The decline in deposits was due to reduced loan demand, a strategic decision to continue to use excess cash to repay wholesale deposits and FHLB advances at their stated maturities and to allow certificates of deposit for non-relationship customers to run off. Time deposits less than \$100,000 declined \$28.0 million while time deposits greater than \$100,000 decreased \$42.7 million. Retail money markets also declined by \$16.8 million during 2012. These decreases were offset by an increase of \$7.2 million in traditional savings accounts, \$17.8 million in interest-bearing demand deposits and \$11.6 million in non-interest bearing demand deposits. Our internal treasury team continues to promote the strategy of increasing our net interest margin by changing the mix of our deposit base and focusing on customers with full banking relationships.

The following table sets forth the maturities of time deposits of \$100,000 or more:

#### **Maturity of Time Deposits of \$100,000 or More**

**Table 11**

(In thousands)	December 31, 2012
<b>Maturities</b>	
3 Months or Less	\$ 38,775
3-6 Months	19,882
6-12 Months	30,022
Over 1 Year	106,640
<b>Total</b>	<b>\$ 195,319</b>

#### **Borrowed Funds**

The following shows the composition of our borrowings at December 31:

(In thousands)	2012	2011	2010
Securities sold under agreements to repurchase	\$39,257	\$36,868	\$39,139
<b>Total short-term borrowings</b>	<b>\$39,257</b>	<b>\$36,868</b>	<b>\$39,139</b>
Long-term FHLB advances	\$136,005	\$160,314	\$196,370
Junior subordinated debentures	46,730	46,730	46,730
<b>Total long-term borrowings</b>	<b>\$182,735</b>	<b>\$207,044</b>	<b>\$243,100</b>
<b>Total borrowings</b>	<b>\$221,992</b>	<b>\$243,912</b>	<b>\$282,239</b>





Total borrowings decreased by \$38.3 million, or 14%, in 2011 when compared to 2010, while the average balance of borrowings decreased by \$39.1 million during the same period. This decrease in 2011 was due to the \$2.3 million decline in short-term borrowings as our Treasury Management customers used their deposits during 2011 and our repayment of \$36.1 million in long-term FHLB advances during the year.

Management will continue to closely monitor interest rates within the context of its overall asset-liability management process. See the discussion under the heading “Interest Rate Sensitivity” in this Item 7 for further information on this topic.

As of December 31, 2012, we had additional borrowing capacity with the FHLB totaling \$24 million, an additional \$16 million of unused lines of credit with various financial institutions, \$36 million of an unused secured line of credit with the Federal Reserve Bank and approximately \$48 million through wholesale money market funds. See Note 12 to the Consolidated Financial Statements for further details about our borrowings and additional borrowing capacity, which is incorporated herein by reference.

## **Capital Resources**

The Bank and First United Corporation are subject to risk-based capital regulations, which were adopted and are monitored by federal banking regulators. These regulations are used to evaluate capital adequacy and require an analysis of an institution’s asset risk profile and off-balance sheet exposures, such as unused loan commitments and stand-by letters of credit. The regulations require that a portion of total capital be Tier 1 capital, consisting of common shareholders’ equity, the qualifying portion of trust issued preferred securities, and perpetual preferred stock, less goodwill and certain other deductions. The remaining capital, or Tier 2 capital, consists of subordinated debt, mandatory convertible debt, the remaining portion of trust issued preferred securities, grandfathered senior debt and the ALL, subject to certain limitations.

Under the risk-based capital regulations, banking organizations are required to maintain a minimum 8% (10% for well capitalized banks) total risk-based capital ratio (total qualifying capital divided by risk-weighted assets), including a Tier 1 ratio of 4% (6% for well capitalized banks). The risk-based capital rules have been further supplemented by a leverage ratio, defined as Tier I capital divided by average assets, after certain adjustments. The minimum leverage ratio is 4% (5% for well capitalized banks) for banking organizations that do not anticipate significant growth and have well-diversified risk (including no undue interest rate risk exposure), excellent asset quality, high liquidity and good earnings. Other banking organizations not in this category are expected to have ratios of at least 4-5%, depending on their particular condition and growth plans. Regulators may require higher capital ratios when warranted by the particular circumstances or risk profile of a given banking organization. In the current regulatory environment, banking organizations must stay well capitalized in order to receive favorable regulatory treatment on acquisition and other expansion activities and favorable risk-based deposit insurance assessments. Our capital policy establishes guidelines meeting these regulatory requirements and takes into consideration current or anticipated risks as well as

potential future growth opportunities.

At December 31, 2012, First United Corporation's total risk-based capital ratio was 14.13% and the Bank's total risk-based capital ratio was 14.63%, both of which were well above the regulatory minimum of 8%. The total risk-based capital ratios of First United Corporation and the Bank for year-end 2011 were 13.05% and 13.38%, respectively. The increase for 2012 was due to the reduction in the goodwill and intangible assets associated with the sale of the assets for the Insurance Agency, a change in composition of risk based assets as well as an increase in net income.

As of December 31, 2012, the most recent notification from the regulators categorizes First United Corporation and the Bank as "well capitalized" under the regulatory framework for prompt corrective action. See Note 4 to the Consolidated Financial Statements for additional information regarding regulatory capital ratios.

Basel is a committee of central banks and bank regulators from major industrialized countries that develops broad policy guidelines for use by each country's regulators with the purpose of ensuring that financial institutions have adequate capital given the risk levels of assets and off-balance sheet financial instruments.

In December 2010, Basel released Basel III, a framework for strengthening international capital and liquidity regulations. Basel III includes defined minimum capital ratios, which must be met when implementation occurs on January 1, 2013. An additional "capital conservation buffer" will be phased-in beginning January 1, 2016 and, when fully phased-in three years later, the minimum ratios will be 2.5% higher. Fully phased-in capital standards under Basel III will require banks to maintain more capital than the minimum levels required under current regulatory capital standards. As Basel III is only a framework, the specific changes in capital requirements are to be determined by each country's banking regulators.

[49]

In June 2012, U.S. Federal banking regulators issued two notices of proposed rulemaking (“NPRs”) that would implement in the United States the Basel III regulatory capital reforms and changes required by the Dodd-Frank Act. A third issued NPR related to banks that are internationally active or that are subject to market risk rules is not applicable to the Corporation.

The first NPR, “Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, and Transition Provisions”, would apply to all depository institutions, bank holding companies with total consolidated assets of \$500 million or more, and savings and loan holding companies (collectively, “banking organizations”). Consistent with the international Basel framework, this NPR would:

- Increase the quantity and quality of capital required by proposing a new minimum Common Equity Tier 1 capital ratio of 4.50% of risk-weighted assets and raising the minimum Tier 1 capital ratio from 4.00% to 6.00% of risk-weighted assets;

- Retain the current minimum Total capital ratio of 8.00% of risk-weighted assets and the minimum Tier 1 leverage capital ratio at 4.00% of average assets;

- Introduce a “capital conservation buffer” of 2.50% above the minimum risk-based capital requirements, which must be maintained to avoid restrictions on capital distributions and certain discretionary bonus payments; and

- Revise the definition of capital to improve the ability of regulatory capital instruments to absorb losses.

The proposed new minimum regulatory capital requirements would be phased in from January 1, 2013 through January 1, 2016. The proposed capital conservation buffer would be phased in from January 1, 2016 through January 1, 2019.

The second NPR, “Regulatory Capital Rules: Standardized Approach for Risk-weighted Assets; Market Discipline and Disclosure Requirement,” also would apply to all banking organizations. This NPR would revise and harmonize the rules for calculating risk-weighted assets to enhance risk sensitivity and address weaknesses that have been identified over the past several years. Banks and regulators use risk weighting to assign different levels of risk to different classes of assets and off balance sheet exposures - riskier items require higher capital cushions and less risky items require smaller capital cushions.

On November 9, 2012, following a public comment period, the U.S. federal banking agencies issued a joint press release announcing that the January 1, 2013 effective date was being delayed so the agencies could consider operational and transitional issues identified in the large volume of public comments received. It is anticipated that the

U.S. federal banking agencies will formalize the implementation of the Basel III framework applicable to domestic banks in the United States during 2013.

We are in the process of modeling our capital ratios under various scenarios in light of these NPRs and intend to take appropriate steps to ensure that we will meet the fully-phased in minimum capital requirements, including capital conservation buffers, if and when the NPRs become final.

The total risk based capital ratios of First United Corporation include \$40.2 million of junior subordinated debentures which qualified as Tier 1 capital at December 31, 2012, under guidance issued by the FRB. First United Corporation will monitor the finalization of the Basel III Capital Rules, including whether its junior subordinated debentures will continue to qualify for Tier 1 capital under the final rules.

In January 2009, pursuant to the Treasury's TARP CPP and in return for \$30 million, First United Corporation sold to the Treasury the shares of its Series A Preferred Stock and the Warrant to purchase 326,323 shares of its common stock for an exercise price of \$13.79 per share. The proceeds from this transaction count as Tier 1 capital and the Warrant qualifies as tangible common equity. Information about the terms of these securities is provided in Note 14 to the Consolidated Financial Statements.

[50]

The terms of the Series A Preferred Stock call for the payment, if declared by the Board of Directors of First United Corporation, of a quarterly cash dividend on February 15<sup>th</sup>, May 15<sup>th</sup>, August 15<sup>th</sup> and November 15<sup>th</sup> of each year. At the request of the Reserve Bank, First United Corporation deferred the payment of cash dividends on the Series A Preferred Stock beginning with the payment that was due on November 15, 2010. As of December 31, 2012, this deferral election remained in effect and dividends of \$.4 million per quarterly dividend period continue to accrue. First United Corporation will be required to pay all accrued and unpaid dividends if and when the Board of Directors declares and pays the next quarterly cash dividend. Management cannot predict whether or when the Board of Directors will resume quarterly cash dividends on the Series A Preferred Stock. First United Corporation's ability to make dividend payments in the future will depend primarily on our earnings in future periods.

On December 15, 2010, also at the request of the Reserve Bank, the Board of Directors of First United Corporation elected to defer quarterly interest payments under the TPS Debentures beginning with the payment that was due in March 2011. As of December 31, 2012, this deferral election remained in effect and cumulative deferred interest was approximately \$4.4 million, which has been fully accrued and must be paid in full when the Board of Directors elects to terminate the deferral. First United Corporation's ability to resume quarterly interest payments will depend primarily on our earnings in future periods. Accordingly, no assurance can be given as to if or when First United Corporation will resume the payment of interest under the TPS Debentures.

In connection with, and as a result of, the aforementioned deferrals, the Board of Directors of First United Corporation voted to suspend the declaration of quarterly cash dividends on the common stock until further notice. The payment of cash dividends on the common stock is at the discretion of the Board of Directors and is dependent on our earnings in future periods. In addition, cash dividends on the common stock may be paid only if all accrued and unpaid interest due under the TPS Debentures and all accrued and unpaid dividends due under the Series A Preferred Stock have been paid in full. There can be no assurance as to if or when First United Corporation will resume the payment of cash dividends on the common stock.

## **Liquidity Management**

Liquidity is a financial institution's capability to meet customer demands for deposit withdrawals while funding all credit-worthy loans. The factors that determine the institution's liquidity are:

- Reliability and stability of core deposits;
- Cash flow structure and pledging status of investments; and
- Potential for unexpected loan demand.

We actively manage our liquidity position through weekly meetings of a sub-committee of executive management, known as the internal treasury team, which looks forward 12 months at 30-day intervals. The measurement is based upon the projection of funds sold or purchased position, along with ratios and trends developed to measure dependence on purchased funds and core growth. Monthly reviews by management and quarterly reviews by the Asset and Liability Committee under prescribed policies and procedures are designed to ensure that we will maintain adequate levels of available funds.

It is our policy to manage our affairs so that liquidity needs are fully satisfied through normal Bank operations. That is, the Bank will manage its liquidity to minimize the need to make unplanned sales of assets or to borrow funds under emergency conditions. The Bank will use funding sources where the interest cost is relatively insensitive to market changes in the short run (periods of one year or less) to satisfy operating cash needs. The remaining normal funding will come from interest-sensitive liabilities, either deposits or borrowed funds. When the marginal cost of needed wholesale funding is lower than the cost of raising this funding in the retail markets, the Corporation may supplement retail funding with external funding sources such as:

1. Unsecured Fed Funds lines of credit with upstream correspondent banks (M&T Bank, Atlantic Central Banker's Bank, Community Banker's Bank).  
Secured advances with the FHLB of Atlanta, which are collateralized by eligible one to four family residential
2. mortgage loans, home equity lines of credit, commercial real estate loans, and various securities. Cash may also be pledged as collateral.
3. Secured line of credit with the Fed Discount Window for use in borrowing funds up to 90 days, using municipal securities as collateral.

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4. Brokered deposits, including CDs and money market funds, provide a method to generate deposits quickly. These deposits are strictly rate driven but often provide the most cost effective means of funding growth.
5. One Way Buy CDARS funding – a form of brokered deposits that has become a viable supplement to brokered deposits obtained directly.

Throughout 2011 and 2012, management implemented a strategic plan to utilize excess liquidity to repay brokered deposits, non-relationship certificates of deposit and wholesale FHLB advances at their stated maturities. The reduction in these liabilities, deemed to be volatile funding by regulatory definition, has not had an impact on our levels of liquidity.

Management believes that we have adequate liquidity available to respond to current and anticipated liquidity demands and is not aware of any trends or demands, commitments, events or uncertainties that are likely to materially affect our ability to maintain liquidity at satisfactory levels.

### **Market Risk and Interest Sensitivity**

Our primary market risk is interest rate fluctuation. Interest rate risk results primarily from the traditional banking activities that we engage in, such as gathering deposits and extending loans. Many factors, including economic and financial conditions, movements in interest rates and consumer preferences affect the difference between the interest earned on our assets and the interest paid on our liabilities. Interest rate sensitivity refers to the degree that earnings will be impacted by changes in the prevailing level of interest rates. Interest rate risk arises from mismatches in the repricing or maturity characteristics between interest-bearing assets and liabilities. Management seeks to minimize fluctuating net interest margins, and to enhance consistent growth of net interest income through periods of changing interest rates. Management uses interest sensitivity gap analysis and simulation models to measure and manage these risks. The interest rate sensitivity gap analysis assigns each interest-earning asset and interest-bearing liability to a time frame reflecting its next repricing or maturity date. The differences between total interest-sensitive assets and liabilities at each time interval represent the interest sensitivity gap for that interval. A positive gap generally indicates that rising interest rates during a given interval will increase net interest income, as more assets than liabilities will reprice. A negative gap position would benefit us during a period of declining interest rates.

Throughout 2012, we continued to shift our focus from a shorter duration balance sheet to a more neutral to slightly asset sensitive position as we anticipate a flat to rising rate environment in the future. As of December 31, 2012, we were asset sensitive.

Our interest rate risk management goals are:



Ensure that the Board of Directors and senior management will provide effective oversight and ensure that risks are adequately identified, measured, monitored and controlled;

Enable dynamic measurement and management of interest rate risk;

Select strategies that optimize our ability to meet our long-range financial goals while maintaining interest rate risk within policy limits established by the Board of Directors;

Use both income and market value oriented techniques to select strategies that optimize the relationship between risk and return; and

Establish interest rate risk exposure limits for fluctuation in net interest income (“NII”), net income and economic value of equity.

In order to manage interest sensitivity risk, management formulates guidelines regarding asset generation and pricing, funding sources and pricing, and off-balance sheet commitments. These guidelines are based on management’s outlook regarding future interest rate movements, the state of the regional and national economy, and other financial and business risk factors. Management uses computer simulations to measure the effect on net interest income of various interest rate scenarios. Key assumptions used in the computer simulations include cash flows and maturities of interest rate sensitive assets and liabilities, changes in asset volumes and pricing, and management’s capital plans. This modeling reflects interest rate changes and the related impact on net interest income over specified periods.

We evaluate the effect of a change in interest rates of +/-100 basis points to +/-400 basis points on both NII and Net Portfolio Value (“NPV”) / Economic Value of Equity (“EVE”). We concentrate on NII rather than net income as long as NII remains the significant contributor to net income.

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NII modeling allows management to view how changes in interest rates will affect the spread between the yield paid on assets and the cost of deposits and borrowed funds. Unlike traditional Gap modeling, NII modeling takes into account the different degree to which installments in the same repricing period will adjust to a change in interest rates. It also allows the use of different assumptions in a falling versus a rising rate environment. The period considered by the NII modeling is the next eight quarters.

NPV / EVE modeling focuses on the change in the market value of equity. NPV / EVE is defined as the market value of assets less the market value of liabilities plus/minus the market value of any off-balance sheet positions. By effectively looking at the present value of all future cash flows on or off the balance sheet, NPV / EVE modeling takes a longer-term view of interest rate risk. This complements the shorter-term view of the NII modeling.

Measures of NII at risk produced by simulation analysis are indicators of an institution's short-term performance in alternative rate environments. These measures are typically based upon a relatively brief period, usually one year. They do not necessarily indicate the long-term prospects or economic value of the institution.

Based on the simulation analysis performed at December 31, 2012 and 2011, management estimated the following changes in net interest income, assuming the indicated rate changes:

(Dollars in thousands)	2012	2011
+400 basis points	\$4,041	\$2,548
+300 basis points	\$4,023	\$2,300
+200 basis points	\$3,494	\$1,937
+100 basis points	\$2,061	\$1,182
-100 basis points	\$(3,763)	\$(984 )

This estimate is based on assumptions that may be affected by unforeseeable changes in the general interest rate environment and any number of unforeseeable factors. Rates on different assets and liabilities within a single maturity category adjust to changes in interest rates to varying degrees and over varying periods of time. The relationships between lending rates and rates paid on purchased funds are not constant over time. Management can respond to current or anticipated market conditions by lengthening or shortening the Bank's sensitivity through loan repricings or changing its funding mix. The rate of growth in interest-free sources of funds will influence the level of interest-sensitive funding sources. In addition, the absolute level of interest rates will affect the volume of earning assets and funding sources. As a result of these limitations, the interest-sensitive gap is only one factor to be considered in estimating the net interest margin.

*Impact of Inflation* – Our assets and liabilities are primarily monetary in nature, and as such, future changes in prices do not affect the obligations to pay or receive fixed and determinable amounts of money. During inflationary periods, monetary assets lose value in terms of purchasing power and monetary liabilities have corresponding purchasing power gains. The concept of purchasing power is not an adequate indicator of the impact of inflation on financial institutions because it does not incorporate changes in interest rates, which are an important determination of First United Corporation’s earnings.

## **ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

The information called for by this item is incorporated herein by reference to Item 7 of Part II of this annual report under the heading “Market Risk and Interest Sensitivity”.

## **ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA**

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**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

To the Board of Directors and Shareholders

First United Corporation

Oakland, Maryland

We have audited the accompanying consolidated statement of financial condition of First United Corporation and subsidiaries (“Corporation”) as of December 31, 2012 and 2011, and the related consolidated statements of income, comprehensive income, changes in shareholders’ equity, and cash flows for each of the years in the two-year period ended December 31, 2012. These financial statements are the responsibility of First United Corporation’s management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of First United Corporation as of December 31, 2012 and 2011, and the consolidated results of their operations and their cash flows for each of the years then ended, in conformity with accounting principles generally accepted in the United States of America.

/s/ ParenteBeard LLC

Pittsburgh, Pennsylvania  
March 15, 2013

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**First United Corporation and Subsidiaries****Consolidated Statement of Financial Condition****(In thousands, except per share amounts)**

	December 31,	
	2012	2011
<b>Assets</b>		
Cash and due from banks	\$71,290	\$52,049
Interest bearing deposits in banks	11,778	13,058
Cash and cash equivalents	83,068	65,107
Investment securities – available-for-sale (at fair value)	223,273	245,023
Investment securities – held to maturity (fair value \$4,347)	4,040	0
Restricted investment in bank stock, at cost	8,349	10,726
Loans	874,829	938,694
Allowance for loan losses	(16,047 )	(19,480 )
Net loans	858,782	919,214
Premises and equipment, net	29,455	30,826
Goodwill and other intangible assets, net	11,004	14,432
Bank owned life insurance	31,407	31,435
Deferred tax assets	28,882	28,711
Other real estate owned	17,513	16,676
Accrued interest receivable and other assets	25,010	28,715
<b>Total Assets</b>	<b>\$1,320,783</b>	<b>\$1,390,865</b>
<b>Liabilities and Shareholders' Equity</b>		
<b>Liabilities:</b>		
Non-interest bearing deposits	\$161,500	\$149,888
Interest bearing deposits	815,384	877,896
<b>Total deposits</b>	<b>976,884</b>	<b>1,027,784</b>
Short-term borrowings	39,257	36,868
Long-term borrowings	182,735	207,044
Accrued interest payable and other liabilities	23,002	22,513
<b>Total Liabilities</b>	<b>1,221,878</b>	<b>1,294,209</b>
<b>Shareholders' Equity:</b>		
Preferred stock – no par value;		
Authorized 2,000 shares of which 30 shares of Series A, \$1,000 per share liquidation preference, 5% cumulative increasing to 9% cumulative on February 15, 2014, were issued and outstanding on December 31, 2012 and 2011 (discount of \$75 and \$140, respectively)	29,925	29,860
Common Stock – par value \$.01 per share;		

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Authorized 25,000 shares; issued and outstanding 6,199 shares at December 31, 2012 and 6,183 shares at December 31, 2011	62	62
Surplus	21,573	21,500
Retained earnings	69,168	66,196
Accumulated other comprehensive loss	(21,823 )	(20,962 )
Total Shareholders' Equity	98,905	96,656
Total Liabilities and Shareholders' Equity	\$1,320,783	\$1,390,865

*See notes to consolidated financial statements*

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**First United Corporation and Subsidiaries****Consolidated Statement of Income****(In thousands, except share and per share amounts)**

	Year ended December 31	
	2012	2011
Interest income		
Interest and fees on loans	\$46,690	\$52,289
Interest on investment securities		
Taxable	4,077	4,081
Exempt from federal income tax	2,035	2,749
Total investment income	6,112	6,830
Other	309	377
Total interest income	53,111	59,496
Interest expense		
Interest on deposits	6,559	11,899
Interest on short-term borrowings	133	236
Interest on long-term borrowings	7,273	9,071
Total interest expense	13,965	21,206
Net interest income	39,146	38,290
Provision for loan losses	9,390	9,157
Net interest income after provision for loan losses	29,756	29,133
Other operating income		
Changes in fair value on impaired securities	850	406
Portion of gain recognized in other comprehensive income (before taxes)	(850)	(425)
Net securities impairment losses recognized in operations	0	(19)
Net gains – other	1,708	2,321
Total net gains	1,708	2,302
Service charges	3,639	3,671
Trust department	4,608	4,413
Insurance commissions	11	2,424
Debit card income	2,010	2,125
Bank owned life insurance	1,778	1,030
Brokerage commissions	778	767
Other	806	536
Total other income	13,630	14,966
Total other operating income	15,338	17,268
Other operating expenses		
Salaries and employee benefits	19,481	20,225
FDIC premiums	1,985	2,362
Equipment	2,624	3,015
Occupancy	2,719	2,804

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Data processing	2,886	2,744
Professional services	1,292	1,575
Other real estate owned expenses	890	2,410
Miscellaneous loan fees	580	849
Other	7,061	7,426
Total other operating expenses	39,518	43,410
Income before income tax expense	5,576	2,991
Applicable income tax expense/(benefit)	913	(635 )
Net Income	4,663	3,626
Accumulated preferred stock dividends and discount accretion	(1,691 )	(1,609 )
Net Income Available to Common Shareholders	\$2,972	\$2,017
Basic and diluted net income per common share	\$0.48	\$0.33
Weighted average number of basic and diluted shares outstanding	6,193,774	6,177,184
<i>See notes to consolidated financial statements</i>		

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**FIRST UNITED CORPORATION****Consolidated Statement of Comprehensive Income****(In thousands, except per share data)**

<b>Components of Comprehensive Income (in thousands)</b>	<b>Year ended</b>	
	<b>December 31,</b>	
	<b>2012</b>	<b>2011</b>
Net Income	\$4,663	\$3,626
Available for sale (AFS) securities with OTTI:		
Securities with OTTI charges during the period	850	406
Less: OTTI charges recognized in income	0	(19 )
Unrealized gains on investments with OTTI	850	425
Taxes	(314 )	(172 )
Net unrealized gains on investments with OTTI	536	253
Available for sale securities – all other:		
Unrealized holding gains during the period	1,850	3,499
Less: reclassification adjustment for gains recognized in income	1,545	875
Less: securities with OTTI charges during the period	850	406
Unrealized (losses)/gains on all other AFS securities	(545 )	2,218
Taxes	212	(895 )
Net unrealized (losses)/gains on all other AFS securities	(333 )	1,323
Net unrealized gains on AFS securities	203	1,576
Derivative instruments:		
Unrealized gains/(losses) on cash flow hedges	185	(202 )
Taxes	(76 )	82
Net unrealized gains/(losses) on cash flow hedges	109	(120 )
Defined benefit plans:		
Net actuarial losses during the period	(2,420)	(4,729)
Less: amortization recognized in income	(475 )	(375 )
Defined benefit plans liability adjustment	(1,945)	(4,354)
Taxes	772	1,757
Net defined benefit plans liability adjustment	(1,173)	(2,597)
Other comprehensive loss, net of tax	(861 )	(1,141)
Comprehensive income	\$3,802	\$2,485

*See accompanying notes to the consolidated financial statements*

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**First United Corporation and Subsidiaries****Consolidated Statement of Changes in Shareholders' Equity****(In thousands, except per share amounts)**

	Preferred Stock	Common Stock	Surplus	Retained Earnings	Accumulated Other Comprehensive Loss	Total Shareholders' Equity
Balance at January 1, 2011	\$ 29,798	\$ 62	\$ 21,422	\$ 64,179	\$ (19,821)	) \$ 95,640
Net income				3,626		3,626
Other comprehensive loss					(1,141)	) (1,141)
Stock based compensation			78			78
Preferred stock discount accretion	62			(62)		0
Preferred stock dividends deferred				(1,547)		) (1,547)
Balance at December 31, 2011	29,860	62	21,500	66,196	(20,962)	) 96,656
Net income				4,663		4,663
Other comprehensive loss					(861)	) (861)
Stock based compensation			73			73
Preferred stock discount accretion	65			(65)		0
Preferred stock dividends deferred				(1,626)		) (1,626)
Balance at December 31, 2012	\$ 29,925	\$ 62	\$ 21,573	\$ 69,168	\$ (21,823)	) \$ 98,905

*See notes to consolidated financial statements*

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**First United Corporation and Subsidiaries****Consolidated Statement of Cash Flows****(In thousands)**

	Year ended December 31	
	2012	2011
Operating activities		
Net income	\$ 4,663	\$ 3,626
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	9,390	9,157
Depreciation	1,992	2,349
Stock compensation	73	78
Amortization of intangible assets	0	268
Gain on sales of Insurance assets	(88 )	0
Gain on sales of other real estate owned	(995 )	(285 )
Write-downs of other real estate owned	1,489	1,986
Gain on sale of loans held for sale	0	(1,366 )
Gain on loan sales	(167 )	(86 )
Proceeds from sale of loans held for sale	0	33,902
Loss on disposal of fixed assets	92	6
Net amortization of investment securities discounts and premiums	1,565	1,785
Other-than-temporary-impairment loss on securities	0	19
Gain on sales of investment securities – available-for-sale	(1,545 )	(875 )
Amortization of deferred loan fees	(629 )	(593 )
Decrease in accrued interest receivable and other assets	1,785	11,587
Deferred tax expense/(benefit)	400	(1,538 )
(Decrease)/increase in accrued interest payable and other liabilities	(1,042 )	4,046
Earnings on bank owned life insurance	(1,778 )	(1,030 )
Net cash provided by operating activities	15,205	63,036
Investing activities		
Proceeds from maturities/calls of investment securities available-for-sale	70,562	80,315
Proceeds from sales of investment securities available-for-sale	46,220	84,396
Purchases of investment securities available-for-sale	(98,787 )	(178,333 )
Proceeds from sales of other real estate owned	5,982	6,017
Proceeds from loan sales	25,392	10,606
Proceeds from disposal of fixed assets	567	0
Proceeds from sale of insurance assets	3,604	0
Proceeds from BOLI death benefit	1,806	0
Net decrease in FHLB stock	2,377	1,723
Net decrease in loans	19,133	10,459
Purchases of premises and equipment	(1,280 )	(236 )

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Net cash provided by investing activities	75,576	14,947
Financing activities		
Net decrease in deposits	(50,900 )	(273,862 )
Net increase/(decrease) in short-term borrowings	2,389	(2,271 )
Proceeds from long-term borrowings	20,000	0
Payments on long-term borrowings	(44,309 )	(36,056 )
Net cash used in financing activities	(72,820 )	(312,189 )
Increase/(decrease) in cash and cash equivalents	17,961	(234,206 )
Cash and cash equivalents at beginning of the year	65,107	299,313
Cash and cash equivalents at end of period	\$ 83,068	\$ 65,107
Supplemental information		
Interest paid	\$ 12,062	\$ 19,985
Taxes paid	\$ 620	\$ 0
Non-cash investing activities:		
Transfers from loans to other real estate owned	\$ 7,313	\$ 6,322
Transfers from loans to loans held for sale	\$ 0	\$ 32,536
Transfers from securities available for sale to held-to-maturity	\$ 4,040	\$ 0

*See notes to consolidated financial statements*

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## **First United Corporation and Subsidiaries**

### **Notes to Consolidated Financial Statements**

#### **1. Summary of Significant Accounting Policies**

##### **Business**

First United Corporation is a Maryland corporation chartered in 1985 and a financial holding company registered under the federal Bank Holding Company Act of 1956, as amended. First United Corporation's primary business is serving as the parent company of First United Bank & Trust, a Maryland trust company (the "Bank"), First United Statutory Trust I ("Trust I") and First United Statutory Trust II ("Trust II"), both Connecticut statutory business trusts, and First United Statutory Trust III, a Delaware statutory business trust ("Trust III" and together with Trust I and Trust II, the "Trusts"). The Trusts were formed for the purpose of selling trust preferred securities that qualified as Tier 1 capital. First United Corporation is also the parent company of First United Insurance Group, LLC, a Maryland limited liability company (the "Insurance Agency") that, through the close of business on December 31, 2011, operated as a full service insurance agency. Effective on January 1, 2012, the Insurance Agency sold substantially all of its assets, net of cash, to a third-party and is no longer an active subsidiary. The Bank has three wholly-owned subsidiaries: OakFirst Loan Center, Inc., a West Virginia finance company; OakFirst Loan Center, LLC, a Maryland finance company (collectively, the "OakFirst Loan Centers"); and First OREO Trust, a Maryland statutory trust formed for the purposes of servicing and disposing of the real estate that the Bank acquires through foreclosure or by deed in lieu of foreclosure. The Bank owns a majority interest in Cumberland Liquidation Trust, a Maryland statutory trust formed for the purposes of servicing and disposing of real estate that secured a loan made by another bank and in which the Bank held a participation interest. The Bank also owns 99.9% of the limited partnership interests in Liberty Mews Limited Partnership, a Maryland limited partnership formed for the purpose of acquiring, developing and operating low-income housing units in Garrett County, Maryland. The Bank provides a complete range of retail and commercial banking services to a customer base serviced by a network of 27 offices and 29 automated teller machines.

First United Corporation and its subsidiaries operate principally in four counties in Western Maryland and four counties in West Virginia.

As used in these Notes, unless the context requires otherwise, the terms "the Corporation", "we", "us", "our" and words of similar import refer collectively to First United Corporation and its direct and indirect subsidiaries.

##### **Basis of Presentation**

The accompanying consolidated financial statements of the Corporation have been prepared in accordance with United States generally accepted accounting principles (“GAAP”) as required by the Financial Accounting Standards Board (“FASB”) Accounting Standards Codification (“ASC”) that require management to make estimates and assumptions that affect the reported amounts of certain assets and liabilities at the date of the financial statements as well as the reported amount of revenues and expenses during the reporting period. Actual results could differ from these estimates. Material estimates that are particularly susceptible to significant change in the near term relate to the determination of the allowance for loan losses, the assessment of other-than-temporary impairment (“OTTI”) pertaining to investment securities, potential impairment of goodwill, and the valuation of deferred tax assets. For purposes of comparability, certain prior period amounts have been reclassified to conform to the 2012 presentation. Such reclassifications had no impact on net income or equity.

The Corporation has evaluated events and transactions occurring subsequent to the statement of financial condition date of December 31, 2012 for items that should potentially be recognized or disclosed in these financial statements as prescribed by ASC Topic 855, *Subsequent Events*.

### **Principles of Consolidation**

The consolidated financial statements of the Corporation include the accounts of the Bank, the Insurance Group, OakFirst Loan Center, Inc., OakFirst Loan Center, LLC, First OREO Trust and Cumberland Liquidation Trust. All significant inter-company accounts and transactions have been eliminated.

First United Corporation determines whether it has a controlling financial interest in an entity by first evaluating whether the entity is a voting interest entity or a variable interest entity (“VIE”) in accordance with GAAP. Voting interest entities are entities in which the total equity investment at risk is sufficient to enable the entity to finance itself independently and provides the equity holders with the obligation to absorb losses, the right to receive residual returns and the right to make financial and operating decisions. The Corporation consolidates voting interest entities in which it has 100%, or at least a majority, of the voting interest. As defined in applicable accounting standards, a VIE is an entity that either (i) does not have equity investors with voting rights or (ii) has equity investors that do not provide sufficient financial resources for the entity to support its activities. A controlling financial interest in an entity exists when an enterprise has a variable interest, or a combination of variable interests that will absorb a majority of an entity’s expected losses, receive a majority of an entity’s expected residual returns, or both. The enterprise with a controlling financial interest, known as the primary beneficiary, consolidates the VIE.

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The Corporation accounts for its investment in a Low Income Housing Tax Credit Partnership, Liberty Mews Limited Partnership, utilizing the effective yield method under guidance that applies specifically to investments in limited partnerships that operate qualified affordable housing projects. Under the effective yield method, the investor recognizes tax credits as they are allocated and amortizes the initial cost of the investment to provide a constant effective yield over the period that tax credits are allocated to the investor. The effective yield is the internal rate of return on the investment, based on the cost of the investment and the guaranteed tax credits allocated to the investor. The tax credit allocated, net of the amortization of the investment in the limited partnership, is recognized in the income statement as a component of income taxes attributable to continuing operations.

### **Significant Concentrations of Credit Risk**

Most of the Corporation's relationships are with customers located in Western Maryland and Northeastern West Virginia. At December 31, 2012, approximately 15%, or \$128 million, of total loans were secured by real estate acquisition, construction and development projects, with \$104 million performing according to their contractual terms and \$24 million considered to be impaired based on management's concerns about the borrowers' ability to comply with present repayment terms. Of the \$24 million impaired loans, \$7 million were troubled debt restructurings ("TDRs") performing according to their modified terms, \$6 million were performing impaired, and \$11 million were non-performing at December 31, 2012. No single industry or borrower comprises greater than 10% of total loans as of December 31, 2012, and the Corporation does not have any significant concentrations in any one industry or customer. Note 6 discusses the types of securities in which the Corporation invests and Note 7 discusses the Corporation's lending activities.

### **Investments**

The investment portfolio is classified and accounted for based on the guidance of ASC Topic 320, *Investments – Debt and Equity Securities*. Securities bought and held principally for the purpose of selling them in the near term are classified as trading account securities and reported at fair value with unrealized gains and losses included in net gains/losses in other operating income. Securities purchased with the intent and ability to hold the securities to maturity are classified as held-to-maturity securities and are recorded at amortized cost. All other investment securities are classified as available-for-sale. These securities are held for an indefinite period of time and may be sold in response to changing market and interest rate conditions or for liquidity purposes as part of our overall asset/liability management strategy. Available-for-sale securities are reported at market value, with unrealized gains and losses excluded from earnings and reported as a separate component of other comprehensive income included in consolidated statement of comprehensive income, net of applicable income taxes.

The amortized cost of debt securities is adjusted for the amortization of premiums to the first call date, if applicable, or to maturity, and for the accretion of discounts to maturity, or, in the case of mortgage-backed securities, over the estimated life of the security. Such amortization and accretion is included in interest income from investments.



Interest and dividends are included in interest income from investments. Gains and losses on the sale of securities are recorded using the specific identification method.

### **Restricted Investment in Bank Stock**

Restricted stock, which represents required investments in the common stock of the Federal Home Loan Bank (“FHLB”) of Atlanta, Atlantic Central Bankers Bank (“ACBB”) and Community Bankers Bank (“CBB”), is carried at cost and is considered a long-term investment.

Management evaluates the restricted stock for impairment in accordance with ASC Industry Topic 942, *Financial Services – Depository and Lending*, (ASC Section 942-325-35). Management’s evaluation of potential impairment is based on management’s assessment of the ultimate recoverability of the cost of the restricted stock rather than by recognizing temporary declines in value. The determination of whether a decline affects the ultimate recoverability is influenced by criteria such as (i) the significance of the decline in net assets of the issuing bank as compared to the capital stock amount for that bank and the length of time this situation has persisted, (ii) commitments by the issuing bank to make payments required by law or regulation and the level of such payments in relation to the operating performance of that bank, and (iii) the impact of legislative and regulatory changes on institutions and, accordingly, on the customer base of the issuing bank. Management has evaluated the restricted stock for impairment and believes that no impairment charge is necessary as of December 31, 2012.

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The Corporation recognizes dividends on a cash basis. For the year ended December 31, 2012, dividends of \$167,000 were recognized in earnings. For the comparable period of 2011, dividends of \$96,500 were recognized in earnings.

## **Loans**

Loans that management has the intent and ability to hold for the foreseeable future or until maturity or full repayment by the borrower are reported at their outstanding unpaid principal balance, adjusted for any deferred fees or costs pertaining to origination. Loans that management has the intent to sell are reported at the lower of cost or fair value determined on an individual basis.

The segments of the Bank's loan portfolio are disaggregated to a level that allows management to monitor risk and performance. The commercial real estate ("CRE") loan segment is further disaggregated into two classes. Non-owner occupied CRE loans, which include loans secured by non-owner occupied nonfarm nonresidential properties, generally have a greater risk profile than all other CRE loans, which include loans secured by farmland, multifamily structures and owner-occupied commercial structures. The acquisition and development ("A&D") loan segment is further disaggregated into two classes. One-to-four family residential construction loans are generally made to individuals for the acquisition of and/or construction on a lot or lots on which a residential dwelling is to be built. All other A&D loans are generally made to developers or investors for the purpose of acquiring, developing and constructing residential or commercial structures. These loans have a higher risk profile because the ultimate buyer, once development is completed, is generally not known at the time of the A&D loan. The commercial and industrial ("C&I") loan segment consists of loans made for the purpose of financing the activities of commercial customers. The residential mortgage loan segment is further disaggregated into two classes: amortizing term loans, which are primarily first liens, and home equity lines of credit, which are generally second liens. The consumer loan segment consists primarily of installment loans (direct and indirect) and overdraft lines of credit connected with customer deposit accounts.

## **Interest and Fees on Loans**

Interest on loans (other than those on non-accrual status) is recognized based upon the principal amount outstanding. Loan fees in excess of the costs incurred to originate the loan are recognized as income over the life of the loan utilizing either the interest method or the straight-line method, depending on the type of loan. Generally, fees on loans with a specified maturity date, such as residential mortgages, are recognized using the interest method. Loan fees for lines of credit are recognized using the straight-line method.

A loan is considered to be past due when a payment has not been received for 30 days past its contractual due date. For all loan segments, the accrual of interest is discontinued when principal or interest is delinquent for 90 days or

more unless the loan is well-secured and in the process of collection. All non-accrual loans are considered to be impaired. Interest payments received on non-accrual loans are applied as a reduction of the loan principal balance. Loans are returned to accrual status when all principal and interest amounts contractually due are brought current and future payments are reasonably assured. The Corporation's policy for recognizing interest income on impaired loans does not differ from its overall policy for interest recognition.

Generally, consumer installment loans are not placed on non-accrual status, but are charged off after they are 120 days contractually past due. Loans other than consumer loans are charged-off based on an evaluation of the facts and circumstances of each individual loan.

### **Allowance for Loan Losses**

An ALL is maintained to absorb losses from the loan portfolio. The ALL is based on management's continuing evaluation of the risk characteristics and credit quality of the loan portfolio, assessment of current economic conditions, diversification and size of the portfolio, adequacy of collateral, past and anticipated loss experience, and the amount of non-performing loans.

The Bank's methodology for determining the ALL is based on the requirements of ASC Section 310-10-35, *Receivables-Overall-Subsequent Measurement*, for loans individually evaluated for impairment and ASC Subtopic 450-20, *Contingencies-Loss Contingencies*, for loans collectively evaluated for impairment, as well as the Interagency Policy Statements on the Allowance for Loan and Lease Losses and other bank regulatory guidance. The total of the two components represents the Bank's ALL.

The Corporation maintains an allowance for losses on unfunded commercial lending commitments and letters of credit to provide for the risk of loss inherent in these arrangements. The allowance is determined utilizing a methodology that is similar to that used to determine the ALL, modified to take into account the probability of a draw down on the commitment. This allowance is reported as a liability on the balance sheet within accrued interest payable and other liabilities. The balance in the liability account was \$44,000 at December 31, 2012 and 2011.

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## **Premises and Equipment**

Land is carried at cost. Premises and equipment are carried at cost, less accumulated depreciation. The provision for depreciation for financial reporting has been made by using the straight-line method based on the estimated useful lives of the assets, which range from 18 to 32 years for buildings and three to 20 years for furniture and equipment. Accelerated depreciation methods are used for income tax purposes.

## **Goodwill and Other Intangible Assets**

Goodwill represents the excess of the cost of an acquisition over the fair value of the net assets acquired in business combinations. In accordance with ASC Topic 350, *Intangibles - Goodwill and Other*, goodwill is not amortized but is subject to an annual impairment test.

Other intangible assets with finite lives consisted of insurance agency books of business, which represent the present value of future net income to be earned from acquired books of business. Effective January 1, 2012, the Corporation sold the assets and related book of business intangibles of the Insurance Agency.

## **Bank-Owned Life Insurance (“BOLI”)**

BOLI policies are recorded at their cash surrender values. Changes in the cash surrender values are recorded as other operating income.

## **Other Real Estate Owned**

Assets acquired through, or in lieu of, loan foreclosure are held for sale and are initially recorded at fair value less the cost to sell at the date of foreclosure, with any losses charged to the ALL, establishing a new cost basis. Subsequent to foreclosure, valuations are periodically performed by management and the assets are carried at the lower of carrying amount or fair value less cost to sell. Changes in the valuation allowance, sales gains and losses, and revenue and expenses from holding and operating properties are all included in net expenses from other real estate owned.

## Income Taxes

First United Corporation and its subsidiaries file a consolidated federal income tax return. Income taxes are accounted for using the liability method. Under the liability method, the deferred tax liability or asset is determined based on the difference between the financial statement and tax bases of assets and liabilities (temporary differences) and is measured at the enacted tax rates that will be in effect when these differences reverse. Deferred tax expense is determined by the change in the net liability or asset for deferred taxes adjusted for changes in any deferred tax asset valuation allowance.

ASC Topic 740, *Taxes*, provides clarification on accounting for uncertainty in income taxes recognized in an enterprise's financial statements and prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. We have not identified any income tax uncertainties.

State corporate income tax returns are filed annually. Federal and state returns may be selected for examination by the Internal Revenue Service and the states where we file, subject to statutes of limitations. At any given point in time, the Corporation may have several years of filed tax returns that may be selected for examination or review by taxing authorities. With few exceptions, we are no longer subject to U.S. Federal, State, and local income tax examinations by tax authorities for years prior to 2009.

Interest and penalties on income taxes are recognized as a component of income tax expense.

## Defined Benefit Plans

The defined benefit pension plan and supplemental executive retirement plan are accounted for in accordance with ASC Topic 715, *Compensation – Retirement Benefits*. Under the provisions of Topic 715, the funded status of the defined benefit pension plan is recognized as an asset, and the supplemental executive retirement plan is recognized as a liability in the Consolidated Statements of Financial Condition, and unrecognized net actuarial losses, prior service costs and a net transition asset are recognized as a separate component of other comprehensive loss, net of tax. Refer to Note 18 for a further discussion of the pension plan and supplemental executive retirement plan obligations.

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## **Statement of Cash Flows**

Cash and cash equivalents are defined as cash and due from banks and interest bearing deposits in banks in the Consolidated Statements of Cash Flows.

## **Trust Assets and Income**

Assets held in an agency or fiduciary capacity are not the Bank's assets and, accordingly, are not included in the Consolidated Statements of Financial Condition. Income from the Bank's trust department represents fees charged to customers and is recorded on an accrual basis.

## **Business Segments**

The Corporation operates in one segment, commercial banking, as defined by ASC Topic 280, *Segment Reporting*. The Corporation in its entirety is managed and evaluated on an ongoing basis by the Board of Directors and executive management, with no division or subsidiary receiving separate analysis regarding performance or resource allocation.

## **Equity Compensation Plan**

At the 2007 Annual Meeting of Shareholders, First United Corporation's shareholders approved the First United Corporation Omnibus Equity Compensation Plan (the "Omnibus Plan"), which authorizes the grant of stock options, stock appreciation rights, stock awards, stock units, performance units, dividend equivalents, and other stock-based awards to employees or directors totaling up to 185,000 shares.

On June 18, 2008, the Board of Directors of First United Corporation adopted a Long-Term Incentive Program (the "LTIP"). This program was adopted as a sub-plan of the Omnibus Plan to reward participants for increasing shareholder value, align executive interests with those of shareholders, and serve as a retention tool for key executives. Under the LTIP, participants are granted shares of restricted common stock of First United Corporation. The amount of an award is based on a specified percentage of the participant's salary as of the date of grant. These shares will vest if the Corporation meets or exceeds certain performance thresholds. There were no grants of restricted stock outstanding at December 31, 2012.

The Corporation complies with the provisions of ASC Topic 718, *Compensation-Stock Compensation*, in measuring and disclosing stock compensation cost. The measurement objective in ASC Paragraph 718-10-30-6 requires public companies to measure the cost of employee services received in exchange for an award of equity instruments based on the grant date fair value of the award. The cost is recognized in expense over the period in which an employee is required to provide service in exchange for the award (the vesting period). The performance-related shares granted in connection with the LTIP are expensed ratably from the date that the likelihood of meeting the performance measures is probable through the end of a three year vesting period.

The American Recovery and Reinvestment Act (the “Recovery Act”) imposes restrictions on the type and timing of bonuses and incentive compensation that may be accrued for or paid to certain employees of institutions that participated in the Treasury’s Troubled Asset Relief Program (“TARP”) Capital Purchase Program (“CPP”). The Recovery Act generally limits bonuses and incentive compensation to grants of long-term restricted stock that, among other requirements, cannot fully vest until the TARP CPP assistance is repaid.

Stock-based awards were made to non-employee directors in 2012 and 2011. Five thousand dollars of their annual retainer is paid in stock. Beginning in 2011, the non-employee directors were given the option to elect to take up to 100% of their annual cash retainer also in stock. The 2012 and 2011 grants totaled 16,526 and 16,720, respectively, of fully-vested shares having a fair market value of \$5.14 and \$5.68, respectively, per share. Director stock compensation expense was \$73,000 for the year ended December 31, 2012 and \$78,000 for the year ended December 31, 2011.

### **Stock Repurchases**

Under the Maryland General Corporation Law, shares of capital stock that are repurchased are cancelled and treated as authorized but unissued shares. When a share of capital stock is repurchased, the payment of the repurchase price reduces stated capital by the par value of that share (currently, \$0.01 for common stock and \$0.00 for preferred stock), and any excess over par value reduces capital surplus. There were no stock repurchases in 2012.

[64]

## Adoption of New Accounting Standards and Effects of New Accounting Pronouncements

In February 2013, the FASB issued Accounting Standards Update (“ASU”) No. 2013-02, *Comprehensive Income (Topic 220): Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income* (“ASU 2013-02”). ASU 2013-02 creates new presentation requirements which will require an entity to present significant amounts reclassified out of accumulated other comprehensive income by the respective line items of net income, but only if the item reclassified is required under U.S. GAAP to be reclassified to net income in its entirety during the same reporting period. For other amounts that are not required under U.S. GAAP to be reclassified in their entirety to net income, an entity is required to cross-reference to other disclosures required under U.S. GAAP that provide additional detail about those amounts. For public companies, the guidance in ASU 2013-02 is effective prospectively for reporting periods beginning after December 15, 2012. Adoption of ASU 2013-02 will not affect the Corporation’s financial position or results of operations, but will impact the presentation of the Corporation’s financial statements.

## 2. Earnings Per Common Share

Basic earnings per common share is derived by dividing net income available to common shareholders by the weighted-average number of common shares outstanding during the period and does not include the effect of any potentially dilutive common stock equivalents. Diluted earnings per share is derived by dividing net income available to common shareholders by the weighted-average number of shares outstanding, adjusted for the dilutive effect of outstanding common stock equivalents. There were no common stock equivalents at December 31, 2012 or December 31, 2011.

The following table sets forth the calculation of basic and diluted earnings per common share for the years ended December 31, 2012 and 2011:

	For the years ended December 31,					
	2012		2011			
(in thousands, except for per share amount)	Income	Average Shares	Per Share Amount	Income	Average Shares	Per Share Amount
Basic and Diluted Earnings Per Share:						
Net income	\$4,663			\$3,626		
Preferred stock dividends deferred	(1,626)			(1,547)		
Discount accretion on preferred stock	(65 )			(62 )		
Net income available to common shareholders	\$2,972	6,194	\$ 0.48	\$2,017	6,177	\$ 0.33



## 3.

## Net Gains

The following table summarizes the gain/(loss) activity for the years ended December 31, 2012 and 2011:

(in thousands)	For the year ended December 31,	
	2012	2011
Other-than-temporary impairment charges:		
Available-for-sale securities	\$ 0	\$ (19 )
Net gains – other:		
Available-for-sale securities:		
Realized gains	1,740	1,083
Realized losses	(195 )	(208 )
Gain on sale of consumer loans	167	86
Gain on sale of insurance assets	88	0
Gain on sale of indirect auto loans	0	1,366
Loss on disposal of fixed assets	(92 )	(6 )
Net gains – other	1,708	2,321
Net gains	\$ 1,708	\$ 2,302

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#### 4. Regulatory Capital Requirements

The Bank and First United Corporation are subject to risk-based capital regulations, which were adopted and are monitored by federal banking regulators. These guidelines are used to evaluate capital adequacy and are based on an institution's asset risk profile and off-balance sheet exposures, such as unused loan commitments and stand-by letters of credit. The regulatory guidelines require that a portion of total capital be Tier 1 capital, consisting of common shareholders' equity, qualifying portion of trust issued preferred securities, and perpetual preferred stock, less goodwill and certain other deductions. The remaining capital, or Tier 2 capital, consists of elements such as subordinated debt, mandatory convertible debt, remaining portion of trust issued preferred securities, and grandfathered senior debt, plus the ALL, subject to certain limitations.

Under the risk-based capital regulations, banking organizations are required to maintain a minimum total risk-based capital ratio (total qualifying capital divided by risk-weighted assets) of 8% (10% for well capitalized banks), including a Tier 1 ratio of at least 4% (6% for well capitalized banks). The risk-based capital rules have been further supplemented by a leverage ratio, defined as Tier I capital divided by average assets, after certain adjustments. The minimum leverage ratio is 4% (5% for well capitalized banks) for banking organizations that do not anticipate significant growth and have well-diversified risk (including no undue interest rate risk exposure), excellent asset quality, high liquidity and good earnings, and between 4% and 5% for other institutions depending on their particular condition and growth plans. Regulators may require higher capital ratios when warranted by the particular circumstances or risk profile of a given banking organization. In the current regulatory environment, banking organizations must stay well capitalized in order to receive favorable regulatory treatment on acquisition and other expansion activities and favorable risk-based deposit insurance assessments. Our capital policy establishes guidelines meeting these regulatory requirements and takes into consideration current or anticipated risks as well as potential future growth opportunities.

	Actual		For Capital Adequacy Purposes		To Be Well Capitalized Under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
December 31, 2012						
Total Capital (to risk-weighted assets)						
Consolidated	\$ 155,560	14.13 %	\$ 88,052	8.00 %	\$ 110,065	10.00 %
First United Bank & Trust	160,381	14.63 %	87,702	8.00 %	109,627	10.00 %
Tier 1 Capital (to risk-weighted assets)						
Consolidated	138,011	12.54 %	44,026	4.00 %	66,039	6.00 %
First United Bank & Trust	146,360	13.35 %	43,851	4.00 %	65,776	6.00 %
Tier 1 Capital (to average assets)						
Consolidated	138,011	10.32 %	53,499	4.00 %	66,874	5.00 %
First United Bank & Trust	146,360	10.98 %	53,326	4.00 %	66,657	5.00 %

For Capital Adequacy      To Be Well Capitalized  
Under Prompt Corrective

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	Actual		Purposes		Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
December 31, 2011						
Total Capital (to risk-weighted assets)						
Consolidated	\$ 152,280	13.05 %	\$ 93,342	8.00 %	\$ 116,677	10.00 %
First United Bank & Trust	155,651	13.38 %	93,035	8.00 %	116,294	10.00 %
Tier 1 Capital (to risk-weighted assets)						
Consolidated	131,884	11.30 %	46,671	4.00 %	70,006	6.00 %
First United Bank & Trust	140,818	12.11 %	46,517	4.00 %	69,776	6.00 %
Tier 1 Capital (to average assets)						
Consolidated	131,884	9.10 %	57,953	4.00 %	72,441	5.00 %
First United Bank & Trust	140,818	9.75 %	57,782	4.00 %	72,228	5.00 %

[66]

As of December 31, 2012 and 2011, the most recent notifications from the regulators categorized First United Corporation and the Bank as “well capitalized” under the regulatory framework for prompt corrective action. All capital ratios increased at December 31, 2012 when compared to December 31, 2011. The increase was due to the reduction in the goodwill associated with the sale of the assets for First United Insurance Group, a change in composition of risk based assets as well as net income for the year ending 2012.

The Basel Committee on Banking Supervision (“Basel”) is a committee of central banks and bank regulators from major industrialized countries that develops broad policy guidelines for use by each country’s regulators with the purpose of ensuring that financial institutions have adequate capital given the risk levels of assets and off-balance sheet financial instruments.

In December 2010, Basel released a framework for strengthening international capital and liquidity regulations, referred to as Basel III. Basel III includes defined minimum capital ratios, which must be met when implementation occurs on January 1, 2013. An additional “capital conservation buffer” will be phased-in beginning January 1, 2016 and, when fully phased-in three years later, the minimum ratios will be 2.5% higher. Fully phased-in capital standards under Basel III will require banks to maintain more capital than the minimum levels required under current regulatory capital standards. As Basel III is only a framework, the specific changes in capital requirements are to be determined by each country’s banking regulators.

In June 2012, U.S. Federal banking regulators issued two notices of proposed rulemaking (“NPRs”) that would implement in the United States the Basel III regulatory capital reforms and changes required by the Dodd-Frank Wall Street Reform and Consumer Protection Act. A third issued NPR related to banks that are internationally active or that are subject to market risk rules is not applicable to the Company.

The first NPR, “Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, and Transition Provisions,” would apply to all depository institutions, bank holding companies with total consolidated assets of \$500 million or more, and savings and loan holding companies (collectively, “banking organizations”). Consistent with the international Basel framework, this NPR would:

Increase the quantity and quality of capital required by proposing a new minimum Common Equity Tier 1 capital ratio of 4.50% of risk-weighted assets and raising the minimum Tier 1 capital ratio from 4.00% to 6.00% of risk-weighted assets;

Retain the current minimum Total capital ratio of 8.00% of risk-weighted assets and the minimum Tier 1 leverage capital ratio at 4.00% of average assets;

Introduce a “capital conservation buffer” of 2.50% above the minimum risk-based capital requirements, which must be maintained to avoid restrictions on capital distributions and certain discretionary bonus payments; and

- Revise the definition of capital to improve the ability of regulatory capital instruments to absorb losses.

The proposed new minimum regulatory capital requirements would be phased in from January 1, 2013 through January 1, 2016. The proposed capital conservation buffer would be phased in from January 1, 2016 through January 1, 2019.

The second NPR, “Regulatory Capital Rules: Standardized Approach for Risk-weighted Assets; Market Discipline and Disclosure Requirement,” also would apply to all banking organizations. This NPR would revise and harmonize the rules for calculating risk-weighted assets to enhance risk sensitivity and address weaknesses that have been identified over the past several years. Banks and regulators use risk weighting to assign different levels of risk to different classes of assets and off balance sheet exposures - riskier items require higher capital cushions and less risky items require smaller capital cushions.

On November 9, 2012, following a public comment period, the U.S. federal banking agencies issued a joint press release announcing that the January 1, 2013 effective date was being delayed so the agencies could consider operational and transitional issues identified in the large volume of public comments received. It is anticipated that the U.S. federal banking agencies will formalize the implementation of the Basel III framework applicable to domestic banks in the United States during 2013.

We are in the process of modeling our capital ratios under various scenarios in light of these NPRs and intend to take appropriate steps to ensure that we meet the fully-phased in minimum capital requirements, including capital conservation buffers, if and when these NPRs are finalized.

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The total risk based capital ratios of First United Corporation include \$40.2 million of junior subordinated debentures which qualified as Tier 1 capital at December 31, 2012, under guidance issued by the FRB. The Company will monitor the finalization of the Basel III Capital Rules, including whether its junior subordinated debentures will continue to qualify for Tier 1 capital under the final rules.

In January 2009, pursuant to the TARP CPP, First United Corporation sold 30,000 shares of its Fixed Rate Cumulative Perpetual Preferred Stock, Series A ("Series A Preferred Stock") and a related warrant to purchase 326,323 shares of its common stock for an exercise price of \$13.79 per share to the Treasury for an aggregate purchase price of \$30 million. The proceeds from this transaction count as Tier 1 capital and the warrant qualifies as tangible common equity.

## 5. Cash and Cash Equivalents

Cash and due from banks, which represents vault cash in the retail offices and invested cash balances at the Federal Reserve, is carried at fair value.

	December 31, 2012	December 31, 2011
Cash and due from banks, weighted average interest rate of 0.18% (at December 31, 2012)	\$ 71,290	\$ 52,049

Interest bearing deposits in banks, which represent funds invested at a correspondent bank, are carried at fair value and, as of December 31, 2012 and 2011, consisted of daily funds invested at the FHLB of Atlanta, First Tennessee Bank ("FTN"), M&T Bank ("M&T"), and CBB.

	December 31, 2012	December 31, 2011
FHLB daily investments, interest rate of 0.005% (at December 31, 2012)	\$ 3,306	\$ 4,244
FTN daily investments, interest rate of 0.09% (at December 31, 2012)	1,350	1,350
M&T daily investments, interest rate of 0.25% (at December 31, 2012)	6,037	6,379
CBB Fed Funds sold, interest rate of 0.22% (at December 31, 2012)	1,085	1,085
	\$ 11,778	\$ 13,058

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## 6. Investment Securities

The following table shows a comparison of amortized cost and fair values of investment securities at December 31, 2012 and 2011:

(in thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value	OTTI in AOCL
December 31, 2012					
Available for Sale:					
U.S. government agencies	\$ 40,334	\$ 97	\$ 111	\$ 40,320	\$ 0
Residential mortgage-backed agencies	43,596	703	191	44,108	0
Commercial mortgage-backed agencies	37,330	288	0	37,618	0
Collateralized mortgage obligations	31,836	188	293	31,731	0
Obligations of states and political subdivisions	55,212	2,842	0	58,054	0
Collateralized debt obligations	36,798	0	25,356	11,442	16,876
Total available for sale	\$ 245,106	\$ 4,118	\$ 25,951	\$ 223,273	\$ 16,876
Held to Maturity:					
Obligations of states and political subdivisions	\$ 4,040	\$ 542	\$ 235	\$ 4,347	\$ 0
December 31, 2011					
Available for Sale:					
U.S. government agencies	\$ 25,490	\$ 107	\$ 17	\$ 25,580	\$ 0
Residential mortgage-backed agencies	43,630	1,059	137	44,552	0
Commercial mortgage-backed agencies	48,112	216	51	48,277	0
Collateralized mortgage obligations	48,120	436	205	48,351	0
Obligations of states and political subdivisions	65,424	3,400	8	68,816	0
Collateralized debt obligations	36,385	0	26,938	9,447	17,726
Total available for sale	\$ 267,161	\$ 5,218	\$ 27,356	\$ 245,023	\$ 17,726

Proceeds from sales of available-for-sale securities and the realized gains and losses are as follows:

(in thousands)	2012	2011
Proceeds	\$ 46,220	\$ 84,396
Realized gains	1,740	1,083
Realized losses	195	208

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The following table shows the Corporation's securities with gross unrealized losses and fair value, aggregated by investment category and length of time that individual securities have been in a continuous unrealized position, at December 31, 2012 and 2011:

(in thousands)	Less than 12 months		12 months or more	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
December 31, 2012				
Available for Sale:				
U.S. government agencies	\$ 18,220	\$ 111	\$0	\$ 0
Residential mortgage-backed agencies	22,407	191	0	0
Commercial mortgage-backed agencies	0	0	0	0
Collateralized mortgage obligations	16,576	293	450	0 *
Obligations of states and political subdivisions	0	0	0	0
Collateralized debt obligations	0	0	11,442	25,356
Totals	\$ 57,203	\$ 595	\$11,892	\$ 25,356
Held to Maturity:				
Obligations of states and political subdivisions	\$ 2,765	\$ 235	\$0	\$ 0

\* - De Minimus

December 31, 2011				
Available for Sale:				
U.S. government agencies	\$ 9,983	\$ 17	\$0	\$ 0
Residential mortgage-backed agencies	16,229	136	4,779	1
Commercial mortgage-backed agencies	20,320	51	0	0
Collateralized mortgage obligations	10,651	82	557	123
Obligations of states and political subdivisions	0	0	2,805	8
Collateralized debt obligations	0	0	9,447	26,938
Totals	\$ 57,183	\$ 286	\$17,588	\$ 27,070

Management systematically evaluates securities for impairment on a quarterly basis. Based upon application of accounting guidance for subsequent measurement in ASC Topic 320 (ASC Section 320-10-35), management assesses whether (i) it has the intent to sell a security being evaluated and (ii) it is more likely than not that the Corporation will be required to sell the security prior to its anticipated recovery. If neither applies, then declines in the fair values of securities below their cost that are considered other-than-temporary declines are split into two components. The first is the loss attributable to declining credit quality. Credit losses are recognized in earnings as realized losses in the period in which the impairment determination is made. The second component consists of all other losses, which are recognized in other comprehensive loss. In estimating OTTI losses, management considers (a) the length of time and the extent to which the fair value has been less than cost, (b) adverse conditions specifically related to the security, an industry, or a geographic area, (c) the historic and implied volatility of the fair value of the security, (d) changes in the rating of the security by a rating agency, (e) recoveries or additional declines in fair value subsequent to the balance sheet date, (f) failure of the issuer of the security to make scheduled interest or principal payments, and (g) the payment structure of the debt security and the likelihood of the issuer being able to make payments that increase in the future. Management also monitors cash flow projections for securities that are considered beneficial interests under



the guidance of ASC Subtopic 325-40, *Investments – Other – Beneficial Interests in Securitized Financial Assets*, (ASC Section 325-40-35).

Management believes that the valuation of certain securities is a critical accounting policy that requires significant estimates in preparation of its consolidated financial statements. Management utilizes an independent third party to prepare both the impairment valuations and fair value determinations for its collateralized debt obligation (“CDO”) portfolio consisting of pooled trust preferred securities. Based on management’s review of the third party evaluations, management believes that there were no material differences in the valuations between December 31, 2012 and December 31, 2011.

U.S. Government Agencies - Three U.S. government agencies have been in a slight unrealized loss position for less than 12 months as of December 31, 2012. These securities are of the highest investment grade and the Corporation does not intend to sell them, and it is not more likely than not that the Corporation will be required to sell them before recovery of their amortized cost basis, which may be at maturity. Therefore, no OTTI existed at December 31, 2012. There were no agency securities for which the cost has been less than market value for a period longer than 12 months.

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Residential Mortgage-Backed Agencies - Five residential mortgage-backed agencies have been in an unrealized loss position for less than 12 months as of December 31, 2012. All of these securities are of the highest investment grade and the Corporation does not intend to sell them, nor is it more likely than not that the Corporation will be required to sell them before recovery of their amortized cost basis, which may be at maturity. Therefore, no OTTI existed at December 31, 2012.

Collateralized Mortgage Obligations – One collateralized mortgage obligation security at December 31, 2012 has been in an unrealized loss position for 12 months or more. Four collateralized mortgage obligation securities have been in a slight unrealized loss position for less than 12 months as of December 31, 2012. The Corporation does not intend to sell these securities and it is not more likely than not that the Corporation will be required to sell them before recovery of their amortized cost basis, which may be at maturity. Accordingly, management does not consider these investments to be other-than-temporarily impaired at December 31, 2012.

Obligations of State and Political Subdivisions – The Corporation owns two tax increment fund bonds in the held to maturity portfolio. One of these bonds has been in an unrealized loss position for less than 12 months. This bond is not rated by the rating agencies and was underwritten by the Corporation prior to purchase and is periodically reviewed for credit quality. Therefore, management does not consider this investment to be other-than-temporarily impaired at December 31, 2012.

Collateralized Debt Obligations - The \$25.4 million in unrealized losses greater than 12 months at December 31, 2012 relates to 18 pooled trust preferred securities that comprise the CDO portfolio. See Note 24 for a discussion of the methodology used by management to determine the fair values of these securities. The Corporation recorded \$19 thousand in credit-related non cash OTTI for the year ended 2011 and did not record any credit-related non-cash OTTI charges for the year ended December 31, 2012. The unrealized losses on the remaining securities in the portfolio are primarily attributable to continued depression in market interest rates, marketability, liquidity and the current economic environment.

The following table presents a cumulative roll-forward of the amount of non-cash OTTI charges related to credit losses which have been recognized in earnings for the trust preferred securities in the CDO portfolio held and not intended to be sold:

(in thousands)	For the year ended	
	December 31, 2012	December 31, 2011
Balance of credit-related OTTI at January 1	\$14,424	\$ 14,653
Additional increases for credit-related OTTI previously recognized when there is no intent to sell and no requirement to sell before recovery of amortized cost basis	0	19
Reduction for increases in cash flows expected to be collected	(465 )	(248 )

Balance of credit-related OTTI at December 31

\$13,959 \$ 14,424

[71]

The amortized cost and estimated fair value of securities by contractual maturity at December 31, 2012 are shown in the following table. Actual maturities will differ from contractual maturities because the issuers of the securities may have the right to call or prepay obligations with or without call or prepayment penalties.

(in thousands)	December 31, 2012	
	Amortized Cost	Fair Value
Contractual Maturity		
Available for sale:		
Due after five years through ten years	\$43,613	\$44,935
Due after ten years	88,731	64,881
	132,344	109,816
Residential mortgage-backed agencies	43,596	44,108
Commercial mortgage-backed agencies	37,330	37,618
Collateralized mortgage obligations	31,836	31,731
	\$245,106	\$223,273
Held to Maturity:		
Due after ten years	\$4,040	\$4,347

At December 31, 2012 and 2011, investment securities with a fair value of \$157 million and \$147 million, respectively, were pledged as permitted or required to secure public and trust deposits, for securities sold under agreements to repurchase as required or permitted by law and as collateral for borrowing capacity.

## 7. Loans and Related Allowance for Loan Losses

The following table summarizes the primary segments of the loan portfolio as of December 31, 2012 and December 31, 2011:

(in thousands)	Commercial Real Estate	Acquisition and Development	Commercial and Industrial	Residential Mortgage	Consumer	Total
December 31, 2012						
Total loans	\$ 298,851	\$ 128,391	\$ 69,013	\$ 346,919	\$ 31,655	\$874,829
Individually evaluated for impairment	\$ 15,941	\$ 24,112	\$ 3,449	\$ 4,304	\$ 36	\$47,842
Collectively evaluated for impairment	\$ 282,910	\$ 104,279	\$ 65,564	\$ 342,615	\$ 31,619	\$826,987
December 31, 2011						
Total loans	\$ 336,234	\$ 142,871	\$ 78,697	\$ 347,220	\$ 33,672	\$938,694
Individually evaluated for impairment	\$ 16,942	\$ 25,699	\$ 13,048	\$ 6,116	\$ 21	\$61,826
Collectively evaluated for impairment	\$ 319,292	\$ 117,172	\$ 65,649	\$ 341,104	\$ 33,651	\$876,868

[72]

The segments of the Bank's loan portfolio are disaggregated to a level that allows management to monitor risk and performance. The CRE loan segment is then segregated into two classes. Non-owner occupied CRE loans, which include loans secured by non-owner occupied, nonfarm, non-residential properties, generally have a greater risk profile than all other CRE loans, which include loans secured by farmland, multifamily structures and owner-occupied commercial structures. The A&D loan segment is segregated into two classes. One-to-four family residential construction loans are generally made to individuals for the acquisition of and/or construction on a lot or lots on which a residential dwelling is to be built. All other A&D loans are generally made to developers or investors for the purpose of acquiring, developing and constructing residential or commercial structures. These loans have a higher risk profile because the ultimate buyer, once development is completed, is generally not known at the time of the A&D loan. The C&I loan segment consists of loans made for the purpose of financing the activities of commercial customers. The residential mortgage loan segment is segregated into two classes: (i) amortizing term loans, which are primarily first liens; and (ii) home equity lines of credit, which are generally second liens. The consumer loan segment consists primarily of installment loans (direct and indirect) and overdraft lines of credit connected with customer deposit accounts.

During the second quarter of 2011, the Bank sold \$32.5 million of the indirect auto portfolio that was included in the consumer loan class.

In the ordinary course of business, executive officers and directors of the Corporation, including their families and companies in which certain directors are principal owners, were loan customers of the Bank. Pursuant to the Bank's lending policies, such loans were made on the same terms, including collateral, as those prevailing at the time for comparable transactions with persons who are not related to the Corporation and do not involve more than the normal risk of collectability. Changes in the dollar amount of loans outstanding to officers, directors and their associates were as follows for the year ended December 31:

(in thousands)	2012
Balance at January 1	\$11,741
Loans or advances	5,233
Repayments	(5,243 )
Balance at December 31	\$11,731

Management uses a 10-point internal risk rating system to monitor the credit quality of the overall loan portfolio. The first six categories are considered not criticized and are aggregated as "Pass" rated. The criticized rating categories utilized by management generally follow bank regulatory definitions. The Special Mention category includes assets that are currently protected but are potentially weak, resulting in an undue and unwarranted credit risk, but not to the point of justifying a Substandard classification. Loans in the Substandard category have well-defined weaknesses that jeopardize the liquidation of the debt, and have a distinct possibility that some loss will be sustained if the weaknesses are not corrected. All loans greater than 90 days past due are considered Substandard. Only the portion of a specific allocation of the allowance for loan losses that management believes is associated with a pending event that could trigger loss in the short term is classified in the Doubtful category. Any portion of a loan that has been charged off is placed in the Loss category. It is possible for a loan to be classified as Substandard in the internal risk rating system,

but not considered impaired under GAAP, due to the broader reach of “well-defined weaknesses” in the application of the Substandard definition.

To help ensure that risk ratings are accurate and reflect the present and future capacity of borrowers to repay a loan as agreed, the Bank has a structured loan rating process with several layers of internal and external oversight. Generally, consumer and residential mortgage loans are included in the Pass categories unless a specific action, such as bankruptcy, repossession, or death occurs to raise awareness of a possible credit event. The Bank’s Commercial Loan Officers are responsible for the timely and accurate risk rating of the loans in the commercial segments at origination and on an ongoing basis. The Credit Quality Department performs an annual review of all commercial relationships \$500,000 or greater. Confirmation of the appropriate risk grade is included as part of the review process on an ongoing basis. The Bank has an experienced Credit Quality and Loan Review Department that continually reviews and assesses loans within the portfolio. In addition, the Bank engages an external consultant to conduct loan reviews on at least an annual basis. Generally, the external consultant reviews commercial relationships greater than \$750,000 and/or criticized relationships greater than \$500,000. Detailed reviews, including plans for resolution, are performed on loans classified as Substandard on a quarterly basis. Loans in the Special Mention and Substandard categories that are collectively evaluated for impairment are given separate consideration in the determination of the allowance.

[73]

The following table presents the classes of the loan portfolio summarized by the aggregate Pass and the criticized categories of Special Mention, Substandard and Doubtful within the internal risk rating system as of December 31, 2012 and 2011:

(in thousands)	Pass	Special Mention	Substandard	Doubtful	Total
December 31, 2012					
Commercial real estate					
Non owner-occupied	\$126,230	\$6,464	\$18,840	\$0	\$151,534
All other CRE	110,365	9,072	27,880	0	147,317
Acquisition and development					
1-4 family residential construction	9,284	1,101	5,967	0	16,352
All other A&D	79,136	1,073	31,830	0	112,039
Commercial and industrial	60,234	2,029	6,750	0	69,013
Residential mortgage					
Residential mortgage - term	255,993	751	11,885	0	268,629
Residential mortgage – home equity	75,935	195	2,160	0	78,290
Consumer	31,376	22	257	0	31,655
Total	\$748,553	\$20,707	\$105,569	\$0	\$874,829
December 31, 2011					
Commercial real estate					
Non owner-occupied	\$119,574	\$4,222	\$32,212	\$0	\$156,008
All other CRE	123,713	18,307	38,206	0	180,226
Acquisition and development					
1-4 family residential construction	11,512	0	5,572	0	17,084
All other A&D	81,268	935	43,584	0	125,787
Commercial and industrial	62,152	697	15,848	0	78,697
Residential mortgage					
Residential mortgage - term	250,701	1,817	15,408	0	267,926
Residential mortgage – home equity	75,517	34	3,743	0	79,294
Consumer	33,147	34	491	0	33,672
Total	\$757,584	\$26,046	\$155,064	\$0	\$938,694

Management further monitors the performance and credit quality of the loan portfolio by analyzing the age of the portfolio as determined by the length of time a recorded payment is past due. A loan is considered to be past due when a payment has not been received for 30 days past its contractual due date. For all loan segments, the accrual of interest is discontinued when principal or interest is delinquent for 90 days or more unless the loan is well-secured and in the process of collection. All non-accrual loans are considered to be impaired. Interest payments received on non-accrual loans are applied as a reduction of the loan principal balance. Loans are returned to accrual status when all principal and interest amounts contractually due are brought current and future payments are reasonably assured. The Corporation's policy for recognizing interest income on impaired loans does not differ from its overall policy for interest recognition.



[74]

The following table presents the classes of the loan portfolio summarized by the aging categories of performing loans and non-accrual loans as of December 31, 2012 and December 31, 2011:

(in thousands)	Current	30-59 Days Past Due	60-89 Days Past Due	90 Days+ Past Due	Total Past Due and still accruing	Non-Accrual	Total Loans
December 31, 2012							
Commercial real estate							
Non owner-occupied	\$ 146,796	\$ 321	\$ 64	\$ 0	\$ 385	\$ 4,353	\$ 151,534
All other CRE	143,108	2,368	0	0	2,368	1,841	147,317
Acquisition and development							
1-4 family residential construction	16,280	61	0	0	61	11	16,352
All other A&D	100,232	619	221	200	1,040	10,767	112,039
Commercial and industrial	68,228	580	29	0	609	176	69,013
Residential mortgage							
Residential mortgage - term	251,673	7,446	5,244	1,639	14,329	2,627	268,629
Residential mortgage – home equity	77,224	583	130	249	962	104	78,290
Consumer	30,434	800	327	58	1,185	36	31,655
Total	\$ 833,975	\$ 12,778	\$ 6,015	\$ 2,146	\$ 20,939	\$ 19,915	\$ 874,829
December 31, 2011							
Commercial real estate							
Non owner-occupied	\$ 146,150	\$ 359	\$ 209	\$ 0	\$ 568	\$ 9,290	\$ 156,008
All other CRE	173,342	558	5,547	0	6,105	779	180,226
Acquisition and development							
1-4 family residential construction	17,009	0	75	0	75	0	17,084
All other A&D	109,351	840	530	128	1,498	14,938	125,787
Commercial and industrial	69,119	182	32	0	214	9,364	78,697
Residential mortgage							
Residential mortgage - term	249,719	10,106	3,753	1,386	15,245	2,962	267,926
Residential mortgage – home equity	77,486	476	375	123	974	834	79,294
Consumer	31,478	1,560	471	142	2,173	21	33,672
Total	\$ 873,654	\$ 14,081	\$ 10,992	\$ 1,779	\$ 26,852	\$ 38,188	\$ 938,694

Non-accrual loans which have been subject to a partial charge-off totaled \$6.7 million as of December 31, 2012, compared to \$13.4 million as of December 31, 2011.

The ALL is maintained to absorb losses from the loan portfolio. The ALL is based on management's continuing evaluation of the risk characteristics and credit quality of the loan portfolio, assessment of current economic conditions, diversification and size of the portfolio, adequacy of collateral, past and anticipated loss experience, and the amount of non-performing loans.

The Bank's methodology for determining the ALL is based on the requirements of ASC Section 310-10-35, *Receivables-Overall-Subsequent Measurement*, for loans individually evaluated for impairment and ASC Subtopic 450-20, *Contingencies-Loss Contingencies*, for loans collectively evaluated for impairment, as well as the Interagency Policy Statements on the Allowance for Loan and Lease Losses and other bank regulatory guidance. The total of the two components represents the Bank's ALL.

The following table summarizes the primary segments of the ALL, segregated into the amount required for loans individually evaluated for impairment and the amount required for loans collectively evaluated for impairment as of December 31, 2012 and December 31, 2011.

[75]

(in thousands)	Commercial Real Estate	Acquisition and Development	Commercial and Industrial	Residential Mortgage	Consumer	Total
December 31, 2012						
Total ALL	\$ 5,206	\$ 5,029	\$ 906	\$ 4,507	\$ 399	\$16,047
Individually evaluated for impairment	\$ 126	\$ 1,506	\$ 0	\$ 0	\$ 0	\$1,632
Collectively evaluated for impairment	\$ 5,080	\$ 3,523	\$ 906	\$ 4,507	\$ 399	\$14,415
December 31, 2011						
Total ALL	\$ 6,218	\$ 7,190	\$ 2,190	\$ 3,430	\$ 452	\$19,480
Individually evaluated for impairment	\$ 92	\$ 2,718	\$ 1,139	\$ 2	\$ 0	\$3,951
Collectively evaluated for impairment	\$ 6,126	\$ 4,472	\$ 1,051	\$ 3,428	\$ 452	\$15,529

Management evaluates individual loans in all of the commercial segments for possible impairment if the loan is greater than \$500,000 or is part of a relationship that is greater than \$750,000 and (i) is either in nonaccrual status, or (ii) is risk-rated Substandard and is greater than 60 days past due. Loans are considered to be impaired when, based on current information and events, it is probable that the Bank will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Factors considered by management in evaluating impairment include payment status, collateral value, and the probability of collecting scheduled principal and interest payments when due. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record, and the amount of the shortfall in relation to the principal and interest owed. The Bank does not separately evaluate individual consumer and residential mortgage loans for impairment, unless such loans are part of larger relationship that is impaired; otherwise loans in these segments are considered impaired when they are classified as non-accrual.

Once the determination has been made that a loan is impaired, the determination of whether a specific allocation of the allowance is necessary is measured by comparing the recorded investment in the loan to the fair value of the loan using one of three methods: (i) the present value of expected future cash flows discounted at the loan's effective interest rate; (ii) the loan's observable market price; or (iii) the fair value of the collateral less selling costs. The method is selected on a loan-by-loan basis, with management utilizing the fair value of collateral method for 95% of the analyses. If the fair value of the collateral less selling costs method is utilized for collateral securing loans in the commercial segments, then an updated external appraisal is ordered on the collateral supporting the loan if the loan balance is greater than \$500,000 and the existing appraisal is greater than 18 months old. If an appraisal is less than 12 months old (the age at which the internal appraisal grid begins) and if management believes that general market conditions in that geographic market have changed considerably, the property has deteriorated or perhaps lost an income stream, or a recent appraisal for a similar property indicates a significant change, then management may adjust the fair value indicated by the existing appraisal until a new appraisal is obtained. If the most recent appraisal is greater than 12 months old or if an updated appraisal has not been received and reviewed in time for the determination of estimated fair value at quarter (or year) end, then the estimated fair value of the collateral is determined by adjusting the existing appraisal by the appropriate percentage from an internally prepared appraisal discount grid. This grid considers the age of a third party appraisal and the geographic region where the collateral is located in order to discount an appraisal that is greater than 12 months old. The discount rates in the appraisal discount grid are updated

at least annually to reflect the most current knowledge that management has available, including the results of current appraisals. If there is a delay in receiving an updated appraisal or if the appraisal is found to be deficient in our internal appraisal review process and re-ordered, the Bank continues to use a discount factor from the appraisal discount grid based on the collateral location and current appraisal age in order to determine the estimated fair value. A specific allocation of the ALL is recorded if there is any deficiency in collateral value determined by comparing the estimated fair value to the recorded investment of the loan. When updated appraisals are received and reviewed, adjustments are made to the specific allocation as needed.

The evaluation of the need and amount of a specific allocation of the ALL and whether a loan can be removed from impairment status is made on a quarterly basis.

[76]

The following table presents impaired loans by class, segregated by those for which a specific allowance was required and those for which a specific allowance was not necessary as of December 31, 2012 and December 31, 2011:

(in thousands)	Impaired Loans with Specific Allowance		Impaired Loans with No Specific Allowance	Total Impaired Loans	
	Recorded Investment	Related Allowances	Recorded Investment	Recorded Investment	Unpaid Principal Balance
December 31, 2012					
Commercial real estate					
Non owner-occupied	\$ 0	\$ 0	\$ 5,309	\$ 5,309	\$ 7,929
All other CRE	1,019	126	9,613	10,632	10,785
Acquisition and development					
1-4 family residential construction	2,052	471	10	2,062	2,062
All other A&D	5,410	1,035	16,640	22,050	26,232
Commercial and industrial	0	0	3,449	3,449	3,449
Residential mortgage					
Residential mortgage - term	0	0	3,755	3,755	4,086
Residential mortgage – home equity	0	0	549	549	549
Consumer	0	0	36	36	36
Total impaired loans	\$ 8,481	\$ 1,632	\$ 39,361	\$ 47,842	\$ 55,128
December 31, 2011					
Commercial real estate					
Non owner-occupied	\$ 448	\$ 92	\$ 9,129	\$ 9,577	\$ 14,765
All other CRE	0	0	7,365	7,365	7,390
Acquisition and development					
1-4 family residential construction	2,489	859	0	2,489	2,577
All other A&D	7,850	1,859	15,360	23,210	27,712
Commercial and industrial	9,043	1,139	4,005	13,048	13,137
Residential mortgage					
Residential mortgage - term	218	2	4,816	5,034	5,488
Residential mortgage – home equity	0	0	1,082	1,082	1,177
Consumer	0	0	21	21	33
Total impaired loans	\$ 20,048	\$ 3,951	\$ 41,778	\$ 61,826	\$ 72,279

Loans that are collectively evaluated for impairment are analyzed with general allowances being made as appropriate. For general allowances, historical loss trends are used in the estimation of losses in the current portfolio. These historical loss amounts are modified by other qualitative factors.

The classes described above, which are based on the Federal call code assigned to each loan, provide the starting point for the ALL analysis. Management tracks the historical net charge-off activity (full and partial charge-offs, net of full and partial recoveries) at the call code level. A historical charge-off factor is calculated utilizing a defined number of consecutive historical quarters. Consumer pools currently utilize a rolling 12 quarters, while Commercial pools currently utilize a rolling eight quarters.

[77]

“Pass” rated credits are segregated from “Criticized” credits for the application of qualitative factors. The un-criticized (“pass”) pools for commercial and residential real estate are further segmented based upon the geographic location of the underlying collateral. There are seven geographic regions utilized – six that represent the Bank’s lending footprint and a seventh for all out-of-market credits. Different economic environments and resultant credit risks exist in each region that are acknowledged in the assignment of qualitative factors. Loans in the criticized pools, which possess certain qualities or characteristics that may lead to collection and loss issues, are closely monitored by management and subject to additional qualitative factors.

Management has identified a number of additional qualitative factors which it uses to supplement the historical charge-off factor because these factors are likely to cause estimated credit losses associated with the existing loan pools to differ from historical loss experience. The additional factors that are evaluated quarterly and updated using information obtained from internal, regulatory, and governmental sources are: (i) national and local economic trends and conditions; (ii) levels of and trends in delinquency rates and non-accrual loans; (iii) trends in volumes and terms of loans; (iv) effects of changes in lending policies; (v) experience, ability, and depth of lending staff; (vi) value of underlying collateral; and (vii) concentrations of credit from a loan type, industry and/or geographic standpoint.

Management reviews the loan portfolio on a quarterly basis using a defined, consistently applied process in order to make appropriate and timely adjustments to the ALL. When information confirms all or part of specific loans to be uncollectible, these amounts are promptly charged off against the ALL. Residential mortgage and consumer loans are charged off after they are 120 days contractually past due. All other loans are charged off based on an evaluation of the facts and circumstances of each individual loan. When the Bank believes that its ability to collect is solely dependent on the liquidation of the collateral, a full or partial charge-off is recorded promptly to bring the recorded investment to an amount that the Bank believes is supported by an ability to collect on the collateral. The circumstances that may impact the Bank’s decision to charge-off all or a portion of a loan include default or non-payment by the borrower, scheduled foreclosure actions, and/or prioritization of the Bank’s claim in bankruptcy. There may be circumstances where due to pending events, the Bank will place a specific allocation of the ALL on a loan for which a partial charge-off has been previously recognized. This specific allocation may be either charged-off or removed depending upon the outcome of the pending event. Full or partial charge-offs are not recovered until full principal and interest on the loan have been collected, even if a subsequent appraisal supports a higher value. Loans with partial charge-offs remain in non-accrual status. Both full and partial charge-offs reduce the recorded investment of the loan and the ALL and are considered to be charge-offs for purposes of all credit loss metrics and trends, including the historical rolling charge-off rates used in the determination of the ALL.

Activity in the ALL is presented for the years ended December 31, 2012 and December 31, 2011:

	Commercial Real Estate	Acquisition and Development	Commercial and Industrial	Residential Mortgage	Consumer	Total
(in thousands)						
ALL balance at January 1, 2012	\$ 6,218	\$ 7,190	\$ 2,190	\$ 3,430	\$ 452	\$ 19,480
Charge-offs	(2,289 )	(809 )	(9,402 )	(1,314 )	(650 )	(14,464)



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Recoveries	156	420	464	177	424	1,641
Provision	1,121	(1,772 )	7,654	2,214	173	9,390
ALL balance at December 31, 2012	\$ 5,206	\$ 5,029	\$ 906	\$ 4,507	\$ 399	\$16,047
ALL balance at January 1, 2011	\$ 8,658	\$ 6,345	\$ 1,345	\$ 4,211	\$ 1,579	\$22,138
Charge-offs	(6,886 )	(3,055 )	(840 )	(1,664 )	(893 )	(13,338)
Recoveries	95	322	57	550	499	1,523
Provision	4,351	3,578	1,628	333	(733 )	9,157
ALL balance at December 31, 2011	\$ 6,218	\$ 7,190	\$ 2,190	\$ 3,430	\$ 452	\$19,480

The ALL is based on estimates, and actual losses will vary from current estimates. Management believes that the granularity of the homogeneous pools and the related historical loss ratios and other qualitative factors, as well as the consistency in the application of assumptions, result in an ALL that is representative of the risk found in the components of the portfolio at any given date.

[78]

The following table presents the average recorded investment in impaired loans and related interest income recognized for the periods indicated:

(in thousands)	December 31, 2012		December 31, 2011			
	Average investment	Interest income recognized on an accrual basis	Interest income recognized on a cash basis	Average investment	Interest income recognized on an accrual basis	Interest income recognized on a cash basis
Commercial real estate						
Non owner-occupied	\$7,237	\$ 34	\$ 0	\$12,643	\$ 44	\$ 91
All other CRE	9,385	318	49	6,781	269	52
Acquisition and development						
1-4 family residential construction	2,248	87	0	2,834	94	0
All other A&D	24,018	481	0	25,860	547	81
Commercial and industrial	5,747	150	0	11,960	155	0
Residential mortgage						
Residential mortgage - term	4,755	117	38	6,415	144	16
Residential mortgage – home equity	828	17	7	724	14	4
Consumer	46	0	0	53	0	0
Total	\$54,264	\$ 1,204	\$ 94	\$67,270	\$ 1,267	\$ 244

In the normal course of business, the Bank modifies loan terms for various reasons. These reasons may include as a retention strategy to compete in the current interest rate environment, and to re-amortize or extend a loan term to better match the loan's payment stream with the borrower's cash flows. A modified loan is considered to be a TDR when the Bank has determined that the borrower is troubled (i.e. experiencing financial difficulties). The Bank evaluates the probability that the borrower will be in payment default on any of its debt in the foreseeable future without modification. To make this determination, the Bank performs a global financial review of the borrower and loan guarantors to assess their current ability to meet their financial obligations.

When the Bank restructures a loan to a troubled borrower, the loan terms (i.e. interest rate, payment, amortization period and/or maturity date) are modified in such a way to enable the borrower to cover the modified debt service payments based on current financials and cash flow adequacy. If a borrower's hardship is thought to be temporary, then modified terms are only offered for that time period. Where possible, the Bank obtains additional collateral and/or secondary payment sources at the time of the restructure in order to put the Bank in the best possible position if the borrower is not able to meet the modified terms. To date, the Bank has not forgiven any principal as a restructuring concession. The Bank will not offer modified terms if it believes that modifying the loan terms will only delay an inevitable permanent default.

All loans designated as TDRs are considered impaired loans and may be in either accruing or non-accruing status. The Corporation's policy for recognizing interest income on impaired loans does not differ from its overall policy for

interest recognition. Accordingly, the accrual of interest is discontinued when principal or interest is delinquent for 90 days or more unless the loan is well-secured and in the process of collection. If the loan was accruing at the time of the modification, then it continues to be in accruing status subsequent to the modification. Non-accrual TDRs may return to accruing status when there has been sufficient payment performance for a period of at least six months. TDRs are considered to be in payment default if, subsequent to modification, the loans are transferred to non-accrual status. A loan may be removed from being reported as a TDR in the calendar year following the modification if the interest rate at the time of modification was consistent with the interest rate for a loan with comparable credit risk and the loan has performed according to its modified terms for at least six months.

The volume and type of TDR activity is considered in the assessment of the local economic trend qualitative factor used in the determination of the ALL for loans that are evaluated collectively for impairment.

[79]

There were 27 loans totaling \$17.7 million and 23 loans totaling \$18.0 million that were classified as TDRs at December 31, 2012 and December 31, 2011, respectively. The following table presents the volume and recorded investment at the time of modification of TDRs by class and type of modification that occurred during the periods indicated:

	Temporary Rate Modification		Extension of Maturity		Modification of Payment and Other Terms	
	Number of Contracts	Recorded Investment (1)	Number of Contracts	Recorded Investment (1)	Number of Contracts	Recorded Investment
(in thousands)						
For the year ended December 31, 2012						
Commercial real estate						
Non owner-occupied	0	\$ 0	0	\$ 0	0	\$ 0
All other CRE	1	3,110	0	0	4	2,634
Acquisition and development						
1-4 family residential construction	0	0	0	0	1	2,125
All other A&D	0	0	1	134	1	1,889
Commercial and industrial	0	0	0	0	1	247
Residential mortgage						
Residential mortgage – term	2	584	2	765	1	284
Residential mortgage – home equity	0	0	0	0	0	0
Consumer	0	0	0	0	0	0
Total (2)	3	\$ 3,694	3	\$ 899	8	\$ 7,179
For the year ended December 31, 2011						
Commercial real estate						
Non owner-occupied	0	\$ 0	3	\$ 809	0	\$ 0
All other CRE	1	3,233	0	0	0	0
Acquisition and development						
1-4 family residential construction	0	0	0	0	1	2,491
All other A&D	0	0	8	8,508	2	328
Commercial and industrial	0	0	0	0	0	0
Residential mortgage						
Residential mortgage – term	2	234	2	513	0	0
Residential mortgage – home equity	0	0	0	0	0	0
Consumer	0	0	0	0	0	0
Total (2)	3	\$ 3,467	13	\$ 9,830	3	\$ 2,819

**Notes:**

- (1) The post-modification recorded investment balances were the same as the pre-modification recorded investment balances, as there were no charge-offs as a result of any of the restructurings.
- (2) Includes 8 existing TDRs totaling \$6.7 million that were restructured in 2011 and 5 existing TDRs totaling \$7.5 million that were restructured in 2012 with new terms providing a concession.

If a loan was considered to be impaired prior to modification as a TDR, then there is no impact on the ALL as a result of the modification because the loan was already being evaluated individually for impairment. If a loan was not impaired prior to modification as a TDR, then there could be an impact on the ALL as a result of the modification because of the movement of the loan from the pools of loans being evaluated collectively for impairment to being evaluated individually for impairment. There was a \$55,000 reduction to the ALL relating to eight loans totaling \$3.7 million modified as TDRs in 2012, resulting from the movement of these loans being evaluated collectively for impairment to being evaluated individually for impairment. There was a \$220,000 reduction to the ALL relating to four loans totaling \$5.5 million modified as TDRs in 2011, resulting from the movement of these loans being evaluated collectively for impairment to being evaluated individually for impairment. The volume, type and performance of TDR activity are considered in the assessment of the local economic trends qualitative factor used in the determination of the ALL for loans that are evaluated collectively for impairment.

[80]

There were no TDRs considered to be in payment default in 2012. In 2011, two other A&D TDRs, totaling \$2.3 million, that were modified in 2011 were transferred to non-accrual status subsequent to their modification and were considered to be in payment default.

At December 31, 2012 and 2011, additional funds of up to \$2.1 million and \$1.6 million, respectively, were committed to be advanced in connection with TDRs.

## 8. Other Real Estate Owned

The following table presents the components of OREO as of December 31, 2012 and 2011:

	2012	2011
Commercial real estate	\$5,559	\$2,913
Acquisition and development	9,831	12,602
Residential mortgage	2,123	1,161
Total OREO	\$17,513	\$16,676

The following table presents the activity in the OREO valuation allowance for the years ended December 31, 2012 and 2011:

	2012	2011
Balance January 1	\$1,745	\$0
Fair value write-down	1,489	1,986
Sales of OREO	(468 )	(241 )
Balance December 31	\$2,766	\$1,745

The following table presents the components of OREO expenses, net for the years ended December 31, 2012 and 2011:

	December 31,	
(in thousands)	2012	2011
(Gains)/losses on real estate, net	\$(995 )	\$(285 )
Fair value write-down	1,489	1,986
Expenses, net	914	858
Rental income	(518 )	(149 )

Total OREO expenses, net	\$ 890	\$ 2,410
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## 9. Premises and Equipment

The composition of premises and equipment at December 31 is as follows:

(in thousands)	2012	2011
Land	\$8,725	\$9,297
Land Improvements	1,168	1,112
Premises	25,247	25,299
Furniture and Equipment	17,380	16,671
Capital Lease	535	535
	53,055	52,914
Less accumulated depreciation	(23,600)	(22,088)
Total	\$29,455	\$30,826

The Corporation recorded depreciation expense of \$2.0 million and \$2.3 million in 2012 and 2011, respectively.

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Pursuant to the terms of noncancelable operating lease agreements for banking and subsidiaries' offices and for data processing and telecommunications equipment in effect at December 31, 2012, future minimum rent commitments under these leases for future years are as follows: (i) \$3.5 million for 2013; (ii) \$3.3 million for 2014; (iii) \$2.5 million for 2015; (iv) \$2.5 million for 2016; (v) \$2.4 million for 2017; and (vi) \$6.5 million thereafter. The leases contain options to extend for periods from one to five years, which are not included in the aforementioned amounts.

Total rent expense for offices amounted to \$.5 million in 2012 and \$.6 million in 2011.

### **10. Goodwill and Other Intangible Assets**

ASC Topic 350, *Intangibles - Goodwill and Other*, establishes standards for the amortization of acquired intangible assets and impairment assessment of goodwill. The \$11.0 million in recorded goodwill at December 31, 2012 is primarily related to the acquisition of Huntington National Bank branches that occurred in 2003 that is not subject to periodic amortization.

Goodwill arising from business combinations represents the value attributable to unidentifiable intangible elements in the business acquired. Goodwill is not amortized but is tested for impairment annually or more frequently if events or changes in circumstances indicate that the asset might be impaired. Impairment testing requires that the fair value of each of the Corporation's reporting units be compared to the carrying amount of its net assets, including goodwill. If the estimated current fair value of the reporting unit exceeds its carrying value, then no additional testing is required and an impairment loss is not recorded. Otherwise, additional testing is performed and, to the extent such additional testing results in a conclusion that the carrying value of goodwill exceeds its implied fair value, an impairment loss is recognized.

Our goodwill relates to value inherent in the banking business and the value is dependent upon our ability to provide quality, cost effective services in a highly competitive local market. This ability relies upon continuing investments in processing systems, the development of value-added service features and the ease of use of our services. As such, goodwill value is supported ultimately by revenue that is driven by the volume of business transacted. A decline in earnings as a result of a lack of growth or the inability to deliver cost effective services over sustained periods can lead to impairment of goodwill, which could adversely impact earnings in future periods. ASC Topic 350 requires an annual evaluation of goodwill for impairment. The determination of whether or not these assets are impaired involves significant judgments and estimates.

Throughout 2012, consistent with First United Corporation's peer group, the shares of First United Corporation common stock traded below its book value. At December 31, 2012, First United Corporation's stock price was below its tangible book value. Management believed that these circumstances could indicate the possibility of impairment. Accordingly, management consulted a third party valuation specialist to assist it with the determination of the fair



value of First United Corporation, considering both the market approach (guideline public company method) and the income approach (discounted future benefits method). Due to the illiquidity in the common stock and the adverse conditions surrounding the banking industry, reliance was placed on the income approach in determining the fair value of First United Corporation. The income approach is a discounted cash flow analysis that is determined by adding (i) the present value, which is a representation of the current value of a sum that is to be received some time in the future, of the estimated net income, net of dividends paid out, that First United Corporation could generate over the next five years and (ii) the present value of a terminal value, which is a representation of the current value of an entity at a specified time in the future. The terminal value was calculated using both a price to tangible book multiple method and a capitalization method and the more conservative of the two was utilized in the fair value calculation.

Significant assumptions used in the above methods include:

- Net income from First United Corporation's forward five-year operating budget, incorporating conservative growth and mix assumptions;

- A discount rate of 10.0% based on the most recent [third quarter of 2012] Cost of Capital Report from Morningstar/Ibbotson Associates for the Commercial Banking Sector adjusted for a size and risk premium of 298 basis points;

- A price to tangible book multiple of 1.16, which was the median multiple of commercial bank mergers and acquisitions during 2012 for selling banks and holding companies with non-performing assets to average assets between 2.0% and 4.0%, as provided by Sheshunoff & Co.; and

- A capitalization rate of 7.0% (discount rate of 10.0% adjusted for a conservative growth rate of 3.0%).

The resulting fair value of the income approach resulted in the fair value of First United Corporation exceeding the carrying value by 68%. Management stressed the assumptions used in the analysis to provide additional support for the derived value. This stress testing showed that (i) the discount rate could increase to 27% before the excess would be eliminated in the tangible multiple method, and (ii) the assumption of the tangible book multiple could decline to 0.44 and still result in a fair value in excess of book value. Based on the results of the evaluation, management concluded that the recorded value of goodwill at December 31, 2012 was not impaired. However, future changes in strategy and/or market conditions could significantly impact these judgments and require adjustments to recorded asset balances. Management will continue to evaluate goodwill for impairment on an annual basis and as events occur or circumstances change.

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The significant components of goodwill and acquired intangible assets at December 31 are as follows:

(In thousands)	2012				2011			
	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount	Weighted Average Remaining Life	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount	Weighted Average Remaining Life
Goodwill	\$14,812	\$ (3,808 )	\$ 11,004		\$16,664	\$ (3,808 )	\$ 12,856	
Insurance agency book of business	0	0	0	0	2,341	(765 )	1,576	0
Total	\$14,812	\$ (3,808 )	\$ 11,004		\$19,005	\$ (4,573 )	\$ 14,432	

There was no amortization expense relating to intangible assets in 2012. The \$1.85 million of goodwill and \$1.58 million of intangible assets associated with the insurance agency were de-recognized through the sale of assets effective January 1, 2012. Amortization expense relating to intangible assets was \$.3 million in 2011.

## 11. Deposits

The aggregate amount of time deposits with a minimum denomination of \$100,000 was \$195.3 million and \$238.0 million at December 31, 2012 and 2011, respectively. At December 31, 2012, \$3.8 million of deposit overdrafts were re-classified as loans.

The following is a summary of the scheduled maturities of all time deposits as of December 31, 2012 (in thousands):

2013	\$ 149,735
2014	68,021
2015	50,303
2016	55,388
2017	60,213
Thereafter	0

In the ordinary course of business, executive officers and directors of the Corporation, including their families and companies in which certain directors are principal owners, were deposit customers of the Bank. Pursuant to the Bank's policies, such deposits are on the same terms as those prevailing at the time for comparable deposits with persons who are not related to the Corporation. At December 31, 2012, executive officers and directors had approximately \$16.6

million in deposits with the Corporation.

## 12. Borrowed Funds

The following is a summary of short-term borrowings at December 31 with original maturities of less than one year:

(Dollars in thousands)	2012	2011
Securities sold under agreements to repurchase:		
Outstanding at end of year	\$39,257	\$36,868
Weighted average interest rate at year end	0.34 %	0.64 %
Maximum amount outstanding as of any month end	52,367	\$51,403
Average amount outstanding	\$38,812	41,728
Approximate weighted average rate during the year	0.34 %	0.56 %

At December 31, 2012, the repurchase agreements were secured by \$56.9 million in available-for-sale investment securities.

The following is a summary of long-term borrowings at December 31 with original maturities exceeding one year:

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(In thousands)	2012	2011
FHLB advances, bearing fixed interest rates ranging from 1.00% to 3.69% at December 31, 2012	\$136,005	\$160,314
Junior subordinated debt, bearing variable interest rates ranging from 2.16% to 3.06% at December 31, 2012	35,929	35,929
Junior subordinated debt, bearing fixed interest rate of 9.88% at December 31, 2012	10,801	10,801
Total long-term debt	\$182,735	\$207,044

At December 31, 2012, the long-term FHLB advances were secured by \$154.5 million in loans and \$5.4 million in investment securities.

The contractual maturities of long-term borrowings are as follows:

	December 31, 2012		2011	
	Fixed Rate	Floating Rate	Total	Total
Due in 2012	\$0	\$0	\$0	\$44,250
Due in 2013	0	0	0	0
Due in 2014	0	0	0	0
Due in 2015	30,000	5,000	35,000	35,000
Due in 2016	0	0	0	0
Due in 2017	0	0	0	0
Thereafter	116,806	30,929	147,735	127,794
Total long-term debt	\$146,806	\$35,929	\$182,735	\$207,044

The Bank has a borrowing capacity agreement with the FHLB in an amount equal to 29% of the Bank's assets. At December 31, 2012, the available line of credit equaled \$381 million. This line of credit, which can be used for both short and long-term funding, can only be utilized to the extent of available collateral. The line is secured by certain qualified mortgage, commercial and home equity loans and investment securities as follows (in thousands):

1-4 family mortgage loans	\$124,972
Commercial loans	3,959
Multi-family loans	239
Home equity loans	25,370
Investment securities	5,370
	\$159,910

At December 31, 2012, \$23.9 million was available for additional borrowings.

The Bank also has various unsecured lines of credit totaling \$16.0 million with various financial institutions and a \$36 million secured line with the Federal Reserve to meet daily liquidity requirements. As of December 31, 2012, there were no borrowings under these credit facilities. In addition, there was approximately \$48 million of available funding through brokered money market funds at December 31, 2012.

**Repurchase Agreements** - The Bank has retail repurchase agreements with customers within its local market areas. Repurchase agreements generally have maturities of one to four days from the transaction date. These borrowings are collateralized with securities that we own and are held in safekeeping at independent correspondent banks.

**FHLB Advances** - The FHLB advances consist of various borrowings with maturities generally ranging from five to 10 years with initial fixed rate periods of one, two or three years. After the initial fixed rate period, the FHLB has one or more options to convert each advance to a LIBOR based, variable rate advance, but the Bank may repay the advance in whole or in part, without a penalty, if the FHLB exercises its option. At all other times, the Bank's early repayment of any advance could be subject to a prepayment penalty.

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### 13. Junior Subordinated Debentures and Restrictions on Dividends

In March 2004, Trust I and Trust II issued preferred securities with an aggregate liquidation amount of \$30.0 million to third-party investors and issued common equity with an aggregate liquidation amount of \$.9 million to First United Corporation. Trust I and Trust II used the proceeds of these offerings to purchase an equal amount of TPS Debentures, as follows:

\$20.6 million—floating rate payable quarterly based on three-month LIBOR plus 275 basis points (3.06% at December 31, 2012), maturing in 2034, became redeemable five years after issuance at First United Corporation's option.

\$10.3 million—floating rate payable quarterly based on three-month LIBOR plus 275 basis points (3.06% at December 31, 2012) maturing in 2034, became redeemable five years after issuance at First United Corporation's option.

In December 2004, First United Corporation issued \$5.0 million of junior subordinated debentures to third-party investors that were not tied to preferred securities. The debentures had a fixed rate of 5.88% for the first five years, payable quarterly, and converted to a floating rate in March 2010 based on the three month LIBOR plus 185 basis points (2.16% at December 31, 2012). The debentures mature in 2015, but became redeemable five years after issuance at First United Corporation's option.

In December 2009, Trust III issued 9.875% fixed-rate preferred securities with an aggregate liquidation amount of approximately \$7.0 million to private investors and issued common securities to First United Corporation with an aggregate liquidation amount of approximately \$.2 million. Trust III used the proceeds of the offering to purchase approximately \$7.2 million of 9.875% fixed-rate TPS Debentures. Interest on these TPS Debentures are payable quarterly, and the TPS Debentures mature in 2040 but are redeemable five years after issuance at First United Corporation's option.

In January 2010, Trust III issued an additional \$3.5 million of 9.875% fixed-rate preferred securities to private investors and issued common securities to First United Corporation with an aggregate liquidation amount of \$.1 million. Trust III used the proceeds of the offering to purchase \$3.6 million of 9.875% fixed-rate TPS Debentures. Interest on these TPS Debentures are payable quarterly, and the TPS Debentures mature in 2040 but are redeemable five years after issuance at First United Corporation's option.

The TPS Debentures issued to each of the Trusts represent the sole assets of that Trust, and payments of the TPS Debentures by First United Corporation are the only sources of cash flow for the Trust. First United Corporation has the right, without triggering a default, to defer interest on all of the TPS Debentures for up to 20 quarterly periods, in which case distributions on the preferred securities will also be deferred. Should this occur, the Corporation may not pay dividends or distributions on, or repurchase, redeem or acquire any shares of its capital stock.

At the request of the Reserve Bank, the Board of Directors of First United Corporation elected to defer quarterly interest payments under its TPS Debentures beginning with the payment that was due in March 2011. As of December 31, 2012, this deferral election remained in effect and accumulated deferred interest in the amount of \$4.4 million has been accrued and are reflected in the consolidated financial statements. All accumulated deferred interest must be paid in full when the Board of Directors elects to terminate the deferral of interest payments. Management cannot predict whether or when the Board of Directors will terminate the deferral prior to the 20-quarter maximum permitted by the terms of the TPS Debentures. First United Corporation's ability to resume quarterly interest payments will depend primarily on our earnings in future periods.

Interest payments on the \$5.0 million junior subordinated debentures that were issued outside of trust preferred securities offerings cannot, and have not, been deferred.

The terms of the Series A Preferred Stock call for the payment, if declared by the Board of Directors of First United Corporation, of cash dividends on February 15<sup>th</sup>, May 15<sup>th</sup>, August 15<sup>th</sup> and November 15<sup>th</sup> of each year. On November 15, 2010, at the request of the Reserve Bank, the Board of Directors of First United Corporation voted to defer the payment of quarterly cash dividends on the Series A Preferred Stock beginning with the November 15, 2010 dividend payment date. As of December 31, 2012, this deferral election remained in effect and accumulated deferred dividends in the amount of \$3.5 million (\$118.30 per share) have been accrued and are reflected on the consolidated financial statements. During the deferral period, dividends continue to accrue at the rate of \$.4 million per dividend period. All accumulated deferred dividends must be paid in full if and when the Board of Directors declares the next quarterly cash dividend. Management cannot predict whether or when First United Corporation will resume the payment of quarterly dividends on the Series A Preferred Stock. First United Corporation's ability to pay cash dividends in the future will depend primarily on our earnings in future periods.

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In December 2010, the Board of Directors of First United Corporation voted to suspend the payment of cash dividends on the common stock starting in 2011 in connection with the above-mentioned deferral of dividends on the Series A Preferred Stock.

#### **14. Preferred Stock**

On January 30, 2009, pursuant to the TARP CPP, First United Corporation issued to the Treasury 30,000 shares of its Series A Preferred Stock, having no par value, and a Warrant to purchase 326,323 shares of common stock at an exercise price of \$13.79 per share, for an aggregate consideration of \$30 million. The proceeds from this transaction qualify as Tier 1 capital and the Warrant qualifies as tangible common equity. The operative documents relating to this transaction are on file with the SEC and available to the public free of charge.

Holders of the Series A Preferred Stock are entitled to receive, if and when declared by the Board of Directors, out of assets legally available for payment, cumulative cash dividends at a rate per annum of 5% per share on a liquidation amount of \$1,000 per share of Series A Preferred Stock with respect to each dividend period from January 30, 2009 to, but excluding, February 15, 2014. From and after February 15, 2014, holders of Series A Preferred Stock are entitled to receive cumulative cash dividends at a rate per annum of 9% per share on a liquidation amount of \$1,000 per share with respect to each dividend period thereafter. Under the terms of the Series A Preferred Stock, on and after February 15, 2012, First United Corporation may, at its option, redeem shares of Series A Preferred Stock, in whole or in part, at any time and from time to time, for cash at a per share amount equal to the sum of the liquidation preference per share plus any accrued and unpaid dividends to but excluding the redemption date. Subject to prior consultation with the Reserve Bank and subject further to the terms of the TPS Debentures, the Recovery Act permits First United Corporation to redeem shares of its Series A Preferred Stock held by Treasury at any time (subject to Treasury's requirement that a minimum of 25% of the Series A Preferred Stock be redeemed). If First United Corporation were to redeem shares of its Series A Preferred Stock pursuant to the Recovery Act, then it may also repurchase a pro rata portion of the Warrant; otherwise, Treasury must liquidate any portion of the Warrant that is not repurchased, at the current market price.

Until the date on which the Treasury disposes of the Series A Preferred Stock, without the consent of the Treasury, First United Corporation is prohibited from increasing its quarterly cash dividend paid on common stock above \$0.20 per share and from repurchasing or redeeming any shares of its capital stock, and the Trusts are prohibited from redeeming their trust preferred securities.

See Note 13 for information about First United Corporation's election to defer quarterly cash dividend payments on the Series A Preferred Stock.

#### **15. Variable Interest Entities**



As noted in Note 13, First United Corporation created the Trusts for the purposes of raising regulatory capital through the sale of mandatorily redeemable preferred capital securities to third party investors and common equity interests to First United Corporation. The Trusts are considered VIEs, but are not consolidated because First United Corporation is not the primary beneficiary of the Trusts. At December 31, 2012, the Corporation reported all of the \$41.7 million of TPS Debentures issued in connection with these offerings as long-term borrowings (along with the \$5.0 million of stand-alone junior subordinated debentures), and it reported its \$1.3 million equity interest in the Trusts as “Other Assets”.

In November 2009, the Bank became a 99.99% limited partner in Liberty Mews Limited Partnership (the “Partnership”), a Maryland limited partnership formed for the purpose of acquiring, developing and operating low-income housing units in Garrett County, Maryland. The Partnership was financed with a total of \$10.6 million of funding, including a \$6.1 million equity contribution from the Bank as the limited partner. The Partnership used the proceeds from these sources to purchase the land and construct a 36-unit low income housing rental complex at a total cost of \$10.6 million. The total assets of the Partnership were \$10.0 million at December 31, 2012 and \$10.9 million at December 31, 2011.

Through December 31, 2012, the Bank had made contributions to the Partnership totaling \$6.1 million. The project was completed in June 2011, and the Bank is entitled to \$8.4 million in federal investment tax credits over a 10-year period as long as certain qualifying hurdles are maintained. The Bank will also receive the benefit of tax operating losses from the Partnership to the extent of its capital contribution. The investment in the Partnership assists the Bank in achieving its community reinvestment initiatives.

Because the Partnership is considered to be a VIE, management performed an analysis to determine whether its involvement with the Partnership would lead it to determine that it must consolidate the Partnership. In performing its analysis, management evaluated the risks creating the variability in the Partnership and identified which activities most significantly impact the VIE’s economic performance. Finally, it examined each of the variable interest holders to determine which, if any, of the holders was the primary beneficiary based on their power to direct the most significant activities and their obligation to absorb potentially significant losses of the Partnership.

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The Bank, as a limited partner, generally has no voting rights. The Bank is not in any way involved in the daily management of the Partnership and has no other rights that provide it with the power to direct the activities that most significantly impact the Partnership's economic performance, which are to develop and operate the housing project in such a manner that complies with specific tax credit guidelines. As a limited partner, there is no recourse to the Bank by the creditors of the Partnership. The tax credits that result from the Bank's investment in the Partnership are generally subject to recapture should the partnership fail to comply with the applicable government regulations. The Bank has not provided any financial or other support to the Partnership beyond its required capital contributions and does not anticipate providing such support in the future. Management currently believes that no material losses are probable as a result of the Bank's investment in the Partnership.

On the basis of management's analysis, the general partner is deemed to be the primary beneficiary of the Partnership. Because the Bank is not the primary beneficiary, the Partnership has not been included in the Corporation's consolidated financial statements.

At December 31, 2012 and December 31, 2011, the Corporation included its total investment in the Partnership in "Other Assets" in its Consolidated Statements of Financial Condition. As of December 31, 2012, the Corporation's commitment in the Partnership is fully funded. The following table presents details of the Bank's involvement with the Partnership at the dates indicated:

(In thousands)	December 31, 2012	December 31, 2011
Investment in LIHTC Partnership		
Carrying amount on Balance Sheet of:		
Investment (Other Assets)	\$ 5,498	\$ 5,980
Maximum exposure to loss	5,498	5,980

#### 16. Accumulated Other Comprehensive Loss ("AOCL")

The following table presents the activity in accumulated other comprehensive loss for the years ended December 31, 2012 and 2011:

(in thousands)	Investment securities- with OTTI	Investment securities- all other	Cash Flow Hedge	Pension Plan	SERP	Total
Accumulated OCL, net:						

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Balance - January 1, 2011	\$ (10,825 )	\$ (3,956 )	\$ (496 )	\$ (4,203 )	\$ (341 )	\$ (19,821 )
Net gain/(loss) during period	253	1,323	(120 )	(2,742 )	145	(1,141 )
Balance – December 31, 2011	\$ (10,572 )	\$ (2,633 )	\$ (616 )	\$ (6,945 )	\$ (196 )	\$ (20,962 )
Net gain/(loss) during period	536	(333 )	109	(1,317 )	144	(861 )
Balance – December 31, 2012	\$ (10,036 )	\$ (2,966 )	\$ (507 )	\$ (8,262 )	\$ (52 )	\$ (21,823 )

[87]

**17. Income Taxes**

The provision for income taxes consists of the following for the years ended December 31:

(In thousands)	2012	2011
Current Tax expense:		
Federal	\$417	\$233
State	96	670
	\$513	\$903
Deferred tax expense/(benefit):		
Federal	\$22	\$(1,291)
State	378	(247)
	\$400	\$(1,538)
Income tax expense/(benefit) for the year	\$913	\$(635)

The reconciliation between the statutory federal income tax rate and effective income tax rate is as follows:

	2012	2011
Federal statutory rate	35.0 %	35.0 %
Tax-exempt income on securities and loans	(11.9)	(30.7)
Tax-exempt BOLI income	(11.2)	(12.1)
State income tax, net of federal tax benefit	7.9	6.3
Tax credits	(10.1)	(22.5)
Other	6.7	2.7
	16.4 %	(21.3)%

Deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. Significant components of the Corporation's temporary differences as of December 31 are as follows:

(In thousands)	2012	2011
Deferred tax assets:		
Allowance for loan losses	\$6,446	\$7,862
Deferred loan fees	70	134
Deferred compensation	704	624
Federal and State Tax loss carry forwards	5,289	4,291
AMT and Other carry forwards	1,712	985
Unrealized loss on investment securities available-for-sale	8,771	8,935
Pension/SERP	1,677	935

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Other than temporary impairment on investment securities	5,937	5,965
Other real estate owned	1,243	1,836
Other	1,874	1,716
Total deferred tax assets	33,723	33,283
Valuation allowance	(1,471 )	(1,364 )
Total deferred tax assets less valuation allowance	32,252	31,919
Deferred tax liabilities:		
Amortization of goodwill and core deposit intangible	(1,857 )	(1,507 )
Depreciation	(1,409 )	(1,601 )
Other	(104 )	(100 )
Total deferred tax liabilities	(3,370 )	(3,208 )
Net deferred tax assets	\$28,882	\$28,711

State income tax expense amounted to \$.5 million during 2012 and \$.4 million during 2011.

[88]

In assessing the ability to realize deferred tax assets, management considers whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. The ultimate realization of the deferred tax assets is dependent upon the generation of future taxable income of the appropriate character (for example, ordinary income or capital gain) within the carry-back or carry-forward period available under the tax law during the periods in which temporary differences are deductible. The Corporation has considered future market growth, forecasted earnings, future taxable income, and feasible and permissible tax planning strategies in determining whether it will be able to realize the deferred tax asset. If the Corporation was to determine that it would not be able to realize a portion of its net deferred tax asset in the future for which there is currently no valuation allowance, an adjustment to the net deferred tax asset would be charged to earnings in the period such determination was made. Conversely, if the Corporation was to make a determination that it is more likely than not that the deferred tax assets for which there is a valuation allowance would be realized, the related valuation allowance would be reduced and a benefit would be recorded.

At December 31, 2012 the Corporation has federal net operating losses (“NOL”) of approximately \$10.0 million and West Virginia NOLs of approximately \$5.3 million for which deferred tax assets of \$3.5 million and \$0.2 million, respectively, have been recorded at December 31, 2012. The federal and West Virginia NOLs were created in 2011 and 2010 and will begin expiring in 2030. Management has determined that a deferred tax valuation allowance is not required for 2012 on the Federal and West Virginia NOLs because we believe it is more likely than not that these deferred tax assets can be realized prior to expiration of their carry-forward period. This determination is based primarily on the ability of the Corporation to immediately generate approximately \$13.4 million of taxable income through tax planning strategies, irrespective of any additional future operating income. At December 31, 2012 these strategies include the ability to generate approximately \$4.1 million in taxable gains through the sale of investment securities, approximately \$8.0 million in taxable gains through the sale of its Bank Owned Life Insurance and approximately \$1.3 million in taxable gains through the sale of its fixed rate mortgage portfolio.

The Corporation has Maryland net operating loss carry-forwards of \$28.4 million for the NOL of the Parent Company for which a deferred tax asset of \$1.5 million has been recorded at December 31, 2012. There has been and continues to be a full valuation allowance on the Parent Company’s NOL based on the fact that it is more likely than not that this deferred tax asset will not be realized because the Parent company files a separate tax return and has recurring tax losses and will not generate sufficient taxable income in the future to utilize them before they expire beginning in 2019. The valuation allowance of \$1.5 million at December 31, 2012 reflects an increase of \$.1 million from the level at December 31, 2011.

In addition, based on our evaluation of the four sources of taxable income, we have concluded that no valuation allowance is deemed necessary for the Corporation’s remaining Federal and State deferred tax assets at December 31, 2012 as it is more likely than not (defined a level of likelihood that is more than 50 percent) that they will be realized based on the expected reversal of deferred tax liabilities, the generation of future income sufficient to realize the deferred tax assets as they reverse and the ability to implement tax planning strategies to prevent the expiration of any carry-forward periods.

## 18. Employee Benefit Plans

First United Corporation sponsors a noncontributory defined benefit pension plan (the “Pension Plan”) covering substantially all full-time employees who qualify as to age and length of service. The benefits are based on years of service and the employees’ compensation during the last five years of employment. First United Corporation’s funding policy is to make annual contributions in amounts sufficient to meet the current year’s minimum funding requirements.

During 2001, the Bank established an unfunded supplemental executive retirement plan (the “SERP”) to provide senior management personnel with supplemental retirement benefits in excess of limits imposed on qualified plans by federal tax law. Concurrent with the establishment of the SERP, the Bank acquired BOLI policies on the senior management personnel and officers of the Bank. The benefits resulting from the favorable tax treatment accorded the earnings on the BOLI policies are intended to provide a source of funds for the future payment of the SERP benefits as well as other employee benefit costs.

The benefit obligation activity for both the Pension Plan and SERP was calculated using an actuarial measurement date of January 1. Plan assets and the benefit obligations were calculated using an actuarial measurement date of December 31.

Effective April 30, 2010, the Pension Plan was amended, resulting in a “soft freeze”, the effect of which prohibits new entrants into the plan and ceases crediting of additional years of service, after that date. Effective January 1, 2013, the plan was amended to unfreeze the plan for those employees for whom the sum of (i) their ages, at their closest birthday, plus (ii) years of service for vesting purposes equals 80 or greater. The “soft freeze” continues to apply to all other plan participants. Pension benefits for these participants will be managed through discretionary contributions to the 401(k) Profit Sharing Plan (the “401(k) Plan”). We anticipate the plan changes to have a minimal impact to the financial statements.

[89]

First United Corporation will assess the need for future annual contributions to the Pension Plan based upon its funded status and an evaluation of the future benefits to be provided thereunder. The Bank expects to fund the annual projected benefit payments for the SERP from operations.

The following tables summarize benefit obligation and funded status, plan asset activity, components of net pension cost, and weighted average assumptions for the Pension Plan and the SERP plans:

(In thousands)	Pension		SERP	
	2012	2011	2012	2011
<b>Change in Benefit Obligation</b>				
Obligation at the beginning of the year	\$26,540	\$22,600	\$4,814	\$4,404
Service cost	0	0	114	322
Interest cost	1,380	1,430	245	233
Change in discount rate assumption	3,933	3,442	0	(54 )
Actuarial (gains)/losses	(437 )	0	(100 )	(47 )
Benefits paid	(1,076 )	(932 )	(83 )	(44 )
Obligation at the end of the year	30,340	26,540	4,990	4,814
<b>Change in Plan Assets</b>				
Fair value at the beginning of the year	29,037	29,152	0	0
Actual return on plan assets	3,193	817	0	0
Employer contribution	0	0	83	44
Benefits paid	(1,076 )	(932 )	(83 )	(44 )
Fair value at the end of the year	31,154	29,037	0	0
Funded Status	\$814	\$2,497	\$(4,990)	\$(4,814)

Components of Net Pension Cost	Pension		SERP	
	2012	2011	2012	2011
Service cost	\$0	\$0	\$114	\$322
Interest cost	1,380	1,430	245	233
Expected return on assets	(2,211)	(2,225)	0	0
Amortization of transition asset	(39 )	(39 )	0	0
Amortization of recognized loss	379	279	15	20
Amortization of prior service cost	12	12	123	123
Net pension (income)/expense in employee benefits	\$(479 )	\$(543 )	\$497	\$698

Weighted Average Assumptions used to determine benefit obligations:

Discount rate for benefit obligations	4.00 %	5.00 %	5.25 %	5.25 %
Discount rate for net pension cost	5.00 %	6.00 %	0	0
Expected long-term return on assets	7.75 %	7.75 %	0	0
Rate of compensation increase	3.00 %	4.00 %	3.00 %	3.00 %



The accumulated benefit obligation for the Pension Plan was \$30.8 million and \$25.4 million at December 31, 2012 and 2011, respectively. The accumulated benefit obligation for the SERP was \$4.5 million and \$4.3 million at December 31, 2012 and 2011, respectively.

The investment assets of a defined benefit plan are managed with the goal of providing for retiree distributions while also supporting long-term plan obligations with a moderate level of portfolio risk. In order to address the variability over time of both risk and return, the plan investment strategy entails a dynamic approach to asset allocation, providing for normalized targets for major asset classes, with the ability to tactically adjust within the following specified ranges around those targets.

[90]

<b>Asset Class</b>	<b>Normalized Target</b>	<b>Range</b>
Cash	5%	0% - 20%
Fixed Income	40%	30% - 50%
Equities	55%	45% - 65%

Decisions regarding tactical adjustments within the above noted ranges for asset classes are based on a top down review of factors expected to have material impact on the risk and reward dynamics of the portfolio as a whole. Such factors include, but are not limited to, the following:

- Anticipated domestic and international economic growth as a whole;
- The position of the economy within its longer term economic cycle; and
- The expected impact of economic vitality, cycle positioning, financial market risks, industry/demographic trends and political forces on the various market sectors and investment styles.

With respect to individual company securities, additional company specific matters are considered, which could include management track record and guidance, future earnings expectations, current relative price expectations and the impact of identified risks on expected performance, among others. A core equity position of large cap stocks will be maintained, with more aggressive or volatile sectors meaningfully represented in the asset mix in pursuit of higher returns.

Strategic and specific investment decisions are guided by an in-house investment committee as well as a number of outside institutional resources that provide economic, industry and company data and analytics. It is management's intent to give the Plan's investment managers flexibility with respect to investment decisions and their timing within the overall guidelines. However, certain investments require specific review and approval by management. Management is also informed of anticipated changes in nonproprietary investment managers, significant modifications of any previously approved investment, or the anticipated use of derivatives to execute investment strategies.

Portfolio risk is managed in large part by a focus on diversification across multiple levels as well as an emphasis on financial strength. For example, current investment policies restrict initial investments in debt securities to be rated investment grade at the time of purchase. Also, with the exception of the highest rated securities (e.g. - U.S. Treasury or government-backed agency securities), no more than 10% of the portfolio may be invested in a single entity's securities. As a result of the previously noted approaches to controlling portfolio risk, any concentrations of risk would be associated with general systemic risks faced by industry sectors or the portfolio as a whole.

Assets in the Pension Plan are valued by the Corporation's accounting system provider who utilizes a third party pricing service. Valuation data is based on actual market data for stocks and mutual funds (Level 1) and matrix pricing for bonds (Level 2). Cash and cash equivalents are also considered Level 1 within the fair value hierarchy.

[91]

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As of December 31, 2012 and 2011, the value of Pension Plan investments was as follows:

December 31, 2012		Fair Value Hierarchy		
(Dollars in thousands)	Assets at Fair Value	% of Portfolio	Level 1	Level 2
Cash and cash equivalents	\$ 3,377	10.8	% \$ 3,377	\$ 0
Fixed income securities:				
U.S. Government and Agencies	138	0.4	% 0	138
Taxable municipal bonds and notes	1,882	6.0	% 0	1,882
Corporate bonds and notes	7,990	25.7	% 0	7,990
Preferred stock	736	2.4	% 0	736
Fixed income mutual funds	2,826	9.1	% 2,826	0
Total fixed income	13,572	43.6	% 2,826	10,746
Equities:				
Large Cap	11,132	35.7	% 11,132	0
Mid Cap	1,543	5.0	% 1,543	0
Small Cap	840	2.7	% 840	0
International	690	2.2	% 690	0
Total equities	14,205	45.6	% 14,205	0
Total market value	\$ 31,154	100.0	% \$ 20,408	\$ 10,746

December 31, 2011		Fair Value Hierarchy		
(Dollars in thousands)	Assets at Fair Value	% of Portfolio	Level 1	Level 2
Cash and cash equivalents	\$ 367	1.4	% \$ 367	\$ 0
Fixed income securities:				
U.S. Government and Agencies	473	1.6	% 0	473
Taxable municipal bonds and notes	1,483	5.1	% 0	1,483
Corporate bonds and notes	7,031	24.2	% 0	7,031
Preferred stock	710	2.4	% 0	710
Fixed income mutual funds	2,206	7.6	% 2,206	0
Total fixed income	11,903	40.9	% 2,206	9,697
Equities:				
Large Cap	12,446	42.9	% 12,446	0
Mid Cap	2,183	7.5	% 2,183	0
Small Cap	1,230	4.2	% 1,230	0
International	908	3.1	% 908	0
Total equities	16,767	57.7	% 16,767	0
Total market value	\$ 29,037	100.0	% \$ 19,340	\$ 9,697

The expected rate of return on Pension Plan assets is based on a combination of the following:

Historical returns of the portfolio of assets;

Monte Carlo simulations of expected returns for a portfolio with strategic asset targets similar to the normalized targets; and

- Market impact adjustments to reflect expected future investment environment considerations.

As of December 31, 2012, the 25-year average return on pension portfolio assets was 8.12%. Monte Carlo simulations modeled against the normalized asset class targets for the pension portfolio suggest an expected long-term return average of 7.28% with a 95% confidence level. Actual and simulated returns have been impacted materially by two significant bear markets that covered four years since the turn of the millennium. Some long-term data suggests that U.S. equities may be near an inflection point to improving multi-year performance. For example, Ibbotson data from 1826 through 2009 indicates that rolling 10-year returns exhibit some cyclicalities. These returns recently touched historical lows and may be turning upward. In addition, the December 2007 recession ended in mid-2009, suggesting further progress toward economic recovery and positive investment performance. The expected long-term return used for 2012 was 7.75%. Based on the above considerations, it is considered appropriate to maintain the forward expected long-term rates of return at 7.75%.

[92]

The Pension Plan did not hold any shares of First United Corporation common stock at December 31, 2012 or 2011.

Estimated cash flows related to expected future benefit payments from the Pension Plan and SERP are as follows:

(In thousands)	Pension Plan	SERP
2013	\$ 1,053	\$ 127
2014	1,085	194
2015	1,119	187
2016	1,203	179
2017	1,235	237
2018-2022	7,830	1,901

First United Corporation will evaluate future annual contributions to the Pension Plan based upon its funded status and an evaluation of the future benefits to be provided thereunder. The Bank expects to fund the annual projected benefit payments for the SERP from operations.

Amounts included in accumulated other comprehensive loss as of December 31, 2012 and 2011, net of tax, are as follows:

(In thousands)	2012		2011	
	Pension	SERP	Pension	SERP
Unrecognized net actuarial loss	\$8,278	\$ 13	\$6,977	\$ 83
Unrecognized prior service costs	42	39	49	113
Net transition asset	(58 )	0	(81 )	0
	\$8,262	\$ 52	\$6,945	\$ 196

Other changes in plan assets and benefit obligations recognized in other comprehensive loss during the year ended December 31, 2012 were as follows:

Defined Benefit Pension Plan	
Net actuarial loss during the period	\$(2,435)
Reclassification into income:	
Amortization of prior service costs	12
Amortization of transition asset	(39 )
Amortization of unrecognized loss	379

	(2,083)
Supplemental Executive Retirement Plan	
Net actuarial gain during the period	15
Reclassification into income:	
Amortization of prior service costs	123
	138
Change in Plan Assets and Benefit Costs	(1,945)
Tax effect	772
Amount included in other comprehensive loss, net of tax	\$(1,173)

[93]

The estimated costs that will be amortized from accumulated other comprehensive loss into net periodic pension cost during the next fiscal year are as follows:

(In thousands)	Pension	SERP
Prior service costs	\$ 12	\$ 123
Net transition asset	(39 )	0
Net actuarial loss	506	15
	\$ 479	\$ 138

### **19.401(k) Profit Sharing Plan**

The First United Corporation 401(k) Plan is a defined contribution plan that is intended to qualify under section 401(k) of the Internal Revenue Code. The 401(k) Plan covers substantially all employees of First United Corporation and its subsidiaries. Eligible employees can elect to contribute to the plan through payroll deductions. The first 1% of contributions of an employee's base salary are matched at 100% and the next 5% are matched on a 50% basis by the Corporation. Expense charged to operations for the 401(k) Plan was \$.7 million in 2012 and \$.4 million in 2011.

### **20. Federal Reserve Requirements**

The Bank is required to maintain cash reserves with the Reserve Bank based principally on the type and amount of its deposits. During 2012, the daily average amount of these required reserves was approximately \$1.0 million.

### **21. Restrictions on Dividend Payments**

First United Corporation is subject to an informal agreement with the Reserve Bank which requires it to seek the prior approval of the Reserve Bank before making any dividend payment or other distribution on its capital securities or other securities that qualify as Tier 1 capital. On November 15, 2010, First United Corporation, at the request of the Reserve Bank, deferred regular quarterly cash dividend payments on its Series A Preferred Stock. Pursuant to the terms of the Series A Preferred Stock, the deferral prohibits First United Corporation from paying dividends or other distributions on its common stock. On December 15, 2010, First United Corporation, at the request of the Reserve Bank, elected to defer regular quarterly interest payments on its TPS Debentures, beginning with the payments that are due in March 2011. This deferral likewise prohibits First United Corporation from paying any dividends or distributions on its capital securities. As of December 31, 2012, First United Corporation remained in deferral.

### **22. Restrictions on Subsidiary Dividends, Loans or Advances**



Federal and state banking regulations place certain restrictions on the amount of dividends paid and loans or advances made by the Bank to First United Corporation. The total amount of dividends that may be paid at any date is generally limited to the retained earnings of the Bank, and loans or advances are limited to 10 % of the Bank's capital stock and surplus on a secured basis. In addition, dividends paid by the Bank to First United Corporation would be prohibited if the effect thereof would cause the Bank's capital to be reduced below applicable minimum capital requirements. At December 31, 2012, the Bank could have paid additional dividends of \$9.4 million to First United Corporation within these limits. Notwithstanding the foregoing, the Bank is subject to an informal agreement with the FDIC and the Maryland Commissioner of Financial Regulation which requires the Bank to seek the prior approval of these regulators before making any dividend payment to First United Corporation.

### **23. Commitments and Contingent Liabilities**

We are at times, and in the ordinary course of business, subject to legal actions. Management believes that losses, if any, resulting from current legal actions will not have a material adverse effect on our financial condition or results of operations.

Loan commitments are made to accommodate the financial needs of our customers. Loan commitments have credit risk essentially the same as that involved in extending loans to customers and are subject to normal credit policies. Commitments to extend credit generally have fixed expiration dates, may require payment of a fee, and contain cancellation clauses in the event of an adverse change in the customer's credit quality.

[94]

We do not issue any guarantees that would require liability recognition or disclosure other than the standby letters of credit issued by the Bank. Standby letters of credit are conditional commitments issued by the Bank to guarantee the performance of a customer to a third party to support contractual obligations and to ensure job performance. Generally, the Bank's letters of credit are issued with expiration dates within one year. Historically, most letters of credit expire unfunded, and therefore, cash requirements are substantially less than the total commitment. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. The Bank generally holds collateral and/or personal guarantees supporting letters of credit. Management believes that the proceeds obtained through a liquidation of collateral and the enforcement of guarantees would be sufficient to cover the potential amount of future payment required by the letters of credit. Management does not believe that the amount of the liability associated with guarantees under standby letters of credit outstanding at December 31, 2012 and December 31, 2011 is material.

The following table is a summary of commitments as of December 31, 2012 and 2011:

(In thousands)	2012	2011
Loan commitments	\$87,147	\$86,047
Commercial letters of credit	1,312	1,537
Total	\$88,459	\$87,584

#### **24. Fair Value of Financial Instruments**

The Corporation complies with the guidance of ASC Topic 820, *Fair Value Measurements and Disclosures*, which defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements required under other accounting pronouncements. The Corporation also follows the guidance on matters relating to all financial instruments found in ASC Subtopic 825-10, *Financial Instruments – Overall*.

Fair value is defined as the price to sell an asset or to transfer a liability in an orderly transaction between willing market participants as of the measurement date. Fair value is best determined by values quoted through active trading markets. Active trading markets are characterized by numerous transactions of similar financial instruments between willing buyers and willing sellers. Because no active trading market exists for various types of financial instruments, many of the fair values disclosed were derived using present value discounted cash flows or other valuation techniques described below. As a result, the Corporation's ability to actually realize these derived values cannot be assumed.

The Corporation measures fair values based on the fair value hierarchy established in ASC Paragraph 820-10-35-37. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1 measurements) and the lowest priority to unobservable inputs (Level 3 measurements). The three levels of inputs that may be used to measure fair value under the hierarchy are as follows:

*Level 1:* Unadjusted quoted prices in active markets that are accessible at the measurement date for identical, unrestricted assets and liabilities. This level is the most reliable source of valuation.

*Level 2:* Quoted prices that are not active, or inputs that are observable either directly or indirectly, for substantially the full term of the asset or liability. Level 2 inputs include inputs other than quoted prices that are observable for the asset or liability (for example, interest rates and yield curves at commonly quoted intervals, volatilities, prepayment speeds, loss severities, credit risks, and default rates). It also includes inputs that are derived principally from or corroborated by observable market data by correlation or other means (market-corroborated inputs). Several sources are utilized for valuing these assets, including a contracted valuation service, Standard & Poor's ("S&P") evaluations and pricing services, and other valuation matrices.

*Level 3:* Prices or valuation techniques that require inputs that are both significant to the valuation assumptions and not readily observable in the market (i.e. supported with little or no market activity). Level 3 instruments are valued based on the best available data, some of which is internally developed, and consider risk premiums that a market participant would require.

The level established within the fair value hierarchy is based on the lowest level of input that is significant to the fair value measurement. Transfers in and out of Level 1, 2 or 3 are recorded at fair value at the beginning of the reporting period.

[95]

Management believes that the Corporation's valuation techniques are appropriate and consistent with the techniques used by other market participants. However, the use of different methodologies and assumptions could result in a different estimate of fair values at the reporting date. The following valuation techniques were used to measure the fair value of assets in the table below which are measured on a recurring and non-recurring basis as of December 31, 2012.

**Investments** – The investment portfolio is classified and accounted for based on the guidance of ASC Topic 320, *Investments – Debt and Equity Securities*.

The fair value of investments available-for-sale is determined using a market approach. As of December 31, 2012, the U.S. Government agencies and treasuries, residential mortgage-backed securities, private label residential mortgage-backed securities, and municipal bonds segments are classified as Level 2 within the valuation hierarchy. Their fair values were determined based upon market-corroborated inputs and valuation matrices, which were obtained through third party data service providers or securities brokers through which we have historically transacted both purchases and sales of investment securities.

The CDO segment, which consists of pooled trust preferred securities issued by banks, thrifts and insurance companies, is classified as Level 3 within the valuation hierarchy. At December 31, 2012, the Bank owned 18 pooled trust preferred securities with an amortized cost of \$36.8 million and a fair value of \$11.4 million. The market for these securities at December 31, 2012 is not active and markets for similar securities are also not active. The inactivity was evidenced first by a significant widening of the bid-ask spread in the brokered markets in which these securities trade and then by a significant decrease in the volume of trades relative to historical levels. The new issue market is also inactive, as few CDOs have been issued since 2007. There are currently very few market participants who are willing to transact for these securities. The market values for these securities or any securities, other than those issued or guaranteed by the Treasury, are very depressed relative to historical levels. Therefore, in the current market, a low market price for a particular bond may only provide evidence of stress in the credit markets in general rather than being an indicator of credit problems with a particular issue. Given the conditions in the current debt markets and the absence of observable transactions in the secondary and new issue markets, management has determined that (i) the few observable transactions and market quotations that are available are not reliable for the purpose of obtaining fair value at December 31, 2012, (ii) an income valuation approach technique (i.e. present value) that maximizes the use of relevant observable inputs and minimizes the use of unobservable inputs will be equally or more representative of fair value than a market approach, and (iii) the CDO segment is appropriately classified within Level 3 of the valuation hierarchy because management determined that significant adjustments were required to determine fair value at the measurement date.

Management utilizes an independent third party to prepare both the evaluations of other-than-temporary impairment as well as the fair value determinations for its CDO portfolio. Management does not believe that there were any material differences in the impairment evaluations and pricing between December 31, 2012 and December 31, 2011.

The approach of the third party to determine fair value involves several steps, including detailed credit and structural evaluation of each piece of collateral in each bond, default, recovery and prepayment/amortization probabilities for each piece of collateral in the bond, and discounted cash flow modeling. The discount rate methodology used by the third party combines a baseline current market yield for comparable corporate and structured credit products with adjustments based on evaluations of the differences found in structure and risks associated with actual and projected credit performance of each CDO being valued. Currently, the only active and liquid trading market that exists is for stand-alone trust preferred securities. Therefore, adjustments to the baseline discount rate are also made to reflect the additional leverage found in structured instruments.

***Derivative financial instruments (Cash flow hedge)*** – The Corporation’s open derivative positions are interest rate swaps that are classified as Level 3 within the valuation hierarchy. Open derivative positions are valued using externally developed pricing models based on observable market inputs provided by a third party and validated by management. The Corporation has considered counterparty credit risk in the valuation of its interest rate swap assets. Management does not believe that there is a significant concentration with the counterparty.

***Impaired loans*** – Loans included in the table below are those that are considered impaired with a specific allocation based upon the guidance of the loan impairment subsection of the *Receivables* Topic, ASC Section 310-10-35, under which the Corporation has measured impairment generally based on the fair value of the loan’s collateral. Fair value consists of the loan balance less its valuation allowance and is generally determined based on independent third-party appraisals of the collateral or discounted cash flows based upon the expected proceeds. These assets are included as Level 3 fair values based upon the lowest level of input that is significant to the fair value measurements.

***Other real estate owned*** – Fair value of other real estate owned was based on independent third-party appraisals of the properties. These values were determined based on the sales prices of similar properties in the approximate geographic area. These assets are included as Level 3 fair values based upon the lowest level of input that is significant to the fair value measurements.

[96]

For Level 3 assets and liabilities measured at fair value on a recurring and non-recurring basis as of December 31, 2012, the significant unobservable inputs used in the fair value measurements were as follows:

	Fair Value at December 31, 2012	Valuation Technique	Significant Unobservable Inputs	Significant Unobservable Input Value
Recurring:				
Investment Securities – available for sale - CDO	\$ 11,442	Discounted Cash Flow	Discount Rate	Swap+19%; Range of Libor+ 9% to 20%
Cash Flow Hedge	\$ (849 )	Discounted Cash Flow	Reuters Third Party Market Quote	99.9% (weighted avg 99.9%)
Non-recurring:				
Impaired Loans	\$ 13,560	Market Comparable Properties	Marketability Discount	10% <sup>(1)</sup>  (weighted avg 10%)
OREO	\$ 3,165	Market Comparable Properties	Marketability Discount	10% to 15% <sup>(1)</sup> (weighted avg 11%)

(1) Range would include discounts taken since appraisal and estimated values

[97]

For assets measured at fair value on a recurring and non-recurring basis, the fair value measurements by level within the fair value hierarchy used at December 31, 2012 and 2011 are as follows:

Description	Assets Measured at 12/31/2012	Fair Value Measurements at December 31, 2012 Using (In Thousands)	
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)
Recurring:			
Investment securities available-for-sale:			
U.S. government agencies	\$ 40,320	\$ 40,320	
Residential mortgage-backed agencies	\$ 44,108	\$ 44,108	
Commercial mortgage-backed agencies	\$ 37,618	\$ 37,618	
Collateralized mortgage obligations	\$ 31,731	\$ 31,731	
Obligations of states and political subdivisions	\$ 58,054	\$ 58,054	
Collateralized debt obligations	\$ 11,442		\$ 11,442
Financial Derivative	\$ (849 )		\$ (849 )
Non-recurring:			
Impaired loans	\$ 13,560		\$ 13,560
Other real estate owned	\$ 3,165		\$ 3,165

Description	Assets Measured at 12/31/2011	Fair Value Measurements at December 31, 2011 Using (In Thousands)	
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)
Recurring:			
Investment securities available-for-sale:			
U.S. government agencies	\$ 25,580	\$ 25,580	
Residential mortgage-backed agencies	\$ 44,552	\$ 44,552	
Commercial mortgage-backed agencies	\$ 48,277	\$ 48,277	
Collateralized mortgage obligations	\$ 48,351	\$ 48,351	
Obligations of states and political subdivisions	\$ 68,816	\$ 68,816	
Collateralized debt obligations	\$ 9,447		\$ 9,447

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Financial Derivative	\$ (1,034 )	\$ (1,034 )
Non-recurring:		
Impaired loans	\$ 30,320	\$ 30,320
Other real estate owned	\$ 3,449	\$ 3,449

There were no transfers of assets between any of the levels of the fair value hierarchy for the years ended December 31, 2012 or December 31, 2011.

[98]



The following tables show a reconciliation of the beginning and ending balances for fair valued assets measured using Level 3 significant unobservable inputs for the years ended December 31, 2012 and 2011:

	Fair Value Measurements Using Significant Unobservable Inputs (Level 3) (In Thousands)	
	Investment Securities Available for Sale	Cash Flow Hedge
Beginning balance January 1, 2012	\$ 9,447	\$ (1,034 )
Total gains/(losses) realized/unrealized:		
Included in earnings	0	0
Included in other comprehensive loss	1,995	185
Ending balance December 31, 2012	\$ 11,442	\$ (849 )

The amount of total gains or losses for the period included in earnings attributable to the change in realized/unrealized gains or losses related to assets still held at the reporting date

\$ 0                      \$ 0

	Fair Value Measurements Using Significant Unobservable Inputs (Level 3) (In Thousands)	
	Investment Securities Available for Sale	Cash Flow Hedge
Beginning balance January 1, 2011	\$ 9,838	\$ (832 )
Total gains/(losses) realized/unrealized:		
Included in earnings	(19 )	0
Included in other comprehensive loss	(372 )	(202 )
Ending balance December 31, 2011	\$ 9,447	\$ (1,034 )

The amount of total gains or losses for the period included in earnings attributable to the change in realized/unrealized gains or losses related to assets still held at the reporting date

\$ (19 )                      \$ 0

Gains and losses (realized and unrealized) included in earnings for the periods above are reported in the Consolidated Statements of Operations in other operating income.

The fair values disclosed may vary significantly between institutions based on the estimates and assumptions used in the various valuation methodologies. The derived fair values are subjective in nature and involve uncertainties and significant judgment. Therefore, they cannot be determined with precision. Changes in the assumptions could significantly impact the derived estimates of fair value. Disclosure of non-financial assets such as buildings as well as certain financial instruments such as leases is not required. Accordingly, the aggregate fair values presented do not represent the underlying value of the Corporation.

We use the following methods and assumptions in estimating fair value disclosures for financial instruments:

[99]

**Cash and due from banks:** The carrying amounts as reported in the statement of financial condition for cash and due from banks approximate their fair values.

**Interest bearing deposits in banks:** The carrying amount of interest bearing deposits approximates their fair values.

**Restricted investment in Bank stock:** The carrying value of stock issued by the FHLB of Atlanta, ACBB and CBB approximates fair value based on the redemption provisions of the stock.

**Loans (excluding impaired loans with specific loss allowances):** For variable-rate loans that reprice frequently or “in one year or less”, and with no significant change in credit risk, fair values are based on carrying values. Fair values for fixed-rate loans that do not reprice frequently are estimated using a discounted cash flow calculation that applies current market interest rates being offered on the various loan products.

**Deposits:** The fair values disclosed for demand deposits (e.g., interest and non-interest checking, savings, and certain types of money market accounts, etc.) are, by definition, equal to the amount payable on demand at the reporting date (i.e., their carrying amounts). Fair values for fixed-rate certificates of deposit are estimated using a discounted cash flow calculation that applies interest rates currently being offered on the various certificates of deposit to the cash flow stream.

**Short-term borrowings:** The carrying amount of short-term borrowings approximates their fair values.

**Borrowed funds:** The fair value of the Bank’s FHLB borrowings and First United Corporation’s TPS Debentures is calculated based on the discounted value of contractual cash flows, using rates currently existing for borrowings with similar remaining maturities. The carrying amounts of federal funds purchased and securities sold under agreements to repurchase approximate their fair values.

**Accrued interest:** The carrying amount of accrued interest receivable and payable approximates their fair values.

**Off-balance-sheet financial instruments:** In the normal course of business, the Bank makes commitments to extend credit and issues standby letters of credit. The Bank expects most of these commitments to expire without being drawn upon; therefore, the commitment amounts do not necessarily represent future cash requirements. Due to the uncertainty of cash flows and difficulty in the predicting the timing of such cash flows, fair values were not estimated

for these instruments.

[100]

The following table presents fair value information about financial instruments, whether or not recognized in the statement of financial condition, for which it is practicable to estimate that value. The actual carrying amounts and estimated fair values of the Corporation's financial instruments that are included in the statement of financial condition are as follows:

(in thousands)	December 31, 2012		Fair Value Measurements		Significant Unobservable Inputs (Level 3)
	Carrying Amount	Fair Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	
<b>Financial Assets:</b>					
Cash and due from banks	\$71,290	\$71,290	\$71,290		
Interest bearing deposits in banks	11,778	11,778	11,778		
Investment securities - AFS	223,273	223,273		\$ 211,831	\$ 11,442
Investment securities - HTM	4,040	4,347			4,347
Restricted Bank stock	8,349	8,349		8,349	
Loans, net	858,782	865,405			865,405
Accrued interest receivable	4,494	4,494		4,494	
<b>Financial Liabilities:</b>					
Deposits – non-maturity	593,224	593,224		593,224	
Deposits – time deposits	383,660	392,155		392,155	
Short-term borrowed funds	39,257	39,257		39,257	
Long-term borrowed funds	182,735	190,531		190,531	
Accrued interest payable	5,415	5,415		5,415	
Financial derivative	849	849			849
Off balance sheet financial instruments	0	0	0		

(In thousands)	2011	
	Carrying Amount	Fair Value
<b>Financial Assets:</b>		
Cash and due from banks	\$52,049	\$ 52,049
Interest bearing deposits in banks	13,058	13,058
Investment securities-AFS	245,023	245,023
Restricted Bank stock	10,726	10,726
Loans, net	919,214	918,156
Accrued interest receivable	5,058	5,058

Financial Liabilities:

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Deposits	1,027,784	994,165
Borrowed funds	243,912	251,850
Accrued interest payable	3,512	3,512
Financial derivative	1,034	1,034
Off balance sheet financial instruments	0	0

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## 25. Derivative Financial Instruments

As a part of managing interest rate risk, the Bank entered into interest rate swap agreements to modify the re-pricing characteristics of certain interest-bearing liabilities. The Bank has designated its interest rate swap agreements as cash flow hedges under the guidance of ASC Subtopic 815-30, *Derivatives and Hedging – Cash Flow Hedges*. Cash flow hedges have the effective portion of changes in the fair value of the derivative, net of taxes, recorded in net accumulated other comprehensive income.

In July 2009, the Bank entered into three interest rate swap contracts totaling \$20.0 million notional amount, hedging future cash flows associated with floating rate trust preferred debt. The fair value of the interest rate swap contracts was (\$.8) million and (\$1.0) million at December 31, 2012 and December 31, 2011, respectively, and was reported in Other Liabilities on the Consolidated Statements of Financial Condition. Cash in the amount of \$1.4 million was posted as collateral as of December 31, 2012 and December 31, 2011.

For the year ended December 31, 2012, the Bank recorded an increase in the value of the derivatives of \$185 thousand and the related deferred tax benefit of \$76 thousand in net accumulated other comprehensive loss to reflect the effective portion of cash flow hedges. ASC Subtopic 815-30 requires this amount to be reclassified to earnings if the hedge becomes ineffective or is terminated. There was no hedge ineffectiveness recorded for the year ended December 31, 2012. The Bank does not expect any losses relating to these hedges to be reclassified into earnings within the next 12 months.

Interest rate swap agreements are entered into with counterparties that meet established credit standards and we believe that the credit risk inherent in these contracts is not significant as of December 31, 2012.

The table below discloses the impact of derivative financial instruments on the Corporation's Consolidated Financial Statements for the years ended December 31, 2012 and year ended December 31, 2011.

### Derivative in Cash Flow Hedging Relationships

(In thousands)	Amount of gain (loss) recognized in OCI on derivative (effective portion)	Amount of gain or (loss) reclassified from accumulated OCI into income (effective portion)	Amount of gain or (loss) recognized in income on derivative (ineffective portion and amount excluded from effectiveness testing) <sup>(2)</sup>
Interest rate contracts:			
December 31, 2012	\$ 185	\$ 0	\$ 0
December 31, 2011	\$ (202)	\$ 0	\$ 0

**Notes:**

- (1) Reported as interest expense
- (2) Reported as other income

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**26. Parent Company Only Financial Information**

## Condensed Statement of Financial Condition

(In thousands)	December 31,	
	2012	2011
Assets		
Cash	\$2,449	\$1,943
Investment in bank subsidiary	146,876	141,651
Investment in non-bank subsidiaries	4,195	4,129
Other assets	2,802	2,392
Total Assets	\$156,322	\$150,115
Liabilities and Shareholder's Equity		
Accrued interest and other liabilities	\$10,687	\$4,807
Dividends payable	0	1,922
Junior subordinated debt	46,730	46,730
Shareholder's equity	98,905	96,656
Total Liabilities and Shareholder's Equity	\$156,322	\$150,115

## Condensed Statement of Income

(In thousands)	Year Ended December 31,	
	2012	2011
Income:		
Dividend income from bank subsidiary	\$0	\$0
Other income	338	101
Total Income	338	101
Expenses:		
Interest expense	2,802	2,680
Other expenses	384	164
Total Expenses	3,186	2,844
Loss before income taxes and equity in undistributed net loss of subsidiaries	(2,848)	(2,743)
Applicable income taxes	0	0
Net loss before equity in undistributed net loss of subsidiaries	(2,848)	(2,743)
Equity in undistributed net income/(loss)of subsidiaries:		
Bank	7,462	6,462
Non-bank	49	(93 )

Net Income	\$4,663	\$3,626
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## Condensed Statement of Comprehensive Income

<b>Components of Comprehensive Income (in thousands)</b>	Year ended December 31,	
	2012	2011
Net Income	\$4,663	\$3,626
Unrealized gains/(losses) on cash flow hedges	185	(202 )
Taxes	(76 )	82
Net unrealized gains/(losses) on cash flow hedges	109	(120 )
Other comprehensive income/(loss), net of tax	109	(120 )
<b>Comprehensive income</b>	<b>\$4,772</b>	<b>\$3,506</b>

## Condensed Statement of Cash Flows

(In thousands)	Year Ended December 31,	
	2012	2011
Operating Activities		
Net Income	\$4,663	\$3,626
Adjustments to reconcile net income to net cash provided by/(used in)operating activities:		
Equity in undistributed net income of subsidiaries	(7,511)	(6,369)
Increase in other assets	(303 )	(127 )
Increase in accrued interest payable and other liabilities	3,958	3,731
Stock Compensation	73	78
Net cash provided by operating activities	880	939
Investing Activities		
Net investment in subsidiaries	1,252	995
Net cash provided by investing activities	1,252	995
Financing Activities		
Dividends - preferred stock deferred	(1,626)	(1,547)
Net cash used in financing activities	(1,626)	(1,547)
Increase in cash and cash equivalents	506	387
Cash and cash equivalents at beginning of year	1,943	1,556
Cash and cash equivalents at end of year	\$2,449	\$1,943

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ITEM CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND  
9. FINANCIAL DISCLOSURE

None.

ITEM 9A. CONTROLS AND PROCEDURES

First United Corporation maintains disclosure controls and procedures that are designed to ensure that information required to be disclosed in First United Corporation's reports filed under the Exchange Act with the SEC, such as this annual report, is recorded, processed, summarized and reported within the time periods specified in those rules and forms, and that such information is accumulated and communicated to First United Corporation's management, including the principal executive officer ("PEO") and the principal accounting officer ("PAO"), as appropriate, to allow for timely decisions regarding required disclosure. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. These inherent limitations include the realities that judgments in decision-making can be faulty, and that breakdowns can occur because of simple error or mistake. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the control. The design of any system of controls also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions; over time, a control may become inadequate because of changes in conditions, or the degree of compliance with the policies or procedures may deteriorate.

An evaluation of the effectiveness of these disclosure controls as of December 31, 2012 was carried out under the supervision and with the participation of First United Corporation's management, including the PEO and the PAO. Based on that evaluation, the Corporation's management, including the PEO and the PAO, has concluded that First United Corporation's disclosure controls and procedures are, in fact, effective at the reasonable assurance level.

During the fourth quarter of 2012, there was no change in First United Corporation's internal control over financial reporting that has materially affected, or is reasonably likely to materially affect, First United Corporation's internal control over financial reporting.

As required by Section 404 of the Sarbanes-Oxley Act of 2002, management has performed an evaluation and testing of First United Corporation's internal control over financial reporting as of December 31, 2012. Management's report on First United Corporation's internal control over financial reporting is included on the following page. First United Corporation is a "smaller reporting company" as defined by Exchange Act Rule 12b-2 and, accordingly, its independent registered public accounting firm is not required to attest to the foregoing management report.

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## Management's Report on Internal Control Over Financial Reporting

The Board of Directors and Shareholders

First United Corporation

First United Corporation's management is responsible for establishing and maintaining adequate internal control over financial reporting. This internal control system was designed to provide reasonable assurance to management and the Board of Directors as to the reliability of First United Corporation's financial reporting and the preparation and presentation of financial statements for external purposes in accordance with accounting principles generally accepted in the United States, as well as to safeguard assets from unauthorized use or disposition.

An internal control system, no matter how well designed, has inherent limitations. Therefore, even those systems determined to be effective can provide only reasonable assurance with respect to financial statement preparation and presentation and may not prevent or detect misstatements in the financial statements or the unauthorized use or disposition of First United Corporation's assets. Also, projections of any evaluation of effectiveness of internal controls to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with policies and procedures may deteriorate.

Management assessed the effectiveness of First United Corporation's internal control over financial reporting as of December 31, 2012, based on the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in Internal Control—Integrated Framework. Based on this assessment and on the foregoing criteria, management has concluded that, as of December 31, 2012, First United Corporation's internal control over financial reporting is effective.

Dated: March 15, 2013

/s/ William B. Grant  
William B. Grant, Esq., CFP  
Chairman of the Board and  
Chief Executive Officer

/s/ Carissa L. Rodeheaver  
Carissa L. Rodeheaver, CPA, CFP  
President and  
Chief Financial Officer

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ITEM 9B. OTHER INFORMATION

None.

PART III

ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE

First United Corporation has adopted a Code of Ethics applicable to its principal executive officer, principal financial officer, principal accounting officer, or controller, or persons performing similar functions, a Code of Ethics applicable to all employees, and a Code of Ethics applicable to members of the Board of Directors. Copies of First United Corporation's Codes of Ethics are available free of charge upon request to Mr. Jason B. Rush, Chief Risk and Operations Officer, First United Corporation, c/o First United Bank & Trust, P.O. Box 9, Oakland, MD 21550-0009. Copies are also available on First United Corporation's website at [www.mybank4.com](http://www.mybank4.com) in the "My Community" tab under "Investors – Corporate Governance".

All other information required by this item is incorporated herein by reference to the following sections of First United Corporation's definitive Proxy Statement for the 2013 Annual Meeting of Shareholders to be filed with the SEC pursuant to Regulation 14A:

Continuing Directors;

Election of Directors (Proposal 1);

Qualifications of Director Nominees and Current Directors;  
Executive Officers;  
Section 16(a) Beneficial Ownership and Reporting Compliance; and  
Corporate Governance Matters (under Audit Committee).

ITEM 11. EXECUTIVE  
COMPENSATION

The information required by this item is incorporated herein by reference to the sections of First United Corporation's definitive Proxy Statement for the 2013 Annual Meeting of Shareholders to be filed with the SEC pursuant to Regulation 14A entitled "Director Compensation" and "Remuneration of Executive Officers".

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ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

At the 2007 Annual Meeting of Shareholders, First United Corporation's shareholders approved the First United Corporation Omnibus Equity Compensation Plan (the "Omnibus Plan"), which authorizes the grant of stock options, stock appreciation rights, stock awards, stock units, performance units, dividend equivalents, and other stock-based awards. The following table contains information about the Omnibus Plan as of December 31, 2012:

Plan Category	Number of securities to be issued upon exercise of outstanding options, warrants, and rights (a)	Weighted-average exercise price of outstanding options, warrants, and rights (b)	Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a)) (c)
Equity compensation plans approved by security holders	0	N/A	129,889 (1)
Equity compensation plans not approved by security holders	0	N/A	N/A
Total	0	N/A	129,889

**Note:**

In addition to stock options and stock appreciation rights, the Omnibus Plan permits the grant of stock awards, stock units, performance units, dividend equivalents, and other stock-based awards. Subject to the anti-dilution provisions of the Omnibus Plan, the maximum number of shares for which awards may be granted to any one participant in any calendar year is 20,000, without regard to whether an award is paid in cash or shares.

All other information required by this item is incorporated herein by reference to the section of First United Corporation's definitive Proxy Statement for the 2013 Annual Meeting of Shareholders to be filed with the SEC pursuant to Regulation 14A entitled "Beneficial Ownership of Common Stock by Principal Shareholders and Management".

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS, AND DIRECTOR INDEPENDENCE

The information required by this item is incorporated herein by reference to the following sections of First United Corporation's definitive Proxy Statement for the 2013 Annual Meeting of Shareholders to be filed with the SEC pursuant to Regulation 14A entitled "Certain Relationships and Related Transactions" and "Corporate Governance Matters" (under "Director Independence").

ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES

The information required by this item is incorporated herein by reference to the section of First United Corporation's definitive Proxy Statement for the 2013 Annual Meeting of Shareholders to be filed with the SEC pursuant to Regulation 14A entitled "Audit Fees and Services".

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PART IV

ITEM 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES

(a)(1), (2) and (c) Financial Statements.

Report of Independent Registered Public Accounting Firm

Consolidated Statement of Financial Condition as of December 31, 2012 and 2011

Consolidated Statement of Income for the years ended December 31, 2012 and 2011

Consolidated Statement of Comprehensive Income for the years ended December 31, 2012 and 2011

Consolidated Statement of Changes in Shareholders' Equity for the years ended December 31, 2012 and 2011

Consolidated Statement of Cash Flows for the years ended December 31, 2012 and 2011

Notes to Consolidated Financial Statements for the years ended December 31, 2012 and 2011

(a)(3) and (b) Exhibits.

The exhibits filed or furnished with this annual report are listed on the Exhibit Index that follows the signatures to this annual report, which list is incorporated herein by reference.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

FIRST UNITED CORPORATION

Dated: March 15, 2013 By: /s/ William B. Grant

William B. Grant, Esq., CFP  
Chairman of the Board and Chief Executive Officer  
(Principal Executive Officer)

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Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities indicated.

/s/ William B. Grant

William B. Grant – Director and Chief Executive Officer,  
(Principal Executive Officer)  
March 15, 2013

/s/ David J. Beachy

David J. Beachy - Director  
March 15, 2013

/s/ M. Kathryn Burkey

M. Kathryn Burkey - Director  
March 15, 2013

/s/ Paul Cox, Jr.

Paul Cox, Jr. - Director  
March 15, 2013

/s/ Robert W. Kurtz

Robert W. Kurtz – Director  
March 15, 2013

/s/ John W. McCullough

John W. McCullough – Director  
March 15, 2013

/s/ Elaine L. McDonald

Elaine L. McDonald - Director  
March 15, 2013

/s/ Donald E. Moran

Donald E. Moran – Director  
March 15, 2013

/s/ Carissa L. Rodeheaver

Carissa L. Rodeheaver – Director and President  
and Chief Financial Officer  
(Principal Accounting Officer)  
March 15, 2013

/s/ Gary R. Ruddell

Gary R. Ruddell - Director  
March 15, 2013

/s/ I. Robert Rudy

I. Robert Rudy - Director  
March 15, 2013

/s/ Richard G. Stanton

Richard G. Stanton – Director  
March 15, 2013

/s/ Robert G. Stuck

Robert G. Stuck - Director  
March 15, 2013

/s/ H. Andrew Walls III

H. Andrew Walls III – Director  
March 15, 2013

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EXHIBIT INDEX

**Exhibit Description**

- 3.1(i) Amended and Restated Articles of Incorporation (incorporated by reference to Exhibit 3.1 of First United Corporation's Quarterly Report on Form 10-Q for the period ended June 30, 1998)
- 3.2(i) Amended and Restated Bylaws (incorporated by reference to Exhibit 3.2(i) of First United Corporation's Annual Report on Form 10-K for the year ended December 31, 2007)
- 3.2(ii) First Amendment to Amended and Restated Bylaws (incorporated by reference to Exhibit 3.2(ii) of First United Corporation's Annual Report on Form 10-K for the year ended December 31, 2007)
- 3.2(iii) Second Amendment to Amended and Restated Bylaws (incorporated by reference to Exhibit 3.2 of First United Corporation's Current Report on Form 8-K filed on February 9, 2009)
- 4.1 Letter Agreement, including the related Securities Purchase Agreement – Standard Terms, dated January 30, 2009 by and between First United Corporation and the U.S. Department of Treasury (incorporated by reference to Exhibit 10.1 of First United Corporation's Form 8-K filed on February 2, 2009)
- 4.2 Certificate of Notice, including the Certificate of Designations incorporated therein, relating to the Fixed Rate Cumulative Perpetual Preferred Stock, Series A (incorporated by reference Exhibit 4.1 of First United Corporation's Form 8-K filed on February 2, 2009)
- 4.3 Sample Stock Certificate for Series A Preferred Stock for the Series A Preferred Stock (incorporated by reference Exhibit 4.3 of First United Corporation's Form 8-K filed on February 2, 2009)
- 4.4 Common Stock Purchase Warrant dated January 30, 2009 issued to the U.S. Department of Treasury (incorporated by reference to Exhibit 4.2 of First United Corporation's Form 8-K filed on February 2, 2009)
- 4.5 Amended and Restated Declaration of Trust, dated as of December 30, 2009 (incorporated by reference to Exhibit 4.1 of First United Corporation's Current Report on Form 8-K filed on December 30, 2009)
- 4.6 Indenture, dated as of December 30, 2009 (incorporated by reference to Exhibit 4.2 of First United Corporation's Current Report on Form 8-K filed on December 30, 2009)
- 4.7 Preferred Securities Guarantee Agreement, dated as of December 30, 2009 (incorporated by reference to Exhibit 4.3 of First United Corporation's Current Report on Form 8-K filed on December 30, 2009)
- 4.8 Form of Preferred Security Certificate of First United Statutory Trust III (included as Exhibit C of Exhibit 4.5)
- 4.9 Form of Common Security Certificate of First United Statutory Trust III (included as Exhibit B of Exhibit 4.5)
- 4.10 Form of Junior Subordinated Debenture of First United Corporation (included as Exhibit A of Exhibit 4.6)

- 10.1 First United Bank & Trust Amended and Restated Supplemental Executive Retirement Plan (“SERP”) (incorporated by reference to Exhibit 10.4 of First United Corporation’s Current Report on Form 8-K filed on February 21, 2007)
- 10.2 Second Amended and Restated Participation Agreement, dated as of August 12, 2011, under the SERP between First United Bank & Trust and William B. Grant (incorporated by reference to Exhibit 10.1 of the Corporation’s Quarterly Report on Form 10-Q for the period ended September 30, 2011)
- 10.3 Form of Second Amended and Restated Participation Agreement, dated as of August 12, 2011, under the SERP between First United Bank & Trust and executive officers other than William B. Grant (incorporated by reference to Exhibit 10.2 of First United Corporation’s Quarterly Report on Form 10-Q for the period ended September 30, 2011)
- 10.4 Form of Endorsement Split Dollar Agreement between the Bank and each of William B. Grant, Robert W. Kurtz, Jeannette R. Fitzwater, Phillip D. Frantz, Eugene D. Helbig, Jr., Steven M. Lantz, Robin M. Murray, Carissa L. Rodeheaver, and Frederick A. Thayer, IV (incorporated by reference to Exhibit 10.3 of First United Corporation’s Quarterly Report on Form 10-Q for the period ended September 30, 2003)
- 10.5 Amended and Restated First United Corporation Executive and Director Deferred Compensation Plan (incorporated by reference to Exhibit 10.1 of First United Corporation’s Current Report on Form 8-K filed on November 24, 2008)
- 10.6 Amended and Restated First United Corporation Change in Control Severance Plan (incorporated by reference to Exhibit 10.5 of First United Corporation’s Current Report on Form 8-K filed on June 23, 2008)

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- 10.7 Change in Control Severance Plan Agreement, dated as of February 14, 2007, with William B. Grant (incorporated by reference to Exhibit 10.2 of First United Corporation's Current Report on Form 8-K filed on February 21, 2007)
- 10.8 First Amendment to Change in Control Severance Plan Agreement, dated as of December 28, 2012, with William B. Grant (filed herewith)
- 10.9 Form of Change in Control Severance Plan Agreement, dated as of February 14, 2007, with executive officers other than William B. Grant (incorporated by reference to Exhibit 10.3 of First United Corporation's Current Report on Form 8-K filed on February 21, 2007)
- 10.10 Form of First Amendment to Change in Control Severance Plan Agreement, dated as of December 28, 2012, with executive officers other than William B. Grant (filed herewith)
- 10.11 First United Corporation Omnibus Equity Compensation Plan (incorporated by reference to Appendix B to First United Corporation's 2007 definitive proxy statement filed on March 23, 2007)
- 10.12 First United Corporation Long-Term Incentive Plan (incorporated by reference to Exhibit 10.1 of First United Corporation's Current Report on Form 8-K filed on June 23, 2008)
- 10.13 Restricted Stock Agreement for William B. Grant (incorporated by reference to Exhibit 10.2 of First United Corporation's Current Report on Form 8-K filed on June 23, 2008)
- 10.14 Form of Restricted Stock Agreement for Executive Officers other than the Chief Executive Officer (incorporated by reference to Exhibit 10.3 of First United Corporation's Current Report on Form 8-K filed on June 23, 2008)
- 10.15 First United Corporation Executive Pay for Performance Plan (incorporated by reference to Exhibit 10.4 of First United Corporation's Current Report on Form 8-K filed on June 23, 2008)
- 10.16 Consulting Agreement, dated as of December 7, 2009, among First United Corporation, First United Bank & Trust and Robert W. Kurtz (incorporated by reference to Exhibit 10.1 of First United Corporation's Current Report on Form 8-K filed on December 7, 2009)
- 21 Subsidiaries of First United Corporation (incorporated by reference to the identification of subsidiaries contained in Item 1 of Part I of this Annual Report on Form 10-K under the heading "General")
- 23.1 Consent of ParenteBeard LLC, Independent Registered Public Accounting Firm (filed herewith)
- 31.1 Certifications of Principal Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act (filed herewith)
- 31.2 Certifications of Principal Accounting Officer pursuant to Section 302 of the Sarbanes-Oxley Act (filed herewith)
- 32.1 Certifications pursuant to Section 906 of the Sarbanes-Oxley Act (furnished herewith)
- 99.1 Certifications of Principal Executive Officer pursuant to 31 C.F.R. § 30.15 (filed herewith)



99.2 Certifications of Principal Accounting Officer pursuant to 31 C.F.R. § 30.15 (filed herewith)

101.INS XBRL Instance Document (furnished herewith)

101.SCH XBRL Taxonomy Extension Schema (furnished herewith)

101.CAL XBRL Taxonomy Extension Calculation Linkbase (furnished herewith)

101.DEF XBRL Taxonomy Extension Definition Linkbase (furnished herewith)

101.LAB XBRL Taxonomy Extension Label Linkbase (furnished herewith)

101.PRE XBRL Taxonomy Extension Presentation Linkbase (furnished herewith)

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