

SANDY SPRING BANCORP INC  
Form DEF 14A  
April 01, 2014

**SCHEDULE 14A INFORMATION**

**Proxy Statement Pursuant to Section 14(a) of the Securities**

**Exchange Act of 1934 (Amendment No. \_\_\_\_)**

Filed by the Registrant

Filed by a Party other than the Registrant

Check the appropriate box:

- Preliminary Proxy Statement
- Confidential, for Use of the Commission Only (as permitted by Rule 14a-6(e)(2))
- Definitive Proxy Statement
- Definitive Additional Materials
- Soliciting Material pursuant to §240.14a-12

**SANDY SPRING BANCORP, INC.**

(Name of Registrant as Specified in Its Charter)

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

Payment of Filing Fee (Check the appropriate box):

- No fee required.
- Fee computed on table below per Exchange Act Rules 14a-6(i)(1) and 0-11.

1. Title of each class of securities to which transaction applies:

2. Aggregate number of securities to which transaction applies:

3. Per unit price or other underlying value of transaction computed pursuant to Exchange Act Rule 0-11 (set forth the amount on which the filing fee is calculated and state how it was determined):

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1. Amount Previously Paid:

2. Form, Schedule or Registration Statement No.:

3. Filing Party:

4. Date Filed:

## **NOTICE OF 2014 ANNUAL MEETING OF SHAREHOLDERS**

### **TO BE HELD**

Wednesday, May 7, 2014, 3:00 p.m.

Manor Country Club

14901 Carrolton Road, Rockville, MD 20853

The 2014 annual meeting of shareholders of Sandy Spring Bancorp, Inc. (“Bancorp”) will be held as indicated above for the purpose of considering:

- (1) The election of Mark E. Friis, Pamela A. Little, and Craig A. Ruppert to serve as Class II directors with terms expiring at the 2017 annual meeting, in each case until their successors are duly elected and qualified;
- (2) A non-binding resolution to approve the compensation for the named executive officers;
- (3) The ratification of the appointment of Ernst & Young LLP as Bancorp’s independent registered public accounting firm for the year 2014; and
- (4) Such other business as may properly come before the annual meeting or any adjournment thereof.

The board of directors established March 19, 2014 as the record date for this meeting. Shareholders of record of Bancorp common stock as of the close of business on that date are entitled to receive this notice of meeting and vote their shares at the meeting and any adjournments or postponements of the meeting.

Your vote is very important. The board urges each shareholder to promptly sign and return the enclosed proxy card or to use telephone or Internet voting, as described on the card. If you choose to attend the meeting, you may withdraw your proxy and vote in person.

By order of the board of directors,

Ronald E. Kuykendall  
General Counsel & Secretary

Olney, Maryland

April 1, 2014

Important Notice Regarding the Availability of Proxy Materials for the  
2014 Annual Meeting of Shareholders to be Held on May 7, 2014

This proxy statement and the 2013 Annual Report on Form 10-K are available at [www.sandyspringbank.com/proxy](http://www.sandyspringbank.com/proxy).

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SANDY SPRING BANCORP, INC.

PROXY STATEMENT

### **General Information**

The board of directors of Sandy Spring Bancorp, Inc., (“Bancorp”) has furnished this proxy statement to you in connection with the solicitation of proxies to be used at the 2014 annual meeting of shareholders. The meeting will be held on Wednesday, May 7, 2014, at 3:00 p.m. at Manor Country Club, 14901 Carrolton Road, Rockville, Maryland 20853. The notice of annual meeting, the proxy card, and this proxy statement are being first mailed on or about April 1, 2014, to shareholders of record as of the close of business on March 19, 2014 (the “Record Date”). The mailing address of our executive offices is Sandy Spring Bancorp, Inc., 17801 Georgia Avenue, Olney, MD 20832.

### **Who Can Vote and What Constitutes a Quorum**

Shareholders of Bancorp common stock, par value \$1.00 per share, as of the close of business on the Record Date may vote. Each share of common stock is entitled to one vote. As of the Record Date 25,230,674 shares of Bancorp common stock were outstanding and eligible to vote. When you execute your right to vote, you authorize the persons named as proxies to vote your shares per your instructions whether or not you attend the annual meeting. The presence, in person or by proxy, of at least a majority of the total number of outstanding shares of common stock is necessary to constitute a quorum at the annual meeting. Proxies marked as abstentions and proxies for shares held in the name of a broker, or other nominee, marked as not voted (broker non-votes) will be counted only for purposes of determining a quorum at the annual meeting.

### **Exercising Your Right to Vote**

By submitting your proxy instructions by card, telephone, or Internet in time to be voted at the annual meeting, the shares represented by your proxy will be voted in accordance with those instructions. Executed but unmarked proxies will be voted FOR the election of all nominees for director, FOR the approval of executive compensation, and FOR the ratification of the appointment of Ernst & Young LLP as Bancorp’s independent registered public accounting firm for 2014. If you are a registered shareholder, meaning you hold your shares directly with Bancorp, and you do not return your proxy, no votes will be cast on your behalf on any of the items of business at the annual meeting.

The board of directors does not know of any other matters that are to come before the annual meeting except for incidental or procedural matters. If any other matters are properly brought before the annual meeting, the persons named in the accompanying proxy card will vote the shares represented by each proxy on such matters in accordance with their best judgment.

### Shares Held Through a Broker

If you hold your shares through a broker, or other nominee, it is critical that you cast your vote if you want it to count in the election of directors (Proposal I of this proxy statement) or the advisory vote on executive compensation (Proposal II of this proxy statement). **Your broker is not allowed to vote shares on your behalf on such matters without your specific instruction.** If you do not instruct your broker how to vote in the election of directors or the advisory vote on executive compensation, no votes will be cast on your behalf. Your broker will, however, continue to have discretion to vote any uninstructed shares on matters considered routine items, such as the ratification of the appointment of Bancorp's independent registered public accounting firm (Proposal III of this proxy statement).

### Telephone and Internet Voting

Bancorp is pleased to offer its shareholders the convenience of voting by telephone and online via the Internet. Please check your proxy card for instructions. If you hold your shares in street name, your broker may allow you to provide voting instructions by telephone or via the Internet. Please check the voting instructions provided by your broker.



### **How to Attend the Meeting In Person and What to Bring**

All shareholders will be asked to check-in at the registration desk prior to admittance to the meeting. Shareholders who own Bancorp stock through a broker, or other nominee, will need to bring a statement as proof of ownership along with photo identification. No cameras or recording equipment will be permitted in the meeting, and all cell phones must be turned off.

If you hold your shares through a broker, or other nominee, and you wish to vote your shares in person at the meeting, you will need to ask the holder for a legal proxy. You will need to bring the legal proxy with you to the meeting and turn it in with a signed ballot that will be provided to you at the meeting.

### **Changing Your Vote**

Your presence at the annual meeting will not automatically revoke your proxy. However, you may revoke your proxy at any time prior to its exercise by 1) filing a written notice of revocation with Ronald E. Kuykendall, General Counsel and Secretary; or 2) delivering to Bancorp a duly executed proxy bearing a later date; or 3) attending the annual meeting and casting a ballot in person.

### **Delivery and Accessibility of Proxy Materials**

To reduce costs, Bancorp utilizes the householding rules of the Securities and Exchange Commission (“SEC”) that permit the delivery of one set of proxy materials to shareholders who have the same address to achieve the benefit of reduced printing and mailing costs. Shareholders residing at a shared address will continue to receive separate proxy cards. If you wish to receive a separate set of materials, please write or call as specified below, and we will promptly mail them to you at no charge. If a broker, or other nominee, holds your shares, please contact your broker or nominee directly.

The Annual Report on Form 10-K for the year ended December 31, 2013, as filed with the SEC, excluding exhibits, is provided with this proxy statement and both documents are available on the Internet at [www.sandyspringbank.com/proxy](http://www.sandyspringbank.com/proxy). Shareholders may obtain a copy of the exhibits to the Annual Report on Form 10-K by writing Ronald E. Kuykendall, General Counsel and Secretary, at Sandy Spring Bancorp, Inc., 17801 Georgia Avenue, Olney, Maryland 20832. Shareholders also may access a copy of the Form 10-K including exhibits on the SEC web site at [www.sec.gov](http://www.sec.gov).

### **Costs of Proxy Solicitation**

The cost of soliciting proxies will be borne by Bancorp. In addition to the solicitation of proxies by mail, Bancorp also may solicit proxies through its directors, officers, and employees. Bancorp also will request persons, firms, and corporations holding shares in their names or in the name of nominees that are beneficially owned by others to send proxy materials to and obtain proxies from those beneficial owners and will reimburse the holders for their reasonable expenses in doing so.

#### **Tabulation of Votes and Public Announcement of Results**

The board of directors has appointed Registrar and Transfer Company (“R&T”) to act as inspector of election at the annual meeting of shareholders. A designated representative from R&T, under oath, will carry out the duties of tabulating the votes at the meeting. The results will be announced at the end of the meeting, and filed with the SEC on Form 8-K within four business days. Shareholders may view the Form 8-K on the investor relations page of [www.sandyspringbank.com](http://www.sandyspringbank.com).

## **PROPOSAL I: Election of Directors**

The board of directors (“board”) is elected by shareholders to represent their interest in Bancorp. With the exception of those matters reserved for shareholders, the board is the highest and ultimate decision-making authority. The board works closely with executive management and oversees the development and execution of Bancorp’s business strategy.

### **Board Complement**

Bancorp maintains a classified board, meaning that only a portion of the board is elected each year. The classified structure provides stability of leadership and supports Bancorp’s long-term strategy. Bancorp’s board is divided into three classes, nearly equal in number as possible. In general, the term of only one class of directors expires each year, and the directors within that class are elected for a term of three years or until their successors are elected and qualified.

There were no changes to the complement of directors on the board since the last proxy statement. If all director-nominees are elected, following the annual meeting the board will stand at 11 members.

### **Director-Nominees**

Mark E. Friis, Pamela A. Little, and Craig A. Ruppert have been nominated for re-election to a three-year term to expire in 2017.

### **Nomination Process**

The Nominating Committee is responsible for recruiting and recommending candidates to the board. In exercising its duties, the committee considers the present skills and experience on the board and the qualifications that are desired in order to meet Bancorp’s changing needs.

The Corporate Governance Policy outlines the general competencies required of all directors including the highest standards in exercising his or her duty of loyalty, care and commitment to all shareholders of Bancorp. Prior to the recruitment of a new director the board gathers input from all directors in order to form a collective picture of the particular competencies needed to fulfill the board’s obligations and support Bancorp’s strategy. Such competencies may include expertise in: the banking industry, financial matters, risk management, marketing, a geographic market, regional economics, strategic planning, executive management, technology or other relevant qualifications. The board also values diversity and seeks to include a broad range of backgrounds, experience and personality styles.

The Nominating Committee encourages suggestions for qualified director candidates from the chief executive officer, the chairman of the board, other directors, and from shareholders, and is responsible for the evaluation of such suggestions. Shareholders may submit suggestions for qualified director candidates by writing to Ronald E. Kuykendall, General Counsel and Secretary, at Sandy Spring Bancorp, Inc., 17801 Georgia Avenue, Olney, Maryland 20832. Submissions should include information regarding a candidate's background, qualifications, experience and willingness to serve as a director. In addition, the Nominating Committee may consider candidates submitted by a third party search firm hired for this purpose. The Nominating Committee uses the same process for evaluating all nominees, including those recommended by shareholders, using the board membership criteria described above. Please see "Shareholder Proposals and Communications" on page 35.

### **Information About Nominees and Incumbent Directors**

The following information sets forth the names of the three nominees for election describing their skills, experience and qualifications for election. Each has given his or her consent to be nominated and has agreed to serve, if elected. If any person nominated by the board of directors is unable to stand for election, the shares represented by proxies may be voted for the election of such other person or persons as the present board of directors may designate.

Also provided is information on the background, skills, and experience of the remaining incumbent directors. Unless described otherwise, each director has held his or her current occupation for at least five years, and the ages listed are as of the Record Date.

The boards of directors of Bancorp and its principal subsidiary Sandy Spring Bank (“the Bank”) are composed of the same persons. Throughout this proxy statement, the singular use of "board of directors" or "board" shall be intended to refer to both boards unless otherwise indicated.

### **Voting Standard**

With respect to the election of directors, a plurality of all the votes cast at the annual meeting will be sufficient to elect a nominee as a director.

### **THE BOARD OF DIRECTORS RECOMMENDS A VOTE "FOR" EACH OF THE NOMINEES NAMED BELOW AS A DIRECTOR OF BANCORP.**

#### **Class II Directors – Nominees for Terms to Expire at the 2017 Annual Meeting**

**Mark E. Friis**, Director, 58, Director since 2005

Mr. Friis is President and CEO of Rodgers Consulting, Inc., a land planning and engineering firm. He is a member of the American Institute of Certified Planners and has numerous affiliations with area professional and civic organizations as well as local government. He currently serves on the board of trustees for Hood College. Mr. Friis is valued for his business management experience, his sales and marketing skills, and in-depth knowledge of the local economy. Mr. Friis chairs the Bank’s Frederick advisory board, and currently chairs the Nominating Committee of the board.

**Pamela A. Little**, Director, 60, Director since 2005

Ms. Little has over 30 years of experience working with companies ranging from privately held start-up firms to large, publicly-traded government contracting firms. She is presently the Executive Vice President and CFO of CALIBRE Systems, Inc., a government contractor, and served as CFO of Planned Systems International during early 2013. Ms. Little was the Co-CEO at the former ATS Corporation, a publicly-traded provider of IT services, from 2011 to 2012, and was CFO from 2007 to 2011. She was also the CFO of Athena Innovative Solutions, Inc. (2005-2007). Ms. Little is on the board of MTSI, Inc., an employee-owned technology firm, and on the advisory board for K2 Group, Inc., a management and technology consulting firm in Northern Virginia. Ms. Little is valued for her range of business experience with public companies, her knowledge of mergers and acquisitions, executive management experience,

human resources experience and her financial expertise. Ms. Little currently chairs the Compensation Committee of the board.

**Craig A. Ruppert**, Director, 60, Director since 2002

Mr. Ruppert is President and CEO of The Ruppert Companies which is comprised of commercial landscape construction and management located in five states; tree-growing operations; and industrial property development. A noted philanthropist, Mr. Ruppert and his company have received numerous awards and recognition for work on behalf of charitable and social causes. Mr. Ruppert is a former Class B director of the Federal Reserve Bank of Richmond. A highly successful entrepreneur, Mr. Ruppert's strengths lie in strategic planning, executive management, mergers and acquisitions and business expertise. Mr. Ruppert currently chairs the Credit and Investment Risk Committee of the board.

**Incumbent Class I Directors – Terms Expiring at the 2015 Annual Meeting**

**Ralph F. Boyd, Jr.**, 57, Director since 2012

Mr. Boyd is a Harvard Law School graduate and previously served as Assistant Attorney General for Civil Rights under President Bush and as Executive Vice President and General Counsel of Freddie Mac. In 2005, Mr. Boyd became the President and CEO of the Freddie Mac Foundation from which he retired in the spring of 2012. He is the current Chairman of the Board of Center City Public Charter Schools in Washington, D.C. Mr. Boyd also currently serves on the board of DirecTV and chairs its Audit Committee. Among other distinctions, Mr. Boyd serves as Chairman of the Board of Trustees for the National Housing Partnership Foundation, as a member of the board of the American Association for People with Disabilities, and as a director on the regional and national boards of Easter Seals. Mr. Boyd's qualifications for nomination include his extensive professional experience, public-company board experience, and risk management experience.

**Susan D. Goff**, 68, Director since 1994

Ms. Goff is the former Director and President of MD-Individual Practice Association, a subsidiary of Mid Atlantic Medical Services, Inc. (MAMSI), a publicly-held healthcare company. Ms. Goff was also an Executive Vice President of MAMSI. In 2004, MAMSI was sold to UnitedHealthcare and Ms. Goff became the regional executive overseeing all products in seven states. She retired in 2005. During her career, Ms. Goff was directly involved with strategic planning, marketing, and product development. Ms. Goff is valued for her executive management and public-company experience and her knowledge of compensation matters.

**Robert L. Orndorff**, Chairman, 57, Director since 1991

Mr. Orndorff is the founder and President of RLO Contractors, Inc., a leading residential and commercial excavating company based in central Maryland. Mr. Orndorff's experience in building a highly successful business with a strong reputation for quality, teamwork, and integrity is a testament to his leadership ability and strongly aligned with Bancorp's culture and values. Mr. Orndorff brings to the board his extensive business experience, leadership skills, strategic planning skills, and knowledge of the local market.

**Daniel J. Schrider**, Director, 49, Director since 2009

Mr. Schrider was named President and CEO of Sandy Spring Bancorp, Inc. on January 1, 2009 and joined the board at that time. Mr. Schrider started his career with Sandy Spring Bank in 1989 and achieved significant success in the commercial banking area. He joined the executive team in 2003 as the Chief Credit Officer and leader in commercial services. Mr. Schrider holds an MBA from Mt. Saint Mary's College and is a graduate of the ABA Stonier Graduate School of Banking. Mr. Schrider currently serves as vice chairman of the Maryland Bankers Association and vice chairman of the advisory board for the Stonier Graduate School of Banking. He is also on the board of directors of the Montgomery County Chamber of Commerce and the Mount Airy Christian Academy.

**Incumbent Class III Directors – Terms Expiring at the 2016 Annual Meeting:**

**Robert E. Henel, Jr.**, 66, Director since 2011

Mr. Henel is the former Chairman, President and CEO of Annapolis Banking & Trust Company, an affiliate bank of the former Mercantile Bankshares Corp., a position he held for 16 years. Upon the acquisition of Mercantile, Mr. Henel became a regional president for PNC Bank for the Annapolis and Anne Arundel County Region until 2010. In addition to 39 years in the banking industry, Mr. Henel is a past chairman of trustees for the Anne Arundel Health System and a past chairman of the Anne Arundel Medical Center Foundation. He has served numerous community, civic, and industry organizations. Mr. Henel's background in banking, executive management, and deep connections to the Annapolis market are highly valued by the board.



**Gary G. Nakamoto, 50, Director since 2011**

Mr. Nakamoto is the principal of The Nakamoto Group, LLC, a consulting firm located in McLean, Virginia. Previously, he was the Chairman of the former Base Technologies (1996 to 2011), a firm that specialized in IT, outsourcing, and consulting. Under Mr. Nakamoto's leadership, Base Technologies was named one of the 2011 Best Places to Work in Virginia and was designated a Top 100 IT federal government contractor. Mr. Nakamoto is currently a member of the AAA Mid-Atlantic Washington Area Regional Board, a board member of the Virginia Chamber of Commerce, and a trustee for The Ohio University Foundation. He also serves on the State Council for Higher Education. Mr. Nakamoto's qualifications include his experience in the government contracting field, executive management experience in the technology industry, his extensive knowledge of the Northern Virginia market, and familiarity with local, state and national government.

**Dennis A. Starliper, 67, Director since 2010**

Mr. Starliper worked for Provident Bankshares Corporation for 24 years and held the position of chief financial officer for 10 years. He retired in 2009. Prior to joining Provident, Mr. Starliper worked for Fairchild Industries, a Fortune 500 aerospace manufacturer. He is a CPA and holds an MBA from Southeastern University. He is currently on the faculty of the Brown School of Business and Leadership at Stevenson University. Mr. Starliper currently chairs the Audit Committee. Among his many qualifications are deep industry experience with a large and respected, local bank; executive management experience with a publicly-traded company; risk management experience and financial expertise.

**Mei Xu, 46, Director since 2012**

Ms. Xu is the President and CEO of Pacific Trade International, Inc., a fully integrated global home fragrance and décor company. Headquartered in Rockville, Maryland, PTI owns and operates Chesapeake Bay Candle, a leading home fragrance brand that draws inspiration from Maryland's shoreline. Ms. Xu is also the CEO for Blissliving Home, a premium interior lifestyle brand. Ms. Xu is a board member of the World Affairs Council, a leading non-profit, non-partisan forum for global education and international affairs. In 2012, she was honored by the World Trade Center Institute with the Maryland International Business Leadership Award and also inducted into the Enterprising Women Hall of Fame by *Enterprising Women* magazine. She is also a member of C200, an invitation-only women CEO organization that helps mentor and foster women in business leadership. Ms. Xu is highly regarded for her knowledge of marketing and retail practices, business acumen, and strategic planning.

**Corporate Governance and Other Matters**

**Corporate Governance Policy and Code of Business Conduct**

The board remains committed to setting a tone of the highest ethical standards and performance for Bancorp's management, officers, and the company as a whole. The board believes that strong corporate governance practices are a critical element of doing business today. To that end, the Corporate Governance Policy is reviewed regularly to ensure that it reflects the best interests of Bancorp and its shareholders.

In addition, Bancorp's board of directors has adopted a Code of Business Conduct (“the Code”) applicable to all directors, officers, and employees of Bancorp and its subsidiaries. It sets forth the legal and ethical standards that govern the conduct of business performed by Bancorp and its subsidiaries. The Code is intended to meet the requirements of Section 406 of the Sarbanes-Oxley Act of 2002, related SEC regulations, and the listing rules of the Nasdaq Stock Market, Inc. More information about corporate governance, including the Corporate Governance Policy and the Code of Business Conduct, may be found on Bancorp's investor relations website at [www.sandyspringbank.com](http://www.sandyspringbank.com).

## **Director Independence**

In accordance with the Corporate Governance Policy, no more than two inside directors may be on the board at any one time. All other directors must be independent. The board of directors has affirmatively determined that all directors other than Mr. Schrider are independent under Nasdaq's listing rules. The board of directors complies with or exceeds the independence requirements for the board and board committees established by the Nasdaq Stock Market, federal securities and banking laws and the additional standards included in Bancorp's Corporate Governance Policy.

## **Board Leadership Structure and Evaluation Process**

The Corporate Governance Policy provides for the selection of a chairman of the board from among the independent directors and states that it is the policy of the board to separate the offices of the chairman and the chief executive officer. This allows the chairman to maintain an independent role in the oversight of management. The chairman of the board also chairs the Executive and Governance Committee, which is comprised of the chairmen of the other standing committees (see Executive and Governance Committee description below).

The board is committed to self-improvement and has established a regular evaluation process. In 2013, that process was facilitated by The Center for Board Excellence ("CBE"), an independent consultant. All directors completed an evaluation on the board's overall effectiveness. The results of the evaluation were compiled by CBE, and a written report was given to the board and discussed in executive session.

## **Board's Role in Risk Oversight**

Bancorp's board fulfills a significant role in the oversight of risk in the company both through the actions of the board as a whole and those of its committees. Credit risk is overseen specifically by the Credit and Investment Risk Committee, which monitors asset quality and the adequacy of the allowance for loan and lease losses. This committee also receives regular investment risk profiles and quarterly updates from the Bank's Asset Liability Committee to monitor compliance with policies concerning interest rate risk, liquidity risk, and capital adequacy. The Compensation Committee reviews reports on risk to the company associated with incentive compensation plans. The Audit Committee meets regularly with the independent registered public accounting firm to receive reports on the results of the audit and review process. In addition, the Audit Committee receives internal audit reports that enable it to monitor operational risk throughout the company. Finally, the board receives a quarterly update from the general counsel on pending large litigation in order to be aware of any potential legal risk facing Bancorp or any of its subsidiaries.

## **Board Committees**

Bancorp's board of directors has the following standing committees: Audit, Executive and Governance, Nominating, Compensation, and Credit and Investment Risk. The charter for each committee may be found on Bancorp's investor relations web site at [www.sandyspringbank.com](http://www.sandyspringbank.com). Each committee's function is described as follows:

***Audit Committee*** – The Audit Committee is appointed by the board to assist in monitoring the integrity of the financial statements and financial reporting, including the proper operation of internal control over financial reporting and disclosure controls and procedures in accordance with the Sarbanes-Oxley Act of 2002, compliance with legal and regulatory requirements and the independence and performance of internal and external auditors. The Audit Committee reviews the quarterly earnings press releases, as well as the Forms 10-Q and 10-K prior to filing. All members of the committee meet all requirements and independence standards as defined in applicable law, regulations of the SEC, Nasdaq listing rules, the Federal Deposit Insurance Act and related regulations. The board has determined that Dennis A. Starliper, a former chief financial officer of a publicly-traded company, qualifies as an audit committee financial expert under the Nasdaq listing rules and applicable securities regulations.

***Executive and Governance Committee*** – This committee conducts board business between regular meetings as needed and provides oversight and guidance to the board of directors to ensure that the structure, policies, and processes of the board and its committees facilitate the effective exercise of the board's role in the governance of Bancorp. The committee reviews and evaluates the policies and practices with respect to the size, composition, independence and functioning of the board and its committees as stated in the Corporate Governance Policy. This committee is comprised of the chairmen of the standing committees of the board, the chairman of the board, and the president and CEO.

**Nominating Committee** – Members of this committee are independent directors within the meaning of the Nasdaq listing rules. In 2012, it was decided that, with the exception of the president and CEO, the same directors serving on the Executive and Governance Committee would also serve on the Nominating Committee. The Nominating Committee makes recommendations to the board with respect to nominees for election as directors. In exercising its responsibilities, the Nominating Committee considers general criteria and particular goals and needs of Bancorp for additional competencies or characteristics. The committee also has the authority to engage an outside search firm to source qualified candidates. See page 5 for a discussion of the nomination process.

**Compensation Committee** – Members of this committee are independent directors within the meaning of the Nasdaq listing rules. The Compensation Committee is responsible for developing Bancorp’s executive compensation philosophy and determining all elements of compensation for executive officers including base salaries, short-term incentive compensation, equity awards, and retirement benefits. In addition, the committee considers other compensation and benefit plans on behalf of the board as required by regulation. The committee is charged with assessing whether the compensation plans encourage or reward unnecessary or excessive risk-taking by participants. The committee is also responsible for reviewing and making recommendations for non-employee director compensation. Until recently, the committee reviewed and made recommendations to the board regarding equity awards. In May 2013, after the annual equity process in March, the committee was given the authority to administer the 2005 Omnibus Stock Plan.

**Credit and Investment Risk Committee** – The Credit and Investment Risk Committee has responsibility for approving all loans requiring board approval; reviewing and approving all credit-related activities that are required by law or regulation to be approved by the board, including, but not limited to: reviewing and approving the adequacy of the allowance for loan and lease losses; monitoring the performance and quality of Bancorp’s credit portfolio; monitoring whether Bancorp’s credit risk management activities are aligned with Bancorp’s overall business strategy; and reviewing and approving Bancorp’s credit risk policies. In addition, the committee reviews and approves all investment-related activities that are required by law or regulation to be approved by the board; monitors the performance and quality of the investment portfolio; monitors whether investment risk management activities are aligned with Bancorp’s risk tolerance and business strategies; and oversees the effectiveness and administration of and compliance with all investment-related policies.

#### Current Board Committee Membership and Number of Meetings

<i>Name</i>	<i>Executive &amp; Governance</i>	<i>Nominating</i>	<i>Audit</i>	<i>Compensation</i>	<i>Credit &amp; Investment Risk</i>
<i>Number of meetings in 2013</i>	4	2	8 <sup>(1)</sup>	6	12
Ralph F. Boyd, Jr.					X
Mark E. Friis	X	Chairman			X
Susan D. Goff			X	X	
Robert E. Henel, Jr.			X		X
Pamela A. Little	X	X		Chairman	
Gary G. Nakamoto			X	X	
Robert L. Orndorff <sup>(2)</sup>	Chairman	X	X	X	X

Craig A. Ruppert	X	X	Chairman
Daniel J. Schrider	X		X
Dennis A. Starliper	X	X	Chairman
Mei Xu			X

(1) The Audit Committee met 4 times in person and 4 times by teleconference.

(2) As chairman of the board, Mr. Orndorff is an ex officio member of all committees.

### **Director Attendance at Board and Committee Meetings**

Each of Bancorp's directors takes his and her commitment to serve on the board very seriously as demonstrated by the superior attendance record achieved each year. During 2013, the board held nine meetings with overall attendance averaging 98%. In accordance with Bancorp's Corporate Governance Policy, all incumbent directors attended well over 80% of the aggregate of (a) the total number of meetings of the board of directors and (b) the total number of meetings held by all committees on which they served.

### **Attendance at the Annual Meeting of Shareholders**

The board of directors believes it is important for all directors to attend the annual meeting of shareholders to show support for Bancorp and to provide an opportunity to interact with shareholders directly. Bancorp has a policy that directors should attend the annual meeting of shareholders unless unable to attend by reason of personal or family illness or other urgent matters. All directors attended the 2013 annual meeting.

### **Stock Ownership Guidelines for Directors**

According to Bancorp's bylaws, qualified directors are required to hold unencumbered shares of Bancorp common stock with a fair market value of \$1,000. The Corporate Governance Policy requires this ownership position to increase with each year of service up to the lesser of 5,000 shares or \$175,000 in fair market value by January 1<sup>st</sup> following the director's fifth anniversary of service.

### **Director Compensation**

#### ***Cash Compensation***

Only non-employee directors are compensated for their service as board members. In 2013, non-employee directors received an annual retainer of \$14,000 and the chairman of the board received \$35,000. Committee chairmen receive an additional retainer as follows: Audit Committee chairman \$7,500; Executive & Governance Committee chairman \$5,000; Nominating Committee chairman \$5,000; Credit & Investment Risk Committee chairman \$5,000; and Compensation Committee chairman \$5,000.

In 2013, non-employee directors received \$1,100 for attendance at each meeting of the board of directors and \$1,000 for attendance at each committee meeting. Directors are encouraged to attend all meetings in person unless the meeting is called by teleconference. Directors who attended a regular board meeting by phone were paid a reduced meeting fee of \$500. Directors were not paid for limited-purpose teleconference meetings, and members of the Nominating Committee were not paid when the Executive & Governance Committee met on the same day. Finally, those directors who served on a regional advisory board were paid \$600 for each advisory board meeting attended. All

directors of Bancorp also serve as directors of Sandy Spring Bank, for which they did not receive any additional compensation. All meetings of the board and its committees are considered joint meetings of the holding company and the principal subsidiary.

***Director Fee Deferral Plan***

Directors of Bancorp are eligible to defer all or a portion of their fees under the Director Fee Deferral Plan. The amounts deferred accrue interest at 120% of the long-term Applicable Federal Rate which is not considered “above market” or preferential. Except in the case of death or financial emergency, deferred fees and accrued interest are payable only following termination of a director's service. In the event a director dies during active service, the Bank will pay benefits that exceed deferred fees and accrued interest to the extent the Bank owns an insurance policy in effect on the director’s life at the time of death that pays a greater amount than the total of deferred fees and accrued interest.

***Director Stock Purchase Plan***

Each director of Bancorp has the option of using from 50 to 100% of his or her annual retainer fee to purchase newly issued Bancorp common stock at the current fair market value at the time the retainer is paid in accordance with the plan. Directors make an annual election to participate in advance, and participation in the plan is ratified by the board.



**Equity Compensation**

Bancorp directors are eligible to receive non-incentive stock options, stock appreciation rights, and restricted stock under the 2005 Omnibus Stock Plan. On March 27, 2013, the board approved 1,234 shares of restricted stock to each non-employee director with the exception of Mr. Graham whose retirement was imminent. The shares had a grant date fair value of \$20.26 per share for a total fair market value of approximately \$25,000. The restricted stock will vest over three years in equal increments, and vesting is accelerated upon the permanent departure from the board other than removal for just cause.

## 2013 Non-Employee Director Compensation

<i>Name</i>	Fees Earned or Paid in Cash (1)	Stock Awards (2)	Option Awards (3)	All Other Compensation (4)	Total
Ralph F. Boyd, Jr.	\$ 33,800	\$25,000		\$ 617	\$59,417
Mark E. Friis	\$ 46,700	\$25,000		\$ 1,657	\$73,357
Susan D. Goff	\$ 34,900	\$25,000		\$ 1,657	\$61,557
Solomon Graham <sup>(5)</sup>	\$ 6,300	-		\$ 379	\$6,679
Robert E. Henel, Jr.	\$ 40,500	\$25,000		\$ 1,239	\$66,739
Pamela A. Little	\$ 39,900	\$25,000		\$ 1,657	\$66,557
Gary G. Nakamoto	\$ 34,500	\$25,000		\$ 1,239	\$60,739
Robert L. Orndorff	\$ 75,900	\$25,000		\$ 1,657	\$102,557
Craig A. Ruppert	\$ 44,900	\$25,000		\$ 1,657	679,500 7.99%
Spence Limited, L.P.,					
Financial Junk, LLC,					
John Wilson Spence, III and					
Gerald J. Bruner <sup>(18)</sup>					
P.O. Box 505					
Blakely, Georgia 39823-0505	747,570	747,570	8.80%		

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Person, Group or Entity	Shares of Common Stock Beneficially Owned <sup>(1)</sup>			Percentage of Total Shares
	Sole Power <sup>(2)</sup>	Shared Power <sup>(3)</sup>	Aggregate	Outstanding
Jeffrey A. Miller and Eric D. Jacobs <sup>(18)</sup> P.O. Box 26039 Gallows Bay Station Christiansted, St. Croix, USVI 00824 Stilwell Value Partners IV, Stilwell Associates, L.P., Stilwell Value LLC and Joseph Stilwell <sup>(18)</sup> 26 Broadway Street, 23rd Floor New York, New York 10004		647,355	647,355	7.62%
		723,831	723,831	8.52%

\* Less than 1%.

(1) Information relating to beneficial ownership of the Company's Common Stock is based upon information furnished by each person using beneficial ownership concepts as set forth in the SEC's rules and regulations. Under those rules and regulations, a person is deemed to be a beneficial owner of a security if that person has or shares voting power, which includes the power to vote or direct the voting of such security, or investment power, which includes the power to dispose of or direct the disposition of such security. The person is deemed to be a beneficial owner of any security of which that person may directly or indirectly have such voting or investment power, whether as the result of any contract, arrangement, understanding, relationship or otherwise. In addition, in computing the number of shares beneficially owned by a person and the percentage ownership of that person, shares of Common Stock subject to options held by that person which are currently exercisable, or which will become exercisable within 60 days following May 10, 2004, are deemed to be outstanding. Such shares, however, are not deemed outstanding for purposes of computing the percentage ownership of any other person. The total number of shares beneficially owned is divided, where applicable, into two categories: (i) shares as to which voting/investment power is held solely, and (ii) shares as to which voting/investment power is shared. Under these rules, more than one person may be deemed to be a beneficial owner of the same securities, and a person may be deemed to be a beneficial owner of securities as to which he or she may disclaim any beneficial interest. Accordingly, stockholders may be named as beneficial owners of shares of the Company's Common Stock as to which they may disclaim any beneficial interest.

(2) Unless otherwise specified in the following footnotes, if a beneficial owner is shown as having sole power, the owner has sole voting as well as sole investment power, and if a beneficial owner is shown as having shared power, the owner has shared voting power as well as shared investment power. Some individuals are shown as beneficial owners of shares held by the Company's ESOP. The individual has sole power to direct the ESOP trustee as to the manner in which shares allocated to the individual's account under the ESOP are to be voted. The individual has no direct power of disposition with respect to shares allocated to the individual's account, except to request a distribution under the terms of the ESOP. The ESOP record keeper has not completed the allocation as of December 31, 2003, so the number of shares shown as allocated to an individual's account are as of December 31, 2002.

(3) This column may include shares held in the name of, among others, a spouse, minor children or certain other relatives sharing the same home as the director, nominee, executive officer or 5% stockholder. In the cases of Messrs. Frawley, Lewis and Trotter this column includes 123,111 shares held by the ESOP that have not been allocated to any participant account. These individuals serve as members of the Administrative Committee of the ESOP and have investment authority over the unallocated shares, but each individual disclaims any

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beneficial ownership with respect to such unallocated shares.

- (4) Includes 22,500 shares which could be acquired within 60 days following May 10, 2004 pursuant to stock options and 1,106 shares allocated to Mr. Boland's ESOP account as of December 31, 2002.

- (5) Includes 50,000 shares which could be acquired within 60 days following May 10, 2004 pursuant to stock options.
- (6) Includes 47,500 shares which could be acquired within 60 days following May 10, 2004 pursuant to stock options and 1,126 shares allocated to Mr. Caughran's ESOP account as of December 31, 2002.
- (7) Includes 75,000 shares which could be acquired within 60 days following May 10, 2004 pursuant to stock options.
- (8) Includes 225,000 shares which could be acquired within 60 days following May 10, 2004 pursuant to stock options.
- (9) Includes 75,000 shares which could be acquired within 60 days following May 10, 2004 pursuant to stock options.
- (10) Includes 50,500 shares which could be acquired within 60 days following May 10, 2004 pursuant to stock options and 738 shares allocated to Ms. Kinney's ESOP account as of December 31, 2002.
- (11) Includes 75,000 shares which could be acquired within 60 days following May 10, 2004 pursuant to stock options and 19,868 shares held by an estate of which Mr. Lewis is the executor and a beneficiary.
- (12) Includes 102,500 shares which could be acquired within 60 days following May 10, 2004 pursuant to stock options and 16,519 shares allocated to Mr. Mann's ESOP account as of December 31, 2002.
- (13) Includes 85,000 shares which could be acquired within 60 days following May 10, 2004 pursuant to stock options and 12,552 shares allocated to Mr. McGruder's ESOP account as of December 31, 2002. Mr. McGruder retired as the President of Community Bank during 2003 and as a director of the Company effective May 1, 2004.
- (14) Includes 42,522 shares allocated to Mr. Patterson's ESOP account as of December 31, 2002.
- (15) Includes 75,000 shares which could be acquired within 60 days following May 10, 2004 pursuant to stock options.
- (16) The totals do not include the shares of Common Stock held by Mr. McGruder, who is a named executive officer of the Company for purposes of the SEC's rules and regulations by virtue the salary he received while employed as the President of the Bank during part of 2003, but who is no longer an executive officer for purposes of this calculation.
- (17) Participants in the ESOP have the power to direct the ESOP trustee how to vote shares allocated to their individual accounts. Any unallocated shares, and any allocated shares with respect to which voting instructions are not received from a participant, will be voted by the appropriate ESOP fiduciary in its discretion.
- (18) Information about this individual group was obtained from a Schedule 13D or 13G, filed by such individual or group with the SEC.

#### **SECTION 16(a) BENEFICIAL OWNERSHIP REPORTING COMPLIANCE**

Section 16(a) of the Securities Exchange Act of 1934 requires the Company's directors, executive officers and persons who beneficially own more than ten percent of the Company's Common Stock to file with the SEC on a timely basis initial reports of ownership and reports of changes in ownership of Common Stock and other equity securities of the Company. These officers, directors and stockholders are also required by the

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SEC's rules to furnish the Company with copies of all Section 16(a) reports they file. There are specific dates by which these reports are to be filed, and the Company is required to disclose any failure to file on a timely basis reports that were required for 2003.

During 2003, Mr. Patrick M. Frawley and Ms. Kerri C. Kinney each reported on Forms 5, filed February 12, 2003, a grant of stock options that took place on February 6, 2003. These grants should have been reported by both Mr. Frawley and Ms. Kinney two days earlier on a Form 4. Mr. Stacey W. Mann filed a Form 4 on August 29, 2003, which was five days late, reporting one transaction related to the sale of the Company's Common Stock. Mr. Kenneth K. Campbell filed an amended Form 3 on November 21, 2003 to include jointly held stock, which was inadvertently omitted from his Form 3 originally filed on April 28, 2003. The Company has relied on written representations of its directors and executive officers and copies of the reports that have been filed in making required disclosures concerning beneficial ownership reporting. However, despite solicitation efforts by the Company, the Company did not receive a written representation from Mr. Kennon R. Patterson, Sr. that he was not required to file a Form 5.

#### AUDIT COMMITTEE REPORT

The Audit Committee monitors the Company's financial reporting process on behalf of the Board of Directors. The Audit Committee operates under a written Charter adopted by the Board of Directors and the Audit Committee during the fourth quarter of 2003 that complies with the requirements of the Sarbanes-Oxley Act of 2002 and the SEC rules promulgated thereunder, as well as certain of the Nasdaq governance standards applicable to the Company. The Audit Committee Charter is included as Exhibit A to this Proxy Statement.

The Audit Committee consists of five directors, each of whom is independent as defined in the Nasdaq and SEC rules. None of the Audit Committee members is or has been an officer or employee of the Company or any of its subsidiaries, has engaged in any nonexempt business transaction or has any nonexempt business or family relationship with the Company or any of its subsidiaries or affiliates, other than in the ordinary course of business. To date, we have been unable to identify a suitable candidate for director that would qualify as an audit committee financial expert, as defined in the SEC rules, to become a member of the Audit Committee. The Board of Directors believes that the incumbent Audit Committee members' financial acumen is strong and that they can properly discharge the Audit Committee's responsibilities.

The Company's management has the primary responsibility for the Company's financial statements and reporting process, including the systems of internal controls. The Company's independent auditors are responsible for performing an independent audit of the Company's consolidated financial statements in accordance with generally accepted auditing standards and issuing a report thereon. The Audit Committee monitors the integrity of the Company's financial reporting process and system of internal controls as well as the independence and performance of the Company's independent auditors and internal auditors. The Audit Committee also appoints or recommends annually to the Board of Directors the accountants to serve as the Company's independent auditors for the coming year. The Audit Committee pre-approves all of the professional services that are provided by the Company's independent auditors.

The Audit Committee believes that it has taken the actions necessary or appropriate to fulfill its oversight responsibilities. To carry out its responsibilities, the Audit Committee met two times in 2003. The Charter requires that the Audit Committee meet at least quarterly, and the Audit Committee has met once in 2004. In fulfilling its responsibilities, the Audit Committee:

Reviewed and discussed with management the Company's audited financial statements for the year ended December 31, 2003 and determined that the Company's internal controls were adequate for preparation of the financial statements;

Discussed with the Company's independent auditors the matters required to be discussed under Statement on Auditing Standards No. 61, Communication with Audit Committees; and

Received the written disclosures and the letter from the Company's independent auditors regarding the auditors' independence as required by Independence Standards Board Standard No. 1, and discussed with the Company's independent auditors their independence.



Based on the Audit Committee's review of the Company's audited financial statements for the year ended December 31, 2003 and its discussions with management and the Company's independent auditors as described above and in reliance thereon, the Audit Committee recommended to the Company's Board of Directors that the Company's audited financial statements for the year ended December 31, 2003 be included in the Company's Annual Report on Form 10-K for the year ended December 31, 2003 for filing with the SEC.

*By the Audit Committee:*

Kenneth K. Campbell (Chairman)

Glynn C. Debter

Roy B. Jackson

John J. Lewis, Jr.

Jimmie A. Trotter

## **EXECUTIVE COMPENSATION**

### **General**

Executive officers are appointed annually by the respective Boards of Directors of the Company and the Bank following the Annual Meetings of Stockholders, to serve until the next Annual Meeting of Stockholders and until their successors are chosen and qualified.

Under rules established by the SEC, the Company is required to provide certain data and information in regard to the compensation and benefits provided to the Company's chief executive officer and other executive officers who make in excess of \$100,000 per year. The disclosure requirements for these named executive officers include the use of tables and a report explaining the rationale and considerations that led to fundamental executive compensation decisions affecting these individuals.

The following report reflects the Company's compensation philosophy, as endorsed by the Board of Directors of each of the Company, Community Bank and the other subsidiaries of the Company, as well as the Executive Compensation Committee, and resulting actions taken by the Company for the reporting periods shown in the various compensation tables supporting the report. The Executive Compensation Committee either approves or recommends to the Board of Directors payment amounts and award levels for executive officers of the Company and its subsidiaries.

### **Compensation Committee Interlocks and Insider Participation**

Mr. Glynn C. Debter, who serves as Chairman, Mr. John J. Lewis, Jr., who serves as Vice Chairman, and Mr. Roy B. Jackson currently serve as members of the Executive Compensation Committee of the Company's Board of Directors. None of Messrs. Debter, Lewis or Jackson are, or



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were previously, officers or employees of the Company or any of its subsidiaries.

During part of 2003, the following individuals also served on the Executive Compensation Committee: Messrs. Denny G. Kelly, Kennon R. Patterson, Jr., Merritt M. Robbins and Jimmie A. Trotter. Mr. Denny G. Kelly was an executive officer of the Company and Community Bank until January 2002. Mr. Kennon R. Patterson, Jr. was an executive officer of Community Bank until December 2000, and is the son of Mr. Kennon R. Patterson, Sr., the Company's former Chief Executive Officer.

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## EXECUTIVE COMPENSATION COMMITTEE REPORT

### Overview

The Company's Executive Compensation Committee (the Compensation Committee) is responsible for establishing and administering the Company's executive compensation program. The Compensation Committee also makes recommendations regarding executive compensation to the Board of Directors, which has final approval of the compensation of each executive officer, including the named executive officers identified in the Summary Compensation Table below. The named executive officers do not participate in the Board of Directors' review and determination of their compensation or in the Compensation Committee's review and recommendation of their compensation.

The Company's executive compensation program is designed to attract, reward, retain and motivate executive officers who will provide strong leadership necessary for the Company to achieve superior financial performance and stockholder return, and who will be an integral part of the communities that the Company serves. During 2003, the Company's executive compensation program consisted only of base compensation and long-term incentives. Executive officers also receive various perquisites comparable to those made available to executive officers of other financial institutions, as well as retirement and other employee benefits that are generally available to employees of the Company and its subsidiaries.

### Executive Compensation Program

#### *Base Compensation*

Base compensation provides the foundation for the Company's executive compensation program. The purpose of the base compensation paid to executives is to compensate the executive for performing the basic duties that he or she is expected to perform. Salaries are typically reviewed and adjusted on an annual basis. In determining the base compensation for a particular executive officer, the Compensation Committee performs a subjective evaluation focusing on two factors: (i) the officer's individual performance, and (ii) the performance of the Company and business unit or units of the Company for which the officer is responsible. The Compensation Committee does not assign any relative or specific weights to these factors, and individual members of the Compensation Committee may give differing weights to different factors. Accordingly, during a particular year, the base compensation of an executive officer of the Company may not necessarily be related to the Company's performance during that year or the prior year.

*Individual Performance.* In determining its recommended compensation for each executive officer of the Company, the Compensation Committee considers the officer's individual performance during the prior year. Individual performance is generally evaluated by reference to the executive officer's annual performance review, in which the officer is subjectively graded by his or her superiors on various specified criteria, including leadership skills and management ability.

*Company Performance.* The Compensation Committee also considers the performance during the prior year of the Company and Community Bank and branches or other business unit or units of the Company for which the executive officer is responsible. For example, in determining the compensation for the Chairman, Chief Executive Officer and President of the Company, the Compensation Committee reviews the performance of the entire Company, on a consolidated basis, and in determining the compensation for the President of Community Bank, the Compensation Committee reviews the performance of Community Bank as a whole. The Compensation Committee subjectively evaluates the performance by the business units with respect to those criteria that the Compensation Committee believes to be relevant in assessing the units' performance. The Compensation Committee has not established any target amounts for these criteria, which may differ from unit to unit, depending on, among

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other things the nature of the unit's business (such as banking, consumer finance or insurance) and how long the unit has been in operation. The Compensation Committee generally focuses on the following four criteria, to the extent applicable, in assessing each unit's performance: (i) growth in loan portfolio; (ii) growth in deposits; (iii) net profit; and (iv) charge-offs and loan losses.

Based on these and other factors that the Compensation Committee and its members may deem to be relevant, the Compensation Committee determines the base compensation of each executive officer and makes its

recommendations to the Board of Directors. The Board of Directors then considers the Compensation Committee's recommendations, and may elect to decrease, increase or approve the compensation recommended by the Compensation Committee. During 2003, the annual base compensation of Mr. Patrick M. Frawley was increased to \$300,000 to reflect his promotion to Chairman, Chief Executive Officer and President of the Company and Chairman and Chief Executive Officer of Community Bank. Likewise, the annual base compensation of Mr. Stacey W. Mann was increased to \$220,000 as a result of his promotion to President of Community Bank. Ms. Kerri C. Kinney's annual base compensation was increased to \$150,000 in recognition of the importance of the Chief Financial Officer's role in the Company. Mr. Lawrence Boland's annual base compensation remained at \$120,000. Mr. William H. Caughran was rehired in March 2003 at an annual base compensation of \$155,000, which was the same annual base compensation being paid to Mr. Caughran when his employment with the Company terminated in August 2002. The employment of Messrs. Kennon R. Patterson, Sr. and Loy D. McGruder with the Company terminated on January 27, 2003 and June 6, 2003, respectively.

### ***Annual Bonuses***

The Company has, to a limited extent, provided short-term incentives to executive officers in the form of annual cash bonuses in recognition of outstanding individual performance and/or business unit performance. The Board of Directors did not award bonuses to any executive officer of the Company for 2003, based on the Board's determination that the officers' base compensation provided adequate compensation given the Company's performance during 2003.

### ***Long-Term Incentives***

The purpose of long-term incentives is to provide incentives and rewards recognizing the performance of the Company over time and to motivate long-term, strategic thinking among executives. During 2003, the Company granted stock options to its directors and certain of its officers as long-term incentives because, among other reasons, the Compensation Committee believes stock options properly align executive pay with stockholders' interests. The grant of stock options is a common method of incentive compensation for financial institutions and other publicly held companies and allows the Company to be competitive with other employers. The number of options granted to a particular executive officer generally reflects the officer's position within the Company, the Compensation Committee's subjective evaluation of the officer's performance and contribution to the Company, and the Compensation Committee's analysis of the value of the options awarded (using a standard methodology for valuing options). During 2003, the Company granted options to each of Patrick M. Frawley, Stacey W. Mann, Kerri C. Kinney, William H. Caughran, Lawrence Boland, Loy D. McGruder and certain other senior officers of the Company, with an exercise price equal to 100% of the fair market value of the Common Stock on the date that the options were granted, as determined by the Board of Directors.

### **Chief Executive Officer Compensation**

On January 27, 2003, the Company's Board of Directors terminated the employment of Mr. Kennon R. Patterson, Sr. as the Company's Chairman, Chief Executive Officer and President, and promoted Mr. Patrick M. Frawley into each of these positions. Mr. Frawley also replaced Mr. Patterson as Chairman and Chief Executive Officer of Community Bank. In determining Mr. Frawley's compensation for 2003, the Board of Directors considered Mr. Frawley's past experience in the banking industry, individual performance as Director of Regulatory Relations of Community Bank, the additional responsibilities assumed upon his promotion, and the Company's financial performance.

*By the Executive Compensation Committee:*

Glynn C. Debter (Chairman)

John J. Lewis, Jr. (Vice Chairman)

Roy B. Jackson

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**Summary of Cash and Certain Other Compensation**

The following table provides summary information concerning compensation paid by the Company and its subsidiaries during 2003 to the Chief Executive Officer and each of the four other most highly compensated executive officers of the Company at December 31, 2003 (collectively, the named executive officers ) for the fiscal years ended December 31, 2003, 2002 and 2001.

**Summary Compensation Table**

Name and Principal Position	Year	Annual Compensation			Long-Term Compensation Awards	All Other Compensation <sup>(1)</sup>
		Salary	Bonus	Other Annual Compensation	Securities Underlying Options/SAR	
Patrick M. Frawley Chairman, Chief Executive Officer and President	2003	\$ 297,577		35,451 <sup>(3)</sup>	150,000	21,671
	2002	175,782 <sup>(2)</sup>		24,854 <sup>(3)</sup>		
	2001					
Stacey W. Mann President Community Bank	2003	\$ 213,386			40,000	23,471
	2002	200,000			12,500	8,889
	2001	185,852			10,000	4,876
Kerri C. Kinney Chief Financial Officer	2003	\$ 149,359			27,500	17,984
	2002	126,200		16,425 <sup>(4)</sup>		8,073
	2001	49,389			3,000	
William H. Caughran General Counsel	2003	\$ 122,212			27,500	13,242
	2002	114,925			12,500	
	2001	150,000			10,000	4,514
Lawrence Boland President Community Insurance Corp	2003	\$ 120,000			10,000	14,802
	2002	119,885				6,049
	2001	113,882				3,860
Kennon R. Patterson, Sr. Former Chairman, President and Chief Executive Officer	2003	\$ 71,379				3,500
	2002	917,000			80,000	17,089
	2001	917,000			80,000	3,076
Loy D. McGruder Former President Community Bank	2003	\$ 126,923			25,000	5,300
	2002	273,782			25,000	8,889
	2001	220,500			10,000	4,876

<sup>(1)</sup> The amounts shown in this column for the fiscal year ended December 31, 2003 include life insurance premiums paid by the Company and contributions by the Company to the Company's ESOP, respectively, as follows: Patrick M. Frawley \$0 and \$21,671; Stacey W. Mann \$1,800 and \$21,671; Kerri C. Kinney \$1,800 and \$16,184; William H. Caughran \$0 and \$13,242; Lawrence Boland \$1,800 and \$13,002; and Loy D. McGruder \$1,800 and \$0. ESOP contributions for 2003 are estimated because the allocations for the 2003 plan year have not yet been completed by the plan record keeper. The amounts also include, in the case of Kennon R. Patterson, Sr. and Loy D. McGruder, \$3,500 in fees paid to each individual in 2003 for service as a director of the Company following the individual's termination of employment.

- (2) Mr. Frawley's employment by Community Bank was subject to regulatory approval, which was obtained on May 30, 2002. Mr. Frawley was an independent contractor from March 1, 2002 until June 10, 2002. The amount shown in the table for 2002 includes \$56,875 paid to Mr. Frawley as an independent contractor and \$118,907 paid to him as a Community Bank employee.
- (3) Includes for 2003 and 2002, respectively, \$3,383 and \$0 with respect to social club dues, \$6,821 and \$4,083 with respect to usage of a Company-owned automobile, and \$25,247 and \$20,771 with respect to expenses related to temporary housing.
- (4) Includes \$5,432 with respect to social club dues, \$7,000 with respect to usage of a Company-owned automobile, and \$3,993 with respect to discounted interest rates through participation in Community Bank's employee loan program.

### Stock Options

The following table provides information concerning grants of stock options by the Company to the named executive officers during 2003:

#### Option Grants in Last Fiscal Year

Name	Individual Grants		Exercise price	Expiration date	Potential realizable value at assumed annual rates of stock price appreciation for option term	
	Number of securities underlying options granted	Percent of total options granted to employees in fiscal year			5%	10%
Patrick M. Frawley	75,000	16.16%	\$ 7.00	2/5/08	\$ 145,043	\$ 320,513
	75,000	16.16	7.00	7/31/08	145,043	320,513
Stacey W. Mann	40,000	8.62	7.00	7/31/08	77,356	170,940
Kerri C. Kinney	12,500	2.69	7.00	2/5/08	24,174	53,419
	15,000	3.23	7.00	7/31/08	29,009	64,103
William H. Caughran	12,500	2.69	7.00	2/5/08	24,174	53,419
	15,000	3.23	7.00	7/31/08	29,009	64,103
Lawrence Boland	10,000	2.16	7.00	7/31/08	19,339	42,735
Kennon R. Patterson, Sr.						
Loy D. McGruder <sup>(1)</sup>	25,000	5.39	7.00	7/31/08	48,348	106,838

(1) Stock options granted to Loy D. McGruder in 2003 were made after his retirement as an officer of Community Bank and were based on his continued service as a director of the Company.

**Option Exercises and Holdings**

The following table provides information concerning the exercise of stock options during 2003 by the named executive officers and the unexercised stock options held by the named executive officers at December 31, 2003. During 2003, none of the named executive officers exercised any stock options.

**Aggregated Option/SAR Exercises in Last Fiscal Year and FY-End Option/SAR Values**

Name	Number of Securities	Value of Unexercised
	Underlying Unexercised	In-the-money
	Options/SARs at FY-End	Options/SARs at FY-End <sup>(1)</sup>
Patrick M. Frawley	150,000	
Stacey W. Mann	62,500	
Kerri C. Kinney	30,500	
William H. Caughran	27,500	
Lawrence Boland	10,000	
Kennon R. Patterson, Sr.		
Loy D. McGruder	60,000	

<sup>(1)</sup> The exercise price of all stock options is higher than the market value of the underlying shares of Common Stock, which was \$5.35 per share at December 31, 2003, as determined by the Board of Directors at that time.

**Retirement Plan**

The following table shows the estimated annual benefits payable at normal retirement age (age 65) under the Community Bancshares, Inc. Revised Pension Plan, a qualified defined benefit retirement plan, as well as under the Community Bancshares Inc. Benefit Restoration Plan, a non-qualified supplemental retirement plan. This supplemental plan provides benefits that would otherwise be denied participants due to the limitations on qualified plan benefits imposed by the Internal Revenue Code. The only named executive officers who are participants in this supplemental plan are Messrs. Stacey W. Mann, Kennon R. Patterson, Sr. and Loy D. McGruder.

**Pension Plan Table**

Average Annual Compensation	Years of Credited Service			
	10	20	30	40
\$ 25,000	\$ 3,750	\$ 7,500	\$ 11,250	\$ 15,000
50,000	7,500	15,000	22,500	30,000
75,000	11,250	22,500	33,750	45,000
100,000	15,000	30,000	45,000	60,000
250,000	37,500	75,000	112,500	150,000



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500,000	75,000	150,000	225,000	300,000
750,000	112,500	225,000	337,500	450,000
1,000,000	150,000	300,000	450,000	600,000
1,250,000	187,500	375,000	562,500	750,000

The benefits shown in the table above are not subject to any deduction for Social Security benefits or other offset amounts. Benefits are computed as a straight-line annuity beginning at age 65. Benefits under both plans were frozen as of December 31, 2003.

The amount of compensation covered by the combination of plans covering the named executive officers is total compensation, including bonuses, overtime or other forms of extraordinary compensation. The amount of the retirement benefit is determined by the length of the retiree's credited service under the plans and his or her average monthly earnings for the five highest compensated, consecutive calendar years of the retiree's final ten consecutive calendar years of employment with the Company and its subsidiaries. The full years of credited service under the plans for the named executive officers as of December 31, 2003 are as follows: Mr. Patrick M. Frawley: 2 years; Mr. Stacey W. Mann: 20 years; Ms. Kerri C. Kinney: 2 years; Mr. William H. Caughran: 5 years; Mr. Lawrence Boland: 4 years; Mr. Kennon R. Patterson, Sr.: 19 years; and Mr. Loy D. McGruder: 15 years.

## **Employment Agreements and Change in Control Arrangements**

### ***Employment Agreements***

Effective April 1, 1996, Community Bancshares entered into an Employment Agreement with Mr. Kennon R. Patterson, Sr., which was amended on October 14, 1999. This Employment Agreement, as amended, provided that Mr. Patterson would serve as the Chairman of the Board of Directors, President and Chief Executive Officer of the Company and receive annual cash compensation of at least \$898,600, which represented the amount of Mr. Patterson's total cash compensation for 1999. The Employment Agreement further provided that Mr. Patterson's cash compensation could be increased if determined by the Board of Directors appropriate to do so based on the recommendation of the Company's Executive Compensation Committee. Mr. Patterson's Employment Agreement also provided that he would receive four weeks of paid vacation annually, use of an automobile for business and personal purposes, reimbursement of reasonable business and professional expenses, memberships in civic and social clubs, and an annual allowance of \$10,000 for the purchase of life insurance. In the event that Mr. Patterson was disabled to the extent that he was incapable of performing his duties, he would have been entitled to a continuation of his compensation during the period of disability, but not to exceed one year. Mr. Patterson's employment with the Company and Community Bank was terminated on January 27, 2003. Pursuant to the Employment Agreement, Mr. Patterson may not engage in the business of banking within a 25 mile radius of any office of the Company or its subsidiaries for a period of two years following the termination of his employment.

### ***Change in Control Agreements***

With the exception of Mr. Lawrence Boland, the Company or Community Bank has entered into Change in Control Agreements with each of the named executive officers. These agreements have terms of three years and are automatically renewed unless terminated by the Company at the end of any three year terms. In the event of a change in control (as defined in the agreements) of the Company, the named executive officer is entitled to receive certain severance benefits, provided the executive officer's employment is terminated by the Company within 30 months following the change in control, unless the termination is for cause or by reason of the officer's death, disability or retirement on or after age 65. The executive officer is also entitled to these severance benefits if the officer terminates his or her employment with the Company within 30 months following a change in control if, among other reasons, the officer's authority, duties, compensation or benefits have been reduced or if the officer is forced to relocate more than 50 miles from his place of employment immediately prior to the change in control. If, during the term of the agreement, a transaction is proposed which, if consummated, would constitute a change in control and (i) the officer's employment is thereafter terminated by the Company other than for cause or by reason of the officer's death, disability or retirement on or after age 65 and (ii) the proposed transaction is consummated within one year following the officer's termination of employment, the change in control will be deemed to have occurred during the term of the agreement and the officer will be entitled to severance benefits. The officer is also entitled to receive severance benefits if the officer terminates employment for any reason during a 30-day period beginning 12 months after the occurrence of a change in control.



Community Bank entered into a Change in Control Agreement with Mr. Patrick M. Frawley on December 12, 2003. The severance benefits payable under the agreement with Mr. Frawley consist solely of a lump sum payment equal to the present value of Mr. Frawley's monthly salary that would have been payable by Community Bank for the 12 months following his termination of employment but for the termination.

The Company entered into Change in Control Agreements with Messrs. Stacey W. Mann, William H. Caughran, Kennon R. Patterson, Sr. and Loy D. McGruder on December 4, 1999, and with Ms. Kerri C. Kinney on September 18, 2001. The severance benefits payable under each of these agreements are as follows: (i) a lump sum payment equal to the present value of the officer's monthly salary that would have been payable by the Company for the 12 months following the officer's termination of employment but for such termination; (ii) a lump sum payment equal to the present value of a monthly payment, which monthly payment is deemed to have been payable by the Company for 30 months following the termination of the officer and is calculated by taking one-twelfth of the average of the bonuses earned by the officer for the two calendar years immediately preceding the year in which the officer's termination of employment occurs; (iii) continuation of the officer's health and life insurance benefits for 30 months following the officer's termination of employment at the same level and on the same terms as provided to the officer immediately prior to his or her termination of employment; (iv) full vesting and continued participation for a period of 30 months following the officer's termination of employment in certain retirement plans or, if such full vesting and continued participation is not allowed, payment by the Company of a lump sum supplemental benefit in lieu of full vesting and continued participation in such plans; and (v) individual career counseling and outplacement services for a reasonable period of time following the officer's termination of employment, up to a maximum cost to the Company of \$5,000 per officer.

The employment of Messrs. Kennon R. Patterson, Sr. and Loy D. McGruder with the Company in every capacity terminated on January 27, 2003 and June 6, 2003, respectively.

### STOCK PERFORMANCE GRAPH

Set forth below is a graph comparing the yearly percentage change for the last five years in the cumulative total return of the Company's Common Stock against the cumulative total return of the NASDAQ Stock Market Bank Index, the American Stock Exchange Major Market Index and the SNL Banking Index for financial institutions with total assets of greater than \$500 million whose stocks are traded in over-the-counter bulletin board exchanges or through the pink sheets. It assumes that the value of the investment in the Company's Common Stock and in each index was \$100.00 and that dividends, if any, were reinvested. There is no established trading market for the Company's Common Stock and, therefore, no reliable information is available as to the prices at which the Company's Common Stock has traded. To the extent that cumulative total return data provided in the graph below is based in part on the price of the Company's Common Stock at the dates indicated, such information should not be viewed as indicative of the actual or market value of the Company's Common Stock at any time presented in the table or in the future.

<i>Index</i>	<i>Period Ending</i>					
	<b>12/31/98</b>	<b>12/31/99</b>	<b>12/31/00</b>	<b>12/31/01</b>	<b>12/31/02</b>	<b>12/31/03</b>
Community Bancshares, Inc.	100.00	123.60	106.22	79.66	79.66	28.41
AMEX Major Markets	100.00	119.71	112.82	109.94	96.69	119.53
NASDAQ Bank Index*	100.00	96.15	109.84	118.92	121.74	156.62
SNL >\$500M OTC-BB and Pink Banks	100.00	82.52	71.33	66.90	86.45	120.49

\*Source: CRSP, Center for Research in Security Prices, Graduate School of Business, The University of Chicago 2004. Used with permission. All rights reserved. crsp.com.

Source : SNL Financial LC, Charlottesville, VA

(434) 977-1600

The information provided under the headings Executive Compensation Committee Report and Stock Performance Graph shall not be deemed to be soliciting material or to be filed with the SEC, or subject to Regulation 14A or 14C, other than as provided in Item 402 of Regulation S-K, or to liabilities of Section 18 of the Exchange Act and, unless specific reference is made therein to such headings, shall not be incorporated by reference to any filings under the Securities Act of 1933 or the Securities Exchange Act of 1934.

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**RELATIONSHIP WITH INDEPENDENT PUBLIC ACCOUNTANTS**
**General**

The Company's independent public accounting firm for the calendar years ended December 31, 2002 and 2003 was Carr, Riggs & Ingram, LLC (CRI). Although the Audit Committee presently intends to recommend to the Board of Directors that the Board appoint CRI as the independent auditors for the Company and its subsidiaries for the current fiscal year ending December 31, 2004, the Audit Committee has not yet made such a recommendation to the Board. A representative from CRI is expected to attend the Annual Meeting, have an opportunity to make a statement and be available to respond to appropriate questions.

The Board of Directors of the Company had previously engaged Dudley, Hopton-Jones, Sims & Freeman, PLLP (Dudley Hopton-Jones) to serve as the independent accountant of the Company for 2000 and 2001. On April 11, 2002, Community Bank requested approval from the Alabama Banking Department (the Department) pursuant to the Alabama state banking statutes for Dudley Hopton-Jones to serve as Community Bank's independent auditor for 2002. By letter dated August 1, 2002, the Department declined the request and prospectively disapproved Dudley Hopton-Jones as Community Bank's independent auditor. The reasons for the disapproval given in the Department's letter were unspecified concerns about the conclusions reached by Dudley Hopton-Jones in connection with the 2001 audit of Community Bank and certain unspecified issues from past audits. On October 4, 2002, Dudley Hopton-Jones tendered its resignation as the Company's independent auditor, which resignation was accepted by the Audit Committee of the Company's Board of Directors. On October 4, 2002 the Chairman of the Audit Committee executed an engagement letter with CRI, and the Board of Directors ratified the engagement the same day.

Neither of Dudley Hopton-Jones' reports on the Company's financial statements for 2000 or 2001 contained an adverse opinion or a disclaimer of opinion or was qualified or modified as to uncertainty, audit scope or accounting principles. During fiscal years 2000, 2001, and through October 4, 2002, there were no disagreements between the Company and Dudley Hopton-Jones on any matter of accounting principles or practices, financial statements disclosure or auditing scope or procedure. CRI's report on the Company's financial statements for the fiscal year ended December 31, 2003 did not contain an adverse opinion or a disclaimer of opinion, and was not qualified or modified as to uncertainty, audit scope or accounting principles.

CRI has advised the Company that neither the firm nor any of its partners has any direct or material interest in the Company and its subsidiaries, except as auditors and independent certified public accountants of the Company and its subsidiaries.

The following table shows the aggregate fees billed to the Company for professional services by CRI for fiscal years 2002 and 2003.

	<u>Fiscal 2003</u>	<u>Fiscal 2002</u> <sup>(1)</sup>
Audit Fees <sup>(2)</sup>	\$ 280,000	\$ 145,000
Audit-Related Fees <sup>(3)</sup>	45,274	0
Tax Fees <sup>(4)</sup>	52,884	0
Other Fees <sup>(5)</sup>	2,945	0
<b>Total</b>	<u>\$ 381,103</u>	<u>\$ 145,000</u>

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- (1) CRI was not engaged as the Company's independent auditors until October 2002. Therefore, the 2002 fees represent only a partial year. The Company paid Audit Fees of \$13,000 and Audit-Related Fees of \$25,665 to Dudley Hopton-Jones for services rendered to the Company in 2002.
- (2) Audit Fees consist of fees billed for professional services rendered for the audit of the Company's consolidated annual financial statements and review of the quarterly interim consolidated financial statements and services that are normally provided by the independent auditor in connection with statutory and regulatory filings or engagements, as well as consents and assistance with, and review of, documents filed with the SEC.

- (3) Audit-Related Fees consist of fees billed for assurance and related services that are reasonably related to the performance of the audit or review of the Company's consolidated financial statements and are not reported under Audit Fees and include employee benefit plan audits, accounting consultations, internal control reviews and attest services that are not required by statute or regulation.
- (4) Tax Fees consist of fees billed for professional services rendered for tax preparation, tax compliance, tax advice and tax planning. These services include assistance regarding federal and state tax compliance and tax planning.
- (5) All Other Fees consist of fees for products and services other than the services reported above. In 2003, Other Fees related primarily to agreed upon procedures for collateral verification for the Federal Home Loan bank of Atlanta.

Based upon the Company's relationship with CRI, including the services and fees set forth above, the Company's Board of Directors believes that the provision of services by CRI to the Company is compatible with maintaining the independence of CRI from the Company.

During the two most recent fiscal years and through the date hereof, the Company has not consulted with CRI or Dudley Hopton-Jones on items that (i) were or should have been subject to SAS 50, or (ii) concerned the subject matter of a disagreement or reportable event with the former auditor as (described in Regulation S-K, Item 304 (a)(2)).

#### **Pre-Approval Policies and Procedures**

Pursuant to Company policy, all audit and permitted non-audit services must be pre-approved by the Audit Committee. All of the services described above for 2003 were pre-approved by the Audit Committee. Any services for 2002 that were not pre-approved were not required to be pre-approved at that time.

### **LEGAL PROCEEDINGS**

#### **Background**

At a June 20, 2000 meeting of the board of directors of Community Bank, one of Community Bank's directors brought to the attention of the board of directors the total amount of money that Community Bank had paid to subcontractors in connection with the construction of a new Community Bank branch office in Guntersville, Alabama. Based upon this amount, management commenced an investigation into these expenditures.

At the request of management, the architects and subcontractors involved in the construction project made presentations to the boards of directors of the Community Bancshares and Community Bank on July 15 and July 18, 2000, respectively. At the July 18, 2000 meeting of the board of directors of Community Bank, another director alleged that Community Bank had been overcharged by subcontractors on that construction project, as well as on another construction project that remained uncompleted at that time.

On July 18, 2000, the boards of directors of Community Bancshares and Community Bank appointed a joint committee comprised of independent directors to investigate these alleged overcharges. The joint committee retained independent legal counsel and an independent



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accounting firm to assist its investigation and has since made its report to the boards of directors.

Community Bank's directors who alleged the construction overcharges also informed bank regulatory agencies and law enforcement authorities of their concerns. These agencies and authorities conducted their own investigations into this matter. Based on its findings, the FDIC issued restitution and/or removal orders against Kennon R. Patterson, Sr., former Chairman and Chief Executive Officer of the Company and Community Bank, and Larry Bishop, former Vice President of Community Bank. These regulatory actions are still pending at this time. The board of directors of Community Bancshares and the board of directors of Community Bank terminated Kennon R. Patterson, Sr. on January 27, 2003, and the board of directors of Community Bank terminated Larry Bishop on February 6, 2003. On October 29,

2003, the United States Department of Justice announced the filing of a 25-count indictment against Messrs. Patterson and Bishop and a construction contractor in connection with a scheme to divest Community Bank's funds for Mr. Patterson's personal benefit. On November 14, 2003, Mr. Patterson informed Community Bancshares that he was taking a leave of absence from Community Bancshares' Board of Directors pending a resolution of the criminal charges against him. Mr. Patterson stated that he would not seek re-election to Community Bancshares' board of directors if the criminal charges were not resolved prior to the expiration of his current term in 2005. Community Bancshares and Community Bank continue to seek Mr. Patterson's resignation as a director of Community Bancshares and recover all amounts owed by Mr. Patterson to Community Bank.

### **Patterson Litigation**

Plaintiffs: Kennon R. Patterson, Sr., Community Bancshares's former Chairman, President and Chief Executive Officer  
Defendants: Community Bancshares, Community Bank, five of the directors of Community Bancshares and Community Bank, and Powell, Goldstein, Frazer and Murphy, LLP, as counsel to Community Bank's Audit Committee

On April 9, 2003, Mr. Patterson filed an adversary proceeding against the defendants in the United States Bankruptcy Court for the Northern District of Alabama in connection with his petition for protection under Chapter 11 of the United States Bankruptcy Code. Mr. Patterson's complaint:

alleges that Community Bancshares breached its employment agreement with Mr. Patterson by terminating his employment on January 27, 2003 and failing to pay him for compensation and benefits that had accrued prior to his termination; and

alleges that Community Bank, members of Community Bank's Audit Committee, the Audit Committee's independent counsel and Community Bancshares' current Chairman, President and Chief Executive Officer conspired to interfere with Mr. Patterson's contract and business relationship with Community Bancshares.

The suit seeks damages in excess of \$150.0 million for, among other things, lost compensation and benefits, mental anguish, and damage to Mr. Patterson's reputation. Community Bancshares presently believes that this lawsuit is without merit and intends to vigorously defend itself against this action.

On May 9, 2003 the defendants filed a motion to dismiss the suit, and, on June 17, 2003, the court denied the motion to dismiss the suit as to Community Bancshares, Community Bank and the named directors. On July 7, 2003, those defendants filed a counterclaim against Mr. Patterson asserting that Mr. Patterson breached his employment agreement with Community Bancshares, engaged in fraudulent conduct, and converted property belonging to Community Bank to his personal use.

On January 12, 2004, the bankruptcy proceeding filed by Mr. Patterson was dismissed without prejudice. Community Bancshares, Community Bank and the individual defendants moved to dismiss the adversary proceeding in bankruptcy filed against them by Mr. Patterson. That motion is currently under consideration by the Bankruptcy Court for the Northern District of Alabama.

Further, on March 15, 2004 the Employee Stock Ownership Plan, or ESOP, of Community Bancshares, together with the ESOP trustee, North Star Trust Company, filed suit in the United States District Court for the Northern District of Alabama against Mr. Patterson. In the lawsuit, the ESOP seeks damages for alleged breaches of fiduciary duty by Mr. Patterson, and both the ESOP and the trustee seek a declaratory judgment that the ESOP has a right of set-off against Mr. Patterson's account in the ESOP, and the ESOP is not required to make a distribution of funds to Mr. Patterson.



### **Corr Family Litigation**

Plaintiffs: Bryan A. Corr and six other of Community Bancshares stockholders related to Mr. Corr

Defendants: Community Bancshares, Community Bank, and certain named directors and officers of Community Bancshares and Community Bank

On September 14, 2000, the plaintiffs filed an action against the defendants in the Circuit Court of Blount County, Alabama, alleging that the named directors actively participated in or ratified the misappropriation of corporate income by Mr. Patterson and others. Because the action was not styled as a stockholder derivative action, on January 3, 2001, the defendants filed a motion for summary judgment on the basis that these claims are derivative in nature and cannot be brought on behalf of individual stockholders. On May 15, 2003, the court granted the defendants motion for summary judgment, and the plaintiffs have appealed the court's ruling.

On April 16, 2004, Community Bancshares and Community Bank entered into a settlement agreement with the plaintiffs pursuant to which Community Bancshares and Community Bank will be dismissed with prejudice as defendants in this lawsuit. The individual defendants will also be dismissed with prejudice following their execution of a similar settlement agreement.

### **Benson Litigation**

Plaintiffs: M. Lewis Benson, Doris E. Benson, John M. Packard, Jr. and Andy C. Mann, four of Community Bancshares stockholders

Defendants: Community Bancshares, Community Bank, certain of the present and former directors of Community Bancshares and Community Bank, an employee of Community Bank and two construction subcontractors previously hired by the Company

On July 21, 2000, the plaintiffs filed a lawsuit, styled as a stockholder derivative suit, in the state Circuit Court of Marshall County, Alabama against the defendants, relating to alleged overcharges in construction costs. At the time, these charges were being investigated by a joint committee of the boards of directors of Community Bancshares and Community Bank.

The complaint:

alleges that the directors, officers and employee named as defendants (i) breached their fiduciary duties, (ii) failed to properly supervise officers and agents of Community Bancshares and Community Bank, and (iii) permitted waste of corporate assets by permitting the subcontractor defendants to overcharge Community Bank in connection with the construction of two new Community Bank branch offices, and to perform the construction work without written contracts, budgets, performance guarantees and assurances of indemnification;

alleges that Kennon R. Patterson, Sr., the Company's former Chairman, President and Chief Executive Officer, breached his fiduciary duties by permitting the two named subcontractors to overcharge for work performed on the two construction projects in exchange for discounted charges for work these subcontractors performed in connection with the construction of Mr. Patterson's residence;

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alleges that the director defendants knew or should have known of this alleged arrangement between Mr. Patterson and the subcontractors; and

alleges that Mr. Patterson, the Community Bank employee and the two subcontractor defendants made false representations and suppressed information about the overcharges and arrangement between Mr. Patterson and the subcontractors.

On August 15, 2000, the plaintiffs filed an amended complaint that generally reiterates the allegations of the original complaint, and further:

alleges that the Bank was overcharged on all construction projects from January 1997 to the present; and

alleges that the defendants breached their fiduciary duties and are guilty of gross financial mismanagement, including making or approving loans and taking improper actions to conceal the fact that the loans were uncollectible.

On September 18, 2000, the plaintiffs filed a second amended complaint generally reiterating the allegations of the original and first amended complaints, and further:

alleging that the plaintiffs were improperly denied their rights to inspect and copy certain records of Community Bancshares and Community Bank; and

alleging that the directors of Community Bancshares abdicated their roles as directors either by express agreement or as a result of wantonness and gross negligence.

The second amended complaint further asserts that the counts involving inspection of corporate records and director abdication are individual, non-derivative claims. The second amended complaint seeks, on behalf of Community Bancshares, an unspecified amount of compensatory damages in excess of \$1.0 million, punitive damages, disgorgement of improperly paid profits and appropriate equitable relief. Upon a motion of the defendants, the case was transferred to the state Circuit Court in Blount County, Alabama by order dated September 21, 2000, as amended on October 12, 2000.

Tentative settlements of the lawsuit were announced in November 2002, August 2003 and November 2003 but were not finalized.

On January 6, 2004, the Circuit Court of Blount County, Alabama disapproved a proposed settlement of the Benson and Packard derivative lawsuits. Subsequently, another settlement proposal was made by the individual defendants, other than Kennon R. Patterson, Sr., directly to Community Bancshares and Community Bank. Pursuant to this new settlement, Community Bank would receive \$1.655 million, less any fees awarded by the Court to the plaintiffs' attorneys. A special committee of the Boards of Directors of the two companies, consisting of the members who are not defendants in the cases, accepted the offer which was then filed with the Court on February 19, 2004. No hearing on the motion has yet been set. All proceedings in these cases have been stayed pending a decision from the Supreme Court of Alabama as to whether the cases can proceed as to Mr. Patterson and Larry Bishop prior to their trial on criminal charges.

On or about April 5, 2004, Travelers Casualty and Surety Company of America filed a motion for permission to intervene in the Benson litigation asserting that, to the extent that it is required to reimburse Community Bancshares and Community Bank for losses pursuant to the Company's fidelity bond, it will be subrogated to the derivative claims made on behalf of Community Bancshares and Community Bank in the Benson litigation.

**Packard Derivative Litigation**

Plaintiffs: M. Lewis Benson, Doris E. Benson, John M. Packard, Jr. and Andy C. Mann, four of Community Bancshares stockholders

Defendants: Sheffield Electrical Contractors, Inc., Steve Sheffield, Jay Bolden, Dudley, Hopton-Jones, Sims & Freeman, PLLP, Glynn C. Debter, Kennon R. Patterson, Jr., Robert O. Summerford, Jimmie A. Trotter, John L. Lewis, Jr., Merritt M. Robbins, Stacey W. Mann, B. K. Walker, Jr., Denny Kelly, Roy B. Jackson, Loy D. McGruder, and Hodge Patterson

On April 4, 2003, the plaintiffs, which are the same as in the Benson case described above, filed a derivative action against the defendants. This action, while stemming from the same facts alleged in the Benson Litigation, is based not upon what the director-defendants did (and did not do) before learning of the over billing [sic.] allegations against [Mr.] Patterson in July 2000 but, instead, is based upon what they have done (and failed to do) after the filing of the Benson lawsuit that is, after they learned of the allegations against [Mr.] Patterson in July 2000.

On June 18, 2003, the Circuit Court of Jefferson County, Alabama granted the motion filed by Community Bancshares, Community Bank and most of the individual defendants to transfer the suit to the Circuit Court of Blount County, Alabama.

On or about October 1, 2003, one of the defendants, Dudley, Hopton-Jones, Sims & Freeman, PLLP, formerly the certified public accountants and outside auditors for Community Bancshares and Community Bank, filed a cross-claim against Community Bank, Community Bancshares, Glynn C. Debter, Kennon R. Patterson, Jr., Robert O. Summerford, Jimmie A. Trotter, John L. Lewis, Jr., Merritt M. Robbins, Stacey W. Mann, B. K. Walker, Jr., Denny Kelly, Roy B. Jackson, Loy D. McGruder, and Hodge Patterson, all of whom are directors or former directors of Community Bancshares and/or Community Bank. The cross-claim demands compensatory damages, interest, and costs, including the amount of any adverse judgment entered in this cause against Dudley, Hopton-Jones. Punitive damages are also demanded in some counts. The basis for the claims is common law indemnity, contractual indemnity, negligence, misrepresentation, suppression, and concealment of material facts, and, civil conspiracy.

On November 11, 2003 Community Bancshares, Community Bank, and certain individual defendants entered into an agreement to settle this case, which was not finalized.

On January 6, 2004, the Circuit Court of Blount County, Alabama disapproved a proposed settlement of the Benson and Packard derivative lawsuits. Subsequently, another settlement proposal was made by the individual defendants, other than Kennon R. Patterson, Sr., directly to Community Bancshares and Community Bank. Pursuant to this new settlement, Community Bank would receive \$1.655 million, less any fees awarded by the Court to the plaintiffs attorneys. A special committee of the Boards of Directors of the two companies, consisting of the members who are not defendants in the cases, accepted the offer which was then was filed with the Court on February 19, 2004. No hearing on the motion has yet been set. All proceedings in these cases have been stayed pending a decision from the Supreme Court of Alabama as to whether the cases can proceed as to Mr. Patterson and Larry Bishop prior to their trial on criminal charges.

### **Lending Acts Litigation**

Plaintiffs: William Alston, Murphy Howard, and Jason Tittle

Defendants: Community Bancshares, Community Bank, Holsombeck Motors, Inc., Lee Brown d/b/a Alabama Bond & Investigation a/k/a ABI Recovery, Chris Holmes d/b/a Alabama Bond & Investigation a/k/a ABI Recovery, Regina Holsombeck, Kennon Ken Patterson, Sr., Hodge Patterson, James Timothy Tim Hodge, Ernie Stephens, and the State of Alabama Department of Revenue

On October 11, 2002, the plaintiffs filed a class action against the defendants alleging that Community Bank and others conspired or used extortionate methods to effect a lending scheme of churning phantom loans, and that profits from the scheme were used to secure an interest in and/or to invest in an enterprise that affects interstate commerce. The plaintiffs specifically allege that Community Bank used various methods to get uneducated customers with fair to poor credit to sign numerous phantom loans when the customers only intended to sign for one loan. Claims include racketeering activity within the meaning of the Racketeer Influenced and Corrupt Organizations Act of 1970, conspiracy, spoliation, conversion, negligence, wantonness, outrage, and civil conspiracy.

On or about February 17, 2004, an amended complaint was filed in this lending acts litigation. The amended complaint, which completely replaces the original complaint, omits class action and racketeering claims and alleges violations of the Truth in Lending Act and Regulation Z of the Federal Reserve Board in addition to conversion, negligence, outrage, suppression, fraud and misrepresentation, trespass, conspiracy and failure to provide notice before disposition of collateral for loans. On April 2, 2004, eighty-one individuals, most of whom were formerly members of the purported class in the lending acts litigation filed by William Alston, filed suit against Community Bancshares, Community Bank and a former Community Bank employee in the Circuit Court of Jefferson County, Alabama. This suit claims that the defendants injured the plaintiffs, primarily in connection with lending at Community Bank's office in Double Springs, Alabama, by wrongfully taking property, committing fraud, furnishing inaccurate information to credit reporting agencies, negligently hiring, training and supervising employees, negligently handling customer accounts, altering loan documents and failing to honor oral and written contracts with the plaintiffs.

### **Employee Litigation**

Plaintiffs: Bishop K. Walker, Jr., former Senior Executive Vice President and General Counsel of Community Bancshares, and his wife, Wanda Walker, and Denny G. Kelly, former President of Community Bank, and his wife Arlene Kelly

Defendants: Community Bancshares, Community Bank, Kennon R. Patterson, Sr., and a number of unidentified defendants

On May 5, 2003, the plaintiffs filed separate suits in the Circuit Court of Blount County, Alabama, against the defendants alleging that they were induced to retire based upon misrepresentations made by Kennon R. Patterson, Sr., who at the time was Community Bancshares' Chairman, President and Chief Executive Officer. The plaintiffs claim that Mr. Patterson's actions constituted fraud, promissory fraud, fraudulent suppression, fraud in the inducement, deceit, fraudulent deceit, negligence, recklessness, wantonness and breach of contract. The complaints seek an unspecified amount of compensatory and punitive damages.

On October 23, 2003 Community Bancshares and Community Bank filed counter claims against Mr. Walker and Mr. Kelly seeking repayment of amounts paid to them as part of a severance arrangement and, in the case of Mr. Kelly, amount owed to Community Bank in connection with the two loans from Community Bank to Mr. Kelly.



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Mr. Kelly and Mr. Walker each filed an amended complaint on or about April 20, 2004. The amended complaints add Mrs. Kelly and Mrs. Walker as parties plaintiff and allege that representations were made by the defendants to Mrs. Kelly and Mrs. Walker that the defendants would purchase their personal and jointly owned stock of the Company. The complaints assert that the defendants' failure to purchase such stock constitutes promissory fraud,

fraudulent misrepresentation, fraudulent suppression, negligence and/or wantonness. Mr. Walker's amended complaint also seeks damages based on Community Bank's refusal to accept a deed in lieu of foreclosure on Mr. Walker's house.

### **Other Litigation**

In addition to the foregoing, Community Bancshares and its affiliates also are from time to time parties to other legal proceedings arising in the ordinary course of Community Bancshares' business. Community Bancshares presently believes that, other than the litigation discussed above, there is no other litigation to which Community Bancshares or its affiliates presently are subject that, if such litigation were to result in an outcome unfavorable to Community Bancshares, would, individually or in the aggregate, have a material adverse effect on Community Bancshares' financial condition or results of operations.

Community Bancshares' Certificate of Incorporation and Bylaws provide that, in certain circumstances, Community Bancshares will indemnify its directors and officers, and, provided such persons acted in accordance with the standards set forth in the Delaware General Corporation Law and Community Bancshares' organizational documents, advance expenses to its directors and officers in connection with investigations and proceedings in connection with their service as officers and directors of Community Bancshares.

### **STOCKHOLDER PROPOSALS FOR THE 2005 ANNUAL MEETING**

In order to be included in the Company's proxy materials for the Company's 2005 Annual Meeting of Stockholders, stockholder proposals must be received in written form at the Company's executive offices on or before January 28, 2005, which is 120 days before the one-year anniversary of the date that the Company mailed this Proxy Statement to the stockholders, and must otherwise be in compliance with Rule 14a-8 (which concerns stockholder proposals that are requested to be included in a company's Proxy Statement) under the Exchange Act and other applicable legal requirements. Pursuant to Rules 14a-4 and 14a-5 (which concern the exercise of discretionary voting authority when a stockholder commences his or her own proxy solicitation outside of the processes of Rule 14a-8) under the Exchange Act, stockholders are advised that under the advance notice provisions of the Company's Bylaws a stockholder proposal will not be considered at the 2005 annual meeting if received by the Company after January 28, 2005.

The Company's Bylaws require that a stockholder proposing business to be considered at an Annual Meeting of Stockholders include in the written notification to the Company the following information: (i) a brief description of the business desired to be brought before the Annual Meeting of Stockholders and the reasons for conducting such business at the meeting; (ii) the name and address, as they appear on the Company's books, of the stockholder proposing such business; (iii) the class and number of shares of the Company that are beneficially owned, as such term is defined in Rule 13d-3 under the Exchange Act, by the stockholder; (iv) any substantial interest of the stockholder in such business; and (v) any other information required pursuant to the rules and regulations promulgated under the Exchange Act relating to stockholder proposals. A stockholder has a substantial interest in the business if such interest would be reportable pursuant to Item 5 of Schedule 14A promulgated under the Exchange Act, assuming that the stockholder's business was in fact considered at the Annual Meeting of Stockholders.

### **OTHER BUSINESS**

Management of the Company presently does not know of any matters to be brought before the Annual Meeting other than those described in this Proxy Statement. If any other matters properly come before the Annual Meeting, then the persons designated as proxies will vote on such matters in accordance with their best judgment.



**COMMUNITY BANCSHARES, INC.**

**CHARTER OF THE AUDIT COMMITTEE**

**OF THE**

**BOARD OF DIRECTORS**

**Title**

The title of this Committee shall be the Audit Committee (the Committee ) of the Board of Directors (the Board ) of Community Bancshares, Inc. (the Company ).

**Composition**

The Committee shall be composed of a minimum of three directors. The independence and qualifications of the members of the Committee shall at all times satisfy the applicable requirements of: (i) the Securities Exchange Act of 1934, as amended (the Exchange Act ), and the rules and regulations of the Securities and Exchange Commission (the Commission ) thereunder; (ii) the Sarbanes-Oxley Act of 2002 (the Sarbanes-Oxley Act ) and the rules and regulations of the Commission thereunder; (iii) the Federal Deposit Insurance Act (the FDIA ), as amended, and the rules, regulations and guidelines of the Federal Deposit Insurance Corporation (the FDIC ) thereunder; and (iv) any exchange (the Exchange ) on which the Company's securities are listed (such independence and qualifications requirements are collectively referred to herein as the Membership Requirements ). In addition, each of the members of the Committee shall at all times be independent and free from any relationship that would interfere with the exercise of his or her independent judgment in carrying out the responsibilities of a director, and independent of management of the Company and its direct and indirect subsidiaries and subsidiary affiliated entities (together, Subsidiaries ).

To facilitate compliance with the Membership Requirements, each proposed member of the Committee shall, on an annual basis, complete and submit to the Board an Independence Questionnaire. The Committee, prior to its taking any action during a particular year, shall first ascertain that the Board has (i) carefully reviewed all such Questionnaires, and (ii) affirmatively determined that each of the proposed members of the Committee satisfies the Membership Requirements.

**Reporting Structure**

The independent auditors shall report to the Committee and shall be ultimately accountable to the Committee. As used herein, the term independent auditors shall mean registered public accounting firm upon and after the establishment of the Public Company Accounting Oversight Board and the implementing rules of such Board and the Commission. Such firm shall meet all requirements of 12 C.F.R. Part 363.

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The Committee shall, in turn, regularly report to the Board, as frequently as may be required or prudent under the Duties and Responsibilities set forth below.

### **Purposes**

The primary purposes of the Committee are to monitor (i) the accounting and financial reporting processes of the Company and its Subsidiaries and the audits of the financial statements of the Company and its Subsidiaries; (ii) the integrity of the Company's financial statements; (iii) the Company's compliance with legal and regulatory requirements; (iv) the independence and qualifications of the Company's independent auditors; and (v) the performance of the Company's internal audit function and its independent auditors (including the resolution of disagreements between management and the independent auditors). The Committee's function is one of oversight and review, and it is not required to prepare or audit the financial statements, define the scope of the audit, control the Company's and its Subsidiaries' accounting policies and practices, or define the standards used in preparing the financial statements, except as required under the Duties and Responsibilities set forth below.

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In furtherance of its purposes, the Committee shall:

1. Provide assistance to the Board in fulfilling its fiduciary responsibilities relating to corporate accounting and reporting practices of the Company and its Subsidiaries.
2. Facilitate communications between the Board and the independent auditors.
3. Oversee the business risk management process that identifies and measures business and financial reporting risks of the Company and its Subsidiaries, and monitor the effectiveness of the control and risk management processes.
4. Provide the independent auditors a private, confidential audience at any time it is desired or requested, with or without the knowledge of management.
5. Review with the auditors (internal and external) and the Company's management, the quality and acceptability of material financial reporting decisions and judgments.
6. Perform the functions of an audit committee for Community Bank and such other of the Company's Subsidiaries that are banks, as contemplated by Section 36 of the FDIA.

#### **Duties and Responsibilities**

The Committee shall observe and perform the following duties and responsibilities:

1. The Committee shall have the sole authority, as set forth in Section 10A(m) of the Exchange Act, to appoint, replace, oversee and determine funding for the independent auditor and to determine whether such auditors are independent pursuant to the Sarbanes-Oxley Act, the FDIA, the Exchange Act and the rules and regulations of the Commission thereunder, the Exchange (if applicable) and the FDIC. The Committee shall be directly responsible for the compensation and oversight of the work of the independent auditor (including resolution of disagreements between management and the independent auditor regarding financial reporting) for the purposes of preparing or issuing an audit report or related work. The Committee shall, at least annually, obtain and review a report by the independent auditor describing:
  - (i) the auditor's internal quality-control procedures;
  - (ii) any material issues raised by the most recent internal quality-control review, or peer review, of the auditor, or by any inquiry or investigation by governmental or professional authorities, within the preceding five years, respecting one or more independent audits carried out by the auditor, and any steps taken to deal with any such issues; and
  - (iii) the auditor's independence, and all relationships between the independent auditor and the Company.
2. The Committee shall not approve the engagement of the independent auditor for the following services while such auditor is engaged to perform audit services:

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- (i) bookkeeping or other services related to the accounting records or financial statements of the Company;
- (ii) financial information systems design and implementation;
- (iii) appraisal or valuation services, fairness opinions, or contribution-in-kind reports;
- (iv) actuarial services;
- (v) internal audit outsourcing services;

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- (vi) management functions or human resources;
  - (vii) broker or dealer, investment adviser, or investment banking services;
  - (viii) legal services and expert services unrelated to the audit; and
  - (ix) any other service that the Public Company Accounting Oversight Board determines, by regulation, is impermissible.
3. The Committee shall approve, in advance, all auditing services and permitted non-audit services, as set forth in Section 10A(i) of the Exchange Act, (including the fees and terms of such services) to be performed for the Company by its independent auditor. The pre-approval requirement shall be waived for certain non-audit services set forth in Section 10A(i)(1)(B) of the Exchange Act.
  4. The Committee may form and delegate authority to subcommittees consisting of one or more members when appropriate, including the authority to grant approvals of audit and permitted non-audit services, provided that decisions of such subcommittee to grant pre-approvals shall be presented to the full Committee at its next scheduled meeting.
  5. The Committee shall provide that approval of any non-audit services by the Committee is disclosed pursuant to Section 10A(i)(2) of the Exchange Act in the Company's periodic reports required by Section 13(a) of the Exchange Act. The Committee shall provide that any disclosures required by Item 9 of Schedule 14A, relating to the payment of fees to the independent auditor and/or pre-approval of services, are properly made.
  6. The Committee shall meet with the independent auditors at least annually to review the scope of the audit for the current year and the audit procedures to be utilized. This review is to include the potential effects of business and financial statement risks on the company's control systems and quality of financial reporting, and a discussion of the extent to which the financial statements contain all disclosures that could reasonably be deemed material within the meaning of applicable requirements. At the conclusion of this meeting, the Committee shall review any comments or recommendations made by the independent auditors.
  7. The Committee shall review and discuss with management and the independent auditor, the Company's annual audited financial statements prior to the filing with the Commission of the Form 10-K and/or the distribution of the Company's Annual Report to Stockholders, including, without limitation, the disclosures made in the section entitled Management's Discussion and Analysis of Financial Condition and Results of Operations (the MD&A Section).
  8. The Committee shall discuss with management and the independent auditor significant financial reporting issues and judgments made in connection with the preparation of the Company's financial statements, including any significant changes in the Company's selection or application of accounting principles, any major issues as to the adequacy of the Company's internal controls and any special steps adopted in light of material control deficiencies.
  9. The Committee shall discuss with the independent auditors a common framework to assess financial reporting quality and facilitate a common vocabulary and understanding about quality among the Committee, management, and the auditors.
  10. The Committee shall review and discuss, at least annually, reports from the independent auditors, including:
    - (i) All critical accounting policies and practices to be used;
    - (ii) All alternative treatments of financial information within GAAP that have been discussed with management, ramifications of the use of such alternative disclosures and treatments, and the treatment preferred by the independent auditors; and



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- (iii) Other material written communications between the independent auditors and management, such as any management letter or schedule of unadjusted differences.
11. The Committee shall discuss with management the Company's earnings press releases, including the use of pro forma or adjusted non-GAAP information, as well as financial information and earnings guidance provided to analysts and rating agencies. This discussion may be general (addressing the types of information to be disclosed and the types of presentations to be made).
12. The Committee shall discuss with management and the independent auditor the effect of regulatory and accounting initiatives, any off-balance sheet structures on the Company's financial statements, any correspondence with regulators or governmental agencies and any published reports that raise material issues regarding the Company's financial statements, accounting policies or compliance by the Company with laws and regulations.
13. The Committee shall work with management and the Board, as appropriate, to ensure that any off-balance sheet transactions or non-GAAP financial information, if any, and the financial statements generally, are accompanied by disclosure that provides investors with a meaningful understanding of the Company's financial position and the effects of such transactions.
14. The Committee shall discuss with management the Company's major financial risk exposures and the steps management has taken to monitor and control such exposures, including the Company's risk assessment and risk management policies.
15. The Committee shall discuss with the independent auditor the matters required to be discussed by Statement on Auditing Standards No. 61 relating to the conduct of the audit, including any difficulties or problems encountered in the course of the audit work, any restrictions on the scope of activities or access to requested information, and any significant disagreements with management, as well as management's responses to such situations.
16. The Committee shall review disclosures made to the Committee by the Company's Chief Executive Officer and Chief Financial Officer during their certification process for the Form 10-K and the Form 10-Q relating to any significant deficiencies in the design or operation of internal controls or material weaknesses therein or any fraud involving management or other employees who have a significant role in the Company's internal controls.
17. The Committee shall ensure the rotation of each audit engagement team partner, principal or stockholder at least once every five years or as otherwise required by law or regulatory authority. The Committee shall consider whether, in order to assure continuing auditor independence, it is appropriate to adopt a policy of rotating the independent auditing firm itself on a regular basis.
18. The Committee shall establish and recommend to the Board, policies for the Company's hiring of employees or former employees of the independent auditor who participated in any capacity in any audit of the Company.
19. The Committee shall be advised by the independent auditor if Section 10A(b) of the Exchange Act, concerning the occurrence of illegal acts (whether or not perceived to have a material effect on the Company's financial statements), is implicated.
20. The Committee shall, with senior management, develop and submit to the Board for its timely adoption, a Code of Ethics for Financial Professionals. The Committee shall from time to time consider any changes thereto that are required by law, rule or regulation, or that the Committee deems appropriate.
21. The Committee shall obtain reports from management, the Company's senior internal auditor and the independent auditor that the Company and its Subsidiaries are in conformity with applicable legal requirements and the Company's Code Ethics for Financial Professionals. The Committee shall review reports and disclosures of insider and affiliated party transactions, and shall advise the Board with respect to the Company's



- policies and procedures regarding compliance with applicable laws and regulations and the Company's Code of Ethics for Financial Professionals.
22. The Committee shall review and approve all related-party transactions prior to consummation.
23. The Committee shall establish procedures for the receipt, retention and treatment of complaints received by the Company regarding accounting, internal accounting controls or auditing matters, the confidential, anonymous submission by employees of concerns regarding questionable accounting or auditing matters, and the protection of any such employee from retaliatory action.
24. Annually, the Committee shall report to the Board that:
- (i) The Company's audited financial statements have been reviewed and discussed with the Company's management and independent auditors, including all communications required by Statement of Accounting Standards No. 61.
  - (ii) The Committee has executed its responsibility to oversee the independent auditors. In particular, the Committee shall (a) have received the written disclosures and the letter from the independent auditors required by Independence Standards Board Standard No. 1 (Independence Standards Board Standard No. 1, Independence Discussions with Audit Committees), as may be modified or supplemented, and (b) have engaged in a dialogue with such auditors concerning whether the provision of permitted non-audit services is compatible with maintaining the auditor's independence, taking into account the opinions of management and internal auditors.
  - (iii) The Committee has recommended that the Company's audited financial statements be included in the Form 10-K.
  - (iv) The Committee's duties and responsibilities have been met for the most recently completed fiscal year.
25. The Committee shall work with the Company's management, the Board and/or the Disclosure Committee, as appropriate, to make any disclosures required by Item 7(d)(3) of Schedule 14A.
26. The Committee shall engage in such review and discussion as it deems appropriate with regard to activities of the Company's Internal Audit Department and the Compliance Department, bank regulatory examination reports and/or other regulatory reports and filings, the Company's Code of Ethics for Financial Professionals, and other legal, regulatory or other matters. The Committee shall assist in the development, approval and monitoring of the internal audit functions of the Company and its Subsidiaries.
27. The Committee shall prepare, review and execute the Report of the Committee for inclusion in the Company's annual proxy statement, as required by the Commission.
28. The Committee shall review the Company's and its Subsidiaries' compliance with applicable laws, including those banking laws and regulations concerning loans to insiders and the federal and state laws and regulations concerning dividend restrictions.
29. The Committee shall keep apprised of developments in such laws and regulations of the Commission, the Exchange (if applicable), the FDIC and otherwise as may be appropriate to ensure that (i) the Company, the Committee and this Charter remain in compliance with the corporate governance provisions thereof; and (ii) that the Committee is able to perform its duties and responsibilities under this Charter.
30. If applicable, the Committee shall provide that any going concern qualification in an audit opinion be disclosed through the Company's issuance of a press release.



### **Limitation of Audit Committee's Role**

The Committee shall have the authority to direct an investigation by the independent auditors into any matter related to the Company's business and affairs. In addition, the Committee shall have the authority and funding to utilize internal company resources, and to retain such outside legal, accounting and other advisors to obtain such advice and assistance as it deems necessary or appropriate at any time in carrying out its duties and responsibilities under this Charter.

This Charter is not intended to, and shall not, alter the standards of conduct set forth in the Delaware General Corporation Law, as amended (the DCGL), the Alabama Business Corporation Act, as amended (the ABCA), and the Alabama Banking Code (the ABC) for directors, including those directors who serve as Committee members. Members of the Committee shall have the duties and the benefits of all limitations and protections from liabilities provided by the DCGL, the ABCA and the ABC and other applicable laws and regulations with respect to their service on the Committee. Further, nothing herein is intended to or shall limit the responsibilities, duties and liabilities of the independent auditors to the Company, the Board or the Committee.

### **Meetings**

The Committee shall meet on an as needed basis, but not less frequently than quarterly. Meetings shall be called as needed to discuss any significant issues.

The Board shall appoint a member of the Committee to serve as the Committee's Chairperson. If a Committee Chairperson is not designated or present at a meeting, the members of the Committee may designate a Chairperson by majority vote of the Committee membership.

The Committee Chairperson may request any officer or employee of the Company or the independent auditor or outside counsel to attend a Committee meeting or to meet with any members of or consultants to the Committee. It is intended that any management representative present at a meeting of the Committee withdraw for a period at the end of such meeting so as to permit discussion in private with the independent auditors and among Committee members generally.

The Committee shall maintain, as part of the Company's permanent records, written minutes of the proceedings and actions of the Committee and shall make such reports to the Board as may be requested by the Board or the Chairperson thereof.

The Committee shall periodically meet separately with management, with internal auditors (or other personnel responsible for the internal audit function) and with the independent auditors.

### **Review and Approval**

The Committee shall, at least annually, review and reassess this Charter. This Charter shall be approved by the Board on an annual basis.



REVOCABLE PROXY

COMMON STOCK

COMMUNITY BANCSHARES, INC.

PROXY SOLICITED BY AND ON BEHALF OF THE BOARD OF DIRECTORS

FOR THE ANNUAL MEETING OF STOCKHOLDERS TO BE HELD ON

THURSDAY, JUNE 24, 2004

The undersigned hereby appoints Messrs. Patrick M. Frawley and William H. Caughran, or either of them, each with full power of substitution, as Proxies, to vote all shares of the Common Stock of Community Bancshares, Inc. (the Company) which the undersigned may be entitled to vote if personally present at the Annual Meeting of Stockholders to be held at the Main Clubhouse at Limestone Springs, 3000 Colonial Drive, Oneonta, Alabama, on Thursday, June 24, 2004, at 10:00 A.M., Central Time, and at any reconvened meetings following any adjournment or postponement thereof (the Annual Meeting), as directed below, upon the proposals described in the Proxy Statement and the Notice of Annual Meeting of Stockholders, both dated May 28, 2004, the receipt of which is hereby acknowledged.

When this proxy is properly executed, all shares of the Company's Common Stock held by the undersigned will be voted in the manner directed herein by the undersigned stockholder. If no direction is specified, then this proxy will be voted **FOR** all proposals.

	FOR all nominees for director		
	listed (except as marked to the	WITHHOLD AUTHORITY	
	contrary below)	(to vote all nominees listed)	
1. <i>Election of Directors</i>			
Class II Directors	Glynn C. Debter		
	John J. Lewis, Jr.	..	..

To withhold authority to vote for any individual nominee, write that nominee's name in the space provided.

2. <i>Removal of a Director</i>	FOR	AGAINST	ABSTAIN
To remove Kennon R. Patterson, Sr. as a Class III director of the Company	..	..	..

3. In their discretion, the Proxies are authorized to vote upon such other matters as may properly come before the Annual Meeting or any adjournment or postponement thereof.

SIGNATURE(S) \_\_\_\_\_

DATE \_\_\_\_\_

THIS PROXY IS SOLICITED BY  
THE BOARD OF DIRECTORS OF



**COMMUNITY BANCSHARES,  
INC., AND MAY BE REVOKED  
PRIOR TO ITS EXERCISE.**

SIGNATURE(S)

DATE

\_\_\_\_\_

\_\_\_\_\_

Please sign exactly as name appears hereon. When shares are held by joint tenants, both should sign. When signing as attorney, executor, administrator, trustee or guardian, please give full title as such. If a corporation, please sign in full corporate name by President or other authorized officer. If a partnership, please sign in partnership name by authorized person.