METROPOLITAN HEALTH NETWORKS INC
Form 10-K
March 16, 2006

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-K

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

For the fiscal year ended December 31, 2005

OR

|_| TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from _____ to _____

Commission file number: 0-28456

METROPOLITAN HEALTH NETWORKS, INC.
(Exact name of registrant as specified in its charter)

Florida	65-0635748
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
250 Australian Avenue South, Suite 400 West Palm Beach, Fl. (Address of principal executive offices)	33401 (Zip Code)

(561) 805-8500
(Registrant's telephone number, including area code)

None
(Former name, former address and former fiscal year, if changed since last report)

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

Title of each class	Name of each exchange on wh
Common Stock, $.001 par value per share	American Stock Exc NYSE Arca

Securities registered pursuant to Section 12(g) of the Act: None

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

Indicate by check mark if the registrant is not required to file reports

pursuant to Section 13 or Section 15(d) of the Exchange Act. Yes [ ] No [X]

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

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act.

Large accelerated filer [ ] Accelerated filer [X] Non-accelerated fi

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

As of June 30, 2005, the aggregate market value of the registrant's common stock held by non-affiliates of the registrant was $109,454,687 based on the closing sale price as reported on the American Stock Exchange This calculation has been performed under the assumption that all directors, officers and stockholders who own more than 10% of the Company's outstanding voting securities are affiliates of the Company.

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

Class	Outstanding at March
Common Stock, $.001 par value per share	49,876,526 shar

DOCUMENTS INCORPORATED BY REFERENCE

None.

METROPOLITAN HEALTH NETWORKS, INC.

FORM 10-K
For the Year Ended
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GENERAL

Unless otherwise indicated or the context otherwise requires, all references in this Form 10-K to the "Company" or "Metropolitan" refers to Metropolitan Health Networks, Inc. and its consolidated subsidiaries. Metropolitan disclaims any intent or obligation to update "forward looking statements".

CAUTIONARY NOTE REGARDING FORWARD-LOOKING STATEMENTS

Some of the discussion under the captions "Risk Factors", "Management's Discussion and Analysis of Financial Condition and Results of Operations" and "Business" and elsewhere in this Form 10-K may include certain "forward-looking statements" within the meaning of Section 27A of the Securities Act of 1933, as amended and Section 21E of the Securities Exchange Act of 1934, as amended, including, without limitation, statements with respect to anticipated future operations and financial performance, growth and acquisition opportunity and other similar forecasts and statements of expectation. These statements involve known and unknown risks and uncertainties, such as the Company's plans, objectives, expectations and intentions, and other factors that may cause its, or its industry's, actual results, levels of activity, performance or achievements to be materially different from any future results, levels of activity, performance or achievements expressed or implied by the forward-looking statements. Many of these factors are listed under "Risk Factors" and elsewhere in this Form 10-K.

In some cases, you can identify forward-looking statements by terminology such as "expects", "anticipates", "intends", "may", "should", "plans", "believes", "seeks", "estimates" or other comparable terminology.

Although it believes that the expectations reflected in these forward-looking statements are reasonable, Metropolitan does not guarantee future results, levels of activity, performance or achievements. Its actual results and the timing of certain events could differ materially from those anticipated in these forward-looking statements. It disclaims any obligation to update or review any forward-looking statements based on the occurrence of future events, the receipt of new information or otherwise.

PART I

ITEM 1 DESCRIPTION OF BUSINESS

Introduction

Through its provider service network ("PSN") and its health maintenance organization ("HMO"), Metropolitan currently provides healthcare benefits to Medicare beneficiaries in Florida. As of December 1, 2005, the PSN and the HMO provided healthcare benefits to approximately 26,200 and 1,400 Medicare Advantage beneficiaries, respectively. The HMO's membership grew to approximately 1,800 by the end of 2005.

Provider Service Network

Pursuant to two contracts with Humana, Inc. (the "Humana Agreements"), the second largest participant in the Medicare Advantage program ("Humana"), Metropolitan's PSN provides, on a non-exclusive basis, healthcare services to Medicare beneficiaries in Flagler and Volusia Counties ("Central Florida") and Palm Beach, Broward and Miami-Dade Counties ("South Florida") who have elected to receive benefits from Humana's Medicare Advantage Plan. As of December 1, 2005, the Humana Agreements covered approximately 19,600 Humana Plan Members (as defined below) in Central Florida and 6,600 Humana Plan Members in South Florida.

The PSN is comprised both of medical practices owned by the Company as well as independently owned medical practices and providers with whom it has contracted ("IPs"). Metropolitan currently owns and operates eight primary care physician practices and a medical oncology physician practice. The Company also contracts with twenty-nine primary care IPs. Through its Humana contracts Metropolitan has established referral relationships with a large number of specialist physicians, ancillary service providers and hospitals throughout South Florida and Central Florida. See "Business Model - Provider Agreements" for more information regarding the PSN's relationships with IPs, specialist physicians, ancillary service providers and hospitals.

Humana directly contracts with the Centers for Medicare and Medicaid Services ("CMS") and is paid a fixed monthly premium payment for each member ("Humana Plan Member") enrolled in Humana's Medicare Advantage Plan. The monthly amount varies by patient, county, age and severity of health status. Pursuant to the Humana Agreements, the PSN provides or arranges for the provision of covered medical services to each Humana Plan Member who selects one of the Company's affiliated providers as his or her primary care physician (a "Humana Participating Member"). In return for the provision of these medical services, the PSN receives from Humana a monthly fee, also known as a "capitated fee", for each Humana Participating Member. The fee rates are established by the contracts

between the PSN and Humana and comprise a vast majority of the monthly premiums received by Humana from CMS with respect to Humana Participating Members.

The Company's PSN assumes the full financial responsibility for the provision of all Medicare-covered medical care to Humana Participating Members, including those medical services that the PSN does not itself provide. To the extent the costs of providing such medical care are less than the related premiums receivable from Humana, the Company's PSN generates an operating profit. Conversely, if the medical costs exceed the fees receivable from Humana, the Company's PSN experiences an operating loss.

The vast majority of the Company's PSN revenues come from the Humana Agreements. The Company does receive additional revenue for providing primary care services to non-Humana Plan Members on a fee-for-service basis in the medical practices it owns and operates.

Health Maintenance Organization

Effective July 1, 2005, METCARE Health Plans, Inc., the Company's wholly owned subsidiary ("MHP"), became licensed as a Medicare Advantage HMO and entered into a contract with CMS (the "CMS Contract") to begin offering Medicare Advantage plans to Medicare beneficiaries in six Florida counties which include the cities of Fort Pierce, Port St. Lucie, Fort Myers, Port Charlotte and Sarasota. MHP has been marketing its "AdvantageCare" branded plan since July 2005. MHP is seeking to expand its HMO and as of December 31, 2005, the total number of enrollees in its plan was approximately 1,800.

In addition to growth within existing service areas, MHP has been exploring the expansion of its HMO business into new geographic areas. However, Metropolitan does not intend to provide HMO services in the geographic markets with respect to which the PSN has a contract with Humana. Metropolitan views its HMO business as an extension of its existing core competencies.

MHP was issued a Health Care Provider Certificate ("HCPC") by Florida's Agency for Health Care Administration ("AHCA"), which is responsible for oversight of quality of care issues, for the counties of Martin, St. Lucie and Okeechobee counties on March 16, 2005. Subsequent to the issuance of the HCPC, MHP submitted an application to expand its service area and received approval of the application from AHCA on May 3, 2005 for the counties of Lee, Charlotte and Sarasota. The Department of Financial Services, Office of Insurance Regulation ("OIR"), which is responsible for issues pertaining to financial stability, approved MHP's application and a Certificate of Authority to operate a HMO in the State of Florida (COA) was issued by OIR on April 22, 2005.

In February 2005, the Company submitted a Coordinated Care Plan application to CMS to provide Medicare Advantage HMO services to Medicare beneficiaries in Martin, St. Lucie, Okeechobee, Lee, Charlotte and Sarasota counties. In March 2005, CMS conducted its site visit in support of the application and, in May 2005, MHP received approval to commence operations as a Medicare Advantage HMO effective July 1, 2005.

MHP's revenues are generated by premiums consisting of monthly payments per member that are established by the CMS Contract. MHP recorded its first revenues in the third quarter of fiscal 2005.

Metropolitan believes that the continuing development efforts, required reserve requirements and operating costs for the HMO can be funded by the Company's current resources and projected cash flows from operations. The Company is

preparing to file expansion applications to operate in several additional Florida counties, with enrollments beginning as early as November 2006 for a January 1, 2007 effective date. During 2005, the Company incurred losses of approximately $6.6 million in connection with the development and operation of the its HMO and anticipates incurring additional losses in fiscal 2006. The actual amount of development costs will depend on a number of variables including, but not limited to, the effectiveness of our sales and marketing efforts in enrolling members and the HMO's revenue to medical expense ratio.

Additional information regarding Metropolitan's PSN and HMO segments for fiscal years 2005, 2004 and 2003 is set forth in Note 11 to Metropolitan's "Notes to Consolidated Financial Statements" contained in this Form 10-K. Such information is incorporated herein by reference.

History of the Company

Metropolitan was incorporated in the State of Florida in January 1996, and began operations as a Physician Practice Management Group. Although it thereafter acquired a number of physician practices and ancillary service providers, the group practice strategy was abandoned in late 1999.

The PSN's first Humana contract was secured through an acquisition in late 1997, and expanded through an additional acquisition in early 1999. Pursuant to this agreement, the PSN contracted with Humana to manage certain designated Humana Medicare Advantage lives in South Florida. In 2000, an additional contract was subsequently secured to manage certain designated Humana Medicare Advantage lives in Central Florida.

Metropolitan acquired a diagnostic laboratory and a pharmacy business in 2000 and 2001, respectively. The laboratory was shut down in 2002 and the pharmacy was sold in November 2003.

The PSN renegotiated its most significant contract with Humana, covering the Central Florida area, effective January 1, 2003. This renegotiation increased the percentage of Medicare premium the PSN received from Humana and resolved a number of contractual disputes between the PSN and Humana.

The Company hired Michael Earley as its Chief Executive Officer and President in March 2003, and subsequently adopted a strategy to focus its resources and energies on its managed care business.

In December 2003, the Medicare Prescription Drug Improvement and Modernization Act of 2003 (the "Medicare Modernization Act" or "MMA") was signed into law, which, among other changes, significantly increased funding for the Medicare Advantage program beginning in 2004.

Effective July 1, 2005, MHP commenced operations as a Medicare Advantage HMO. The HMO business has been launched in six Florida counties and MHP has been marketing its "AdvantageCare"-branded health plan since July 2005.

Metropolitan's principal place of business is 250 Australian Ave., Suite 400, West Palm Beach, FL 33401. Its telephone number is (561) 805-8500.

Industry

The Florida Medicare Advantage Market

Behind only California, which has 4.3 million Medicare eligibles, Florida has the second largest Medicare population in the U.S. with an estimated three million lives. California's Medicare Advantage penetration is approximately 31% while Florida's is only 18%. Within Florida, the Company believes that of the approximate 981,000 and 357,000 persons who are eligible for Medicare in the counties served by its PSN and HMO, respectively, approximately 38% and 7% are members of Medicare Advantage plans, respectively. Florida's Medicare eligible population is expected to grow to four million by 2015.

Medicare Advantage Penetration in Counties Served By PSN

(CMS data modified January 2006)

County	Medicare Eligibles	Medicare Advantage Penetration	Penetration %
Broward	248,637	106,364	42.8%
Miami-Dade	347,328	160,926	46.3%
Palm Beach	254,676	68,828	27.0%
Flagler	20,064	4,973	24.8%
Volusia	110,013	32,959	30.0%
	980,718	374,050	38.1%

Medicare Advantage Penetration in Counties Served By HMO

(CMS data modified January 2006)

County	Medicare Eligibles	Medicare Advantage Penetration	Penetration %
Charlotte	41,072	3,297	8.0%
Lee	114,348	7,672	6.7%
Sarasota	111,186	5,345	4.8%
Martin	35,181	3,053	8.7%
Okeechobee	7,568	662	8.7%
St. Lucie	47,862	5,474	11.4%
	357,217	25,503	7.1%

Medicare

A report issued in early 2005 by the Office of the Actuary at CMS estimated that national healthcare spending in the United States was $1.9 trillion, or $6,280 for every American, in 2004. The CMS report projected that healthcare spending, which today accounts for nearly 16% of the national economy, would grow to $4.0 trillion by 2015. The projected principal drivers for this growth include continued cost-increasing medical innovation, inflation, continued strong demand for prescription drugs and the aging baby-boomer demographic.

Medicare is the nationwide health insurance program providing health insurance to people aged 65 and older, people entitled to Social Security disability payments for two years or more, and people with end-stage renal disease, regardless of income. Medicare currently provides healthcare benefits to approximately 42 million elderly and disabled Americans. Medicare spending per beneficiary, including the new Part D prescription benefit described below, is projected to be $10,621 in 2006 and grow to $15,600 by 2014.

The Medicare program has three primary components:

(i) Part A - Medicare Part A covers inpatient hospital, skilled nursing facility, home health and hospice care. All citizens of the United States are automatically enrolled in Medicare Part A upon reaching the age of 65.

(ii) Part B - Medicare Part B covers almost all reasonable and necessary medical services, including doctors' services, laboratory and x-ray services, durable medical equipment (wheelchairs, hospital beds), ambulance services, outpatient hospital care, home health care, blood and medical supplies. Medicare's Part B is optional and is financed largely by monthly premiums paid by individuals enrolled in the program. Participants may have this premium automatically deducted from their Social Security check. The monthly premium is $88.50 per month in 2006. Medicare Part B has an annual deductible requirement, which equals $124 in 2006. Once the deductible has been met, Medicare Part B will generally pay 80% of the Medicare allowable fee schedule and beneficiaries pay the remaining 20%.

(iii) Part D - First available in 2006, Medicare Part D permits every Medicare recipient to select a prescription drug plan. Medicare Part D replaces the transitional prescription drug discount program and replaces Medicaid prescription drug coverage for dual-eligible beneficiaries.

Initially, Medicare was offered only on a "fee-for-service" ("FFS") basis. Under the Medicare FFS payment system, an individual can choose any licensed physician and use the services of any hospital, healthcare provider, or facility certified by Medicare. CMS reimburses providers if Medicare covers the service and CMS considers it "medically necessary."

As an alternative to the traditional Medicare "fee-for-service" program, Medicare offers beneficiaries the option to receive care through private managed care plans. These private managed care options are part of Medicare Part C, which has also been known as Medicare+Choice plans, and is now called Medicare Advantage.

Medicare Advantage plans contract with CMS to provide benefits that exceed those offered under the traditional FFS Medicare program by at least thirty percent in exchange for a fixed monthly premium payment per member from CMS. The monthly premium varies based on the county in which the member resides, as adjusted to reflect the member's demographics and the plans' risk scores. Individuals who elect to participate in the Medicare Advantage program receive greater benefits than traditional FFS Medicare beneficiaries, including, but not limited to, eye exams, hearing aids and routine physical exams. Out-of-pocket costs for the Medicare beneficiary may also be lower. However, in exchange for these enhanced benefits, members are generally required to use only the services and provider networks offered by the Medicare Advantage plan. This participation of private health plans in the Medicare Advantage Program under full risk contracts began in the 1980's and grew to a peak membership in 2000 when Medicare HMOs covered 6.3 million lives. According to information provided by the Henry J. Kaiser Family Foundation, as of September 1, 2005, Medicare Advantage plans accounted for slightly more than 12% of the Medicare population, down from a peak penetration of 16% in 2000. The Balanced Budget Act of 1997 (the "BBA"), among other things, imposed limitations on reimbursement, which contributed to a decline in the number of Medicare Advantage plans from 346 in 1998 to 151 in 2003. The exodus of managed care companies from the Medicare program left many Medicare beneficiaries without a private plan option.

The Medicare Modernization Act

The Medicare Modernization Act, signed into law in December 2003, provided sweeping changes to the Medicare program. The MMA, among other things (i) generally increased the rates payable to Medicare Advantage plans from CMS, (ii) added the Medicare Part D prescription drug benefit beginning in January 2006, (iii) implemented a competitive bidding process for the Medicare Advantage Program and (iv) provided a limited annual enrollment period.

Increase in Rates Payable

The MMA made favorable changes to the premium rate calculation methodology and generally provides for program rates that will better reflect the increased cost of medical services provided by managed care organizations to Medicare beneficiaries. The MMA rates for 2004 reflected an average increase of 10.6% over the prior year rates, the MMA rates for 2005 reflected an average increase of 6.6% over the prior year rates and the announced MMA rates for 2006 are expected to reflect an average increase of 4.8% over the prior year.

The MMA's funding increases were intended to both offset medical cost inflation and to allow enhanced plan benefit design to encourage increased participation by managed care organizations in the Medicare Advantage program. According to information provided by the Henry J. Kaiser Family Foundation, as of July 2005, the number of Medicare Advantage plans had increased to 247, up from 151 in 2003.

Medicare Part D

As part of the MMA, effective January 1, 2006, Medicare beneficiaries are eligible to receive assistance paying for prescription drugs through new Medicare Part D. The drug benefit is not part of the traditional fee-for-service Medicare program, but rather is offered through private insurance plans. Medicare beneficiaries were able to choose and enroll in a prescription drug plan through Medicare Part D. Prescription drug coverage under Part D is voluntary. Fee-for-service beneficiaries may purchase Part D coverage from a stand-along prescription drug plan (a "PDP") from a list of CMS approved PDPs.

Individuals who are enrolled in a Medicare Advantage plan must receive their drug coverage through their Medicare Advantage prescription drug plan ("MA-PD plan") and may not enroll in a separate PDP. Beneficiaries who are eligible for both Medicare and Medicaid, known as dual eligible beneficiaries, who have not enrolled in a MA-PD Plan or a PDP have been automatically enrolled by CMS with approved PDPs in their region.

The Medicare Part D prescription drug benefit will be largely subsidized by the federal government and is additionally supported by risk-sharing with the federal government through risk corridors designed to limit the profits or losses of the drug plans and reinsurance for catastrophic drug costs. The government subsidy will be based on the national weighted average monthly bid for this coverage, adjusted for member demographics and risk factor payments. The subsidy for Part D benefits is estimated for 2006 to be $92.30 per beneficiary per month on average. The beneficiary will be responsible for payment of a monthly premium, anticipated to be approximately $32.20 per

beneficiary per month, subject to certain co-pays, an annual deductible, and late enrollment penalties.

Humana Participating Members and MHP's plan members will be automatically enrolled in their MA-PD plans as of January 1, 2006 unless they choose another provider's prescription drug coverage. Any Medicare Advantage member enrolling in a stand-alone PDP, however, will automatically be disenrolled from the Medicare Advantage plan altogether, thereby resuming traditional fee-for-service Medicare. Medicare Advantage members will have the right to change drug plans, either MA-PD or PDP, two times during the open enrollment period. Duel eligible beneficiaries and other members qualified for the low-income subsidy (LIS) will be able to change plans year round.

Competitive Bidding Process

Beginning in 2006 CMS will use a new rate calculation system for Medicare Advantage plans, which system will be based on a competitive bidding process that will allow the federal government to share in any cost savings achieved by Medicare Advantage plans. In general, the statutory payment rate for each county, which is primarily based on CMS's estimated per beneficiary fee-for-service expenses, will be relabeled as the "benchmark" amount, and local Medicare Advantage plans will annually submit bids that reflect the costs they expect to incur in providing the base Medicare Part A and Part B benefits in their applicable service areas.

If the bid is less than the benchmark for that year, Medicare will pay the plan its bid amount, risk adjusted based on its risk scores, plus a rebate equal to 75% of the amount by which the benchmark exceeds the bid, resulting in an annual adjustment in reimbursement rates. Plans must use the rebate to provide beneficiaries with extra benefits, reduced cost sharing, or reduced premiums, including premiums for MA-PD and other supplemental benefits. CMS has the right to audit the use of these proceeds. The remaining 25% of the excess amount will be retained in the statutory Medicare trust fund. If a Medicare Advantage plan's bid is greater than the benchmark, the plan will be entitled to charge a premium to enrollees equal to the difference between the bid amount and the benchmark, which is expected to make such plans less competitive. For 2006, the county benchmarks were 4.8% greater than the 2005 rates, which is the national growth rate in fee-for-service expenditures.

Enrollment Period

Prior to the MMA, Medicare beneficiaries were permitted to enroll in a Medicare managed care plan or change plans at any point during the year. Beginning in 2006, Medicare beneficiaries will have defined enrollment periods, similar to commercial plans, in which they can select a Medicare Advantage plan, a stand-alone PDP, or traditional fee-for-service Medicare. The initial enrollment period for 2006 is November 15, 2005 through May 15, 2006 for a MA-PD or stand-alone PDP. In addition, beneficiaries will have an open election period from January 1, 2006 through June 30, 2006 in which they can make or change an equivalent election. Thereafter, the annual enrollment period for a PDP will be from November 15 through December 31 of each year, and enrollment in Medicare Advantage plans will occur from November 15 through March 31 of the subsequent year.

Business Model

PSN Segment

Metropolitan's PSN provides healthcare services to Medicare Advantage beneficiaries who participate in the Medicare Advantage program through Humana. Metropolitan conducts all of its PSN business operations through Metcare of Florida, Inc., its wholly-owned subsidiary.

Humana Agreements

Pursuant to the Humana Agreements, the PSN provides, on a non-exclusive basis, healthcare services to Medicare beneficiaries in Central Florida and South Florida who have elected to receive benefits from it, pursuant to Humana's Medicare Advantage Plan.

The PSN's agreements with Humana (the "Humana Agreements") have one-year terms and renew automatically each December 31 for additional one-year terms unless terminated for cause or upon 180 days' prior notice. Pursuant to the Humana Agreements, the PSN provides or arranges for the provision of covered medical services to each Humana Plan Member who selects one of its affiliated physicians as the member's primary care physician. The PSN is entitled to receive a capitated fee with respect to each Humana Participating Member representing a vast majority of the premium that Humana receives with respect to the subject Humana Plan Member.

The Humana Agreements are subject to the changes to the covered benefits that Humana elects to provide to its members and other terms and conditions.

Pursuant to the Humana Agreements, the Company is required to comply with Humana's general policies and procedures, including Humana's policies regarding referrals, approvals, utilization management and quality assessment.

Humana may immediately terminate either of the Humana Agreements and/or any individual physician credentialed under the Humana Agreements, upon written notice, (i) if the PSN and/or any of its affiliated physician's continued participation may adversely affect the health, safety or welfare of any Humana member or bring Humana into disrepute; (ii) in the event of one of PSN's physician's death or incompetence; (iii) if any of the PSN's physicians fail to meet Humana's credentialing criteria; (iv) in accordance with Humana's policies and procedures as specified in Humana's manual, (v) if the PSN engages in or acquiesces to any act of bankruptcy, receivership or reorganization; or (vi) if Humana loses its authority to do business in total or as to any limited segment or business (but only to that segment). The PSN and Humana may also each terminate each of the Humana Agreements upon 90 days' prior written notice (with a 60 day opportunity to cure, if possible) in the event of the other's material breach of the applicable Humana Agreement.

Humana may provide 30 days notice as to certain amendments or modifications of the Humana Agreements, including but not limited to, compensation rates, covered benefits and other terms and conditions. If Humana exercises its right to amend either of the Humana Agreements upon 30 days' written notice, the PSN may object to such amendment within the 30 day notice period. If the PSN objects to such amendment within the requisite time frame, Humana may terminate the applicable Humana Agreement upon 90 days' written notice.

For the term of the Humana Agreement pertaining to the Central Florida region (the "Central Florida Humana Agreement"), Humana has agreed that it will not, with the exception of one existing service provider, enter into any new global risk deals for Humana's Medicare Advantage HMO products in Central Florida. It is the PSN's understanding that Humana has an existing risk contract with Island Doctors for Humana's Medicare Advantage HMO product in Central Florida.

For the term of the Central Florida Humana Contract, the PSN has agreed that it will not enter into any global, full or limited risk contracts with respect to Medicare Advantage members with any non-Humana Medicare Advantage HMO or PSO in the Florida counties in which it and Humana have a Medicare Advantage contract.

In addition, for the term plus one year of each of the Humana Agreements, the PSN has agreed that it and its affiliated providers will not, directly or indirectly, engage in any activities which are in competition with Humana's health insurance, HMO or benefit plans business, including obtaining a license to become a managed health care plan offering HMO or point of service, or POS, products, or (ii) acquire, manage, establish or have any direct or indirect interest in any provider sponsored organization or network for the purpose of administering, developing, implementing or selling government sponsored health insurance or benefit plans, including Medicare and Medicaid, or (iii) contract or affiliate with another licensed managed care organization, where the purpose of such affiliation is to offer and sponsor HMO or POS products and where the PSN and/or its affiliated providers obtain an ownership interest in the HMO or POS products to be marketed, and (iv) not enter into agreements with other managed care entities, insurance companies or provider sponsored networks for the provision of healthcare services to Medicare HMO, Medicare POS and/or other Medicare replacement patients at the same office sites or within five miles of the office sites where services are provided to the Humana Plan Members.

Provider Agreements

The PSN operates predominantly as an "affiliated" model as contrasted with a "staff" model in which the physician practices are owned and operated by the risk provider. Under its model, the physicians maintain their independence but are aligned with Metropolitan's professional staff that assists in providing high quality, cost effective health care.

The Company's PSN is comprised of 37 primary care physician practices, eight of which Metropolitan owns. The others are IPs that are contracted with the Company on a exclusive or non-exclusive basis and primarily reimbursed through the receipt of capitated fees. Under these contracts with the IPs (the "IP Contracts"), the IP providers are paid a set amount per member, per month, to provide all the necessary primary care medical services to Participating Members. The monthly amount is negotiated and is subject to change based on certain quality metrics under the PSN's Partners In Quality ("PIQ") program, a proprietary care management model that it implemented in 2002.

PIQ is a "pay for performance" program that measures performance based on quality metrics including patient satisfaction, disease state management of high-risk, chronically ill patients, increased frequency of physician-patient encounters, and enhanced medical record documentation. Management believes that the PIQ program differentiates the Company's PSN from other PSNs or Management Service Organizations ("MSOs").

The IP Contracts generally have one-year terms and renew automatically for one-year periods unless either party provides written notice at least 120 days prior to the termination date. The IP providers generally may participate in any number of other provider service networks, HMO's and IPs. However, during the term of the IP Contract, and for a period of six months after the expiration or termination of the IP Contract, the IP providers are generally prohibited from participating in any other provider service network, HMO or IP which contracts directly or indirectly with the Medicare or Medicaid Program on a capitated or risk basis. The IP providers are further prohibited during the term and for a

period of six months after the expiration of the terms from encouraging or soliciting the Participating Members the Company serves to change their primary care provider, disenroll from their health plan, or leave the PSN's network.

The PSN has established referral relationships with a large number of Humana contracted specialist physicians, ancillary service providers and hospitals throughout South Florida and Central Florida. These providers have contracted with Humana to deliver services to the Company's PSN patients based on certain fee schedules and care requirements. Specialist physicians, ancillary service providers and hospitals, are generally paid on a contractual fee-for-service basis. Certain specialist physicians dealing with high volumes of cases are paid on a capitated basis.

Claims Processing

The PSN does not pay or process any of the payments to its providers. Pursuant to the Humana Agreements, Humana, among other things, processes claims received by affiliated providers, makes a determination whether and to what extent to allow such claims and makes payments for covered services rendered to Humana Plan Members using Humana's claims processing policies, procedures and guidelines. Humana provides notice to the PSN upon qualification of a claim and it has the opportunity within seven days of receipt of a claim to review such claim and approve, deny or modify the claim, as appropriate. Humana provides the PSN with reports of actual claims history. Such data is statistically evaluated by the PSN for a variety of factors. Once this information is received from Humana, such data is maintained on a server system maintained at the Company's executive offices. The PSN's claims suspense staff seeks to identify and correct non-qualifying claims prior to payment. After payments are made by Humana, the PSN's contestation staff is responsible for reviewing paid claims, identifying errors and seeking recoveries. The PSN's management monitors and measures Humana's estimates of claims incurred but not yet reported (IBNR), for adequacy.

The PSN is certified as a Utilization Review Agent by Florida's Agency for Health Care Administration. Utilization review is a process whereby multiple data is analyzed and considered to ensure that appropriate health services are provided in a cost-effective manner. Factors include the risks and benefits of a medical procedure, the cost of providing those services, specific payer coverage guidelines, and historical outcomes of healthcare providers such as physicians and hospitals.

PSN Growth Strategy

The PSN's growth strategy includes, among other things:

- increase patient volume at its existing medical practices and affiliated IPs through enhanced marketing efforts; and
- selectively expand its network to include additional medical centers within its existing geographic markets.

Increasing Patient Volume

The PSN believes its existing network has the capacity to handle additional Humana Participating Members and could realize certain additional economies of scale if the number of Participating Members in its network increased. It seeks to increase the number of patients in its network through the general marketing efforts of Humana and through its own targeted marketing efforts towards Medicare eligible patients.

Selectively Expanding Its Network of Medical Centers

Within its existing geographic markets, the PSN seeks to add additional medical centers to its network either through acquisition, start up or affiliation with an IP. It expects it will identify and select candidates based in large part on the following broad criteria:

- a history of profitable operations or a perceived synergy such as opportunities for economies of scale through a consolidation of management or service provision functions; and
- a geographic proximity to the Company's current operations.

PSN Competition

The PSN believes there are at least five and fifteen Medicare Advantage plans in the Central Florida and South Florida markets, respectively. It is its understanding that as of December 2005 Humana has enrolled in its Medicare Advantage Plans approximately 16% and 15% of the persons enrolled in Medicare Advantage Plans in Central Florida and South Florida, respectively. It also believes through its provider network it provides medical services to approximately 95% and 5% of the Humana Plan Members in the Central Florida and South Florida markets, respectively. See "RISK FACTORS - Our Industry is Already Very Competitive... ."

HMO Segment

In July 1, 2005, MHP began offering its Medicare Advantage health plan in the Florida counties of Martin, St. Lucie, Okeechobee, Lee, Charlotte and Sarasota. Its Medicare Advantage plan covers Medicare eligible members who reside at least six months or more in its service area with benefits that are better than those offered under traditional Medicare fee-for-service plans. Through its Medicare Advantage Plan, MHP has the flexibility to offer benefits not covered under traditional fee-for-service Medicare. Its plan is designed to be attractive to seniors and offer a broad range of benefits which include, prescription drug benefits, eye glasses, hearing aids, dental care, massage therapy and acupuncture.

During 2006, MHP's Medicare Advantage members, depending on the market, will pay either a $0 or $10 monthly premium but, in some cases, are subject to co-payments and deductibles, depending upon the market and benefit. Except in limited cases, including emergencies, MHP's members are required to use primary care physicians within MHP's network of providers and generally must receive referrals from their primary care physician in order to see a specialist or other ancillary provider.

Pursuant to the agreement between MHP and CMS (the "CMS Agreement"), MHP has agreed to provide services to Medicare beneficiaries pursuant to the Medicare Advantage program. Under the CMS Agreement, CMS pays MHP a fixed capitation payment based on membership and adjusted for demographic and health risk factors. Inflation, changes in utilization patterns and average per capita fee-for-service Medicare costs are also considered in the calculation of the fixed capitation payment by CMS. The initial term of the CMS Agreement expires on December 31, 2006 and is subject to annual renewal at the election of CMS. Amounts payable under Medicare Advantage arrangements are subject to annual revision by CMS. Pursuant to the CMS Agreement, MHP is required to comply with federal Medicare laws and regulations and the CMS Agreement is subject to

termination by CMS in the event of MHP's noncompliance.

Provider Arrangements and Payment Methods

Metropolitan has attempted to structure its HMO provider arrangements and payment methods in a manner that encourages the medical provider to deliver high quality medical care to its members. To date, it has primarily structured its non-exclusive provider contracts on a fee for service basis.

Management Services

MHP has engaged a third party service provider, HF Administrative Services, Inc. ("HFAS"), to provide various administrative and management services, including, but not limited to, claims processing and adjudication, certain management information services, regulatory reporting and customer services pursuant to the terms of an Administrative Services Agreement (the "Services Agreement").

In addition to approximately $329,000 of implementation and start-up costs it paid to HFAS during fiscal 2005, MHP compensates HFAS for its management services based upon the number of enrolled members, subject to various monthly minimum payments. In addition, HFAS is compensated for providing additional programming services on an hourly basis. During fiscal 2005, MHP paid an aggregate of $158,000 to HFAS in accordance with the Services Agreement.

Pursuant to the Services Agreements, HFAS verifies claims by MHP's affiliated providers against MHP's policies regarding member eligibility, benefits, referrals and pre-authorizations and makes a determination whether and to what extent to allow such claims using MHP's guidelines. HFAS provides notice to MHP of claim denials. MHP has the right and responsibility within three business days of receipt of a claim denial to independently review such claim and approve, deny or modify the claim, as appropriate. It has access to the management information systems provided and maintained by HFAS for our benefit. In addition, HFAS is required under the Services Agreement to provide MHP with reports and information regarding claim adjudication.

The initial term of the Services Agreement expires on June 30, 2010 and thereafter is automatically renewable for additional one-year terms. After the initial term, either party may terminate the Services Agreement for any reason upon 180 days written notice. Either party may also terminate the Services Agreement upon prior written notice (with a 30 day opportunity to cure) in the event of the other's material breach of the Services Agreement in any manner, including but not limited to, MHP's failure to maintain sufficient funds in order for HFAS to pay claims, or in the event MHP engages in or acquiesce to any act of bankruptcy, receivership or reorganization or in the event either party fails to secure any license, government approval or exemption required by law. See "RISK FACTORS - The Company Depends on Third Parties to Provide It Crucial Information and Data.."

Sales and Marketing Programs

As of December 31, 2005, MHP's sales force consisted of 37 active third party agents and 9 internal licensed sales employees. Its third party agents are compensated on a commission basis. Medicare Advantage enrollment is generally an individual decision made by the member. Accordingly, MHP's sales agents and representatives focus their efforts on in-person contacts with potential enrollees. Its marketing efforts also include television, radio and print advertising.

Prior to 2006, Medicare beneficiaries could enroll in or change health plans at any time during the year. Commencing in 2006, Medicare beneficiaries will have a limited annual enrollment period during which they can choose between a Medicare Advantage plan and traditional fee-for-service Medicare. After this annual enrollment period ends, generally only seniors turning 65 during the year, dual-eligible beneficiaries, Low-Income Subsidy (LIS) beneficiaries and others who qualify for special needs plans, Medicare beneficiaries permanently relocating to another service area, and employer group retirees will be permitted to enroll in or change health plans. See "Industry - The Medicare Modernization Act - Enrollment Period."

HMO Competition

Metropolitan believes there are at least five Medicare Advantage plans offering enrollment in the six Florida counties where its HMO operates. As of December 31, 2005, it estimates that it had enrolled approximately 7% of the membership market in each of the six countries. See "RISK FACTORS - Our Industry is Already Very Competitive..."

Insurance

Metropolitan relies upon insurance to protect it from many business risks, including medical malpractice, errors and omissions and certain significantly higher than average Participating Member medical expenses. Although Metropolitan maintains insurance of the types and in the amounts that is believes are reasonable, there can be no assurances that the insurance policies maintained by Metropolitan will insulate it from material expenses and/or losses in the future. See "RISK FACTORS - Claims Relating to Medical Malpractice and Other Litigation...."

Employees

As of December 31, 2005, Metropolitan had 169 full-time employees, of which 49 were employed at Metropolitan's executive offices. Of this total, 105 and 47 were employed by the PSN and MHP, respectively, with the balance representing corporate administrative employees. No employees of Metropolitan are covered by a collective bargaining agreement or are represented by a labor union. Metropolitan considers its employee relations to be good.

Government Regulation

Metropolitan's businesses are regulated by the federal government and the State of Florida. The laws and regulations governing its operations are generally intended for the benefit of health plan members and providers. These laws and regulations, along with the terms of our contracts, regulate how the Company does business, what services it offers, and how it interacts with Participating Members, affiliated providers and the public. The government agencies administering these laws and regulations have broad latitude to enforce them. The Company is subject to various governmental reviews, audits and investigations to verify its compliance with its contracts and applicable laws and regulations.

The Company believes it is in material compliance with all government regulations applicable to its business. It further believes it has implemented reasonable systems and procedures to assist it in maintaining compliance with such regulations. Nonetheless, it believes it faces a variety of regulatory related risks. See "Risk Factors - Reductions in Government Funding...", "-The

MMA will materially impact its operations...", "CMS Risk Adjustment Payment System...", "The Company's Business Activities Are Highly Regulated...", "The Healthcare Industry is Highly Regulated...", "If The Company Is Required to Maintain Higher Statutory Capital Levels..." and "The Company Is Required to Comply with Laws..."

A summary of the material aspects of the government regulations to which the Company is subject is set forth below.

Federal and State Reimbursement Regulation.

The Company's operations are affected on a day-to-day basis by numerous legislative, regulatory and industry-imposed operational and financial requirements, which are administered by a variety of federal and state governmental agencies as well as by self-regulatory associations and commercial medical insurance reimbursement programs. The Company has filed for all its employed physicians the necessary reassignments of billing rights applications with Medicare.

Federal "Fraud and Abuse" Laws and Regulations.

The Anti-Kickback Law makes it a criminal felony offense to knowingly and willfully offer, pay, solicit or receive remuneration in order to induce business for which reimbursement is provided under federal health care programs, including without limitation, the Medicare and Medicaid programs. Violations of these laws are punishable by monetary fines, civil and criminal penalties, exclusion from care programs and forfeiture of amounts collected in violation of such laws. The scope of prohibited payments in the Anti-Kickback Law is broad and includes economic arrangements involving hospitals, physicians and other health care providers, including joint ventures, space and equipment rentals, purchases of physician practices and management and personal services contracts.

CMS has promulgated regulations that prohibit health plans with Medicare contracts from including any direct or indirect payment to physicians or other providers as an inducement to reduce or limit medically necessary services to a Medicare beneficiary. These regulations impose disclosure and other requirements relating to physician incentive plans including bonuses or withholdings that could result in a physician being at "substantial financial risk" as defined in Medicare regulations.

Federal False Claims Act.

The Company is subject to a number of laws that regulate the presentation of false claims or the submission of false information to the federal government. For example, the federal False Claims Act provides, in part, that the federal government may bring a lawsuit against any person or entity whom it believes has knowingly presented, or caused to be presented, a false or fraudulent request for payment from the federal government, or who has made a false statement or used a false record to get a claim approved. The federal government has taken the position that claims presented in violation of the federal Anti-Kickback Statute may be considered a violation of the federal False Claims Act. Violations of the False Claims Act are punishable by treble damages and penalties of up to $11,000 per false claim. In addition to suits filed by the government, a special provision under the False Claims Act allows a private individual (e.g., a "whistleblower" such as a disgruntled former employee, competitor or patient) to bring an action under the False Claims Act on behalf of the government alleging that an entity has defrauded the federal government and permits the whistleblower to share in any settlement or judgment that may

result from that lawsuit.

Florida Fraud and Abuse Regulations.

Florida enacted "The Patient Brokering Act" which imposes criminal penalties, including jail terms and fines, for receiving or paying any commission, bonus, rebate, kickback, or bribe, directly or indirectly in cash or in kind, or engage in any split-fee arrangement, in any form whatsoever, to induce the referral of patients or patronage from a healthcare provider or healthcare facility. The Florida statutory provisions regulating the practice of medicine include similar language as grounds for disciplinary action against a physician.

Restrictions on Physician Referrals.

Federal regulations under the Social Security Act that restrict physician referrals to health care entities with which they have financial relationships (commonly referred to as the "Stark Law") prohibit certain patient referrals by physicians. Specifically, the Stark Law prohibits a physician, or an immediate family member, who has a financial relationship with a health care entity, from referring Medicare patients with limited exceptions, to that entity for certain "designated health services". A financial relationship is defined to include an ownership or investment in, or a compensation relationship with, a health care entity. The Stark Law also prohibits a health care entity receiving a prohibited referral from billing the Medicare or Medicaid programs for any services rendered to a patient as a result of the prohibited referral. The Stark Law contains certain exceptions that protect parties from liability if the parties comply with all of the requirements of the applicable exception. The sanctions under the Stark Law include denial and refund of payments, civil monetary penalties and exclusions from participation in the Medicare programs.

Privacy Laws.

The privacy, security and transmission of health information is subject to federal and state laws and regulations, including the Healthcare Insurance Portability and Accountability Act of 1996 ("HIPAA"). Final regulations with respect to the privacy of certain individually identifiable health information (the "Protected Health Information") became effective in April 2003 (the "Privacy Rule"). The Privacy Rule specifies authorized or required uses and disclosures of the Protected Health Information, as well as the rights patients have with respect to their health information. HIPAA also provides that to the extent that state laws impose stricter privacy standards than the HIPAA privacy rule, such standards are not preempted, requiring compliance with any stricter state privacy law. In addition, in October 2002, the electronic data standards regulations under HIPAA became effective. The final HIPAA security rule became effective in February 2003, and established security standards with respect to Protected Health Information transmitted or maintained electronically. These regulations establish uniform standards relating to data reporting, formatting, and coding that certain health care providers must use when conducting certain transactions involving health information.

Clinic Licensure.

AHCA requires the Company to license each of its medical centers individually as health care clinics. Each medical center must renew its health care clinic licensure bi-annually.

Occupational Safety and Health Administration ("OSHA").

In addition to OSHA regulations applicable to businesses generally, the Company must comply with, among other things, the OSHA directives on occupational exposure to blood borne pathogens, the federal Needlestick Safety and Prevention Act, OSHA injury and illness recording and reporting requirements, federal regulations relating to proper handling of laboratory specimens, spill procedures and hazardous waste disposal, and patient transport safety requirements.

Medicare Marketing Restrictions

The Company is subject to federal marketing rules and regulations that limit, among other things, offering any gift or other inducement to Medicare beneficiaries to encourage them to come to the Company for their health care.

State Regulation

MHP is subject to the rules, regulations and oversight by the Department of Financial Services, Office of Insurance Regulation and the Agency for Health Care Administration in the areas of licensing and solvency. It files reports with these state agencies describing its capital structure, ownership, financial condition, certain inter-company transactions and business operations. It also is generally required to demonstrate, among other things, that it has an adequate provider network, that its systems are capable of processing provider's claims in a timely fashion and of collecting and analyzing the information needed to manage their business. State regulations also require the prior approval or notice of acquisitions or similar transactions involving an HMO, and of certain transactions between an HMO and its parent or affiliated entities or persons. Generally, HMOs are limited in their ability to pay dividends to their stockholders.

MHP is required to maintain a minimum level of statutory capital. These requirements assess the capital adequacy of an HMO based upon investment asset risks, insurance risks, interest rate risks and other risks associated with its business to determine the amount of statutory capital believed to be required to support the HMO's business. If MHP's statutory capital level falls below certain required capital levels, it may be required to submit a capital corrective plan to the state department of insurance, and at certain levels may be subjected to regulatory orders, including regulatory control through rehabilitation or liquidation proceedings.

ITEM 1A. RISK FACTORS

The PSN's Operations are Dependent on Humana, Inc.

The PSN currently derives, and expect to continue to derive, the vast majority of its revenues from its Humana Agreements which provide for the receipt of capitated fees. For the twelve months ended December 31, 2005, approximately 98% of its revenue was obtained from these Humana Agreements. Humana may immediately terminate either of the Humana Agreements and/or any individual physician credentialed under the Humana Agreements upon the occurrence of certain events. Humana may also amend the material terms of the Humana Agreements under certain circumstances. See "ITEM 1. BUSINESS - Humana Agreements" for a detailed discussion of the Humana Agreements.

Failure to maintain the Humana Agreements on favorable terms, for any reason, would adversely affect the Company's results of operations and financial condition. A material decline in enrollees in Humana's Medicare Advantage program could also have a material adverse effect on the Company's results of

operation.

Because Most of the Company's Revenue Is Established by Contract and Cannot Be Modified During the Contract Terms, the Company's Operating Margins Could be Negatively Impacted if It is Unable to Manage Its Medical Expenses Effectively.

The Humana Agreements and the CMS Agreement are risk agreements under which it receives monthly payments per participating member ("Participating Member") at a rate established by the agreements, also called a capitated fee. In accordance with the agreements, the total monthly payment is a function of the number of Participating Members, regardless of the actual utilization rate of covered services. In return, the PSN or MHP, as applicable, through its affiliated providers, assumes full financial responsibility for the provision of all necessary medical care to the Participating Members, regardless of whether or not its affiliated providers directly provide the covered medical services.

To the extent that the Participating Members require more care than is anticipated, aggregate capitation rates may be insufficient to cover the costs associated with the treatment of such Participating Members. If medical expenses exceed the Company's estimates, except in very limited circumstances, it will be unable to increase the premiums it receives under these contracts during the then-current terms.

Relatively small changes in the Company's ratio of medical expense to revenue can create significant changes in its financial results. Accordingly, the failure to adequately predict and control medical expenses and to make reasonable estimates and maintain adequate accruals for incurred but not reported, or IBNR, claims, may have a material adverse effect on the Company's financial condition, results of operations, or cash flows.

Historically, the Company's medical expenses as a percentage of revenue have fluctuated. Factors that may cause medical expenses to exceed estimates include:

- higher than expected utilization of new or existing healthcare services or technologies;
- an increase in the cost of healthcare services and supplies, including pharmaceuticals, whether as a result of inflation or otherwise;
- changes to mandated benefits or other changes in healthcare laws, regulations, and practices;
- Humana's periodic renegotiation of provider contracts with specialist physicians, hospitals and ancillary providers;
- periodic renegotiation of IP contracts;
- changes in the demographics of our members and medical trends affecting them;
- contractual or claims disputes with providers, hospitals, or other service providers within the Humana network; and
- the occurrence of catastrophes, major epidemics, or acts of terrorism.

Metropolitan attempts to control these costs through a variety of techniques,

including capitation and other risk-sharing payment methods, collaborative relationships with primary care physicians and other providers, advance approval for hospital services and referral requirements, case and disease management and quality assurance programs, information systems, and reinsurance. Despite its efforts and programs to manage its medical expenses, Metropolitan may not be able to continue to manage these expenses effectively in the future.

If Its HMO Contracts Are Not Renewed or Are Terminated, MHP's Business Would Be Negatively Impacted.

Effective July 1, 2005, MHP entered into the CMS Agreement to begin offering Medicare Advantage plans to Medicare beneficiaries in six Florida counties which include the cities of Fort Pierce, Port St. Lucie, Fort Myers, Port Charlotte and Sarasota. The initial term of the CMS Agreement expired on December 31, 2005 and was subject to annual renewal at the election of CMS. A new CMS Agreement was entered into effective January 1, 2006 and expires on December 31, 2006. Pursuant to the CMS Agreements, MHP is required to comply with federal Medicare laws and regulations and the CMS Agreement is subject to termination by CMS in the event of MHP's noncompliance. If MHP is unable to renew or to successfully rebid for the CMS Agreement, or if the CMS Agreement is terminated, its business would be negatively impacted.

Reductions in Government Funding for Medicare Programs Could Adversely Affect the Company's Results of Operations.

As of December 31, 2005, substantially all of the Company's revenues were indirectly or directly derived from reimbursements generated by Medicare Advantage health plans. As a result, its revenue and profitability are dependent on government funding levels for Medicare Advantage programs. The Medicare programs are subject to statutory and regulatory changes, retroactive and prospective rate adjustments, administrative rulings and funding restrictions, any of which could have the effect of limiting or reducing reimbursement levels. These government programs, as well as private insurers such as Humana, have taken and may continue to take steps to control the cost, use and delivery of health care services. Any changes that limit or reduce Medicare reimbursement levels could have a material adverse effect on the Company's business. For example, the following events could result in an adverse effect on its results of operations:

- reductions in or limitations of reimbursement amounts or rates under programs;
- reductions in funding of programs;
- elimination of coverage for certain benefits; or
- elimination of coverage for certain individuals or treatments under programs.

For instance, the President recently signed the Deficit Reduction Act of 2005. According to the Congressional Budget Office, the provisions of this Act are expected to reduce federal Medicare spending by $6.4 billion over the next five years.

In addition, in his 2007 budget proposal, President Bush has requested that Congress implement legislative changes to produce approximately $35.9 billion in Medicare savings over five years. The Company cannot predict whether Congress will implement the changes requested by the President and, if implemented, the

sources of such savings.

The MMA Will Materially Impact the Company's Operations and Could Reduce Its Profitability and Increase Competition for Members.

The MMA substantially changed the Medicare program and is complex and wide-ranging. The Company has not yet been able to fully assess the impact of all of the changes. While it anticipates that many of these changes will generally benefit the Medicare Advantage sector, certain provisions of the MMA may increase competition, create challenges with respect to educating the PSN's and MHP's existing and potential Participating Members about the changes, and create other risks and substantial and potentially adverse uncertainties, including the following:

- Increased reimbursement rates for Medicare Advantage plans could result in an increase in the number of plans that participate in the Medicare program. This could create new competition that could adversely affect the number of Participating Members the PSN or MHP serve and their respective results of operations.

- Managed care companies began offering various new products beginning in 2006 pursuant to the MMA, including regional preferred provider organizations, or PPOs, and private fee-for-service plans. Medicare PPOs and private fee-for-service plans allow their members more flexibility in selecting physicians than Medicare Advantage HMOs, which typically require members to coordinate with a primary care physician. The MMA has encouraged the creation of regional PPOs through various incentives, including certain risk corridors, or cost-reimbursement provisions, a stabilization fund for incentive payments, and special payments to hospitals not otherwise contracted with a Medicare Advantage plan who treat regional plan enrollees. The Company currently is unable to determine whether the formation of regional Medicare PPOs and private fee-for-service plans will affect its PSN's or HMO's relative attractiveness to existing and potential Medicare members in its service areas.

- Beginning in 2006, the payments for the local and regional Medicare Advantage plans will be based on a competitive bidding process that may directly or indirectly cause the PSN and/or MHP to decrease the amount of premiums paid to it or cause it to increase the benefits it offers.

- Beginning in 2006, Medicare beneficiaries generally have a more limited annual enrollment period during which they can choose to participate in a Medicare Advantage plan or receive benefits under the traditional fee-for-service Medicare program. After the annual enrollment period, most Medicare beneficiaries will not be permitted to change their Medicare benefits. This "lock-in" may make it difficult for MHP to retain an adequate sales force. The new annual enrollment process and subsequent "lock-in" provisions of the MMA may adversely affect the Company's level of revenue growth as it will limit its ability to market to and enroll new Participating Members in its established service areas outside of the annual enrollment period. Such limitations could adversely and materially affect its profitability and results of operations.

- Beginning in 2006, managed care companies that offer Medicare Advantage plans are required to offer prescription drug benefits as

part of their Medicare Advantage plans. Managed care plans offering drug benefits are, under the new law, called MA-PDs. It is not known at this time whether the governmental payments will be adequate to cover the actual costs for these new MA-PD benefits or whether it will be able to profitably or competitively manage its MA-PD. Individuals who are enrolled in a Medicare Advantage plan must receive their drug coverage through their Medicare Advantage prescription drug plan. Enrollees may prefer a stand-alone drug plan and may cease to be a Participating Member in order to participate in a stand-alone drug plan. Accordingly, the new Medicare Part D prescription drug benefit could reduce the PSN's and/or MHP's Participating Member enrollment and revenues.

CMS's Risk Adjustment Payment System and Budget Neutrality Payment Adjustments Make The Company's Revenue and Profitability Difficult to Predict and Could Result In Material Retroactive Adjustments to Its Results of Operations.

CMS has implemented a risk adjustment payment system for Medicare health plans to improve the accuracy of payments and establish incentives for Medicare plans to enroll and treat less healthy Medicare beneficiaries. CMS is phasing-in this payment methodology with a risk adjustment model that bases a portion of the total CMS reimbursement payments on various clinical and demographic factors including hospital inpatient diagnoses, diagnostic data from ambulatory treatment settings, including hospital outpatient facilities and physician visits, gender, age, and Medicaid eligibility. CMS requires that all managed care companies capture, collect, and submit the necessary diagnosis code information to CMS twice a year for reconciliation with CMS's internal database. As part of the phase-in, during 2003, risk adjusted payments accounted for 10% of Medicare health plan payments, with the remaining 90% being reimbursed in accordance with the traditional CMS demographic rate books. The portion of risk adjusted payments was increased to 30% in 2004, 50% in 2005, and 75% in 2006, and will increase to 100% in 2007. As a result of this process, it is difficult to predict with certainty the Company's future revenue or profitability. In addition, MHP's and/or Humana's risk scores for any period may result in favorable or unfavorable adjustments to the payments directly or indirectly received from CMS and the Company's Medicare premium revenue. There can be no assurance that the Company's contracting physicians and hospitals will be successful in improving the accuracy of related recording diagnostic code information and thereby enhancing its risk scores.

Since 2003, payments to Medicare Advantage plans have also been adjusted by a "budget neutrality" factor that was implemented by Congress and CMS to prevent health plan payments from being reduced overall while, at the same time, directing higher, risk adjusted payments to plans with more chronically ill enrollees. In general, this adjustment has favorably impacted payments to all Medicare Advantage plans. The President's budget for 2005 assumed the phasing out of the budget neutrality adjustments over a five year period from 2007 through 2011. The President recently signed the Deficit Reduction Act of 2005 which, among other changes, provides for an accelerated phase-out of budget neutrality for risk adjustment of payments made to Medicare Advantage plans. This legislation will have the effect of reducing payments to Medicare Advantage plans in general. Consequently, the Company expects the premiums it receives could be reduced, dependent upon MHP's and Humana's risk scores.

A Disruption in Its or Humana's Healthcare Provider Networks Could Have an Adverse Effect on The Company's Operations and Profitability.

The PSN's operations are dependent on the management information systems of

Humana. Humana provides the PSN with claims processing, billing services, data collection and other information, including reports and calculations of costs of services provided and payments to be received by the PSN. While the PSN relies on Humana's information systems, it does not own or control such systems and, accordingly, has limited ability to ensure that these systems are properly maintained, serviced and updated. In addition, information systems such as these may be vulnerable to failure, acts of sabotage and obsolescence. Although the PSN has the contractual right to receive various information and data from Humana, and it receives monthly downloads of claims data from Humana, the PSN's business and results of operations could be materially and adversely affected by its inability, for any reason, to timely receive information from Humana.

A significant portion of the PSN's Total Medical Expenses are payable to entities that are not members and/or directly contracted with the PSN. Although virtually all of such entities are Humana approved service providers, and although the PSN can provide Humana input with respect to Humana's service providers, the PSN does not control the process by which Humana negotiates and/or contracts with service providers in the Humana Medicare Advantage network.

The Company Depends on Third Parties to Provide It with Crucial Information and Data.

The Company's PSN operations are dependent on the management information systems of Humana. Humana provides it with claims processing, billing services, data collection and other information, including reports and calculations of costs of services provided and payments to be received by us. While it relies on Humana's information systems, it does not own or control such systems and, accordingly, has limited ability to ensure that it is properly maintained, serviced and updated. In addition, information systems such as these may be vulnerable to failure, acts of sabotage and obsolescence. Although it has the contractual right to receive various information and data from Humana, and it receives monthly downloads of claims data from Humana, its business and results of operations could be materially and adversely affected by its inability, for any reason, to timely receive information from Humana.

MHP relies on HFAS, a third party service provider, to provide various administrative and management services, including, but not limited to, claims processing and adjudication, certain management information services, regulatory reporting and customer services pursuant to the terms of the Services Agreement. The initial term of the Services Agreement expires on June 30, 2010 and thereafter is automatically renewable for additional one-year terms. After the initial term, either party may terminate the Services Agreement for any reason upon 180 days written notice. Either party may also terminate the Services Agreement upon prior written notice (with a 30 day opportunity to cure) in the event of the other's material breach of the Services Agreement in any manner, including but not limited to, MHP's failure to maintain sufficient funds for HFAS to pay claims, or in the event MHP engages in or acquiesce to any act of bankruptcy, receivership or reorganization or in the event either party fails to secure any license, government approval or exemption required by law.

Because these matters are outsourced as opposed to handled internally, MHP has less control over the manner in which these matters are handled and the data that is ultimately provided to it than it would have if it handled these matters internally. Additionally, any loss of information by HFAS could have a material adverse effect on the Company's business and the results of its operations.

Claims Relating to Medical Malpractice and Other Litigation Could Cause the

Company to Incur Significant Expenses.

From time to time, the Company is party to various litigation matters, some of which seek monetary damages. Managed care organizations may be sued directly for alleged negligence, including in connection with the credentialing of network providers or for alleged improper denials or delay of care. In addition, providers affiliated with the PSN or MHP involved in medical care decisions may be exposed to the risk of medical malpractice claims. A small percentage of these providers do not have malpractice insurance. As a result of increased costs or inability to secure malpractice insurance, the percentage of physicians who do not have malpractice insurance may increase. Although most of its network providers are independent contractors, claimants sometimes allege that a PSN and/or HMO should be held responsible for alleged provider malpractice, particularly where the provider does not have malpractice insurance, and some courts have permitted that theory of liability. Similar to other managed care companies, MHP may also be subject to other claims of Participating Members in the ordinary course of business, including claims arising out of decisions to deny or restrict reimbursement for services.

The Company cannot predict with certainty the eventual outcome of any pending litigation or potential future litigation, and there can be no assurances that it will not incur substantial expense in defending these or future lawsuits or indemnifying third parties with respect to the results of such litigation. The loss of even one of these claims, if it results in a significant damage award, could have a material adverse effect on its business. In addition, exposure to potential liability under punitive damage or other theories may significantly decrease the Company's ability to settle these claims on reasonable terms.

The Company maintains errors and omissions insurance and other insurance coverage that it believes are adequate based on industry standards. Nonetheless, potential liabilities may not be covered by insurance, insurers may dispute coverage or may be unable to meet their obligations, or the amount of insurance coverage and/or related reserves may be inadequate. There can be no assurances that it will be able to obtain insurance coverage in the future, or that insurance will continue to be available on a cost-effective basis, if at all. Moreover, even if claims brought against it are unsuccessful or without merit, it would have to defend itself against such claims. The defense of any such actions may be time-consuming and costly and may distract management's attention. As a result, it may incur significant expenses and may be unable to effectively operate its business.

The Company's Industry is Already Very Competitive; Increased Competition Could Adversely Affect the Company's Revenues; the PSN Competes with Other Service Providers for Humana's Business.

Metropolitan competes in the highly competitive and regulated health care industry, which is subject to continuing changes with respect to the provisioning of services and the selection and compensation of providers. Substantially all of its revenues come from the Humana Agreements. Humana competes with other HMOs and PPOs in securing and serving patients in the Medicare Advantage Program. Companies in other health care industry segments, some of which have financial and other resources comparable to Humana, may become competitors to Humana. The market in Florida may become increasingly attractive to HMOs and PPOs that may compete with Humana or MHP. Humana and MHP may not be able to continue to compete effectively in the health care industry if additional competitors enter the same market.

The Humana Agreements are structured as one-year automatically renewable

agreements. In addition to terminations for cause, Humana may terminate such agreements upon 180 days' notice to the PSN of non-renewal. The PSN competes with other service providers for Humana's business and Humana competes with other HMOs and PPOs in securing and serving patients in the Medicare Advantage Program. Failure to maintain favorable terms in its agreements with Humana would adversely affect the Company's results of operations and financial condition.

The Company's competitors vary in size and scope, in terms of products and services offered. It believes that it competes directly with various national, regional and local companies in providing its services. Some of the PSN's direct competitors are Continucare Corporation, Primary Care Associates, Inc., MCCI and Island Doctors, all based and operating in Florida. Metropolitan believes that Continucare Corporation, Primary Care Associates, Inc. and MCCI provide PSN services to Humana in South Florida and Island Doctors provides PSN services to Humana in Central Florida. Additionally, companies in other health care industry segments, some of which have financial and other resources greater than us, may become competitors in providing similar services at any given time. The market in Florida may become increasingly attractive to competitor PSNs due to the large population of Medicare participants. Humana and the Company may not be able to continue to compete effectively in the health care industry if additional competitors enter the same markets.

Metropolitan believes that many of its competitors and potential competitors are substantially larger than its PSN and/or MHP and have significantly greater financial, sales and marketing, and other resources. The Company believes that most of its competitors also have more experience operating as an HMO and that these competitors may be able to respond more rapidly to changes in the regulatory environment in which it operates and changes in managed care organization business or to devote greater resources to the development and promotion of their services than it can. Furthermore, it is the Company's belief that some of its competitors may make strategic acquisitions or establish cooperative relationships among themselves.

The Company is Dependent upon Certain Executive Officers and Key Management Personnel for Its Future Success.

The Company's success depends to a significant extent on the continued contributions of certain of its executive officers and key management personnel. The loss of these persons could have a material adverse effect on the Company's business, results of operations, financial condition and plans for future development. While it has employment contracts with certain executive officers and key members of management, these agreements may not provide sufficient incentive for these persons to continue their employment with the Company. It competes with other companies in the industry for executive talent and there can be no assurance that highly qualified executives would be readily and easily available without delay, given the limited number of individuals in the industry with expertise particular to its business operations.

The Company's Business Activities Are Highly Regulated and New and Proposed Government Regulation or Legislative Reforms Could Increase Its Cost of Doing Business, and Reduce Its Membership, Profitability, and Liquidity.

The Company's business is subject to substantial federal and state regulation. These laws and regulations, along with the terms of its contracts and licenses, directly or indirectly regulate how it does business, what services it offers, and how it interacts with its members, providers, and the public. Healthcare laws and regulations are subject to frequent change and varying interpretations. Changes in existing laws or regulations, or their interpretations, or the

enactment of new laws or the issuance of new regulations could adversely affect the Company's business by, among other things:

- imposing additional license, registration, or capital reserve requirements;
- increasing its administrative and other costs;
- forcing it to undergo a corporate restructuring;
- increasing mandated benefits without corresponding premium increases;
- limiting its ability to engage in inter-company transactions with our affiliates and subsidiaries;
- forcing it to restructure our relationships with providers; or
- requiring it to implement additional or different programs and systems.

It is possible that future legislation and regulation and the interpretation of existing and future laws and regulations could have a material adverse effect on the Company's ability to operate under the Medicare program and to continue to serve Participating Members and attract new Participating Members.

The Health Care Industry is Highly Regulated the Company's Failure to Comply with Laws or Regulations, or a Determination that in the Past It Had Failed to Comply with Laws or Regulations, Could Have an Adverse Effect on the Company's Business, Financial Condition and Results of Operations.

The health care services that the Company and its affiliated professionals provide are subject to extensive federal, state and local laws and regulations governing various matters such as the licensing and certification of its facilities and personnel, the conduct of its operations, billing and coding policies and practices, policies and practices with regard to patient privacy and confidentiality, and prohibitions on payments for the referral of business and self-referrals. These laws are generally aimed at protecting patients and not shareholders of Metropolitan and the agencies charged with the administration of these laws have broad authority to enforce them. See "ITEM 1. BUSINESS - Government Regulation" for a discussion of the various federal government and the State laws and regulations to which we are subject.

The federal and state agencies administering the laws and regulations applicable to Metropolitan have broad discretion to enforce them. The Company is subject, on an ongoing basis, to various governmental reviews, audits, and investigations to verify its compliance with its contracts, licenses, and applicable laws and regulations. These reviews, audits and investigations can be time consuming and costly. An adverse review, audit, or investigation could result in any of the following:

- loss of the PSN's or MHP's right to directly or indirectly participate in the Medicare program;
- loss of one or more of the PSN's and/or MHP's licenses to act as a service provider, HMO or third party administrator or to otherwise provide a service;

- forfeiture or recoupment of amounts the PSN and/or MHP has been paid pursuant to its contracts;
- imposition of significant civil or criminal penalties, fines, or other sanctions on the Company and its key employees;
- damage to the Company's reputation in existing and potential markets;
- increased restrictions on marketing of the PSN's or MHP's products and services; and
- inability to obtain approval for future products and services, geographic expansions, or acquisitions.

The U.S. Department of Health and Human Services Office of the Inspector General, Office of Audit Services, or OIG, is conducting a national review of Medicare Advantage plans to determine whether they used payment increases consistent with the requirements of the MMA. Under the MMA, when a Medicare Advantage plan receives a payment increase, it must reduce beneficiary premiums or cost sharing, enhance benefits, put additional payment amounts in a benefit stabilization fund, or use the additional payment amounts to stabilize or enhance access. There can be no assurances that the findings of an audit or investigation of the Company's business would not have an adverse effect on it or require substantial modifications to its operations. In addition, private citizens, acting as whistleblowers, are entitled to bring enforcement actions under a special provision of the federal False Claims Act.

A Failure to Estimate Incurred But Not Reported Medical Benefits Expense Accurately Could Affect the Company's Profitability.

Direct medical expenses incurred by the Company include costs paid by Humana on its behalf. These costs also include estimates of claims incurred but not reported ("IBNR"). The IBNR estimates are made by Humana utilizing actuarial methods and are continually evaluated and adjusted by the Company's management, based upon its specific claims experience. Adjustments, if necessary, are made to direct medical expenses when the criteria used to determine IBNR change and when actual claim costs are ultimately determined. With regards to MHP, the cost of medical benefits includes an IBNR estimate based on management's best estimate of medical benefits payable, in conjunction with an independent actuarial firm. Due to the inherent uncertainties associated with the factors used in these estimations, materially different amounts could be reported in the Company's financial statements for a particular period under different possible conditions or using different, but still reasonable, assumptions. Although its past estimates of IBNR have typically been adequate, they may be inadequate in the future, which would adversely affect the Company's results of operations. Further, the inability to estimate IBNR accurately may also affect its ability to take timely corrective actions, further exacerbating the extent of any adverse effect on its results.

If MHP Is Required to Maintain Higher Statutory Capital Levels for Its Existing Operations or if It Is Subject to Additional Capital Reserve Requirements as It Pursues New Business Opportunities, the Company's Liquidity May Be Adversely Affected.

MHP is subject to state regulations that, among other things, require the maintenance of minimum levels of statutory capital, or net worth. The State of Florida may raise the statutory capital level from time to time. Other states

have adopted risk-based capital requirements based on guidelines adopted by the National Association of Insurance Commissioners, which tend to be, although are not necessarily, higher than existing statutory capital requirements. Regardless of whether Florida adopts risk-based capital requirements, the Florida state department of insurance can require MHP to maintain minimum levels of statutory capital in excess of amounts required under the applicable state laws if it determines that maintaining additional statutory capital is in the best interests of MHP's Participating Members. Any increases in these requirements could materially increase our reserve requirements. In addition, as it continues to expand plan offerings in Florida or pursue new business opportunities, MHP may be required to maintain additional statutory capital reserves. In either case, available funds could be materially reduced, which could harm the Company's ability to implement its business strategy.

The Company Is Required to Comply With Laws Governing the Transmission, Security and Privacy of Health Information That Require Significant Compliance Costs, and Any Failure to Comply With These Laws Could Result in Material Criminal and Civil Penalties.

Regulations under the Health Insurance Portability and Accountability Act of 1996, or HIPAA, require the Company to comply with standards regarding the exchange of health information within its company and with third parties, including healthcare providers, business associates and members. These regulations include standards for common healthcare transactions, including claims information, plan eligibility, and payment information; unique identifiers for providers and employers; security; privacy; and enforcement. HIPAA also provides that to the extent that state laws impose stricter privacy standards than HIPAA privacy regulations, a state seeks and receives an exception from the Department of Health and Human Services regarding certain state laws, or state laws concern certain specified areas, such state standards and laws are not preempted.

The Company will conduct its operations in an attempt to comply with all applicable HIPAA requirements. Given the complexity of the HIPAA regulations, the possibility that the regulations may change, and the fact that the regulations are subject to changing and, at times, conflicting interpretation, its ongoing ability to comply with the HIPAA requirements is uncertain. Furthermore, a state's ability to promulgate stricter laws, and uncertainty regarding many aspects of such state requirements, make compliance more difficult. To the extent that the Company submits electronic healthcare claims and payment transactions that do not comply with the electronic data transmission standards established under HIPAA, payments may be delayed or denied. Additionally, the costs of complying with any changes to the HIPAA regulations may have a negative impact on operations. Sanctions for failing to comply with the HIPAA health information provisions include criminal penalties and civil sanctions, including significant monetary penalties. In addition, failure to comply with state health information laws that may be more restrictive than the regulations issued under HIPAA could result in additional penalties.

Recent Challenges Faced by CMS Related to Implementation of Part D May Temporarily Disrupt or Adversely the PSN's and MHP's Relationships with their Respective Members.

Partially in anticipation of the implementation of Part D, CMS transitioned to new information and reporting systems, which have recently generated confusing and, the Company believes in some cases, erroneous membership and payment reports concerning Medicare eligibility and enrollment, most of which it

believes reflects inadvertently disenrolled dual-eligible and other beneficiaries who were already members of the Company's PSN or HMO. In addition, recent media reports are prevalent concerning the confusion caused by failures in systems and reporting for Part D, particularly as these failures adversely affect the access of dual-eligibles and low-income beneficiaries to their prescription drugs. These developments have caused the Company's business to experience short-term disruptions in its operations and challenged its information and communications systems. Although the Company believes the current conditions are temporary, there can be no assurance that the current confusion, systems failures, and mistaken payment reports will not temporarily disrupt or adversely affect the PSN's or MHP's relationships with their respective members, which could result in a reduction of membership and adversely affect its results of operations.

There Can be No Assurance that The Company Will be Successful in Its Operation of MHP.

Although the Company has operated as a risk provider since 1997, it has only operated MHP since July 1, 2005. To successfully operate MHP, the Company believes it will have to continue its development of the following capabilities, among others: sales and marketing, customer service and regulatory compliance. The Company anticipates that the continued development efforts and reserve requirements for MHP can be funded by the Company's current resources and projected cash flows from operations. The Company expects to spend approximately $3.0 million to $5.0 million of its existing or future cash resources in 2006 to continue development and expansion of MHP. No assurances can be given that the Company will be successful in operating this segment of its business despite its allocation of a substantial amount of resources for this purpose. If MHP does not develop as anticipated or planned, the Company may have to devote additional managerial and/or capital resources to MHP, which could limit the Company's ability to manage and/or grow its PSN.

The Company May Be Unsuccessful in Implementing Its Growth Strategy If It Is Unable to Expand into New Service Areas in a Timely Manner in Accordance with Its Strategic Plans.

The Company's strategy is to continue to focus on growth within certain geographic regions of Florida. Continued growth may impair its ability to manage its existing operations and provide its services efficiently and to manage its employees adequately. Future results of operations could be materially adversely affected if it is unable to manage its growth efforts effectively.

The Company is seeking to continue to increase PSN and MHP membership and to expand to new service areas within its existing markets and in other markets.

The Company is likely to incur additional costs if the PSN or MHP enters new service areas in Florida where they do not respectively currently operate. The Company's rate of expansion into new geographic areas may also be limited by:

- the time and costs associated with obtaining an HMO license to operate in the new area or expanding MHP's licensed service area, as the case may be;
- the PSN and/or MHP's inability to develop a network of physicians, hospitals, and other healthcare providers that meets their respecitve requirements and those of the applicable regulators;
- competition, which could increase the costs of recruiting members,

reduce the pool of available members, or increase the cost of attracting and maintaining providers;

- the cost of providing healthcare services in those areas;
- demographics and population density; and
- the new annual enrollment period and lock-in provisions of the MMA.

The Company has Anti-Takeover Provisions Which May Make it Difficult to Acquire It or Replace or Remove Current Management.

Provisions in the Company's Articles of Incorporation and Bylaws may delay or prevent an acquisition of it or a change in its management or similar change in control transaction, including transactions in which its shareholders might otherwise receive a premium for their shares over then current prices or that shareholders may deem to be in their best interests. In addition, these provisions may frustrate or prevent any attempts by the Company's shareholders to replace or remove its current management by making it more difficult for shareholders to replace members of its Board of Directors. Because its Board of Directors is responsible for appointing the members of its management team, these provisions could in turn affect any attempt by its shareholders to replace current members of its management team. These provisions provide, among other things, that:

- any shareholder wishing to properly bring a matter before a meeting of shareholders must comply with specified procedural and advance notice requirements;

- special meetings of the Company's shareholders may be called only by the Chairman of the Board of Directors, its President or by the Board of Directors pursuant to a resolution adopted by a majority of the directors;
- the authorized number of directors may be changed only by resolution of the Board of Directors; and
- the Board of Directors has the ability to issue up to 10,000,000 shares of preferred stock, with such rights and preferences as may be determined from time to time by the Board of Directors, without shareholder approval.

The Company's Quarterly Results Will Likely Fluctuate, Which Could Cause the Value of Its Common Stock to Decline.

The Company is subject to quarterly variations in its Total Medical Expenses due to sometimes pronounced fluctuations in patient utilization. It has significant fixed operating costs and, as a result, is highly dependent on patient utilization to sustain profitability. Its results of operations for any quarter are not necessarily indicative of results of operations for any future period or full year. Metropolitan experiences a greater use of medical services in the winter months. As a result, its results of operations may fluctuate significantly from period to period, which could cause the value of its Common Stock to decline.

The Market Price of the Company's Common Stock Could Fall as a Result of Sales of Shares of Common Stock in the Market or the Price Could Remain Lower because of the Perception that Such Sales May Occur.

Metropolitan cannot predict the effect, if any, that future sales or the possibility of future sales may have on the market price of its Common Stock. As of December 31, 2005, there were 49,851,526 shares of its Common Stock outstanding, all of which are freely tradable without restriction with the exception of approximately 12,100,000 shares, owned by certain of its officers, directors and affiliates which may be sold publicly at any time subject to the volume and other restrictions promulgated pursuant to Rule 144 of the Securities Act. In addition, as of December 31, 2005, approximately 6,400,000 shares of the Company's Common Stock were reserved for issuance upon the exercise of options which were previously granted.

Sales of substantial amounts of Metropolitan's Common Stock or the perception that such sales could occur could adversely affect prevailing market prices which could impair its ability to raise funds through future sales of its Common Stock.

The market price and trading volume of Metropolitan's Common Stock could fluctuate significantly and unexpectedly as a result of a number of factors, including factors beyond the Company's control and unrelated to its business. Some of the factors related to Metropolitan's business include: termination of the Humana Agreements, announcements relating to the Company's business or that of its competitors, adverse publicity concerning organizations such as Metropolitan, changes in state or federal legislation and programs, general conditions affecting the industry, performance of companies comparable to the Company, and changes in the expectations of analysts with the respect to the Company's future financial performance. Additionally, Metropolitan's Common Stock may be affected by general economic conditions or specific occurrences such as epidemics (such as influenza), natural disasters (including hurricanes), acts of war or terrorism. Because of the limited trading market for the Company's Common Stock, and because of the possible price volatility, the Company's shareholders may not be able to sell their shares of Common Stock when they desire to do so. The inability to sell shares in a rapidly declining market may substantially increase the Company's shareholders' risk of loss because of such illiquidity and because the price for the Company's Common Stock may suffer greater declines because of its price volatility.

Delisting of Its Common Stock from AMEX Would Adversely Affect the Company and Its Shareholders.

Metropolitan's Common Stock is listed on the AMEX. To maintain listing of securities, the AMEX requires satisfaction of certain maintenance criteria that the Company is not sure that it will continue to be able to satisfy. If it is unable to satisfy such maintenance criteria in the future and it fails to comply, its Common Stock may be delisted from trading on AMEX. If its Common Stock is delisted from trading on AMEX, then trading, if any, might thereafter be conducted in the over-the-counter market in the so-called "pink sheets" or on the "Electronic Bulletin Board" of the National Association of Securities Dealers, Inc. and consequently an investor could find it more difficult to dispose of, or to obtain accurate quotations as to the price of, the Company's Common Stock.

The Company's Common Stock May Not be Excepted from "Penny Stock" Rules, Which May Adversely Affect the Market Liquidity of Our Common Stock.

The Securities Enforcement and Penny Stock Reform Act of 1990 requires additional disclosure relating to the market for penny stocks in connection with trades in any stock defined as a "penny stock". The Securities Exchange

Commission's (the "Commission" or the "SEC") regulations generally define a penny stock to be an equity security that has a market price of less than $5.00 per share, subject to certain exceptions. For example, such exceptions include any equity security listed on a national securities exchange such as the AMEX. Currently, Metropolitan's Common Stock meets this exception. Unless an exception is available, the regulations require the delivery, prior to any transaction involving a penny stock, of a disclosure schedule explaining the penny stock market and the risks associated therewith. In addition, if our Common Stock becomes delisted from the AMEX and we do not meet another exception to the penny stock regulations, trading in its Common Stock would be covered by the Commission's Rule 15g-9 under the Exchange Act for non-national securities exchange listed securities. Under this rule, broker/dealers who recommend such securities to persons other than established customers and accredited investors must make a special written suitability determination for the purchaser and receive the purchaser's written agreement to a transaction prior to sale. Securities also are exempt from this rule if the market price is at least $5.00 per share. If the Company's Common Stock becomes subject to the regulations applicable to penny stocks, the market liquidity for its Common Stock could be adversely affected. In such event, the regulations on penny stocks could limit the ability of broker/dealers to sell Metropolitan's Common Stock and thus the ability of purchasers of its Common Stock to sell their shares in the secondary market.

ITEM 1B. UNRESOLVED STAFF COMMENTS

None.

ITEM 2 PROPERTIES

Metropolitan's principal executive offices are located at 250 Australian Avenue South, Suite 400, West Palm Beach, Florida where it occupies 13,211 square feet at a current monthly rent of $16,800 pursuant to a lease expiring March 31, 2011. Starting in April 2006, it will occupy an additional 4,890 square feet in the same office building for an additional monthly fee of $7,100.

Metropolitan has a satellite office in Daytona Beach, Florida with 5,700 square feet and monthly rent of $8,600. The lease expires December 31, 2006.

The PSN leases seven offices serving patients in Central and South Florida with an aggregate monthly rental of $33,200 with expiration dates ranging from one to five years from December 31, 2005.

The HMO leases three offices that are located in Central and South Florida with an aggregate monthly rental of $8,800 with expiration dates ranging from one to three years from December 31, 2005.

ITEM 3 LEGAL PROCEEDINGS

The Company is a party to various legal proceedings which are either immaterial in amount to it and its subsidiaries or involve ordinary routine litigation incidental to its business and the business of its subsidiaries. There is no material pending legal proceedings, other than routine litigation incidental to business and the business of Metropolitan's subsidiaries, to which it or any of its subsidiaries is a party or of which any our or its subsidiaries' property is the subject.

ITEM 4 SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

No matter was submitted to a vote of the security holders, through the solicitation of proxies or otherwise, during the quarter ended December 31, 2005.

PART II

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

Metropolitan's Common Stock is currently traded on the American Stock Exchange and the Pacific Stock Exchange under the symbol "MDF". The following table sets forth the high and low sales prices for its Common Stock, as reported by American Stock Exchange, for each full quarterly period within the two most recent fiscal years:

	High ($)	Low ($)
COMMON STOCK		
Quarter ended March 31, 2004	1.10	0.67
Quarter ended June 30, 2004	1.07	0.81
Quarter ended September 30, 2004	1.70	0.80
Quarter ended December 31, 2004	2.90	1.35
Quarter ended March 31, 2005	3.25	2.14
Quarter ended June 30, 2005	3.14	2.16
Quarter ended September 30, 2005	2.85	2.41
Quarter ended December 31, 2005	2.68	2.00

At March 1, 2006, the price per share of Metropolitan's common stock was $2.16 and it believes we had approximately twelve beneficial shareholders.

Metropolitan has never declared or paid any cash dividends on its Common Stock and does not intend to pay cash dividends in the foreseeable future. Pursuant to Florida law, it is prohibited from paying dividends or otherwise distributing funds to our shareholders, except out of legally available funds. The declaration and payment of dividends on its common stock and the amount thereof will be dependent upon its results of operations, financial condition, cash requirements, future prospects and other factors deemed relevant by the Board of Directors. No assurance can be given that it will pay any dividends on its common stock in the future. Metropolitan presently intends to invest its earnings, if any, in the development and growth of its operations and the reduction of debt.

Equity Compensation Plan

Information regarding Metropolitan's existing equity compensation plans as of December 31, 2005 is included in Item 12 of this Form 10-K and is incorporated herein by reference.

ITEM 6 SELECTED FINANCIAL DATA

Set forth below is Metropolitan's selected historical consolidated financial data for the five fiscal years ended December 31, 2005. The selected historical consolidated financial data should be read in conjunction with the consolidated financial statements and accompanying notes and "Management's Discussion and Analysis of Financial Condition and Results of Operations" included in Item 7 of this Annual Report. The consolidated statement of operations data and balance sheet data for the years ended December 31, 2001, 2002, 2003, 2004 and 2005 are

derived from its audited consolidated financial statements which have been audited by Kaufman, Rossin & Co., P.A., Metropolitan's registered public accounting firm.

	For the years ended December			
	2005 (2)	2004 (1)	2003	
Net revenues	$ 183,765,191	$ 158,069,791	$ 143,874,488	$
Operating income/(loss)	3,232,678	11,855,915	7,106,428	
Income/(Loss) from continuing operations before income taxes	3,849,549	11,473,732	5,861,303	
Income/(Loss) from continuing operations	2,381,743	18,853,978	5,861,303	
Discontinued operations, net of tax	--	(31,266)	(1,459,550)	
Net income/(loss)	2,381,743	18,822,712	4,401,753	
Basic income/(loss) from continuing operations per share	0.05	0.42	0.17	
Basic earnings/(loss) per share	0.05	0.42	0.13	
Diluted earnings/(loss) per share	0.05	0.38	0.10	
Weighted average common shares outstanding-basic	48,975,803	45,123,843	34,750,173	
Weighted average common shares outstanding-diluted	51,007,396	50,028,303	46,914,839	
Cash dividend declared	--	--	--	
Financial Position				
Cash and equivalents	$ 15,572,862	$ 11,344,113	$ 2,176,204	$
Total current assets	24,479,528	18,923,011	5,452,254	
Total assets	33,115,106	28,037,263	9,223,729	
Total current liabilities	3,416,244	3,224,633	7,822,298	
Total liabilities	3,416,244	3,474,633	9,726,390	
Total working capital	21,063,284	15,698,378	(2,370,044)	
Long - term obligations, including current portion	--	1,132,000	2,983,576	
Total stockholder's equity/ accumulated deficit	29,698,862	24,562,630	(502,661)	

(1) The financial data for 2004 includes a deferred tax asset of $8,281,110 and a benefit from income taxes of $7,380,246.

(2) The financial data for 2005 includes a deferred tax asset of $7,993,000 and an income tax expense of $1,467,806.

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

As of December 31, 2005, substantially all of the Company's revenues were directly or indirectly derived from reimbursements generated by Medicare Advantage health plans. As a result, the Company's revenue and profitability are dependent on government funding levels for Medicare Advantage programs. See "ITEM 1 - DESCRIPTION OF BUSINESS - Medicare", "-Medicare Modernization Act".

For the twelve months ended December 31, 2005, approximately 98% of

Metropolitan's revenue came from the Humana Agreements. The Humana Agreements have one-year terms and renew automatically each December 31 for additional one-year terms unless terminated for cause or upon 180 days' prior notice. Failure to maintain the Humana Agreements on favorable terms would adversely affect Metropolitan's results of operations and financial condition.

The Humana Agreements and MHP's agreement with CMS are risk agreements under which the PSN and MHP, respectively, receive net monthly payments per Participating Member at a rate established by the agreements, also called a capitated fee. In accordance with the agreements, the capitated fee is a function of the number of Participating Members, regardless of the actual utilization rate of covered services.

To the extent that the Participating Members require more care than is anticipated, aggregate capitation fees may be insufficient to cover the costs associated with the treatment of such members. If medical expenses exceed the Company's estimates, except in very limited circumstances, it will be unable to increase the premiums it receives under these contracts during the then-current terms.

Relatively small changes in the Company's ratio of medical expense to revenue can create significant changes in its financial results. Accordingly, the failure to adequately predict and control medical expenses and to make reasonable estimates and maintain adequate accruals for incurred but not reported, or IBNR, claims, may have a material adverse effect on the Company's financial condition, results of operations and/or cash flows.

See "ITEM 1B. RISK FACTORS" for further discussion of the most significant risks that affect the Company's business, financial condition, results of operations and/or cash flows.

Critical Accounting Policies

The Company's significant accounting policies are described in Note 1 on pages F-8 through F-13 of the "Notes to Consolidated Financial Statements" included in this Form 10-K. The Company believes that its most critical accounting policies include "Use of Estimates, Revenue, Expense and Receivables" and "Use of Estimates, Deferred Tax Asset."

Use of Estimates, Revenue, Expense and Receivables.

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the amounts reported in the accompanying financial statements. The most significant area requiring estimates relate to the PSN's arrangement with Humana and such estimates are based on knowledge of current events and anticipated future events, and accordingly, actual results may ultimately differ materially from those estimates.

With regard to revenues, expenses and receivables arising from the Humana Agreements, Metropolitan estimates amounts it believes will ultimately be realizable based in part upon estimates of IBNR (claims incurred but not reported) and estimates of retroactive adjustments or unsettled costs to be applied by Humana. The IBNR estimates are made by Humana utilizing actuarial methods and are continually evaluated by Metropolitan's management based upon its specific claims experience. With regards to MHP, the cost of medical benefits is recognized in the period in which services are provided and includes an IBNR estimate based on management's best estimate of medical benefits

payable, in conjunction with an independent actuarial firm. It is reasonably possible that some or all of these estimates could change in the near term by an amount that could be material to the financial statements. See "Notes to Consolidated Financial Statements," Note 1 - "Use of Estimates, Revenue, Expense and Receivables" and "RISK FACTORS - "A Failure To Estimate Incurred But Not Reported...".

During 2005, the Company incurred approximately $4.0 million of medical costs related to the implantation of certain Implantable Automatic Defibrillators ("AICD's"). CMS has directed that the costs of certain of these procedures that meet 2005 eligibility requirements be paid by CMS, rather than billed to Medicare Advantage plans. The Company is working with Humana and the related providers to secure reimbursement for these amounts, and has estimated a recovery of approximately $2.2 million at December 31, 2005. It is reasonably possible that this estimate could change in the near term by an amount that could be material to the financial statements.

Use of Estimates, Deferred Tax Asset.

The Company has recorded a deferred tax asset of approximately $8.0 million at December 31, 2005. Realization of the deferred tax asset is dependent on generating sufficient taxable income in the future. The amount of the deferred tax asset considered realizable could change in the near term if estimates of future taxable income are modified and those changes could be material (see "Notes to Consolidated Financial Statements," Note 1 - "Use of Estimates, Deferred Tax Asset" and Note 6 - "Income Taxes").

In the future, if Metropolitan determines that it cannot, on a more likely than not basis, realize all or part of its deferred tax assets in the future, an adjustment to establish (or record an increase in) the deferred tax asset valuation allowance would be charged to income in the period in which such determination is made.

Off-Balance Sheet Arrangements

Metropolitan does not have any off-balance sheet arrangements that have or are reasonably likely to have a current or future effect on Metropolitan's financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources that are material to investors.

Contractual Obligations

		Payment Due by Period		
Contractual Obligations	Total	Less Than 1 Year	1-3 Years	4-5 Years
Operating lease obligations	$ 7,715,000	$ 1,821,000	$ 3,248,000	$ 2,350,000
Employment obligations	2,368,000	2,368,000	--	--
	$ 10,083,000	$ 4,189,000	$ 3,248,000	$ 2,350,000

As of December 31, 2005, Metropolitan had no long-term debt and no payment obligations that would constitute capital lease obligations.

Comparison of Fiscal 2005 and 2004

Introduction

For the year ended December 31, 2005, Metropolitan recognized revenues of $183.8 million compared to $158.1 million in the prior year, an increase of $25.7 milw roman"> Loans
receivable, including fees

	$4,887	$5,038	$14,335	$14,572
Securities:				
Taxable	631	439	1,698	1,239
Tax-exempt	248	255	710	762
Federal funds sold	111	193	223	354
Interest bearing deposits	1	1	2	4
Total Interest Income	5,878	5,926	16,968	16,931
INTEREST EXPENSE				
Deposits	2,219	2,548	6,417	7,111
Borrowings	377	241	1,132	706
Junior subordinated debentures	135	226	459	460
Total Interest Expense	2,731	3,015	8,008	8,277
Net Interest Income	3,147	2,911	8,960	8,654
PROVISION FOR LOAN LOSSES	279	324	569	868
Net Interest Income after Provision for Loan Losses	2,868	2,587	8,391	7,786
OTHER INCOME				
Service fees on deposit accounts	409	362	1,111	1,016
ATM and debit card fees	123	109	348	300
Insurance commissions and fees	576	618	1,972	2,136
Investment brokerage fees	22	26	117	239
Holding gains (losses) on trading securities				

	(8)	194	13	192
Gain on sale of securities, available for sale				
	-	10	152	10
Impairment write-down on equity securities				
	(3,526)	-	(3,526)	-
Other				
	129	149	445	396
Total Other Income				
	(2,275)	1,468	632	4,289
OTHER EXPENSES				
Salaries and employee benefits				
	1,842	1,792	5,697	5,403
Occupancy, net				
	315	319	977	932
Furniture, equipment and data processing				
	372	372	1,119	1,066
Stationary and supplies				
	50	46	141	138
Professional fees				
	140	120	337	424
Advertising and promotion				
	92	174	379	415
Insurance				
	42	41	127	135
FDIC assessment				
	95	9	280	26
Postage and freight				
	34	36	118	124
Amortization of intangible assets				
	14	15	43	78
Other				
	443	360	1,261	1,119
Total Other Expenses				
	3,439	3,284	10,479	9,860
Income (Loss) before Income Taxes				
	(2,846)	771	(1,456)	2,215
PROVISION FOR INCOME TAXES				
	181	238	575	664
Net Income (Loss)				
	$(3,027)	$533	$(2,031)	$1,551
EARNINGS (LOSS) PER SHARE				
Basic				
	$(0.92)	$0.16	$(0.62)	$0.46
Diluted				
	$(0.92)	$0.16	$(0.62)	$0.46

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SUSSEX BANCORP
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY
Nine Months Ended September 30, 2008 and 2007
(Dollars In Thousands, Except Per Share Amounts)
(Unaudited)

	Number of Shares Outstanding	Common Stock	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Treasury Stock	Total Stockholders' Equity
Balance December 31, 2006	3,152,374	$ 27,306	$ 7,415	$ (129)	$ -	$ 34,592
Adjustment to opening balance, net of tax, for the adoption of SFAS No. 159 (see Note 8)	-	-	(262)	262	-	-
Adjusted opening balance, January 1, 2007	3,152,374	27,306	7,153	133	-	34,592
Comprehensive income:						
Net income	-	-	1,551	-	-	1,551
Change in unrealized gains on securities available for sale, net of tax	-	-	-	(177)	-	(177)
Total Comprehensive Income						1,374
Treasury shares purchased	(30,800)	-	-	-	(397)	(397)
Treasury shares retired	-	(397)	-	-	397	-
Exercise of stock options	20,851	256	-	-	-	256
Income tax benefit of stock options exercised	-	18	-	-	-	18
Restricted stock vested during the period (a)	1,925	-	-	-	-	-
Compensation expense related to stock option and restricted stock grants	-	54	-	-	-	54
Compensation expense related to stock awards	1,000	15	-	-	-	15
Dividends on common stock ($0.20 per share)	-	-	(667)	-	-	(667)
Balance September 30, 2007	3,145,350	$ 27,252	$ 8,037	$ (44)	$ -	$ 35,245
Balance December 31, 2007	3,093,699	$ 26,651	$ 7,774	$ 15	$ -	$ 34,440

Comprehensive loss:						
Net loss	-	-	(2,031)	-	-	(2,031)
Change in unrealized losses on securities available for sale, net of tax	-	-	-	(1,011)	-	(1,011)
Total Comprehensive Loss						(3,042)
Treasury shares purchased	(4,765)	-	-	-	(40)	(40)
Treasury shares retired	-	(40)	-	-	40	-
Exercise of stock options	3,606	34	-	-	-	34
Income tax benefit of stock options exercised	-	1	-	-	-	1
Restricted stock vested during the period (a)	4,025	-	-	-	-	-
Compensation expense related to stock option and restricted stock grants	-	60	-	-	-	60
Dividends on common stock ($0.20 per share)	-	-	(654)	-	-	(654)
6.5% stock dividend	201,802	1,413	(1,413)	-	-	-
Balance September 30, 2008	3,298,367	$ 28,119	$ 3,676	$ (996)	$ -	$ 30,799

(a) Balance of unvested shares of restricted stock; 12,945 in 2008 and 10,675 in 2007

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SUSSEX BANCORP
CONSOLIDATED STATEMENTS OF CASH FLOWS
(Dollars in Thousands)
(Unaudited)

	Nine Months Ended September 30,	
	2008	2007
Cash Flows from Operating Activities		
Net income (loss)	$ (2,031)	$ 1,551
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Provision for loan losses	569	868
Provision for depreciation and amortization	775	770
Net change in trading securities	740	2,488
Impairment on equity securities	3,526	-
Net amortization of securities premiums and discounts	8	5
Net realized gain on sale of securities	(152)	(10)
Earnings on investment in life insurance	(78)	(79)
Compensation expense for stock options and stock awards	60	69
(Increase) decrease in assets:		
Accrued interest receivable	(23)	(136)
Other assets	107	(615)
Increase in accrued interest payable and other liabilities	106	647
Net Cash Provided by Operating Activities	3,607	5,558
Cash Flows from Investing Activities		
Securities available for sale:		
Purchases	(33,720)	(15,475)
Proceeds from sale of securities	5,240	2,335
Maturities, calls and principal repayments	7,322	6,886
Net increase in loans	(16,560)	(31,740)
Proceeds from sale of foreclosed real estate	316	-
Purchases of premises and equipment	(317)	(1,795)
Increase in FHLB stock	(79)	(170)
Net Cash Used in Investing Activities	(37,798)	(39,959)
Cash Flows from Financing Activities		
Net increase in deposits	48,123	24,661
Proceeds from borrowings	3,000	8,000
Repayments of borrowings	(2,040)	(6,038)
Proceeds from junior subordinated debentures	-	12,887
Repayments of junior subordinated debentures	-	(5,155)
Proceeds from the exercise of stock options	34	256
Purchase of treasury stock	(40)	(397)
Dividends paid	(654)	(667)

Net Cash Provided by Financing Activities		48,423		33,547
Net Increase(Decrease) in Cash and Cash Equivalents		14,232		(854)
Cash and Cash Equivalents - Beginning		11,775		22,165
Cash and Cash Equivalents - Ending	$	26,007	$	21,311
Supplementary Cash Flows Information				
Interest paid	$	8,207	$	7,920
Income taxes paid	$	384	$	1,227
Supplementary Schedule of Noncash Investing and Financing Activities				
Foreclosed real estate acquired in settlement of loans	$	4,247	$	-

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SUSSEX BANCORP
Notes to Consolidated Financial Statements (Unaudited)

Note 1 - Basis of Presentation

The consolidated financial statements include the accounts of Sussex Bancorp (the “Company”) and its wholly-owned subsidiary Sussex Bank (the “Bank”). The Bank’s wholly-owned subsidiaries are SCB Investment Company, Inc., SCBNY Company, Inc., and Tri-State Insurance Agency, Inc. (“Tri-State”) a full service insurance agency located in Sussex County, New Jersey. Tri-State’s operations are considered a separate segment for financial disclosure purposes. All inter-company transactions and balances have been eliminated in consolidation. Sussex Bank is also a 49% partner of SussexMortgage.com LLC, an Indiana limited liability company and mortgage banking joint venture with National City Mortgage, Inc. The Bank operates ten banking offices, eight located in Sussex County, New Jersey and two in Orange County, New York. The Bank has also received regulatory approval for a branch location in Pike County, Pennsylvania.

The Company is subject to the supervision and regulation of the Board of Governors of the Federal Reserve System (the "FRB"). The Bank's deposits are insured by the Deposit Insurance Fund ("DIF") of the Federal Deposit Insurance Corporation ("FDIC") up to applicable limits. The operations of the Company and the Bank are subject to the supervision and regulation of the FRB, FDIC and the New Jersey Department of Banking and Insurance (the "Department") and the operations of Tri-State are subject to supervision and regulation by the Department.

The accompanying unaudited consolidated financial statements have been prepared in accordance with generally accepted accounting principles for interim financial information. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for full year financial statements. In the opinion of management, all adjustments considered necessary for a fair presentation have been included and are of a normal, recurring nature. Operating results for the nine-month period ended September 30, 2008, are not necessarily indicative of the results that may be expected for the year ending December 31, 2008. These consolidated financial statements should be read in conjunction with the consolidated financial statements and the notes thereto that are included in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2007.

Note 2 - Stockholders’ Equity and Subsequent Events

On October 15, 2008, the Board of Directors declared a 6.5% common stock dividend payable on November 12, 2008 to shareholders of record as of October 29, 2008. Accordingly, 201,802 shares of common stock will be issued to the Company’s stockholders and $1,413,000 will be transferred from retained earnings to common stock. The effect of the stock dividend has been retroactively reflected as of September 30, 2008 in the consolidated balance sheet and the consolidated statement of stockholders’ equity. The earnings per share amounts, stock options, restricted stock grants and dividend per share amounts disclosed in the consolidated financial statements and related footnote reflect the effect of the stock dividend as noted.

Note 3 –Other Than Temporary Impairment

As previously announced in an 8-K filing on September 8, 2008, Sussex Bancorp held Fannie Mae and Freddie Mac perpetual preferred stock at September 30, 2008 with a cost basis of approximately $3.8 million. These securities were subject to an other than temporary impairment (“OTTI”) charge. On September 7, 2008, the Federal Housing Finance Agency placed both Fannie Mae and Freddie Mac under conservatorship. Although this action did not

eliminate the equity in Fannie Mae and Freddie Mac represented by the perpetual preferred stock, it has negatively impacted the value of the perpetual preferred stock. The fair value of these securities at September 30, 2008 was $284 thousand and the OTTI charge taken in the quarter ended September 30, 2008 was $3.5 million.

At September 30, 2008, Sussex Bank's capital ratios were all above the level required to be categorized as a "well capitalized" bank. Sussex Bank's total risk-based capital, Tier I capital and leverage ratios were 12.16%, 10.91% and 8.41%, respectively.

While the reported results for the three and nine month periods reflect the effects of the OTTI charge, they do not reflect the change in tax treatment enacted as part of the Emergency Economic Stabilization Act of 2008 (the "Act"), which was

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adopted on October 3, 2008. Under the Act, the Company is permitted to deduct the loss as an ordinary loss for tax purposes, thereby offsetting a portion of the Company's ordinary income. However, since the Act was not enacted until the fourth quarter, the Company can not recognize this tax benefit as part of its third quarter results. The tax benefit will be recognized in the fourth quarter, and it is expected to amount to approximately $1.3 million or $0.40 per share, based on the average shares outstanding for the quarter ended September 30, 2008 and adjusted for the 6.5% stock dividend.

Note 4 – Earnings (Loss) per Share

Basic earnings (loss) per share are calculated by dividing net income by the weighted average number of shares of common stock outstanding during the period, as adjusted for the dividend discussed in Note 2. Diluted earnings (loss) per share reflects additional common shares that would have been outstanding if dilutive potential common shares (nonvested restricted stock grants and stock options) had been issued, as well as any adjustment to income that would result from the assumed issuance of potential common shares that may be issued by the Company. For the three months and nine months ended September 30, 2008, the Company had 9,237 and 14,363 shares, respectively, not included in the below calculation due to their anti-dilutive effect on earnings per share. Potential common shares related to stock options are determined using the treasury stock method.

The following table sets forth the computations of basic and diluted earnings (loss) per share as retroactively adjusted for the 6.5% stock dividend declared October 15, 2008.

	Three Months Ended September 30, 2008			Three Months Ended September 30, 2007		
(In thousands, except per share data)	Income (Numerator)	Shares (Denominator)	Per Share Amount	Income (Numerator)	Shares (Denominator)	Per Share Amount
Basic earnings (loss) per share:						
Net income (loss) applicable to common stockholders	$ (3,027)	3,299	$ (0.92)	$ 533	3,363	$ 0.16
Effect of dilutive securities:						
Stock options	-	-		-	25	
Diluted earnings (loss) per share:						
Net income (loss) applicable to common stockholders and assumed conversions	$ (3,027)	3,299	$ (0.92)	$ 533	3,388	$ 0.16

	Nine Months Ended September 30, 2008			Nine Months Ended September 30, 2007		
	Income (Numerator)	Shares (Denominator)	Per Share Amount	Income (Numerator)	Shares (Denominator)	Per Share Amount

(Dollars in thousands, except per share data)						
Basic earnings (loss) per share:						
Net income (loss) applicable to common stockholders	$ (2,031)	3,300	$ (0.62)	$ 1,551	3,366	$ 0.46
Effect of dilutive securities:						
Stock options	-	-		-	33	
Diluted earnings (loss) per share:						
Net income (loss) applicable to common stockholders and assumed conversions	$ (2,031)	3,300	$ (0.62)	$ 1,551	3,399	$ 0.46

Note 5 - Comprehensive Income

The components of other comprehensive income (loss) and related tax effects are as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
(Dollars in thousands)	2008	2007	2008	2007
Unrealized holding gain (loss) on available for sale securities	$ (4,357)	$ 382	$ (5,060)	$ (283)
Reclassification adjustments for gains (losses) included in net income	(3,526)	10(10)	(3,374)	10
Net unrealized gain (loss)	(831)	372	(1,686)	(293)
Tax effect	333	(150)	675	116
Other comprehensive income (loss), net of tax	$ (498)	$ 222	$ (1,011)	$ (177)

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Note 6 – Segment Information

The Company's insurance agency operations are managed separately from the traditional banking and related financial services that the Company also offers. The insurance agency operation provides commercial, individual, and group benefit plans and personal coverage.

	Three Months Ended September 30, 2008			Three Months Ended September 30, 2007		
(Dollars in thousands)	Banking and Financial Services	Insurance Services	Total	Banking and Financial Services	Insurance Services	Total
Net interest income from external sources	$ 3,147	$ -	$ 3,147	$ 2,911	$ -	$ 2,911
Other income from external sources	(2,851)	576	(2,275)	850	618	1,468
Depreciation and amortization	241	12	253	247	10	257
Income (loss) before income taxes	(2,822)	(24)	(2,846)	756	15	771
Income tax expense (benefit) (1)	191	(10)	181	232	6	238
Total assets	435,932	3,147	439,079	388,650	3,284	391,934

	Nine Months Ended September 30, 2008			Nine Months Ended September 30, 2007		
(Dollars in thousands)	Banking and Financial Services	Insurance Services	Total	Banking and Financial Services	Insurance Services	Total
Net interest income from external sources	$ 8,960	$ -	$ 8,960	$ 8,654	$ -	$ 8,654
Other income from external sources	(1,340)	1,972	632	2,153	2,136	4,289
Depreciation and amortization	741	34	775	740	30	770
Income (loss) before income taxes	(1,540)	84	(1,456)	1,922	293	2,215
Income tax expense (1)	541	34	575	547	117	664
Total assets	435,932	3,147	439,079	388,650	3,284	391,934

(1) Insurance services calculated at statutory tax rate of 40%

Note 7 - Stock-Based Compensation

The Company currently has stock-based compensation plans in place for directors, officers, employees, consultants and advisors of the Company. Under the terms of these plans the Company may grant restricted shares and stock

options for the purchase of the Company's common stock. The stock-based compensation is granted under terms determined by the Compensation Committee of the Board of Directors. Stock options granted have a maximum term of ten years, generally vest over periods ranging between one and four years, and are granted with an exercise price equal to the fair market value of the common stock on the date the options are granted. Restricted stock is valued at the market value of the common stock on the date of grant and generally vests between two and five years. All dividends paid on restricted stock, whether vested or unvested, are granted to the shareholder.

During the first nine months of 2008 and 2007, the Company expensed $60 thousand and $54 thousand, respectively, in stock-based compensation under stock option plans and restricted stock awards, including $12 thousand in 2008 and $15 thousand in 2007 related to previous grants under stock option plans. No stock options have been granted in 2008. As of September 30, 2008, all unrecognized compensation expense for stock option plans has been expensed.

Information regarding the Company's stock option plans as of September 30, 2008 was as follows, as adjusted for the 6.5% stock dividend:

	Number of Shares	Weighted Average Exercise Price Per Share	Weighted Average Contractual Term	Aggregate Intrinsic Value
Options outstanding, beginning of year	231,974	$ 12.31		
Options exercised	(3,840)	8.80		
Options forfeited	(9,531)	11.69		
Options outstanding, end of quarter	218,603	$ 12.32	6.88	$ 436
Options exercisable, end of quarter	218,603	$ 12.32	6.88	$ 436
Option price range at end of quarter	$ 6.88 to $16.45			
Option price range for exercisable shares	$ 6.88 to $16.45			

The total intrinsic value or fair market price over the exercise price, of stock options exercised was $7 thousand during the first nine months of 2008.

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Information regarding the Company's restricted stock activity as of September 30, 2008, as adjusted for the 6.5% stock dividend, was as follows:

	Number of Shares		Weighted Average Grant Date Fair Value
Restricted stock, beginning of year	11,371	$	14.14
Granted	7,237		9.77
Forfeited	(533)		13.03
Vested and stock dividend	(5,130)		13.80
Restricted stock, end of quarter	12,945	$	12.68

Compensation expense recognized for restricted stock was $48 thousand for the first nine months of 2008. At September 30, 2008, unrecognized compensation expense for non-vested restricted stock was $128 thousand, which is expected to be recognized over an average period of 2.9 years.

Note 8 - Guarantees

The Company does not issue any guarantees that would require liability recognition or disclosure, other than its standby letters of credit. Standby letters of credit are conditional commitments issued by the Company to guarantee the performance of a customer to a third party. Generally, all letters of credit, when issued have expiration dates within one year. The credit risk involved in issuing letters of credit is essentially the same as those that are involved in extending loan facilities to customers. The Company, generally, holds collateral and/or personal guarantees supporting these commitments. The Company had $2,343,000 of undrawn standby letters of credit outstanding as of September 30, 2008. Management believes that the proceeds obtained through a liquidation of collateral and the enforcement of guarantees would be sufficient to cover the potential amount of future payments required under the corresponding guarantees. The amount of the liability as of September 30, 2008 for guarantees under standby letters of credit issued is not material.

Note 9 - Adoption of SFAS 157 and 159

The Company elected to early adopt Statement of Financial Accounting Standards ("SFAS") No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities", including an amendment of FASB Statement No. 115 and FASB Statement No. 157, "Fair Value Measurements." SFAS No. 157 defines fair value, establishes a framework for measuring fair value under GAAP, and expands disclosures about fair value measurements. SFAS No. 157 applies to other accounting pronouncements that require or permit fair value measurements. SFAS No. 159, which was issued in February 2007, generally permits the measurement of selected eligible financial instruments at fair value at specified election dates, subject to the conditions set forth in the standard, one of which is a requirement to adopt all the requirements of SFAS No. 157 at the early adoption date of SFAS No. 159 or earlier.

On January 1, 2007, the Company elected to early adopt SFAS No. 159 for 28, or 20.3%, of its 138 available for sale securities, or $14.4 million of its $23.2 million in mortgage-backed securities, and reclassified them as trading securities. At December 31, 2006, it was the Company's intent to hold these investments until maturity or market price recovery and the Company classified the securities as available for sale. In the weeks following the filing of the Company's annual report on Form 10-K, the Company evaluated the impact of the adoption of each of the statements on the Company's consolidated balance sheets and consolidated statements of income. The purposes weighing most heavily in favor of adoption of SFAS No. 159 included the potential net-interest margin improvements afforded by the election and the balance sheet management flexibility which the Company has achieved. The Company selected these

mortgage-backed securities primarily on the basis of yield.

The following table summarizes the impact of adopting SFAS No. 159 for certain investment securities:

(Dollars in thousands)	Balance Sheet 1/1/2007 prior to adoption	Adjustment Pretax	Balance Sheet 1/1/2007 after FVO adoption
Securities, available for sale, at amortized cost	$ 54,851	$ (14,828)	$ 40,023
Net unrealized losses on securities available for sale	(216)	436	220
Securities available for sale, at fair value	54,635	(14,392)	40,243
Trading securities	-	14,392	14,392
	$ 54,635	$ -	$ 54,635
Pretax cumulative effect of adoption of the fair value option		$ (436)	
Increase in deferred tax assets		174	
Cumulative effect of adoption of the fair value option (charged to retained earnings)		$ (262)	

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The Company records trading securities at fair value. Any holding gains and losses on those trading securities are reflected in the consolidated statement of income. The degree of judgment utilized in measuring the fair value of trading securities generally correlates to the level of pricing observability. Pricing observability is impacted by a number of factors, including the type of asset, whether the asset has an established market and the characteristics specific to the transaction. Trading securities with readily active quoted prices or for which fair value can be measured from actively quoted prices generally will have a higher degree of pricing observability and a lesser degree of judgment utilized in measuring fair value. Conversely, assets rarely traded or not quoted will generally have less, or no, pricing observability and a higher degree of judgment utilized in measuring fair value.

Impaired loans are evaluated and valued at the time the loan is identified as impaired, at the lower of cost or market value. Other real estate owned is evaluated at the time the loan is foreclosed upon at market value. Market value is measured based on the value of the collateral securing these loans and assets. The value of real estate collateral is determined based on appraisals by qualified licensed appraisers hired by the Company. Appraised and reported values may be discounted based on management's historical knowledge, changes in market conditions from the time of valuation, and management's expertise and knowledge of the client and client's business. Impaired loans and other real estate owned are reviewed and evaluated on at least a quarterly basis for additional impairment and adjusted accordingly, based on the same factors identified above.

Under SFAS No. 157, there is a hierarchal disclosure framework associated with the level of pricing observability utilized in measuring assets and liabilities at fair value. The three broad levels defined by the SFAS No. 157 hierarchy are as follows:

Level 1 - Quoted prices are available in active markets for identical assets or liabilities as of the reported date.

Level 2 - Pricing inputs are other than quoted prices in active markets, which are either directly or indirectly observable as of the reported date. The nature of these asset and liabilities include items for which quoted prices are available but traded less frequently, and items that are fair valued using other financial instruments, the parameters of which can be directly observed.

Level 3 - Assets and liabilities that have little to no pricing observability as of reported date. These items do not have two-way markets and are measured using management's best estimate of fair value, where the inputs into the determination of fair value require significant management judgment or estimation.

The following table summarizes the valuation of the Company's assets measured at fair value by the above SFAS No. 157 pricing observability levels:

		Fair Value Measurements Using:		
(Dollars in thousands)	Fair Value Measurements	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
At September 30, 2008:				
Trading securities	$ 13,519	$ -	$ 13,519	$ -
Available for sale securities	64,487	-	64,487	-

Impaired loans	9,629	-	-	9,629
Other real estate owned	3,931	-	-	3,931
At December 31, 2007:				
Trading securities	$ 14,259	$ -	$ 14,259	$ -
Available for sale securities	48,397	-	48,397	-
Impaired loans	13,461	-	-	13,461
Other real estate owned	-	-	-	-

The Company's trading securities and available for sale securities portfolios contain investments which are all rated within the Company's investment policy guidelines and upon review of the entire portfolio all securities are marketable and have observable pricing inputs. There was an unrealized gain on trading securities recorded on the income statement of $13 thousand for the nine months ended September 30, 2008 and $192 thousand unrealized gain for the same period in 2007.

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The table below presents a reconciliation for assets measured at fair value using Level 3 significant unobservable inputs:

	2008			2007		
	Impaired Loans	Other Real Estate Owned	Total	Impaired Loans	Other Real Estate Owned	Total
Beginning balance, January 1,	$ 13,461	$ -	$ 13,461	$ 2,185	$ -	$ 2,185
Total gains or losses (realized/unrealized):						
Included in earnings	-	-	-	-	-	-
Other changes in fair value	(612)	-	(612)	25	-	25
Purchases, Issuances, and settlements	(3,220)	3,931	711	6,357	-	6,357
Transfers in and/or out of Level 3	-	-	-	-	-	-
Ending balance, September 30,	$ 9,629	$ 3,931	$ 13,560	$ 8,567	$ -	$ 8,567

Impaired loans, which are measured for impairment using the fair value of collateral-dependent loans, had carrying amounts of $11.2 million and $9.1 million, with valuation allowances of $1.6 million and $502 thousand at September 30, 2008 and 2007, respectively. For the nine month period ended September 30, 2008, a $122 thousand decrease in the provision for loan losses was recorded, as $522 thousand in impaired loans were charged-off. In the nine month period ended September 30, 2007, impaired loans required an additional provision for loan losses of $480 thousand.

Note 10 - New Accounting Standards

In May 2008, the FASB issued SFAS No. 162, “The Hierarchy of Generally Accepted Accounting Principles.” This Statement identifies the sources of accounting principles and the framework for selecting the principles used in the preparation of financial statements. This Statement is effective 60 days following the SEC’s approval of the Public Company Accounting Oversight Board amendments to AU Section 411, “The Meaning of Present Fairly in Conformity with Generally Accepted Accounting Principles.” The Company is currently evaluating the potential impact the new pronouncement will have on its consolidated financial statements.

In April 2008, the FASB issued FASB Staff Position (“FSP”) FAS 142-3, “Determination of the Useful Life of Intangible Assets.” This FSP amends the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset under FASB Statement No. 142, “Goodwill and Other Intangible Assets” (“SFAS 142”). The intent of this FSP is to improve the consistency between the useful life of a recognized intangible asset under SFAS 142 and the period of expected cash flows used to measure the fair value of the asset under SFAS 141R, and other GAAP. This FSP is effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years. Early adoption is prohibited. The Company is currently evaluating the potential impact the new pronouncement will have on its consolidated financial statements.

In June 2008, the FASB issued FASB Staff Position (FSP) EITF 03-6-1, “Determining Whether Instruments Granted in Share-Based Payment Transactions Are Participating Securities.” This FSP clarifies that all outstanding unvested share-based payment awards that contain rights to nonforfeitable dividends participate in undistributed earnings with common shareholders. Awards of this nature are considered participating securities and the two-class method of

computing basic and diluted earnings per share must be applied. This FSP is effective for fiscal years beginning after December 15, 2008. The Company is currently evaluating the potential impact the new pronouncement will have on its consolidated financial statements.

In June 2008, the FASB ratified EITF Issue No. 08-3, "Accounting for Lessees for Maintenance Deposits Under Lease Arrangements" (EITF 08-3). EITF 08-3 provides guidance for accounting for nonrefundable maintenance deposits. It also provides revenue recognition accounting guidance for the lessor. EITF 08-3 is effective for fiscal years beginning after December 15, 2008. The Company is currently evaluating the potential impact the new pronouncement will have on its consolidated financial statements.

In March 2008, the FASB issued Statement No. 161, "Disclosures about Derivative Instruments and Hedging Activities—an amendment of FASB Statement No. 133" (Statement 161). Statement 161 requires entities that utilize derivative instruments to provide qualitative disclosures about their objectives and strategies for using such instruments, as well as any details of credit-risk-related contingent features contained within derivatives. Statement 161 also requires entities to disclose additional information about the amounts and location of derivatives located within the financial statements, how the provisions of SFAS 133 have been applied, and the impact that hedges have on an entity's financial position, financial performance, and cash flows. Statement 161 is effective for fiscal years and interim periods beginning after November 15, 2008, with early application encouraged. The Company is currently evaluating the potential impact the new pronouncement will have on its consolidated financial statements.

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In February 2008, the FASB issued a Staff Position (FSP) FAS 140-3, “Accounting for Transfers of Financial Assets and Repurchase Financing Transactions.” This FSP addresses the issue of whether or not these transactions should be viewed as two separate transactions or as one "linked" transaction. The FSP includes a "rebuttable presumption" that presumes linkage of the two transactions unless the presumption can be overcome by meeting certain criteria. The FSP will be effective for fiscal years beginning after November 15, 2008 and will apply only to original transfers made after that date; early adoption will not be allowed. The Company is currently evaluating the potential impact the new pronouncement will have on its consolidated financial statements.

FASB statement No. 141(R) “Business Combinations” was issued in December of 2007. This Statement establishes principles and requirements for how the acquirer of a business recognizes and measures in its consolidated financial statements the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree. The Statement also provides guidance for recognizing and measuring the goodwill acquired in the business combination and determines what information to disclose to enable users of the consolidated financial statements to evaluate the nature and financial effects of the business combination. The guidance will become effective as of the beginning of the Company’s fiscal year beginning after December 15, 2008. This new pronouncement will impact the Company’s accounting for business combinations completed beginning January 1, 2009.

FASB statement No. 160 “Noncontrolling Interests in Consolidated Financial Statements—an amendment of ARB No. 51” was issued in December of 2007. This Statement establishes accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. The guidance will become effective as of the beginning of the Company’s fiscal year beginning after December 15, 2008. The Company is currently evaluating the potential impact the new pronouncement will have on its consolidated financial statements.

In October 2008, the FASB issued FSP SFAS No. 157-3, “Determining the Fair Value of a Financial Asset When The Market for That Asset Is Not Active” (FSP 157-3), to clarify the application of the provisions of SFAS 157 in an inactive market and how an entity would determine fair value in an inactive market. FSP 157-3 is effective immediately and applies to our September 30, 2008 financial statements. The application of the provisions of FSP 157-3 did not materially affect our results of operations or financial condition as of and for the periods ended September 30, 2008.

In September 2008, the FASB issued FSP 133-1 and FIN 45-4, “Disclosures about Credit Derivatives and Certain Guarantees: An Amendment of FASB Statement No. 133 and FASB Interpretation No. 45; and Clarification of the Effective Date of FASB Statement No. 161” (FSP 133-1 and FIN 45-4). FSP 133-1 and FIN 45-4 amends and enhances disclosure requirements for sellers of credit derivatives and financial guarantees. It also clarifies that the disclosure requirements of SFAS No. 161 are effective for quarterly periods beginning after November 15, 2008, and fiscal years that include those periods. FSP 133-1 and FIN 45-4 is effective for reporting periods (annual or interim) ending after November 15, 2008. The implementation of this standard will not have a material impact on our consolidated financial position and results of operation.

In September 2008, the FASB ratified EITF Issue No. 08-5, “Issuer’s Accounting for Liabilities Measured at Fair Value With a Third-Party Credit Enhancement” (EITF 08-5). EITF 08-5 provides guidance for measuring liabilities issued with an attached third-party credit enhancement (such as a guarantee). It clarifies that the issuer of a liability with a third-party credit enhancement should not include the effect of the credit enhancement in the fair value measurement of the liability. EITF 08-5 is effective for the first reporting period beginning after December 15, 2008. The Company is currently assessing the impact of EITF 08-5 on its consolidated financial position and results of operations.

Item 2 - Management’s Discussion and Analysis of Financial Condition and Results of Operations

MANAGEMENT STRATEGY

The Company's goal is to serve as community-oriented financial institution serving the northwestern New Jersey, northeastern Pennsylvania and Orange County, New York marketplace. Our market presence has expanded by opening branch offices in Port Jervis and Warwick, New York. In addition, the Company has received regulatory approval to open an office in Pike County, Pennsylvania. While offering traditional community bank loan and deposit products and services, the Company obtains non-interest income through its Tri-State Insurance Agency, Inc. ("Tri-State") insurance brokerage operations and the sale of non-deposit products. We report the operations of Tri-State as a separate segment from our commercial banking operations.

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The Company has continued to face competition for cost effective deposits in its primary trade area. This competition has caused us to rely more heavily on promotional rate savings and time deposits than traditional deposit accounts to fund our loan portfolio and maintain liquidity. There has been a concentrated effort to increase lower costing deposits relationships with business customers to help offset the high cost of competing for deposits in the present economic environment. Additionally, the reduction in interest rates continues to pressure our ability to increase the Company's net interest margin. In response, the Company closely monitors rates offered on deposit products, continues to market lower costing commercial products, through the efforts of its retail business development and loan personnel, and seeks to maximize its return on interest earning assets. The Company has maintained its loan to deposit ratio in 2008 to within policy guidelines while focusing on its more profitable loan and deposit relationships and deemphasizing construction development loans. Management believes this will benefit the Company's net interest margin and profitability.

CRITICAL ACCOUNTING POLICIES

Our accounting policies are fundamental to understanding Management's Discussion and Analysis of Financial Condition and Results of Operations. Disclosure of the Company's significant accounting policies is included in Note 1 to the consolidated financial statements included in the Company's Annual Report on Form 10-K for the year ended December 31, 2007. The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions about future events that affect the amounts reported in our consolidated financial statements and accompanying notes. Since future events and their effect cannot be determined with absolute certainty, actual results may differ from those estimates. Management makes adjustments to its assumptions and judgments when facts and circumstances dictate. The amounts currently estimated by us are subject to change if different assumptions as to the outcome of future events were made. We evaluate our estimates and judgments on historical experience and on various other factors that are believed to be reasonable under the circumstances. Management believes the critical accounting policies relating to the allowance for loan losses, stock-based compensation, goodwill and other intangible assets, and investment securities impairment evaluation, encompass the most significant judgments and estimates used in preparation of our consolidated financial statements. These estimates, judgments and policies were unchanged from the Company's Annual Report on Form 10-K for the year ended December 31, 2007.

FORWARD LOOKING STATEMENTS

When used in this discussion the words: "believes", "anticipates", "contemplates", "expects" or similar expressions are intended to identify forward looking statements. Such statements are subject to certain risks and uncertainties that could cause actual results to differ materially from those projected. Those risks and uncertainties include changes to interest rates, the ability to control costs and expenses, general economic conditions, the success of the Company's efforts to diversify its revenue base by developing additional sources of non-interest income while continuing to manage its existing fee based business, risks associated with the quality of the Company's assets and the ability of its borrowers to comply with repayment terms, and the risks inherent in integrating acquisitions into the Company and commencing operations in new markets. The Company undertakes no obligation to publicly release the results of any revisions to those forward looking statements that may be made to reflect events or circumstances after this date or to reflect the occurrence of unanticipated events.

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COMPARISION OF OPERATING RESULTS FOR THREE MONTHS ENDED SEPTEMBER 30, 2008 AND 2007

Overview - The Company realized a net loss of $3.0 million for the third quarter of 2008, a decrease of $3.6 million from the $533 thousand in net income reported for the same period in 2007. Basic and diluted earnings per share for the three months ended September 30, 2008 were ($0.92) compared to $0.16 for the comparable period of 2007.

The decrease in both net income and earnings per share reflects a $3.5 million other than temporary impairment charge related to our holdings of Fannie Mae and Freddie Mac preferred stock. The reported loss does not take into account a tax benefit we will recognize in the fourth quarter, when we are able to offset the loss against our ordinary income for Federal tax purposes. The fourth quarter benefit will be approximately $1.3 million or $0.40 per share, based on the average shares outstanding for the quarter ended September 30, 2008 and adjusted for the stock dividend.

During the quarter, our net interest income increased compared to the prior year period, as our interest income remained stable and our interest expense declined, reflecting changes in market rates offset by increases in average earning assets and average liabilities.

Comparative Average Balances and Average Interest Rates

The following table presents, on a fully taxable equivalent basis, a summary of the Company's interest-earning assets and their average yields, and interest-bearing liabilities and their average costs for the three month period ended September 30, 2008 and 2007.

(Dollars in thousands)	2008			2007		
Earning Assets:	Average Balance	Interest (1)	Average Rate (2)	Average Balance	Interest (1)	Average Rate (2)
Securities:						
Tax exempt (3)	$ 24,131	$ 370	6.10%	$ 24,187	$ 329	5.40%
Taxable	53,957	631	4.65%	36,026	439	4.83%
Total securities	78,088	1,001	5.10%	60,213	768	5.06%
Total loans receivable (4)	308,154	4,887	6.31%	288,773	5,038	6.92%
Other interest-earning assets	22,653	112	1.97%	14,959	194	5.16%
Total earning assets	408,895	$ 6,000	5.84%	363,945	$ 6,000	6.54%
Non-interest earning assets	32,386			29,053		
Allowance for loan losses	(4,955)			(3,878)		
Total Assets	$ 436,326			$ 389,120		
Sources of Funds:						
Interest bearing deposits:						
NOW	$ 57,983	$ 174	1.20%	$ 60,917	$ 329	2.15%
Money market	19,933	98	1.95%	41,624	393	3.75%
Savings	110,888	825	2.96%	37,294	86	0.91%
Time	121,689	1,122	3.67%	141,317	1,740	4.88%
Total interest bearing deposits	310,493	2,219	2.84%	281,152	2,548	3.60%
Borrowed funds	36,165	377	4.08%	20,218	241	4.65%

Junior subordinated debentures	12,887	135	4.10%	13,335	226	6.65%
Total interest bearing liabilities	359,545	$ 2,731	3.02%	314,705	$ 3,015	3.80%
Non-interest bearing liabilities:						
Demand deposits	40,581			37,076		
Other liabilities	2,481			2,320		
Total non-interest bearing liabilities	43,062			39,396		
Stockholders' equity	33,719			35,019		
Total Liabilities and Stockholders' Equity	$ 436,326			$ 389,120		
Net Interest Income and Margin (5)		$ 3,269	3.18%		$ 2,985	3.25%

(1) Includes loan fee income
(2) Average rates on securities are calculated on amortized costs
(3) Fully taxable equivalent basis, using a 39% effective tax rate and adjusted for TEFRA (Tax and Equity Fiscal Responsibility Act) interest expense disallowance
(4) Loans outstanding include non-accrual loans
(5) Represents the difference between interest earned and interest paid, divided by average total interest-earning assets

Net Interest Income - Net interest income is the difference between interest and fees on loans and other interest-earning assets and interest paid on interest-bearing liabilities. Net interest income is directly affected by changes in volume and mix of interest-earning assets and interest-bearing liabilities that support those assets, as well as changing interest rates when differences exist in repricing dates of assets and liabilities.

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Net interest income, on a fully taxable equivalent basis (a 39% tax rate), increased $284 thousand, or 9.5%, to $3.3 million for the three months ended September 30, 2008 from $3.0 million for the third quarter of 2007. Total average interest earning assets increased by $45.0 million, or 12.4%, to $409.0 million for the three months ended September 30, 2008, while total interest bearing liabilities increased $44.8 million, or 14.3 %, to $359.5 million during the same three month period. The major increase in average earning assets were in the loan and investment securities portfolios, while the largest increase in interest bearing liabilities was in savings deposits.

The net interest margin decreased, on a fully taxable equivalent basis, by 7 basis points to 3.18% for the three months ended September 30, 2008 compared to 3.25% for the same period in 2007, as the yield on total earning assets decreased 70 basis points to 5.84% and the cost of total interest bearing liabilities decreased 78 basis points to 3.02% in the three month period ended September 30, 2008 from the same period a year earlier. The decrease in yield on earning assets reflects the decrease in market rates of interest and the increase in non-performing loans while the decrease in cost of interest bearing liabilities is related to a shift from higher costing time deposits to a lower costing savings account product. During 2008, the Company began offering a higher yielding savings account product linked to a demand deposit account. The goal of the program is to reduce the Company's interest expense by increasing savings and demand deposit accounts, reducing reliance on time deposits, and increasing the Company's total deposits.

Interest Income - Total interest income, on a fully taxable equivalent basis, was unchanged at $6.0 million for both three month periods ended September 30, 2008 and 2007. Total interest income primarily reflects a $151 thousand decrease in interest earned on third quarter average loan receivable balances, as the yield on loan receivables decreased 61 basis points to 6.31% for the three month period ended September 30, 2008 from 6.92% in the same period in 2007. This decrease in loan receivable income and yield was offset by a $233 thousand increase in interest income earned on average investment securities.

Total interest income on securities, on a fully taxable equivalent basis, increased $233 thousand, to $1.0 million for the quarter ended September 30, 2008 from $768 thousand for the third quarter of 2007. As the average balance of total securities increased $17.9 million, or 29.7%, the yield on securities increased 4 basis points, from 5.06% in the third quarter of 2007 to 5.10% for the third quarter of 2008. The increase in the average balance in the securities portfolio reflects a $17.9 million increase in taxable securities and a $56 thousand decrease in tax-exempt securities, as new purchases exceeded sales, paydowns and maturities of securities. The increase in yield was accomplished by the repricing of existing mortgage backed securities, new security purchases and the effective tax rate adjustments on tax exempt securities between the two third quarter periods. The suspension of dividends on the Freddie Mac and Fannie Mae securities resulted in a $51 thousand reduction to income and a 38 basis point decrease in the yield on taxable securities in the third quarter of 2008.

The average balance in loans receivable increased $19.4 million, or 6.7%, to $308.2 million in the current three month period from $288.8 million in the same period of 2007, while the interest earned on total loans receivable decreased $151 thousand, or 3.0% from the third quarter of 2007 to the current period. The average rate earned on loans decreased 61 basis points from 6.92% for the three months ended September 30, 2007 to 6.31% for the same period in 2008. The increase in our loan portfolio average balance reflects our continuing efforts to build market share, while the decrease in yield is the result of increased loan competition on the basis of rate and the impact of non-accrual loans. At September 30, 2008, non-accrual loan balances increased $3.1 million, to $10.0 million from $6.8 million at September 30, 2007.

Interest Expense - The Company's interest expense for the three months ended September 30, 2008 decreased $284 thousand, or 9.4%, to $2.7 million from $3.0 million for the same period in 2007, as the balance in average interest-bearing liabilities increased $44.8 million, or 14.3%, to $359.5 million from $314.7 million in the year ago period. The average rate paid on total interest-bearing liabilities has decreased by 78 basis points from 3.80% for the

three months ended September 30, 2007 to 3.02% for the same period in 2008. The decrease in rate reflects the Company's efforts to reprice higher costing time deposits into a promotional savings account product, as well as repricing borrowings and junior subordinated debentures in a declining interest rate environment.

The Company's time deposits represent the largest component of interest-bearing deposits. The average balance in time deposits decreased by $19.6 million, or 13.9%, to $121.7 million for the three month period ended September 30, 2008 compared to $141.3 million for the same period in 2007, while the related interest expense on time deposits decreased $618 thousand, or 35.5%, to $1.1 million from $1.7 million in the third quarter of 2007. The average rate paid on time deposits decreased 121 basis points from 4.88% for the three months ended September 30, 2007 to 3.67% for the same period in 2008 reflecting the current decrease in market interest rates and the Company's emphasis on its new savings account product.

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In February of 2008 the Company began offering a promotional savings account product linked to a demand deposit account. The new savings account product has been well received by customers. Third quarter 2008 average savings balances increased by $73.6 million, or 197.3%, over the same period balances in 2007, to $110.9 million. The yield on savings accounts increased 205 basis points to 2.96% from 0.91% between the three month periods ending September 30, 2008 and 2007, respectively. The result was an increase of $739 thousand in savings deposit interest expense to $825 thousand for the third quarter of 2008 from $86 thousand a year earlier, while contributing to the overall decline in interest expense.

Offsetting the savings account average balance increase, money market account average balances declined $21.7 million, to $19.9 million for the three month period ended September 30, 2008 from $41.6 million one year earlier. The yield on money market accounts declined 180 basis points from 3.75% to 1.95% during the two periods as interest expense decreased $295 thousand, or 75.1%, from $393 thousand for the three months ended September 30, 2007 to $98 thousand during the same period in 2008. The decline in yield on our money market account reflects the decline in market rates between the two comparable three month periods.

For the quarter ended September 30, 2008, the Company's average borrowed funds increased $15.9 million to $36.2 million compared to average borrowed funds of $20.2 million during the third quarter of 2007. The balance at September 30, 2008 consisted of six convertible notes totaling $30.0 million, one $3.0 million repurchase agreement and one $3.2 million amortizing advance from the Federal Home Loan Bank. The average rate paid on total borrowed funds decreased 57 basis points from the third quarter of 2007 to the same period in 2008, as $15.0 million in lower yielding convertible advances and $3.0 million in lower yielding repurchase agreements were purchased in December of 2007 and March of 2008, respectively.

The Company had an average balance of $12.9 million in junior subordinated debentures outstanding during the third quarter of 2008 compared to $13.3 million during the same period in 2007. One $5.2 million debenture which bore a floating rate of interest averaging 9.01% was called and repaid on July 9, 2007 and replaced with a $12.9 million junior subordinated debenture, issued on June 28, 2007 which also bares a floating rate of interest tied to the three month LIBOR. The rate on the new debenture averaged 4.10% for the three months ended September 30, 2008. The restructuring of the junior subordinated debentures increased the balance of these instruments by $7.7 million while lowering the Company's cost 255 basis points.

Provision for Loan Losses - The loan loss provision for the third quarter of 2008 decreased $45 thousand, or 13.9%, to $279 thousand compared to a provision of $324 thousand in the third quarter of 2007. The higher provision during the third quarter of 2007 was related to an increase in non-performing loan balances during that period of $2.0 million compared to a decrease in non-performing loans in the third quarter of 2008 of $742 thousand. The provision for loan losses reflects management's judgment concerning the risks inherent in the Company's existing loan portfolio and the size of the allowance necessary to absorb the risks, as well as the activity in the allowance during the periods. Management reviews the adequacy of its allowance on an ongoing basis and will provide additional provisions, as management may deem necessary.

Non-Interest Income - The Company's non-interest income decreased $3.7 million, or 255.0%, to a net expense of $2.3 million for the three months ended September 30, 2008 as compared to non-interest income of $1.5 million for the same period in 2007. The net expense resulted from a $3.5 million other than temporary impairment charge related to the Company's holdings of Fannie Mae and Freddie Mac preferred stock, that was written down due to the Federal Housing Finance Agency placing both Fannie Mae and Freddie Mac under conservatorship. Although this action did not eliminate the equity in Fannie Mae and Freddie Mac perpetual preferred stock, it has negatively impacted its value.

The Company's non-interest income is primarily generated through insurance commissions earned through the operation of Tri-State and service fees on deposit accounts. Insurance commission income from Tri-State has decreased $42 thousand, or 6.8%, to $576 thousand in the third quarter of 2008 over the same period in 2007. For the three months ended September 30, 2008, we recognized a loss before taxes of $24 thousand from Tri-State's operations, compared to net income before taxes of $15 thousand in the year ago period, as market pricing has fallen between the two third quarter periods. Service fees on deposit accounts have increased by $47 thousand, or 13.0%, to $409 thousand in the third quarter of 2008 from $362 thousand during the same period in 2007. ATM and debit card fees increased $14 thousand, or 12.8%, from $109 thousand in the third quarter of 2007 to $123 thousand in the three month period ended September 30, 2008, due to increased usage of our ATMs and debit cards.

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The Company had $8 thousand in holding losses on trading securities in the third quarter of 2008, compared to $194 thousand in holding gains reported in the same period one year ago. The trading securities losses reflect the mark to market adjustment at each quarter end to the investment securities for which the Company has elected the fair value option under SFAS No. 159. The Company reported no gains or losses on the sale of securities available for sale in the third quarter of 2008 compared to $10 thousand gain in the same period of 2007. Investment brokerage fees have decreased $4 thousand, or 15.4%, to $22 thousand in the third quarter of 2008 compared to $26 thousand during the same period in 2007.

Other non-interest income decreased $20 thousand, or 13.4%, in the third quarter of 2008 to $129 thousand from $149 thousand during the same period a year earlier. The majority of the decrease in other income in the third quarter of 2008 was an $18 thousand decrease in other loan fee income compared to third quarter 2007 earnings.

Non-Interest Expense - Total non-interest expense increased $155 thousand, or 4.7%, from $3.3 million in the third quarter of 2007 to $3.4 million in the third quarter of 2008, as the Company has instituted several cost containment measures during 2008. Salaries and employee benefits increased 2.8% due to restricted pay increases and recent reductions to staff; furniture, equipment and data processing expenses remained unchanged at $372 thousand and occupancy expenses decreased $4 thousand, or 1.3%, between the two periods. Advertising and promotion expenses decreased $82 thousand, or 47.1%, in the third quarter of 2008 from the same period in 2007 as the Company decreased its newspaper advertising and reduced its marketing campaign for new account promotions in the third quarter of 2008.

FDIC insurance premiums related to the new assessment rate calculations from the Federal Deposit Insurance Reform Act of 2005 increased $86 thousand to $95 thousand for the third quarter of 2008 from $9 thousand in the same year ago period. Professional fees have increased $20 thousand, or 16.7%, to $140 thousand in the third quarter of 2008, as we retained consultants to review the executives' deferred compensation plan and perform an operational review of Tri-State Insurance Company. The $83 thousand increase in other non-interest expenses in third quarter 2008 over 2007 was mostly attributable to a $75 thousand increase in foreclosed real estate expenses directly related to the $3.9 million in foreclosed real estate owned by the Company which was not present during the third quarter of 2007.

Income Taxes - The Company's income tax provision, which includes both federal and state taxes, was $181 thousand and $238 thousand for the three months ended September 30, 2008 and 2007, respectively. This $57 thousand decrease in income taxes resulted from a decrease in income before taxes. While the reported results for the three month period ended September 30, 2008 reflects the $3.5 million other than temporary impairment charge for the Company's holdings in Fannie Mae and Freddie Mac perpetual preferred stock, it does not reflect the change in tax treatment enacted as part of the Emergency Economic Stabilization Act of 2008 (the "Act"), which was adopted on October 3, 2008. Under the Act, the Company is permitted to deduct the loss as an ordinary loss for tax purposes, thereby offsetting a portion of the Company's ordinary income. However, since the Act was not enacted until the fourth quarter, the Company can not recognize this tax benefit as part of its third quarter results. The tax benefit will be recognized in the fourth quarter, and it is expected to amount to approximately $1.3 million.

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COMPARISION OF OPERATING RESULTS FOR NINE MONTHS ENDED SEPTEMBER 30, 2008 AND 2007

Overview - For the nine months ended September 30, 2008, the Company reported a net loss of $2.0 million, a decrease of $3.6 million from the net income of $1.6 million reported for the same period in 2007. Basic and diluted earnings per share were ($0.62) and $0.46 for the nine month period ended September 30, 2008 and 2007, respectively. The decline in net income reflects an other than temporary impairment charge of $3.5 million for the write-down of Fannie Mae and Freddie Mac preferred equity securities and a $619 thousand increase in non-interest expenses, offset by a $306 thousand increase in net interest income and a $299 thousand decrease in the provision for loan losses

Comparative Average Balances and Average Interest Rates

The following table presents, on a fully taxable equivalent basis, a summary of the Company's interest-earning assets and their average yields, and interest-bearing liabilities and their average costs for the nine month period ended September 30, 2008 and 2007.

(Dollars in thousands)	2008			2007		
Earning Assets:	Average Balance	Interest (1)	Average Rate (2)	Average Balance	Interest (1)	Average Rate (2)
Securities:						
Tax exempt (3)	$ 22,906	$ 1,061	6.19%	$ 24,083	$ 992	5.51%
Taxable	45,576	1,698	4.98%	34,773	1,239	4.76%
Total securities	68,482	2,759	5.38%	58,856	2,231	5.07%
Total loans receivable (4)	304,859	14,335	6.28%	278,102	14,572	7.01%
Other interest-earning assets	14,350	225	2.10%	9,283	358	5.16%
Total earning assets	387,691	$ 17,319	5.97%	346,241	$ 17,161	6.63%
Non-interest earning assets	30,837			28,420		
Allowance for loan losses	(5,188)			(3,626)		
Total Assets	$ 413,340			$ 371,035		
Sources of Funds:						
Interest bearing deposits:						
NOW	$ 58,277	$ 604	1.38%	$ 59,130	$ 971	2.20%
Money market	26,346	451	2.29%	38,379	1,097	3.82%
Savings	73,098	1,376	2.51%	38,860	264	0.91%
Time	130,380	3,986	4.08%	132,081	4,779	4.84%
Total interest bearing deposits	288,101	6,417	2.98%	268,450	7,111	3.54%
Borrowed funds	35,998	1,132	4.13%	19,785	706	4.70%
Junior subordinated debentures	12,887	459	4.68%	8,052	460	7.54%
Total interest bearing liabilities	336,986	$ 8,008	3.17%	296,287	$ 8,277	3.74%
Non-interest bearing liabilities:						
Demand deposits	39,721			37,454		
Other liabilities	2,207			2,252		
Total non-interest bearing liabilities	41,928			39,706		
Stockholders' equity	34,426			35,042		

Total Liabilities and Stockholders' Equity	$ 413,340			$ 371,035		
Net Interest Income and Margin (5)		$ 9,311	3.21%		$ 8,884	3.43%

(1) Includes loan fee income
(2) Average rates on securities are calculated on amortized costs
(3) Fully taxable equivalent basis, using a 39% effective tax rate and adjusted for TEFRA (Tax and Equity Fiscal Responsibility Act) interest expense disallowance
(4) Loans outstanding include non-accrual loans
(5) Represents the difference between interest earned and interest paid, divided by average total interest-earning assets

Net Interest Income - Net interest income, on a fully taxable equivalent basis (a 39% tax rate), increased $427 thousand, or 4.8%, to $9.3 million for the nine months ended September 30, 2008 from $8.9 million for the same nine month period in 2007. The net interest margin decreased, on a fully taxable equivalent basis, by 22 basis points to 3.21% for the nine months ended September 30, 2008 compared to 3.43% for the same period in 2007, as the yield on total earning assets decreased 66 basis points to 5.97% and the cost of total interest bearing liabilities decreased 57 basis points to 3.17% in the nine month period ended September 30, 2008 from the same period a year earlier. The decrease in both yield on earning assets and cost of interest bearing liabilities largely reflects the decrease in market rates of interest and, with regard to the decrease in yield on earning assets, an increase in non-accrual loans.

Interest Income - Total interest income, on a fully taxable equivalent basis, increased by $158 thousand to $17.3 million for the nine months ended September 30, 2008. The increase in interest income primarily reflects a $41.5 million

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increase in average earning assets, offset by a decline in yield of 66 basis points to 5.97% for the first nine months of 2008 from 6.63% in the same period in 2007. This decrease in yield is the net result of a 73 basis point decline in the yield on loan receivables and an increase in non-accrual loans offset by a 31 basis point increase in yield on investment securities.

Total interest income on securities, on a fully taxable equivalent basis, increased $528 thousand, to $2.8 million for the first nine months of 2008 from $2.2 million for the first nine months of 2007. As the average balance of total securities increased $9.6 million, the yield on securities increased 31 basis points, from 5.07% in the first nine months of 2007 to 5.38% for the first nine months of 2008. The increase in the average balances of the securities portfolio reflects a $10.8 million increase in taxable securities and a $1.2 million decrease in tax-exempt securities, as new purchases exceeded sales, paydowns and maturities of securities. The increase in yield was accomplished by the repricing of existing mortgage backed securities, new security purchases and the effective tax rate adjustments on tax exempt securities between the two nine month periods. The suspension of dividends on the Fannie Mae and Freddie Mac preferred equity securities resulted in a $51 thousand loss in interest income, or 2 basis point reduction to the Company's net interest margin.

The average balance in loans receivable increased $26.8 million, or 9.6%, to $304.9 million in the current nine month period from $278.1 million in the same period of 2007, while the interest earned on total loans receivable decreased $237 thousand, or 1.6% between the two nine month periods. The average rate earned on loans decreased 73 basis points from 7.01% for the nine months ended September 30, 2007 to 6.28% for the same period in 2008. The increase in our loan portfolio average balance reflects our continuing efforts to grow our loan portfolio, while the decrease in yield is the result of market competition and the reclassification of $7.1 million in loan receivable balances to non-accrual and foreclosed real estate between the two nine month periods.

Interest Expense - The Company's interest expense for the nine months ended September 30, 2008 decreased $269 thousand, or 3.3%, to $8.0 million. During the current nine month period, the balance in average interest-bearing liabilities increased $40.7 million, or 13.7%, to $337.0 million from $296.3 million in the year ago period. However, the average rate paid on total interest-bearing liabilities has decreased by 57 basis points from 3.74% for the nine months ended September 30, 2007 to 3.17% for the same period in 2008. The decrease in rate reflects the Company's successful efforts to reprice interest-bearing liabilities in a declining interest rate environment, while offering very competitive deposit products in the Company's market area.

The Company's time deposits represent the largest component of interest-bearing deposits. The average balance in time deposits decreased by $1.7 million, or 1.3%, to $130.4 million for the nine month period ended September 30, 2008 compared to $132.1 million for the same period in 2007, while the interest expense on time deposits decreased $792 thousand, or 16.6%, to $4.0 million. The average rate paid on time deposits decreased 76 basis points from 4.84% for the nine months ended September 30, 2007 to 4.08% for the same period in 2008, reflecting the current decrease in market interest rates.

In March of 2008, the Company began offering a high rate savings account associated with a checking account to attract core deposits and build customer relationships. The promotion has successfully increased savings account average balances by $34.2 million, or 88.1%, to $73.1 million in the first nine months of 2008 from $38.9 million in the same period a year earlier. The yield on savings accounts increased 160 basis points to 2.51% and interest expense on savings accounts increased $1.1 million to $1.4 million in the first nine months of 2008 from the first nine months of 2007.

Total average interest bearing deposit balances increased $19.7 million, or 7.3%, to $288.1 million, while interest expense decreased $694 thousand, or 9.8%, to $6.4 million during the first nine months of 2008 from the same period in 2007. As the Company has repositioned higher costing time deposits into lower yielding core deposits in a declining interest rate environment, the average rate paid on interest bearing deposits decreased 56 basis points to

2.98% for the first nine months of 2008 from 3.54% in the first nine months of 2007. Also contributing to the interest bearing deposit rate decline was a 153 basis point decrease in the rate paid on money market accounts to 2.29% during the first nine months of 2008 from 3.82% during the same period in 2007. This decline reduced the Company's interest expense on money market accounts $646 thousand to $451 thousand while average money market balances decreased $12.0 million to $26.3 million in the first nine months of 2008 from the same period in 2007.

For the nine months ended September 30, 2008, the Company's average borrowed funds increased $16.2 million to $36.0 million compared to average borrowed funds of $19.8 million during the first nine months of 2007. The average rate paid on total borrowed funds decreased 57 basis points to 4.13% during the first nine months of 2008 from 4.70% for the same period in 2007, as the Company has restructured its advances into lower yielding instruments while meeting asset liability needs.

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The Company had an average balance of $12.9 million in junior subordinated debentures outstanding during the first nine months of 2008 compared to $8.1 million during the same period in 2007. As described in the three month comparison, the restructuring of the junior subordinated debentures increased the average balance of these instruments by $4.8 million while lowering the Company's cost 286 basis points between the two nine month periods.

Provision for Loan Losses - The loan loss provision for the first nine months of 2008 decreased $299 thousand, or 34.5%, to $569 thousand compared to a provision of $868 thousand in the first nine months of 2007. The higher provision during the first nine months of 2007 was related to an increase in non-performing loan balances during that period of $4.7 million compared to a decrease in non-performing loans in the first nine months of 2008 of $2.0 million. In addition, the Company's loan growth increased 12.1% during the first nine months of 2007, as compared to loan growth of 3.9% in the first nine months of 2008. The provision for loan losses reflects management's judgment concerning the risks inherent in the Company's existing loan portfolio and the size of the allowance necessary to absorb the risks, as well as the activity in the allowance during the periods. Management reviews the adequacy of its allowance on an ongoing basis and will provide additional provisions, as management may deem necessary.

Non-Interest Income - The Company's non-interest income decreased by $3.7 million, or 85.3%, to $632 thousand for the nine months ended September 30, 2008 from $4.3 million for the same period in 2007. The majority of this decrease was the $3.5 million other than temporary impairment ("OTTI") charge on equity securities previously discussed in the quarterly operating results. Net of the OTTI, non-interest income decreased $131 thousand for the first nine months of 2008 compared to the same nine month period in 2007.

Insurance commissions earned through the operation of Tri-State are the Company's primary source of non-interest income. Insurance commissions decreased $164 thousand, or 7.7%, in the first nine months of 2008 over the same period in 2007, largely due to a decrease in contingency commission income, which is based upon criteria set by each insurance carrier. Investment brokerage fees have also decreased in the first nine months of 2008 by $122 thousand, or 51.1%, to $117 thousand compared to $239 thousand during the same period in 2007. During the first quarter of 2007 several new large brokerage accounts were opened and the Company earned related commission income. There was no similar activity in 2008. Holding gains on trading securities decreased $179 thousand to $13 thousand for the first nine months of 2008 compared to $192 thousand in holding gains on trading securities recorded in the first nine months of 2007.

Offsetting these decreases, several other sources of non-interest income increased. Service fees on deposit accounts have increased by $95 thousand, or 9.4%, to $1.1 million in the first nine months of 2008 from $1.0 million during the same period in 2007. Due to increased usage of our ATMs and debit cards, related fees increased $48 thousand, or 16.0%, from $300 thousand in the first nine months of 2007 to $348 thousand in the nine month period ended September 30, 2008. The Company has reported a $152 thousand gain on the sale of securities available for sale in the first nine months of 2008 compared to gains of $10 thousand in the same period of 2007. The largest components of the $49 thousand increase in other non-interest income include a $19 thousand increase in loan fees and a $24 thousand increase in joint venture income from SussexMortgage.com between the two nine month periods.

Non-Interest Expense - Total non-interest expense increased $619 thousand, or 6.3%, from $9.9 million in the first nine months of 2007 to $10.5 million in the first nine months of 2008. The Company has instituted several cost containment measures during 2008 to mitigate the decrease in its net interest margin and increases in other real estate expenses and FDIC insurance assessment. Salaries and employee benefits increased $294 thousand, or 5.4%, reflecting normal pay increases and an increase in staff, as outsourced loan review and compliance services are now performed internally by salaried staff. We believe this will provide better quality loan review and compliance at a more effect cost. Offsetting the increase to salaries and employee benefits is an $87 thousand, or 20.5%, decrease in

professional fees to $337 thousand in the first nine months of 2008.

Advertising and promotion expenses decreased $36 thousand, or 8.7%, in the first nine months of 2008 from the same period in 2007 as the Company has reduced its newspaper advertising and new account promotions in a cost cutting effort. In addition, certain amortization expenses on intangible assets have expired, reducing these expenses $35 thousand in the first nine months of 2008.

FDIC insurance premiums have increased from $26 thousand during the first nine months of 2007 to $280 thousand in the first nine months of 2008. The increase reflects the exhaustion of one-time assessment credits which were applied in 2007 and higher assessment charges in 2008. Other non-interest expenses increased $142 thousand, or 12.7%, to $1.3 million as foreclosed real estate expenses increased $131 thousand during the first nine months of 2008 compared to the same period in 2007.

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Occupancy expenses increased $45 thousand or 4.8%, and furniture, equipment and data processing expenses rose $53 thousand, or 5.0%, between the two nine month periods due to an increase in overhead costs associated with the new Wantage branch site, increased energy costs and the purchase of competitive software products and technology enhancements.

Income Taxes - The Company's federal and state income tax provision decreased $89 thousand, or 13.4%, to $575 thousand for the nine months ended September 30, 2008 from $664 thousand recorded for the first nine months of 2007. This income tax provision does not reflect the change in tax treatment resulted from the Emergency Economic Stabilization Act of 2008 (the "ACT"), which permits the Company to deduct the $3.5 million other than temporary impairment charge for the Company's holding in Fannie Mae and Freddie Mac perpetual preferred stock as an ordinary loss for tax purposes. Since the Act was not enacted until the fourth quarter, the Company can not recognize this tax benefit as part of its nine month results. The tax benefit of approximately $1.3 million will be recognized in the fourth quarter of 2008. The Company's effective tax rate was 29.5% for the nine months period ended September 30, 2007 and is below the statutory tax rate due to tax-exempt interest on securities and earnings on the investment in life insurance.

COMPARISION OF FINANCIAL CONDITION AT SEPTEMBER 30, 2008 TO DECEMBER 31, 2007

At September 30, 2008 the Company had total assets of $439.1 million compared to total assets of $393.5 million at December 31, 2007, an increase of 11.6%, or $45.5 million. Loans receivable, net of unearned income increased $11.7 million, or 3.9%, to $312.3 million while total deposits increased $48.1 million, or 15.6%, to $356.7 million at September 30, 2008 from $308.5 million at December 31, 2007. Additionally, cash and cash equivalents increased $14.2 million to $26.0 million at September 30, 2008, up from $11.8 million at December 31, 2007 and securities available for sale increased $16.1 million, or 33.3%, to $64.5 million since year end 2007.

Cash and Cash Equivalents - The Company's cash and cash equivalents increased by $14.2 million at September 30, 2008 to $26.0 million from $11.8 million at December 31, 2007. This increase mostly reflects the Company's increase in federal funds sold of $11.7 million to $15.5 million at September 30, 2008 from $3.8 million at year-end 2007. The increased balance in federal funds sold is the result of the Company's deposit growth outpacing loan growth in the first nine months of 2008. The Company intends to use the cash and cash equivalents to fund future loan demand and purchase securities.

Securities Portfolio and Trading Securities - The Company's securities, available for sale, at fair value, increased $16.1 million from $48.4 million at December 31, 2007 to $64.5 million at September 30, 2008. During the first nine months of 2008 the Company purchased $33.7 million in new available for sale securities, including $3.6 million in Fannie Mae and Freddie Mac equity securities; $4.9 million in available for sale securities matured; $5.2 million were sold or called and $2.4 million were repaid. Net amortization expenses were $8 thousand and a realized gain on the sale of securities available for sale of $152 thousand was recorded in the first nine months of 2008. The Fannie Mae and Freddie Mac equity securities held a fair value of $284 thousand, after the impairment write-down of $3.5 million on September 30, 2008. As of September 30, 2008 trading securities balances decreased $740 thousand to $13.5 million due to the net effect of $4.7 million in new security purchases, $3.2 million in sales or calls, $2.3 million in paydowns and net amortization expenses offset by $13 thousand in holding gains on trading securities.

Balances in state and municipal tax-exempt securities, at fair value, increased $238 thousand to $24.5 million from $24.3 million at December 31, 2007 and balances in taxable securities, at fair value, increased $15.9 million to $40.0 million at September 30, 2008. This shift from tax-exempt to taxable security balances was the result of realizing net

gains on the sale of municipal securities, while increasing the taxable securities balance to fulfill collateral requirements.

The carrying value of the available for sale portfolio at September 30, 2008 includes a net unrealized loss of $1.7 million, reflected as an accumulated other comprehensive loss of $1.0 million in stockholders' equity, net of a deferred income tax asset of $664 thousand. This compares with an unrealized gain at December 31, 2007 of $25 thousand, shown as an accumulated other comprehensive gain of $15 thousand in stockholders' equity, net of a deferred income tax liability of $10 thousand. Management considers the unrealized gains and losses to be temporary and primarily resulting from changes in the interest rate environment. Other than the Fannie Mae and Freddie Mac equity securities, as of September 30, 2008, the securities portfolio contains no other high-risk securities or derivatives, as the Company only invests in agency, mortgage-backed and municipal debt securities and marketable equity securities. There were no held to maturity securities at September 30, 2008 or December 31, 2007.

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Loans - The loan portfolio comprises the largest part of the Company's earning assets. Total loans receivable, net of unearned income, at September 30, 2008 increased $11.7 million to $312.3 million from $300.6 million at year-end 2007. The balance in loans secured by non-residential property accounts for 50.5% of the Company's total loan portfolio and increased $3.1 million, to $157.7 million at September 30, 2008 from $154.6 million on December 31, 2007. The largest percentage increase during this nine month period was in one to four family residential mortgage loans which increased 15.8%, or $11.1 million, from $70.6 million at December 31, 2007 to $81.8 million at September 30, 2008. Commercial and industrial loans increased 10.9% to $23.0 million at September 30, 2008. During the first nine months of 2008, the Company had a net decrease in construction and land development loans of $2.8 million, or 6.6%, to $39.2 million from $42.0 million at December 31, 2007, as $3.4 million in these loan balances were transferred to foreclosed real estate properties. The Company's does not originate sub-prime or unconventional one to four family real estate loans.

The increase in loans was funded during the first nine months of 2008 by an increase in deposits. The loan to deposit ratios at September 30, 2008 and December 31, 2007 were 86.2% and 95.8%, respectively.

Loan and Asset Quality - Total non-performing assets, which include non-accrual loans, loans past due 90 days and still accruing, restructured loans, foreclosed real estate owned ("OREO") and impaired equity securities, increased by $2.2 million to $15.1 million at September 30, 2008 from $12.9 million at year end 2007. The Company's non-accrual loans decreased $2.3 million to $10.0 million at September 30, 2008 from $12.3 million at December 31, 2007, as $3.9 million in non-accrual loan receivable balances, consisting of four parcels of real estate, were transferred to foreclosed real estate. The Company had no foreclosed real estate properties at December 31, 2007. The non-accrual loans at September 30, 2008 primarily consist of loans which are collateralized by real estate. The Company had $488 thousand in restructured loans and $433 thousand in loans past due over 90 days and still accruing at September 30, 2008 compared to $494 thousand in restructured loans and $69 thousand in loans past due over 90 days and still accruing at December 31, 2007. The fair value on September 30, 2008 of the Fannie Mae and Freddie Mac equity securities, which the Company recorded the $3.5 million impairment write-down, was $284 thousand.

The Company seeks to actively manage its non-performing assets. In addition to active monitoring and collecting on delinquent loans, management has an active loan review process for customers with aggregate relationships of $500,000 or more if the credit(s) are unsecured or secured, in whole or substantial part, by collateral other than real estate and $1,000,000 or more if the credit(s) are secured in whole or substantial part by real estate. During the first quarter of 2008 the Company has brought the credit review process in-house through the hiring of a credit review officer.

Management continues to monitor the Company's asset quality and believes that the non-performing assets are adequately collateralized and anticipated material losses have been adequately reserved for in the allowance for loan losses. However, given the uncertainty of the current real estate market additional provisions for losses may be deemed necessary in future periods. The following table provides information regarding risk elements in the loan portfolio at each of the periods presented:

(Dollars in thousands)	September 30, 2008	December 31, 2007
Non-accrual loans	$ 9,964	$ 12,301
Non-accrual loans to total loans	3.19%	4.09%
Non-performing assets	$ 15,100	$ 12,864
Non-performing assets to total assets	3.44%	3.35%
Allowance for loan losses as a % of non-performing loans	46.67%	39.96%

Allowance for loan losses to total loans	1.63%	1.71%

Allowance for Loan Losses - The allowance is allocated to specific loan categories based upon management's classification of problem loans under the bank's internal loan grading system and to pools of other loans that are not individually analyzed. Management makes allocations to specific loans based on the present value of expected future cash flows or the fair value of the underlying collateral for impaired loans and to other classified loans based on various credit risk factors. These factors include collateral values, the financial condition of the borrower and industry and current economic trends.

Allocations to commercial loan pools are categorized by commercial loan type and are based on management's judgment concerning historical loss trends and other relevant factors. Installment and residential mortgage loan allocations are made at a total portfolio level based on historical loss experience adjusted for portfolio activity and current conditions. Additionally, all other delinquent loans are grouped by the number of days delinquent with this amount assigned a general reserve amount.

At September 30, 2008, the total allowance for loan losses was $5.1 million, consistent with the allowance at December 31, 2007. The total provision for loan losses was $569 thousand and there were $662 thousand in charge-offs and $33

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thousand in recoveries for the first nine months of 2008. A charge-off for $454 thousand was taken on one loan with a balance of $3.4 million upon transfer to foreclosed real estate at its fair value of $3.0 million. The allowance for loan losses as a percentage of total loans was 1.63% at September 30, 2008 and 1.71% at December 31, 2007.

Management regularly assesses the adequacy of the loan loss reserve in relation to credit exposure associated with individual borrowers, overall trends in the loan portfolio and other relevant factors, and believes the reserve is adequate for each of the periods presented. Additional provisions for losses may be deemed necessary in future periods due to the uncertainty of current trends in the real estate market.

Deposits - Total deposits increased $48.1 million, or 15.6%, from $308.5 million at December 31, 2007 to $356.7 million at September 30, 2008. The Company's total non-interest bearing deposits increased $3.8 million to $40.4 million at September 30, 2008 from $36.6 million at December 31, 2007 and interest-bearing deposits increased $44.3 million to $316.2 million at September 30, 2008 from $271.9 million at December 31, 2007. In February of 2008 the Company began offering a promotional rate on a savings deposit product which must be opened in conjunction with a checking account. The focus of the promotion was to attract banking relationships with lower-costing core deposits and reduce the Company's dependency on higher priced time deposits. As a result of the highly successful promotion, total savings account balances have increased $83.9 million, or 229.1%, to $120.6 million at September 30, 2008 from $36.7 million on December 31, 2007, while NOW, money market and time deposit balances have decreased a combined $39.6 million, as depositors transferred balances into the new promotional savings account.

Included in time deposit balances at September 30, 2008 are $535 thousand in brokered time deposits, a decrease of $966 thousand from $1.5 million at December 31, 2007. As a participant with a third party service provider, the Company can either buy, sell or reciprocate balances of time deposits in excess of a single bank's FDIC insurance coverage with one or more other banks, to ensure that the entire deposit is insured. This permits the Company to obtain time deposits, as an alternate source of funding, when the need arises. Management continues to monitor the shift in deposits through its Asset/Liability Committee.

Borrowings - Borrowings consist of long-term advances and a repurchase agreement from the Federal Home Loan Bank ("FHLB"). The advances are secured under terms of a blanket collateral agreement by a pledge of qualifying investment securities and certain mortgage loans and the repurchase agreement is secured by selected investment securities held at the FHLB. As of September 30, 2008, the Company had $36.2 million in borrowings at a weighted average interest rate of 4.09%, compared to $35.2 million in borrowings at an average rate of 4.30% at December 31, 2007. The advances total $30.0 million, all with quarterly convertible options, that allow the FHLB to change the note rate to a then current market rate. In November of 2005, the Company entered into a $3.2 million amortizing advance that matures on November 3, 2010 at a rate of 5.00%. A nine month $3.0 million repurchase agreement was entered into in March of 2008 at a rate of 2.24%, replacing a matured $2.0 million repurchase agreement at 5.15%, lowering the weighted average rate on borrowings by 291 basis points.

Junior Subordinated Debentures - On June 28, 2007, the Company raised an additional $12.5 million in capital through the issuance of junior subordinated debentures to a non-consolidated statutory trust subsidiary. The subsidiary in turn issued $12.5 million in variable rate capital trust pass through securities to investors in a private placement. The interest rate is based on the three-month LIBOR plus 144 basis points and adjusts quarterly. The rate at September 30, 2008 was 4.26%. The capital securities are redeemable by Sussex Bancorp during the first five years at a redemption price of 103.5% of par for the first year and thereafter on a sliding scale down to 100% of par on or after September 15, 2012 in whole or in part or earlier if the regulatory capital or tax treatment of the securities is substantially changed. The proceeds of these trust preferred securities which have been contributed to the Bank are included in the Bank's capital ratio calculations and treated as Tier I capital.

In accordance with FASB Interpretation No. 46, “Consolidation of Variable Interest Entities, an Interpretation of ARB No. 51”, our wholly-owned subsidiary, Sussex Capital Trust II, is not included in our consolidated financial statements.

Equity - Stockholders' equity, inclusive of accumulated other comprehensive loss, net of income taxes, was $30.8 million at September 30, 2008, a decrease of $3.6 million over the $34.4 million at year-end 2007, largely due to the $3.5 million impairment write-down on Fannie Mae and Freddie Mac preferred equity securities. Stockholders' equity decreased due to $2.0 million in a net loss in the first nine months of 2008, a $40 thousand decrease in common stock due to the purchase and retirement of treasury shares, cash dividends paid of $654 thousand and an unrealized loss on securities available for sale, net of income tax, of $1.0 million. These changes were offset by $34 thousand from the exercise of stock options and $61 thousand through the compensation expense of stock options, restricted stock and the tax benefit of stock options exercised. The 6.5% stock dividend, as retroactively adjusted to stockholders’ equity, reclassified $1.4 million to common stock from retained earnings.

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LIQUIDITY AND CAPITAL RESOURCES

It is management's intent to fund future loan demand with deposits and maturities and pay downs on investments. In addition, the Bank is a member of the Federal Home Loan Bank of New York and as of September 30, 2008, had the ability to borrow up to $75.3 million against selected mortgages and investment securities as collateral for borrowings. At September 30, 2008, the Bank had outstanding borrowings with the FHLBNY totaling $36.2 million. The Bank also has available an overnight line of credit and a one-month overnight repricing line of credit, each in an amount of $40.3 million at the Federal Home Loan Bank and an overnight line of credit in the amount of $4.0 million at the Atlantic Central Bankers Bank.

At September 30, 2008, the amount of liquid assets remained at a level management deemed adequate to ensure that contractual liabilities, depositors' withdrawal requirements, and other operational customer credit needs could be satisfied. At September 30, 2008, liquid investments totaled $26.0 million and all mature within 30 days.

At September 30, 2008, the Company had $64.5 million of securities classified as available for sale. Of these securities, $34.2 million had $1.9 million of unrealized losses and therefore are not available for liquidity purposes because management's intent is to hold them until market price recovery

The Bank's regulators have implemented risk based guidelines which require banks to maintain Tier I capital as a percent of risk-adjusted assets of 4.0% and Tier II capital as of risk-adjusted assets of 8.0% at a minimum. The Bank meets the well-capitalized regulatory standards applicable to it. At September 30, 2008, the Bank's Tier I and Tier II capital ratios were 10.91% and 12.16%, respectively. The Company also maintained $26.0 million in cash and cash equivalents which could be contributed to the Bank as capital.

In addition to the risk-based guidelines, the Bank's regulators require that banks which meet the regulators' highest performance and operational standards to maintain a minimum leverage ratio (Tier I capital as a percent of tangible assets) of 4.0%. As of September 30, 2008, the Bank had a leverage ratio of 8.41%.

On October 14, the United States Treasury (the "UST") announced its Troubled Assets Relief Program ("TARP") Capital Purchase Program ("CPP). Under the CPP, the UST will purchase shares of senior preferred stock in insured depository institutions or their holding companies, bearing a dividend rate of 5%. In addition, participating institutions must issue to the UST common stock purchase warrants, permitting the UST to purchase common stock with a value equal to 15% of the UST's preferred stock investment. The Company is currently analyzing whether participation in this program is appropriate and will likely file an application to participate to ensure that the Company has that alternative, while assessment of the Government's requirements continue.

The Company has no investment or financial relationship with any unconsolidated entities that are reasonably likely to have a material effect on liquidity or the availability of capital resources, except for the junior subordinated debentures of Sussex Capital Trust II. The Company is not aware of any known trends or any known demands, commitments, events or uncertainties, which would result in any material increase or decrease in liquidity. Management believes that any amounts actually drawn upon can be funded in the normal course of operations.

Off-Balance Sheet Arrangements - The Company's financial statements do not reflect off-balance sheet arrangements that are made in the normal course of business. These off-balance sheet arrangements consist of unfunded loans and letters of credit made under the same standards as on-balance sheet instruments. These unused commitments, at September 30, 2008 totaled $49.5 million and consisted of $23.1 million in commitments to grant commercial real estate, construction and land development loans, $12.7 million in home equity lines of credit, and $13.7 million in

other unused commitments. These instruments have fixed maturity dates, and because many of them will expire without being drawn upon, they do not generally present any significant liquidity risk to the Company. Management believes that any amounts actually drawn upon can be funded in the normal course of operations.

IMPACT OF INFLATION AND CHANGING PRICES

Unlike most industrial companies, virtually all of the assets and liabilities of a financial institution are monetary in nature. As a result, the level of interest rates has a more significant impact on a financial institution's performance than effects of general levels of inflation. Interest rates do not necessarily move in the same direction or change with the same magnitude as the price of goods and services, which prices are affected by inflation. Accordingly, the liquidity, interest rate sensitivity and maturity characteristics of the Company's assets and liabilities are more indicative of its

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ability to maintain acceptable performance levels. Management of the Company monitors and seeks to mitigate the impact of interest rate changes by attempting to match the maturities of assets and liabilities to gap, thus seeking to minimize the potential effect of inflation.

Item 3 - Quantitative and Qualitative Disclosures about Market Risk

Not applicable

Item 4 (T) - Controls and Procedures

(a) Evaluation of disclosure controls and procedures

The Company carried out an evaluation, under the supervision and with the participation of the Company's management, including the Company's Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures pursuant to Exchange Act Rule 13a-15. Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures are, as of the end of the period covered by this report, effective in timely alerting them to material information relating to the Company (including its consolidated subsidiaries) required to be included in the Company's periodic SEC filings.

Management of the Company is responsible for establishing and maintaining adequate internal control over financial reporting as defined in Rule 13A-15 (f) and 15d-15 (f) of the Securities and Exchange Act of 1934. The Company's internal control system was designed to provide reasonable assurance to the Company's management and Board of Directors as to the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements, errors or fraud. Also, projections of any evaluations of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

(b) Changes in Internal Control over Financial Reporting

Not applicable

PART II – OTHER INFORMATION

Item 1 - Legal Proceedings

The Company and the Bank are periodically involved in various legal proceedings as a normal incident to their businesses. In the opinion of management, except as described below, no material loss is expected from any such pending lawsuit.

In connection with a non-performing asset with a current balance of $3.3 million, the Bank has initiated a foreclosure and collection proceeding. The borrower and the guarantor, who are related parties, have asserted various counterclaims against the Bank, claiming, among other things, that they were coerced into signing loan modifications and that the Bank has breached its obligations under the loan agreements. As is permitted under New Jersey law, the

claimants have not made demand for any specific amount of damages. The Bank believes the claims are wholly without merit, and the counterclaims have been dismissed in the foreclosure proceeding, although they are still at issue in the collection action. The Bank intends to vigorously defend the counterclaims in the collection action and pursue the foreclosure and collection actions.

Item 2 - Unregistered Sales of Equity Securities and Use of Proceeds

On April 16, 1999 the Company announced a stock repurchase plan whereby the Company may purchase up to 50,000 shares of outstanding stock. There is no expiration date to this plan. On April 27, 2005, the Company's Board increased this plan to 100,000 shares; on April 19, 2006 to 150,000 shares and on August 23, 2007 to 250,000 shares of the Company's common stock.

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Period	Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs
July 1, 2008 through July 31, 2008	4,265	$ 8.14	189,062	60,938
August 1, 2008 through August 31, 2008	-	-	189,062	60,938
September 1, 2008 through September 30, 2008	-	-	189,062	60,938
Total	4,265	$ 8.14	189,062	60,938

Item 3 - Defaults upon Senior Securities

Not applicable

Item 4 - Submission of Matters to a Vote of Security Holders

Not applicable

Item 5 - Other Information

Not applicable

Item 6 - Exhibits

Number	Description
31.1	Certification of Donald L. Kovach pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certification of Candace A. Leatham pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32	Certification pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

In accordance with the requirements of the Exchange Act, the registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

SUSSEX BANCORP

By: /s/ Candace A. Leatham
CANDACE A. LEATHAM

Executive Vice President and
Chief Financial Officer
Date: November 14, 2008