

HARBOR BANKSHARES CORP

Form PRE 14A

May 02, 2006

SCHEDULE 14A INFORMATION
Proxy Statement Pursuant to Section 14(a) of the Securities
Exchange Act of 1934 (Amendment No.)

Filed by the Registrant

Filed by a Party other than the Registrant

Check the appropriate box:

- Preliminary Proxy Statement
- Confidential, for Use of the Commission Only (as permitted by Rule 14a-6(e)(2))
- Definitive Proxy Statement
- Definitive Additional Materials
- Soliciting Material Pursuant to Rule 14a-11(c) or Rule 14a-12

HARBOR BANKSHARES CORPORATION
(Name of Registrant as Specified in its Charter)

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

Payment of Filing Fee (Check the appropriate box):

No fee required.

Fee computed on table below per Exchange Act Rules 14a-6(i)(4) and 0-11.

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

Common Stock , \$0.01 par value

2. Aggregate number of securities to which transaction applies:

12,478

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

\$31.00, the per share price to be paid in the transaction

4. Proposed maximum aggregate value of transaction:

\$386,818

5. Total Fee Paid:

\$41.39

Fee paid previously with preliminary materials:

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Check box if any part of the fee is offset as provided by Exchange Act Rule 0-11(a)(2) and identify the filing for which the offsetting fee was paid previously. Identify the previous filing by registration statement number, or the Form or Schedule and the date of its filing.

1. Amount Previously Paid:
 2. Form, Schedule or Registration Statement No.:
 3. Filing Party:
 4. Date Filed:
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HARBOR BANKSHARES CORPORATION

25 West Fayette Street
Baltimore, Maryland 21201
May 12, 2006

To Our Shareholders:

On behalf of our Board of Directors, we cordially invite you to attend the Annual Meeting of Shareholders of Harbor Bankshares Corporation to be held at Harbor Inn Pier 5 Hotel, 711 Eastern Avenue, Baltimore, Maryland 21202 on Wednesday, June 14, 2006, at 12:00 noon Eastern Time. The formal Notice of Annual Meeting appears on the next page.

At the Annual Meeting, you will be asked to consider and vote on the approval of a merger agreement which provides for the merger of Harbor Bankshares Corporation with Harbor Merger Corporation, its wholly-owned subsidiary, in what is commonly referred to as a "going private" transaction. Harbor Bankshares Corporation will continue after the merger as the surviving company.

The purpose of the merger is to reduce the number of our shareholders of record to fewer than 300, as required for the suspension of our reporting requirements under Section 13 of the Securities Exchange Act of 1934, in order to eliminate the significant expense required to comply with the reporting and related requirements of that law and related laws and regulations.

If you approve the merger agreement and the merger is completed, each share of Harbor Bankshares Corporation common stock owned of record at the effective time of the merger by a shareholder owning 100 or fewer shares (other than shareholders who properly exercise their rights as objecting shareholders) will be converted into the right to receive from Harbor Bankshares Corporation \$31.00 in cash per share, without interest. Shares owned of record by a holder of more than 100 shares will remain as outstanding shares of Harbor Bankshares Corporation common stock after the merger and those shareholders will not receive any cash payment.

Because Harbor Bankshares Corporation has a large number of shareholders who own 100 or fewer shares each, we expect that the merger will reduce the number of shareholders of record from 626 to approximately 266, and will reduce the number of outstanding shares from 641,784 to approximately 629,306.

Our Board of Directors believes that the merger agreement is fair to our shareholders and is in the best interests of Harbor Bankshares Corporation and its shareholders and unanimously recommends that shareholders vote **FOR** approval of the merger agreement. The approval of the merger agreement requires the affirmative vote of the holders of at least two-thirds (2/3) of the outstanding shares of Harbor Bankshares Corporation common stock.

The enclosed proxy statement gives you detailed information about the Annual Meeting, the merger, and related matters. We urge you to read carefully the enclosed proxy statement, including the considerations discussed under "Special Factors," beginning on page 11, and the appendices to the proxy statement, which include the merger agreement.

Shareholders also are asked to reelect Nathaniel Higgs, Delores G. Kelley, Erich March, and Stanley W. Tucker as Class II Directors for three-year terms.

It is important that your views be represented whether or not you attend the Annual Meeting. Your vote is important, whether you own a few shares or many. We urge you to vote your shares either in person at the Annual Meeting or by returning your proxy as soon as possible. The Board of Directors recommends that shareholders vote FOR approval of the merger and FOR reelection of the four class II Directors.

Sincerely,

Joseph Haskins, Jr.

Chairman, President, and Chief
Executive Officer

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HARBOR BANKSHARES CORPORATION
25 West Fayette Street
Baltimore, Maryland 21201

NOTICE OF ANNUAL MEETING OF SHAREHOLDERS
TO BE HELD JUNE 14, 2006

To Our Shareholders:

The Annual Meeting of Shareholders of Harbor Bankshares Corporation will be held at the Harbor Inn—Pier 5 Hotel, 711 Eastern Avenue, Baltimore, Maryland 21202 on Wednesday, June 14, 2006, at 12:00 noon Eastern Time, for the following purposes:

- Proposal I—To consider and vote upon a proposal to approve the Agreement and Plan of Merger, dated as of May 5, 2006, by and between Harbor Bankshares Corporation and Harbor Merger Corporation, a Maryland corporation and wholly-owned subsidiary of Harbor Bankshares Corporation (the “merger subsidiary”), pursuant to which the merger subsidiary will merge with and into Harbor Bankshares Corporation, with Harbor Bankshares Corporation being the surviving corporation;
- Proposal II—To elect four Class II Directors, each to serve for a three-year term; and
- To act upon such other matters as may properly come before the Annual Meeting or any adjournments or postponements thereof.

Note: The Board of Directors is not aware of any other business to come before the Special meeting.

The Board of Directors has fixed the close of business on May 1, 2006, as the record date for determination of shareholders entitled to vote at the Annual Meeting. The Harbor Board of Directors unanimously recommends that you vote **FOR** approval of the merger agreement and **FOR** the election of four Class II Directors.

Only shareholders of record of Harbor Bankshares Corporation voting common stock at the close of business on the record date will be entitled to notice of, and to vote at the Annual Meeting or any adjournment thereof. To grant a proxy to vote your shares, you may complete and return the enclosed proxy card. You may also vote in person at the Annual Meeting. Please vote promptly whether or not you expect to attend the Annual Meeting. In the event that there are not sufficient votes to vote upon the merger or to approve other business properly before the Annual Meeting, the Annual Meeting may be adjourned in order to permit further solicitation of proxies by Harbor Bankshares Corporation.

You are requested to fill in and sign the enclosed Form of Proxy and to mail it in the enclosed envelope. The Proxy will not be used if you attend and choose to vote in person at the Annual Meeting. **Executed but unmarked proxies will be voted FOR Proposal I to approve the Agreement and Plan of Merger and FOR election of the four Class II Directors.**

Harbor Bankshares Corporation’s only class of stock is its common stock, par value \$0.01 per share. A complete list of shareholders entitled to vote at the Annual Meeting will be available for inspection by any shareholder at the offices of Harbor Bankshares Corporation during ordinary business hours for a period of at least ten days prior to the Annual Meeting.

By Order of the Board of Directors,

George F. Vaeth, Jr.
Corporate Secretary

Baltimore, Maryland
May 12, 2006

Your Vote Is Important. Please promptly sign, date, and return the enclosed proxy card. If you attend the Annual Meeting and decide that you wish to vote in person or for any other reason desire to revoke your proxy, you can do so at any time prior to its use.

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**HARBOR BANKSHARES CORPORATION
25 West Fayette Street
Baltimore, Maryland 21201**

**PROXY STATEMENT
FOR THE ANNUAL MEETING OF SHAREHOLDERS
TO BE HELD ON JUNE 14, 2006**

INTRODUCTION

This Proxy Statement is being sent to holders of the common stock, \$0.01 par value, of Harbor Bankshares Corporation, a Maryland corporation (“Harbor” or the “Company”), in connection with the solicitation of proxies by the Board of Directors of Harbor for use at the 2006 Annual Meeting of Shareholders to be held at Harbor Inn Pier 5 Hotel, 711 Eastern Avenue, Baltimore, Maryland 21202 on Wednesday, June 14, 2006, at 12:00 noon Eastern Time, and at any adjournment or postponement of the meeting, for the following purposes:

- Proposal I To consider and vote upon a proposal to approve the Agreement and Plan of Merger, dated as of May 5, 2006, by and between Harbor Bankshares Corporation and Harbor Merger Corporation, a Maryland corporation and wholly-owned subsidiary of Harbor Bankshares Corporation (the “merger subsidiary”), pursuant to which the merger subsidiary will merge with and into Harbor Bankshares Corporation, with Harbor Bankshares Corporation being the surviving corporation;
- Proposal II To elect four Class II Directors, each to serve for a three-year term; and
- To act upon such other matters as may properly come before the Annual Meeting or any adjournments or postponements thereof.

The purpose of the Agreement and Plan of Merger is to allow Harbor to eliminate the substantial expenses of being a Securities and Exchange Commission (“SEC”) reporting company under the Securities Exchange Act of 1934. If approved and completed, the merger will reduce the number of Harbor record shareholders to fewer than 300, and will allow Harbor to terminate the registration of its common stock under the Exchange Act. In the merger, holders of record of 100 or fewer shares will receive \$31.00 per share in exchange for their shares; holders of more than 100 shares will remain shareholders of Harbor after the merger. The merger cannot occur unless the merger agreement is approved by the holder of at least two-thirds (2/3) of the outstanding shares of Harbor common stock that are eligible to vote.

This document provides you with detailed information about the proposed merger. Please see the “Summary Term Sheet” on page 4 and the other material referred to therein for important additional information and “Where You Can Find More Information” on page 43 or additional information about Harbor on file with the SEC.

This Proxy Statement and the accompanying form of proxy are being sent to Harbor shareholders on or about May 12, 2006.

Only shareholders of record of voting common stock at the close of business on May 1, 2006, the record date, are entitled to notice of and to vote at the annual meeting and any adjournment or postponement of the meeting. As of May 1, 2006, there were 675,579 shares of Harbor common stock, par value \$0.01 per share, outstanding, consisting of 641,784 shares of voting common stock and 33,795 shares of nonvoting common stock.

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

This transaction has not been approved or disapproved by the Securities and Exchange Commission nor has the Commission passed upon the fairness or merits of such transaction nor upon the accuracy or adequacy of the information contained in this document. Any representation to the contrary is unlawful.

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PROPOSAL AGREEMENT AND PLAN OF MERGER

SUMMARY TERM SHEET

This summary highlights selected information from this proxy statement regarding the proposed transaction and may not contain all of the information that is important to you. For a more complete description of the terms and conditions of the transaction and its effects, you should carefully read this entire document, the attachments, and any other documents to which we refer.

Why is Harbor proposing the merger?

The purpose of the merger is to reduce the number of shareholders of record below 300, which will enable Harbor to terminate the registration of its common stock under the Securities Exchange Act of 1934.

By terminating the Harbor's registration under that Act, we hope to:

- Achieve significant savings in ongoing legal and accounting costs related to the reporting process and shareholder communications required by the Act;
- Avoid significant expenses and efforts that would be necessary for the Company to comply with additional procedures relating to internal control that otherwise are required by year-end 2007 under the Sarbanes-Oxley Act and SEC regulations; and.
- Enable management, employees, and the Board of Directors to focus their efforts on the operations and management of the Company's business, rather than the reporting processes. See "Special Factors Reasons for the Merger" on page 12.

What are the effects of not being a reporting company?

After we terminate the registration of our common stock, we will no longer prepare and file the quarterly, annual, and other reports and proxy statements with the Securities and Exchange Commission. We will continue to issue reports and proxy materials, but these may not contain all of the information that is contained in the annual report and proxy statements that Harbor currently distributes.

Harbor common stock is not currently traded on any exchange and is not listed or quoted on any exchange following the merger, but is traded from time to time in the over the counter market. After we terminate the registration of our common stock, we will not be eligible for future quotation or listing on any stock exchange or organized market.

Harbor and Harbor Bank would continue to be highly regulated and subject to periodic examination by federal and state bank regulatory agencies

See "Special Factors Effects of the Merger" on page 19 and " Reasons for the Merger" on page 12.

What will I receive if the merger is approved by shareholders and becomes effective?

If the merger is approved by shareholders and becomes effective:

- Each holder of 100 or fewer shares of common stock will receive \$31.00 in cash per share. Share ownership will be calculated by adding all shares registered in the same manner under procedures established by Harbor.
- Each holder of 101 or more shares of common stock will continue as a Harbor shareholder and will own the same number of shares as the holder owned before the merger.

Does the Board of Directors believe that the terms of the merger are fair?

Yes. The Board of Directors believes that the terms of the merger, including the amount to be paid per share, are fair to and in the best interest of Harbor and all of its shareholders. In reaching its conclusion, the Board considered, among other things:

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- The matters discussed under “Reasons for the Merger”;
- The opinion of Harbor’s financial advisor, Danielson Associates, as to the fair value of the common stock;
- Harbor’s current financial position and its available sources of liquidity;
- Harbor’s business and financial prospects;

- The continued costs of compliance with Harbor's reporting obligations under the Exchange Act; and
- The current and historical prices for our common stock and the liquidity of the market for the common stock.

See "Special Factors-Reasons for the Merger" on page 12, "-Recommendation of the Board of Directors; Fairness of the Merger Proposal" on page 13, "-Fairness Determination by Filing Persons" on page 14, "-Opinion of Financial Advisor" on page 14, and "-Price Adjustment Since Opinion Date" on page 18.

What is the merger, and how will Harbor be operated after the merger?

In the merger, Harbor Merger Corporation, a newly formed wholly-owned subsidiary of Harbor, will merge with and into Harbor, with Harbor being the surviving corporation. As a result of the merger, shareholders who own 100 or fewer shares of Harbor common stock, except for shares owned by shareholders who properly exercise their rights to object to the merger, will receive \$31.00 in cash for each share owned, without interest. Shareholders who own more than 100 shares of Harbor common stock will continue to hold shares of Harbor common stock and will not receive any cash in connection with the merger.

After the merger, Harbor will continue to operate as a bank holding company and as the parent corporation for Harbor Bank, and expects its business and operations to continue as they are currently being conducted, but without the need to file reports with the SEC. Also, the executive officers and Directors of Harbor will continue to be the executive officers and Directors of Harbor following the merger. We expect to complete the merger in June 2006.

See: "The Merger Agreement" on page 31 and the copy of the merger agreement attached as Appendix A.

What vote is required to approve the merger agreement?

The affirmative vote of least two-thirds (2/3) of the outstanding shares of Harbor common stock eligible to vote is needed for approval of the merger. Members of Harbor's Board of Directors having the power to vote approximately 193,177 or 30.1% of the 641,784 outstanding voting shares have indicated that they intend to vote FOR the merger. All holders of record of Harbor voting common stock as of May 1, 2006, will receive a copy of this proxy statement and are entitled to vote at the Annual Meeting.

Who is entitled to vote?

Shareholders of voting common stock as of the close of business on May 1, 2006, the record date, are entitled to vote at the meeting. Each share of voting common stock is entitled to one vote. See "The Annual Meeting-Shares Entitled to Vote; Quorum and Vote Required" on page 41.

How does the Board of Directors recommend that I vote?

The Board of Directors, by a unanimous vote, has approved the merger agreement and recommends that you vote FOR approval of the merger agreement. You should note that all of the Directors own more than 100 shares and expect to remain Harbor shareholders after the merger, and that no Director or executive officer is expected to receive cash in the merger.

How do I vote?

Each shareholder should sign and date the enclosed proxy card and return it to us in the prepaid envelope. Unless contrary instructions are indicated on the proxy, all shares represented by valid proxies received pursuant to this solicitation will be voted in favor of the merger and in favor of the election of all nominees as Director. If you own your shares through a bank, broker, or other nominee, you must vote through your record holder. See "The Annual Meeting" on page 41.

Do I have appraisal or dissenter's rights?

Yes. If the merger is approved by the shareholders and is completed, any shareholder who properly perfects his or her right to object to the merger will be entitled to receive an amount of cash equal to the fair value of his shares rather than the consideration provided by the merger agreement. See "Special Factors Appraisal Rights of Harbor Shareholders" on page 25.

What are the federal income tax implications of the merger?

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The receipt of cash in the merger will be taxable for United States federal income tax purposes. You will be treated as either having sold your shares of Harbor common stock for the cash received or as having received the cash as a dividend. In general, your receipt of cash in exchange for your shares of Harbor common stock will be treated as a sale or exchange and you will recognize gain or loss in an amount equal to the cash received less your adjusted tax basis of your shares exchanged for such cash if you actually and constructively own no shares of Harbor common stock immediately after the exchange. If you actually or constructively own shares of Harbor common stock after the exchange, your receipt of cash in exchange for your shares of Harbor common stock may be taxed as a dividend. Shareholders who do not receive cash should not recognize any gain or loss on continuing to hold their shares of Harbor common stock as a result of the merger.

See "Special Factors Material U.S. Federal Income Tax Consequences" on page 23.

☐ Should I send in my certificates now?

No. After the effectiveness of the merger, holders of 100 or fewer shares will be sent a letter of transmittal and instructions for submitting shares for payment. Holders of 101 or more shares will not be required to exchange their certificates. See "The Merger Agreement-Exchange of Certificates" on page 32.

☐ Who can help answer my questions?

If you have additional questions about the merger, you should contact Teodoro J. Hernandez, Vice President and Treasurer, at Harbor Bankshares Corporation, 25 West Fayette Street, Baltimore, MD 21201, telephone (410) 528-1800.

STATEMENT REGARDING FORWARD-LOOKING INFORMATION

This proxy statement and the documents incorporated by reference in this proxy statement include forward-looking statements such as: statements of Harbor's goals, intentions, and expectations; estimates of risks and of future costs and benefits; and statements of Harbor's ability to achieve financial and other goals. These forward-looking statements are subject to significant uncertainties because they are based upon: the amount and timing of future changes in interest rates, market behaviors, and other economic conditions; future laws and regulations; and a variety of other matters. Because of these uncertainties, the actual future results may be materially different from the results indicated by these forward-looking statements. In addition, Harbor's past performance does not necessarily indicate its future results.

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	Year ended December 31,				
	2005	2004	2003	2002	2001
<u>OPERATING DATA</u>					
Interest Income	\$ 15,014	\$ 12,648	\$ 11,886	\$ 11,647	\$ 13,609
Interest Expense	3,787	2,283	2,411	3,402	5,973
Net Interest Income	11,227	10,365	9,475	8,245	7,636
Provision for Loan Losses	410	360	755	340	400
Non-Interest Income	1,771	1,514	2,506	2,220	2,329
Non-Interest Expenses	9,638	9,295	8,610	8,575	8,526
Income Before Taxes	2,950	2,224	2,616	1,550	1,039
Income Taxes	1,067	762	831	473	309
Net Income	\$ 1,883	\$ 1,462	\$ 1,785	\$ 1,077	\$ 730
<u>PER SHARE DATA</u>					
Net Income □ Basic	\$ 2.73	\$ 2.07	\$ 2.46	\$ 1.47	\$ 1.02
Net Income □ Diluted	2.55	1.93	2.36	1.43	0.99
Cash and Stock Dividends	0.40	0.35	0.25	0.25	□
Book Value	\$ 24.73	\$ 23.04	\$ 21.69	\$ 19.23	\$ 16.72
<u>BALANCE SHEET DATA</u>					
Total Assets	\$ 256,636	\$ 235,464	\$ 219,547	\$ 210,234	\$ 186,586
Deposits	229,845	210,224	195,901	193,294	171,531
Total Net Loans	188,936	172,205	149,729	120,523	105,847
Total Shareholder's Equity	16,954	16,240	15,274	14,149	12,241
Return on Average Assets	0.78%	0.63%	0.84%	0.54%	0.37%
Return on Average Equity	11.57%	9.33%	12.23%	8.20%	6.20%
Tier 1 Regulatory Capital to Average Assets	7.31%	7.36%	7.46%	5.20%	5.40%
Average Equity to Average Assets	6.74%	7.27%	6.48%	5.24%	4.77%
Dividend Paid to Diluted Net Income	15.69%	18.13%	10.59%	17.48%	NA

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The following summary information includes unaudited and preliminary financial information as of March 31, 2006, and the three months then ended.

	March 31,	
	2006	2005
<i>(In thousands, except per share data)</i>		
NET INCOME	\$ 447	\$ 294
<u>PER SHARE DATA</u>		
Net Income□Basic	\$ 0.66	\$ 0.42
Net Income□Diluted	0.62	0.39
Cash Dividends	0.50	0.40
Book Value	24.82	24.73
<u>BALANCE SHEET DATA</u>		
Total Assets	\$ 250,955	\$ 234,799
Deposits	221,917	210,230
Total Net Loans	200,545	177,291
Total Shareholder's Equity	16,765	15,796
	8	

[Back to Contents](#)**Summary Unaudited Pro Forma Financial Information**

The following table sets forth the Harbor's shareholders' equity accounts as of December 31, 2005, and pro forma equity accounts as of such date as if the merger were then effective, resulting in the cashing out of 12,478 shares of common stock for an aggregate payment of \$417,187, including payments for shares of stock of \$386,818 and payment of related professional and other costs of \$55,325. Shares acquired will be classified as authorized and unissued. Harbor's shareholder's equity as of the date of this proxy statement, the date of the Annual Meeting, or as of any other day, may be higher or lower than the amount set forth below, as a result of earnings or losses from operations, the payment of dividends or other distributions, and changes in the value of Harbor's available for sale securities.

(In thousands, except per share data)

	<u>Actual</u>	<u>Pro forma</u>
Common stock (par value \$0.01 per share):		
Authorized 10,000,000 shares; issued		
685,579, including 33,795 common nonvoting		
Shares	\$ 7	\$ 7
Additional paid in capital	6,616	6,199
Retained earnings	10,853	10,853
Accumulated other comprehensive loss	(522)	(522)
	<u> </u>	<u> </u>
Total Shareholders' Equity	\$ 16,954	\$ 16,537

Common equity per share	\$ 24.73	\$ 24.57
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The following table sets forth Harbor's and the Bank's actual and estimated pro forma regulatory capital ratios as of December 31, 2005, as if the merger were effective as of that date, resulting in the cashing out of 12,478 shares of common stock for an aggregate payment of \$417,187.

	<u>Actual</u>	<u>Pro forma</u>
Total Capital to risk weighted assets		
Harbor Bankshares Corporation	11.67%	11.45%
Harbor Bank of Maryland	11.59%	11.37%
Tier I Capital to risk weighted assets		
Harbor Bankshares Corporation	9.07%	8.85%
Harbor Bank of Maryland	9.47%	9.27%
Tier I Capital to average assets		
Harbor Bankshares Corporation	7.31%	7.13%
Harbor Bank of Maryland	8.83%	8.65%

Harbor's pro-forma capital ratios remain in excess of the levels required at December 31, 2005, for well capitalized status for regulatory purposes.

[Back to Contents](#)**CONSOLIDATED UNAUDITED RATIO OF EARNINGS TO FIXED CHARGES****Ratio of Earnings to Fixed Charges***(Dollars in thousands)*

	<u>2005</u>	<u>2004</u>	<u>2003</u>	<u>2002</u>	<u>2001</u>
INCLUDING INTEREST ON DEPOSITS					
Earnings:					
Pre-tax income (loss)	\$ 2,951	\$ 2,224	\$ 2,616	\$ 1,550	\$ 1,039
Plus: Fixed charges	3,851	2,333	2,514	3,541	6,118
Total Earnings	<u>\$ 6,802</u>	<u>\$ 4,557</u>	<u>\$ 5,130</u>	<u>\$ 5,091</u>	<u>\$ 7,157</u>
Fixed Charges					
Interest expense and capitalized interest	\$ 3,787	\$ 2,283	\$ 2,411	\$ 3,402	\$ 5,973
Rent expense (for operating leases)	213	168	343	464	482
Ratio of interest expense included in rent expense	30%	30%	30%	30%	30%
Estimated interest within rental expense	64	50	103	139	145
Total Fixed Charges	<u>\$ 3,851</u>	<u>\$ 2,333</u>	<u>\$ 2,514</u>	<u>\$ 3,541</u>	<u>\$ 6,118</u>
Ratio of Earnings to Fixed Charges with Interest on Deposits	<u>177%</u>	<u>195%</u>	<u>204%</u>	<u>144%</u>	<u>117%</u>
EXCLUDING INTEREST ON DEPOSITS					
Earnings:					
Pre-tax income (loss)	\$ 2,951	\$ 2,224	\$ 2,616	\$ 1,550	\$ 1,039
Plus: Fixed charges	529	381	278	280	296
Total Earnings	<u>\$ 3,480</u>	<u>\$ 2,605</u>	<u>\$ 2,894</u>	<u>\$ 1,830</u>	<u>1,335</u>
Fixed Charges					
Interest expense and capitalized interest	\$ 465	\$ 331	\$ 175	\$ 141	\$ 151
Rent expense (for operating leases)	213	168	343	464	482
Ratio of interest expense included in rent expense	30%	30%	30%	30%	30%
Estimated interest within rental expense	64	50	103	139	145
Total Fixed Charges	<u>\$ 529</u>	<u>\$ 381</u>	<u>\$ 278</u>	<u>\$ 280</u>	<u>\$ 296</u>
Ratio of Earnings to Fixed Charges without Interest on Deposits	<u>658%</u>	<u>683%</u>	<u>1,041%</u>	<u>654%</u>	<u>451%</u>

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SPECIAL FACTORS

Background of the Merger

Harbor was organized in 1992 to be the registered holding company for the Bank. Harbor became a "public" company filing reports with the Securities and Exchange Commission in 1992. No organized market for the Harbor common stock has ever existed, however, and trading is infrequent and sporadic. From time to time over the years, management has informally discussed the alternatives available to the Company to cease being a reporting company and the relative benefits and costs of deregistration with counsel to the Company. No formal presentations were made by counsel or management on this issue, and no outside evaluation or opinion as to the value of the Company's common stock was solicited. No follow-up on these discussions occurred, and the Company continued to file reports and other documents with the Securities and Exchange Commission.

In July 2002, the Public Company Accounting Reform and Investor Protection Act of 2002, commonly referred to as Sarbanes-Oxley, was signed into law. Since then, the Securities and Exchange Commission has issued and adopted a substantial body of new and revised regulations and disclosure requirements to implement the requirements of Sarbanes-Oxley. During this period, management and the Board of Directors periodically received information from Company counsel, its independent accountants, banking industry trade groups, and other sources regarding the requirements of these new provisions of law and regulation. As a result of the implementation of these new provisions, management and the Board of Directors became concerned that the new procedures and disclosures required to comply with Sarbanes-Oxley would significantly increase the management, staff, and Board time and resources dedicated to the securities reporting and disclosure process, including the time needed for training employees in the particulars of the new provisions and additional procedures involved in the management attestations and certifications of internal controls and financial statements. Concern also arose with respect to potential increases in expenses incurred for those processes, including the fees of counsel, accountants, and other compliance advisors and service providers. The Board of Directors and management were also concerned about the potential additional civil and criminal proceedings or liabilities to which the President and Chief Financial Officer could become subject as a result of the new financial statement certification requirements, and Harbor's potential liability to indemnify them if they successfully defended themselves, and the costs of the Company's participation in any such suit, investigation, or proceeding.

In the third quarter of 2004, management informally discussed with Harbor's special legal counsel the ability to deregister, and the procedure Harbor should follow in pursuing a possible deregistration transaction. Following those discussions, management began a study of the potential costs and benefits to Harbor of deregistration, and, from time to time, had additional discussions with legal counsel regarding deregistration and the costs of Sarbanes-Oxley compliance and of fulfilling the reporting obligations of a public company. At a regular meeting of the Board of Directors on May 11, 2005, management discussed the effects on Harbor and its shareholders of deregistration and the related costs and benefits, and formally proposed that the Board of Directors consider a transaction which would result in the reduction of the number of shareholders of record sufficient to permit the Company to deregister the common stock under the Securities Act of 1934. Following discussion, the Board voted to proceed with the process in general, but did not at that time determine the timing, structure, or terms of any transaction. Following that meeting, members of management engaged in further discussions with legal counsel and Harbor's independent accountants regarding the process of deregistration, and began the preparation of the necessary filings. After considering the proposals of several investment banking and financial advisory firms experienced in the valuation and appraisal of financial institutions, Harbor retained the firm of Danielson Associates, Inc., Rockville, Maryland, to provide it with an appraisal of the shares and an opinion that the price to be paid for shares which would be cashed out was a fair value of the common stock. Danielson Associates was selected because of its extensive experience, over a twenty year period, in the valuation and appraisal of financial institutions in connection with mergers, acquisitions, stock offerings, repurchases, fairness opinions, and similar matters, its reputation in the financial services industry for providing such services, the recommendation of counsel, who had previously worked with Danielson Associates, and the price of obtaining the appraisal and opinion from Danielson Associates, which was substantially below the prices quoted by other investment banks. Danielson Associates also had assisted Harbor with respect to the valuation of its common stock in the past. The opinion of Danielson Associates is summarized below, and its fairness opinion is attached as Appendix B hereto.

Harbor's Board of Directors considered the deregistration at its regular meeting on December 14, 2005. In attendance for its consideration of this matter were a representative of Danielson Associates and outside legal counsel as well as the President and CEO and the Treasurer. At that meeting, the Board discussed the structure and effects of deregistration of Harbor as a public company and the merger; the effects of the merger on Harbor, on shareholders whose shares would be acquired in the merger, and on the remaining shareholders; the fiduciary duties of Directors to shareholders; and related matters. In the meeting, outside legal counsel described the process and alternative structures of deregistration to the Board, and the representative of Danielson Associates presented its report, which had previously been distributed to the Board, regarding the fair value of Harbor common stock. Following discussion, the Board unanimously determined that the merger was fair to Harbor and its shareholders, established a price of \$29.00 per share to be paid per share to shareholders whose shares would be purchased in the merger, and authorized and directed executive management to proceed with the appropriate actions to effect the merger.

At its meeting of April 19, 2006, the Board reviewed the price to be paid to shareholders whose shares will be purchased in the merger based upon factors it previously had considered and upon the performance of Harbor since the original price was determined. As a result of that review, the Board unanimously increased the price to be paid per share in the merger to \$31.00 per share from the original \$29.00 per share.

See "Special Factors—Recommendation of the Board of Directors; Fairness of the Merger Proposal" on page 13, and "Summary Financial Information-Recent Developments" on page 8.

Reasons for the Merger

The primary purpose of the merger is to reduce the number of holders of the common stock below 300, which will enable Harbor to suspend filing periodic and annual reports with the SEC and to no longer incur the significant costs of complying with the reporting requirements of the Exchange Act. The elimination of those requirements will allow management to refocus the time spent preparing reporting documents and engaging in securities law compliance activities to the pursuit of operational and business goals. In considering the proposed amendments, the Board of Directors considered the benefits and costs to Harbor and the shareholders set forth below, and the factors discussed under the caption "Background of the Merger."

- Harbor believes that as a result of the merger it will be able to realize cost savings of at least \$87,600 annually by eliminating the requirements to make periodic public reports and by reducing the expenses of shareholder communications, including legal expense (\$12,000), accounting expense (\$30,000), printing (\$20,000), postage (\$1,800), data entry, stock transfer, and other administrative expenses (\$7,500), as well as a result of reduced staff and management time (\$10,000) spent on reporting and securities law compliance matters, and reduction in aggregate total dividend costs (\$6,300). In addition, Harbor will avoid the costs of initial compliance with the internal control over financial reporting systems requirements of the Sarbanes Oxley Act, currently expected to be required for public companies of Harbor's size by year-end 2007, which are estimated to range from \$150,000 to \$200,000, and continued annual costs of related compliance and reporting in amounts not determined. The Board of Directors believes that the increased disclosure and procedural requirements will result in continuing increased legal, accounting, and administrative expense, and diversion of Board of Directors, management, and staff effort without a commensurate benefit to the shareholders.
- Given the absence of a public market for the common stock, and the sporadic and limited trading in the common stock, the Board of Directors does not believe that the costs of reporting are justified. Harbor's earnings are sufficient to permit Harbor's expected growth, and Harbor is not dependent on access to the capital markets to obtain additional financing. If it becomes necessary to raise additional capital, Harbor believes that there are adequate sources of additional capital available, whether through borrowing at the holding company level, or through private or institutional sales of equity or debt securities, although it recognizes that there can be no assurance that Harbor will be able to raise additional capital when required, or that the cost of such capital will be attractive.
- The merger is expected to result in the cashing-out at a price determined to be fair by the Board of Directors of the equity interest of approximately 360 shareholders (58%) of Harbor common stock who, at the Effective Time of the merger, own 100 or fewer shares of Harbor common stock.

- The Board of Directors has determined that the price to be paid for the shares of Harbor common stock to be cashed out in the merger is fair, and that the transaction is fair to the remaining shareholders of Harbor. The Board of Directors has determined that the price at which shares will be cashed out is a fair value for the Harbor common stock. In reaching this conclusion the Board of Directors considered the valuation factors summarized in the opinion of its financial advisor, the performance of Harbor since that opinion was rendered, and other factors. In particular, the Board considered that the \$31.00 price represents 11.2 times trailing twelve month earnings at March 31, 2006, and 130% of fully diluted book value per common share (assuming all outstanding options are exercised) at March 31, 2005.
- The merger will enable small shareholders to divest themselves of their positions without the expenditure of efforts disproportionate to the value of their holdings, without transaction expenses, and at a price which is significantly higher than recent trades of which Harbor is aware, which have been at \$25.00 per share.
- The merger and deregistration will have little if any effect on the ability to trade common stock, as no organized market currently exists. Trades will continue to be the result of direct communications between buyers and sellers. The amount paid for the shares being cashed out may result in an increase in the pricing level of future trades, although there can be no assurance that higher prices for the common stock will result or that a continuing shareholder will be able to sell shares at the price being paid to shareholders being cashed out.
- Operating as a private company will allow management to better focus its efforts on the operations of the Bank, which will benefit our customers and the communities in which we operate.
- The merger will permit a significant percentage of our shareholders to continue as shareholders and to enjoy the benefits of share ownership, including dividends, when and if declared, potential capital appreciation, and civic benefits from owning shares in a community oriented institution such as Harbor. At the same time, Harbor will be relieved of significant expense and diversion of management time and effort, which may result in improved operating efficiencies and reduced need for additional compliance-related employees, and in potentially increased net earnings.
- Harbor and the Bank would continue to be highly regulated and subject to periodic examination by the federal and state bank regulatory agencies. The management and Board of Directors of Harbor would not be affected by the transaction. Substantial information about Harbor's financial affairs would remain available to interested shareholders.
- Harbor believes that no material adverse impact on Harbor's financial position would result from the transaction. The payment of cash from Harbor's capital accounts, however, could result in a future reduction in earnings or reduced asset levels as a result of reduced capital levels and compliance with regulatory capital requirements. The Board of Directors considered the impact of reduced capital levels, but determined that Harbor's and Bank's capital levels would remain more than sufficient to meet the levels required for well capitalized status under applicable regulations after the merger, and that any reduction in income resulting from reduced assets would likely be offset by cost savings realized as a result of deregistration.

Recommendation of the Board of Directors; Fairness of the Merger Proposal

The Board of Directors has unanimously determined that the merger is in the best interests of Harbor and all of its shareholders. In reaching its conclusion, the Board also determined that the transaction is in the best interests of unaffiliated shareholders who will receive cash in the merger as well as those who will retain their shares of common stock after the merger. The Board also believes that the process by which the transaction was approved is fair to all of Harbor's shareholders, and fair to unaffiliated shareholders receiving cash in the merger as well as those unaffiliated shareholders who will retain their shares after the merger. The Board's determination as to the per share price of \$31.00 was made at following a vote of the members of the Board of Directors at which the price was approved by a unanimous vote. As set forth in the section entitled "Special Factors Background of the merger," prior to voting upon the per share price, the members of the Board of Directors agreed that the going-private transaction is in the best interests of Harbor and all of its shareholders and, based upon the report and opinion provided by Danielson Associates and other factors, unanimously agreed that the per share price to be paid in the merger is fair to all of the shareholders of Harbor and unanimously approved the merger agreement, which included the \$31.00 per share price.

The Board of Directors also believes that the process by which the transaction is to be approved by shareholders is fair. The Board of Directors unanimously recommends that the shareholders vote **FOR** approval of the merger agreement. Each member of the Board of Directors and each executive officer of Harbor has advised Harbor that he or she intends to vote his or her shares in favor of the merger agreement for the reasons described above. As of May 1, 2005, the Directors and executive officers of Harbor and the Bank (16 persons) beneficially owned a total of 193,177 shares of Harbor's outstanding common stock, or approximately 28.6% (not including any shares that may be acquired pursuant to the exercise of stock options), of the total shares entitled to vote at the Annual Meeting. Accordingly, the approval of shareholders owning an additional 234,679 shares is necessary for the approval of the merger agreement.

The Board has the authority to reject (and not implement) the merger (even after approval thereof by shareholders) if it determines subsequently that the merger is not then in the best interests of Harbor and its shareholders.

Merger Subsidiary's Determination of Fairness of the Merger Proposal

The merger subsidiary and its Board of Directors believe that the merger is fair to, and in the best interests of, all of Harbor's shareholders. The merger subsidiary and its Board of Directors have determined that the merger is fair to the unaffiliated shareholders who will receive cash in the merger and those who will retain their shares of Harbor common stock after the merger. The merger subsidiary and its Board also believe that the process by which the transaction was approved is fair to all of Harbor's shareholders and have concluded that the process was fair to unaffiliated shareholders receiving cash in the merger as well as those unaffiliated shareholders who will retain their shares after the merger. In reaching its conclusions, the merger subsidiary relied upon the factors considered by, and has expressly adopted the analyses and conclusions of, Harbor's Board of Directors. See "Special Factors—Recommendation of the Board of Directors; Fairness of the Merger Proposal." Merger subsidiary has not received a report, opinion, or appraisal from an outside party. The merger agreement has been approved by merger subsidiary's Board of Directors and by Harbor, as the sole shareholder of merger subsidiary.

Fairness Determination by Filing Persons

Our Directors and executive officers are deemed to be "filing persons" under the SEC rules that govern going-private transactions. These rules require each filing person to state whether he or she believes that the transaction is fair to unaffiliated security holders. The filing persons consist of the following individuals: Joseph Haskins, Jr., Teodoro J. Hernandez, Darius L. Davis, James H. DeGraffenreidt, Jr., Louis J. Grasmick, Nathaniel Higgs, Delores G. Kelley, Erich March, John Paterakis, John D. Ryder, James Scott, Jr., Edward St. John, Walter S. Thomas, Stanley W. Tucker, and George F. Vaeth, Jr. (together, the "Filing Persons").

In forming his or her belief as to the fairness of the transaction to the unaffiliated shareholders, each of the Filing Persons has relied upon the factors considered by Harbor's Board of Directors, including Danielson Associates' analyses and opinion, and has adopted Harbor's Board of Directors' analysis and conclusions. See "Special Factors—Recommendation of the Board of Directors; Fairness of the Merger Proposal." Based on those factors, each of the Filing Persons believes that the merger agreement and the process by which the transaction was approved are fair to each of the unaffiliated shareholders, including those who will receive cash in the merger and those who will retain their shares of Harbor common stock. The Filing Persons have not received any report, opinion, or appraisal from an outside party that is materially related to the merger other than the report of Danielson Associates. The belief of each of the Filing Persons is his or her individual belief and does not constitute investment advice. If a shareholder is unsure of whether to vote in favor of the merger agreement, that shareholder should consider the recommendation of the Board of Directors or consult with the shareholder's personal financial advisor.

Opinion of Financial Advisor

Harbor retained Danielson Associates Inc. ("Danielson Associates") to perform an independent appraisal of the "fair" market value of the common stock of Harbor as of December 8, 2005. Market value is defined as the price at which the common stock would change hands between a willing seller and a willing buyer, each having reasonable knowledge of relevant facts and assuming a significant amount of stock changing hands daily to assure a true reflection of market forces. Danielson Associates rendered its written and oral opinion as of December 8, 2005, to the Harbor at its meeting of the Board of Directors on December 14, 2005. No limitations were imposed by Harbor's Board of Directors upon Danielson Associates with respect to the investigation made or procedures followed by it in arriving at its opinion.

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Danielson Associates is regularly engaged in the valuation of banks and bank holding companies in connection with mergers, acquisitions, and other securities transactions; and has knowledge of, and experience with Maryland and other mid-Atlantic markets and banking organizations operating in those markets. Danielson Associates was selected by Harbor because of its knowledge of, expertise with, and reputation in the financial services industry.

In arriving at its opinion, Danielson Associates:

- Reviewed certain business and financial information relating to Harbor including reports of condition and income and related schedules (commonly referred to as "call reports") filed by the Bank with federal banking regulators from 1990 through September 30, 2005, the annual reports of Harbor on Form 10-KSB for 2003 and 2004 and the quarterly report of Harbor on Form 10-QSB for September 30, 2005.
- Discussed the past and current operations, financial condition, and prospects of Harbor with its senior executives.
- Reviewed and compared the pricing ratios, to the extent publicly available, with those of comparable institutions.
- Considered such other factors as it deemed appropriate.

Danielson Associates did not obtain any independent appraisal of assets or liabilities of Harbor. Further, Danielson Associates did not independently verify the information provided by Harbor and assumed the accuracy and completeness of all such information.

In arriving at its opinion, Danielson Associates performed a variety of financial analyses. Danielson Associates believes that its analyses must be considered as a whole and that consideration of portions of such analyses could create an incomplete view of Danielson Associates' appraisal. The preparation of an appraisal of "fair" market value is a complex process involving subjective judgments and is not necessarily susceptible to partial analysis or summary description.

In its analyses, Danielson Associates made certain assumptions with respect to industry performance, business and economic conditions, and other matters, many of which were beyond Harbor's control. Any estimates contained in Danielson Associates analyses are not necessarily indicative of future results of value, which may be significantly more or less favorable than such estimates. Estimates of the value of companies do not purport to be appraisals or necessarily reflect the prices at which companies or their securities may actually be sold.

The following is a summary of selected analyses considered by Danielson Associates in connection with its opinion.

Comparable Companies. In determining what is a "fair" price for the outstanding shares of Harbor common stock, Harbor was compared with four groups of publicly-traded banking organizations. The first group is comprised of fourteen commercial banking organizations based in urban areas with assets between \$150 and \$500 million, have returns on average assets above .50%, and trade on a national exchange ("urban exchange group"). The second group consists of eleven commercial banking organizations with the same restrictions as the urban exchange group but which trade instead on the over-the-counter bulletin Board market ("urban OTC group"). Since these first two groups contained several newly-formed banking organizations and banking organizations with much better performance than Harbor, a third group was created from the banks in the urban exchange group and the urban OTC group which eliminated those less comparable banks. The remaining eight banks ("urban most applicable group") are the banks most applicable to Harbor based on location, performance, and history. Finally, a fourth group was comprised of the seventeen minority-owned banks and thrifts that are publicly-traded. This group was condensed further ("minority-owned group") as those banking organizations with assets over \$900 million or with attributes that would make them not comparable to Harbor were eliminated.

The urban exchange group's financial performance was comparable to Harbor's. The urban exchange group's median returns on average assets and equity of .78% and 9.74% were similar to Harbor's .74% and 10.94%, respectively. Additionally, nonperforming assets ("NPAs") as a percent of assets were .38% for Harbor which was higher, but not much higher, than the .22% for the comparable group. The urban exchange group had equity-to-assets of 8.24% while Harbor's was 6.66%. Harbor's net interest income of 4.61% of average assets in the nine months ending September 30, 2005, was much higher than the urban exchange group median of 3.65%, but this was more than offset by net operating expense that was about one and a half times the comparative

group's median. The urban exchange group's stock price multiples were diverse. The price times earnings multiples for the fourteen banks, ranged from 12.8 to 34.0 times earnings, with a median of 22.7 times earnings. The price-to-book ratios also had a wide range with a low of 143%, a high of 288% and the median was 178%.

The urban OTC group performed much better than Harbor with median returns on average assets and equity of 1.12% and 14.18%, respectively, compared to .74% and 10.94%, respectively, for Harbor. Equity-to-assets was similar with the urban OTC group having a median of 6.53% to Harbor's 6.66%. Once again the NPAs of the comparable group were lower than Harbor's, but at .23% of assets versus .38% of assets for Harbor the difference was negligible. In comparing income and expense ratios, Harbor outperformed the OTC group in terms of net interest income but gave away its advantage with higher net operating expense. Harbor had net interest income to average assets of 4.59% for the first nine months ended September 30, 2005 versus a median of 3.96% for the urban OTC group. Net operating expense was the opposite with Harbor having a much higher net operating expense to average assets of 3.23% compared to 2.12% for the comparable group. As a result Harbor's net operating as a percent of assets was lower than that of the comparable group's median \square 1.36% to 2.04%. The pricing ratios for the urban OTC group were just as diverse as the urban exchange group's. Price-to-earnings multiples ranged from 11.6 to 30.7, with a median of 17.8. Price-to-book multiples ranged from 159% to 296% of book with a median of 223%.

Since the members of the urban exchange group and the urban OTC group were selected based on their having similar asset to Harbor and being in urban markets, there were differences in their other characteristics that distort their comparability to Harbor. For example, the pricing multiples of the urban exchange group and the urban OTC group were in the range of 18 to 23 times earnings and 170% to 230% of book, but these groups contain several newly formed banks and banks with far superior performance that are valued at high multiples.

The urban most applicable group's seven banks had median returns on average assets and equity of .91% and 11.30%, respectively. While this was higher than Harbor's .74% and 10.94%, respectively, both are in the range of moderate performing banks.

There are seventeen publicly traded minority-owned institutions as defined by the Federal Reserve Bank. These banks represent African-American, Hispanic, Asian and women minorities. Some of these banks are comparable to Harbor but others because of their size, performance, or minority orientation are not comparable and have been excluded. The remaining four banks that are most comparable to Harbor provide the best basis on which to value its stock.

The minority-owned institutions that were non-comparable were excluded based on size, performance, or minority orientation. The five banks with assets over \$900 million were so much larger than Harbor that they were not comparable. In terms of performance there were three banks whose performance was too far above Harbor's to be comparable and five banks whose performance was too far below Harbor's to be comparable. The three top performers all had returns on equity near 14% or more and the five poorly performing banks all had returns on equity below 4%. In addition two of these poor performers with assets under \$100 million and were too small to be comparable, and a third had high NPAs which might add another reason that it would be not comparable. One of the top performers \square Abigail Adams \square has performance that could be considered comparable but it was also eliminated based on being a women's owned bank, rather than an African-American owned bank, and it does not market itself as a minority-owned institution.

The remaining four minority-owned institutions (the "minority-owned group") were all African-American owned, three of which were banks and the other a thrift. The largest in the group was the New York City based thrift Carver Bancorp, Inc. ("Carver") with assets of \$648 million and the smallest was the Miami, Florida based PanAmerican Bancorp ("PanAmerican") with assets of \$244 million. The other two banks were the Atlanta, Georgia based Citizens Bancshares Corporation ("Citizens") and the Washington, D.C. based IBW Financial Corporation ("IBW"). Harbor with assets of \$247 million was nearly identical in assets to PanAmerican.

Equity as a percent of assets was similar for three of the banks, but the fourth was substantially higher. The three with similar capital-to-asset ratios \square Carver, Citizens, and IBW all had ratios between 7.33% and 8.29%. Harbor had capital-to-assets of 6.66%. The fourth bank PanAmerican had capital-to-assets of 17.59% but it just raised about \$15 million in new equity in the third quarter of 2005.

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In terms of performance the four banks in the minority-owned group had performance comparable but below that of Harbor. Returns on average equity ranged from 5.93% to 8.66% with a median of 7.24%. Harbor's return on average equity was 10.94% but it was aided by its low capital ratio. Returns on average assets were closer with the four banks posting returns of .45%, .48%, .69%, and .99%. Harbor had a return on average assets of .74%, above all but one of the minority owned group. In terms on NPAs none of the four banks in the minority-owned group has significant NPAs. The bank with the lowest NPAs-to-assets was PanAmerican at .02% and the highest was Citizens with 1.23%. Harbor had NPAs-to-assets of .38%.

Harbor's net interest income and net operating expense as a percent of average assets was similar to that of three of the four banks in the minority-owned group. Harbor's net interest income to average assets of 4.59% was inside the range of 4.48% to 4.65% posted by Citizens, IBW, and PanAmerican. In terms on net operating expense to average assets Harbor's 3.23% was again inside the range of the same three banks □ 3.16% to 3.87%. The fourth bank Carver posted net interest income and net operating income as a percent of average assets of 3.05% and 2.29%, respectively.

The pricing of three of the four banks in the minority-owned group were similar. Citizens, Carver and IBW all had price times earnings multiples in a fairly tight range with multiples of 9.8, 14.0 and 14.0 times earnings, respectively. These same banks had price-to-book ratios of 82%, 80%, and 90%, respectively. The fourth bank, PanAmerican had a price times earnings multiple of 22.2 and price-to-book of 141%. The pricing of PanAmerican can be discounted as it recently raised a substantial amount of new capital after years of losses and its stock trades for less than \$5.00.

Absent adjustments for illiquidity of the market for the stock discussed below, Harbor's common stock would be expected to trade within the comparative groups' normal range of earnings multiples, as its financial characteristics are comparable with those of the comparative groups. However, the banking organizations most similar to Harbor, the urban minority owned banks, do not trade in line with the pricing values of the other comparable groups', and as a result the fair value of Harbor will similarly not be in line with the pricing values of the other groups.

Discounted Dividends Analysis. Danielson Associates applied present value calculations to Harbor's estimated dividend stream under several specific growth and earnings scenarios. The projected dividend streams and terminal values, which were based on a range of earnings multiples, were then discounted to present value using discount rates based on assumptions regarding the rates of return required by holders or prospective buyers of Harbor common stock. In performing this analysis, Danielson Associates used the following assumptions: (a) growth rate of 6%; (b) ending price/earnings ratios of 12X and 14X; (c) tax rate of 36%; (d) discount rates of 10% and 12%; and (e) dividends in amounts so that capital over 6.50% is paid out as dividends. Based on this analysis, the value of the Harbor common stock would be between \$24.54 and \$33.72 per share.

Other Factors. In addition to performing the analyses summarized above, Danielson Associates also considered other factors. These included the general trading levels for comparable banks, the past financial performance, their market positions and future prospects and general economic conditions.

Value Adjustments. In order to determine the "fair" price for shares of Harbor common stock, it was necessary to consider how it differs from the comparable banks and make the adjustments reflecting the differences. These adjustments considered such items as profitability, capital, growth momentum, market, deposit mix, asset mix and quality, management, liquidity of common stock as well as any unique circumstances. These valuation adjustments, other than the minority ownership discount which is based on the comparative pricing levels of the comparative groups, are not mathematically derived, but are based on a subjective analysis based on the experience of Danielson Associates and its review of market reactions to valuation issues over more than 20 years. In performing its analysis, Danielson believed that a discount of between 5% and 15% was appropriate to account for the illiquidity of the common stock, and an additional discount of 15% was appropriate to account for the other interrelated factors of market, growth, and minority ownership.

When all of the elements of possible adjustments to the value of Harbor are considered, it merits discounts based on market, stock liquidity, and minority ownership.

- *Market:* Harbor has continued to look for branches in growing areas within its market, but the majority of its branches and deposits are in Baltimore City, a declining market. This is particularly important in a valuation since part of the value of a banking organization is its growth opportunities and the likelihood that it will be acquired. Harbor's market limits both its potential growth and is likely to deter most

potential acquirers. Thus, market is a reason for a downward value adjustment in comparison to the urban most applicable group, which generally served better markets, but not the minority-owned group, which served similar large urban markets.

- *Stock liquidity:* Harbor differs from most of the comparable banking organizations in the illiquidity of its stock. The comparable banks, generally, do not trade extensively, but they are listed on either a national exchange or trade over-the-counter. Harbor is not listed on any exchange, and its stock trades very sporadically.
- *Minority-ownership:* A significant characteristic of Harbor is its minority ownership, particularly its African-American ownership. This characteristic is reflected in the minority-owned group, but not in the urban most applicable group. This minority-ownership adversely affects the value of the stock by decreasing the likelihood Harbor will be sold, and thus its potential sale value. Investors do not consider minority banks likely to sell, and, thus, no acquisition premium is normally included in the value. The reason for this perception is that minority banks seldom are sold willingly because there is a stronger community commitment than for most non-minority urban banks and non-minority banks, which represent the bulk of possible buyers, have minimal interest in acquiring minority banks because of the poor economic dynamics of the urban markets they normally serve and the potential run-off of customers after a merger. In the view of Danielson Associates, a non-minority bank may buy a minority bank, but it is unlikely to pay a full premium for it.

Conclusion. In the opinion of Danielson Associates, the best guide as to the value of Harbor's stock is the price times earnings multiples of other African-American banks having similar size and performance, and being located in similar urban markets, and that the value determined by the urban most applicable group □ which is slightly lower □ should also be considered, but only to determine that the value is to the lower half of the range determined by the minority-owned group.

Since no comparable banking organizations used in the various analyses are totally identical to Harbor, the results do not represent mathematical certainty. Instead the comparisons rely on the likelihood that the median stock prices of comparable banks are applicable to the stock value of Harbor.

Based on these comparisons, an analysis of Harbor's past performance and future potential and by applying discounts for market, stock liquidity and its minority ownership, Danielson arrived at its opinion that the "fair" value of its common stock as of December 8, 2005 is between \$28.13 and \$29.63 per share with the midpoint being \$28.88 per share. In Danielson's opinion, any price in this range would be a "fair" price for purposes of the merger.

The summary set forth above is not a complete description of the analyses and procedures performed by Danielson Associates in the course of arriving at its opinion. The full text of the report of Danielson Associates dated December 8, 2005, which sets forth the assumptions made and matters considered, is available for inspection and copying at Harbor's principal executive offices during regular business hours by any interested shareholder, or the representative of any shareholder designated in writing. . Danielson Associates' opinion is directed only to the "fairness" of the value of Harbor common stock and does not constitute a recommendation to any Harbor shareholder as to how such shareholder should vote.

Compensation of Danielson Associates. Pursuant to an agreement, Danielson Associates was will be paid a fee of \$8,000, plus reasonable out-of-pocket expense not to exceed \$250.

Price Adjustment Since Opinion Date.

At its meeting of December 14, 2005, the Board originally established a price of \$29.00 per share for shares to be purchased in the merger in consideration of the opinion of Danielson Associates and other factors. At its meeting of April 19, 2006, the Board reviewed the price to be paid to shareholders whose shares will be purchased in the merger based upon factors it previously had considered and upon the performance of Harbor since the opinion of Danielson Associates was rendered and the original price was determined. As a result of that review, the Board unanimously increased the price to be paid per share in the merger to \$31.00 per share from the original \$29.00 per share.

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Effects of the Merger

The merger will have various effects on Harbor, as described below.

Reduction in the Number of Shareholders. We believe that the merger will reduce the number of record shareholders from approximately 626 to approximately 266, and the number of outstanding shares of common stock from 641,784 as of the record date, to approximately 629,306 after the merger.

Decrease in Book Value. Assuming: the price to be paid to holders of 100 or fewer shares of common stock will be \$31.00 per share, (ii) the maximum number of shares of common stock expected to be cashed-out as a result of the merger is 12,478, (iii) the total cost to Harbor (including expenses) of effecting the merger is expected to be approximately \$442,000, and (iv) at December 31, 2005, aggregate shareholders' equity in Harbor was approximately \$17.0 million, or \$24.73 per share. Based upon these facts and assumptions, Harbor expects that, as a result of the merger:

Aggregate shareholders' equity of Harbor as of December 31, 2005, will be reduced from approximately \$17.0 million on a historical basis to approximately \$16.5 million on a pro forma basis;

The book value per share of common stock as of December 31, 2005, will be reduced from \$24.73 per share on a historical basis to \$24.57 per share on a pro forma basis; and

Decrease in Capital. The merger will reduce Harbor's capital. However, Harbor expects to remain "well capitalized" for bank regulatory purposes. Harbor's tier 1 capital to risk-weighted assets ratio will decrease from 9.07% on a historical basis to approximately 8.85% on a pro forma basis. Harbor's tier 1 to average assets ratio will decrease from 7.31% on a historical basis to approximately 7.13% on a pro forma basis, and its total risk-based capital ratio will decrease from 11.67% on a historical basis to approximately 11.45% on a pro forma basis. All regulatory capital ratios have been calculated assuming that 12,478 shares are cashed-out in the merger.

Suspension of Exchange Act Reporting Obligations. Once our common stock is no longer held by 300 or more shareholders of record, we will suspend filing reports required by the Exchange Act. Suspension of our reporting obligations under Section 13 of the Exchange Act and the Sarbanes-Oxley Act will substantially reduce the information we are required to furnish to our shareholders and to the SEC. It would also make certain provisions of the Exchange Act, such as proxy statement disclosure in connection with shareholder meetings and the related requirement of an annual report to shareholders, no longer applicable to Harbor. Accordingly, we estimate it will eliminate costs and expenses associated with continuance of the Exchange Act registration, estimated at approximately \$87,600 per year. In addition, Harbor will avoid the costs of initial compliance with the internal control systems requirements of the Sarbanes Oxley Act of 2002, currently expected to be required for public companies of Harbor's size by year-end 2007, which are estimated to range from \$150,000 to \$200,000, and continued annual compliance costs related to those requirements in amounts not determined. We intend to apply for such suspension of registration as soon as practicable following completion of the merger.

Effect on Market for Shares. Harbor common stock is not currently traded on any exchange and will not be listed or quoted on any exchange following the merger. Because we will no longer be required to file reports under the Exchange Act, the market for shares of Harbor common stock may be adversely affected. Currently, there is minimal liquidity in our shares of common stock and there may be a further reduction in the liquidity of our common stock after the merger.

Effect on Dividends. The principal source of our cash revenues comes from dividends received from the Bank. The amount of dividends that may be paid by the Bank to us depends on the Bank's earnings and capital position and is limited by federal and state law, regulations, and policies. In addition to the availability of funds from the Bank, our future dividend policy is subject to the discretion of our Board of Directors and will depend upon a number of factors, including future earnings, financial condition, cash needs, and general business conditions. If dividends should be declared in the future, the amount of such dividends cannot be estimated and it cannot be known whether such dividends would continue for future periods.

We anticipate that the merger will not have a material effect on our dividend policy, and we intend to continue paying an annual cash dividend; however, any future declaration and payment of dividends will depend upon,

among other factors, our results of operations and financial condition, future prospects, regulatory limitations and capital requirements, and other factors deemed relevant by the Board of Directors. See “Common Stock and Dividend Information.”

Furthermore, in 2003 in connection with the private placement of trust preferred securities, we formed Harbor Bankshares Corporation Capital Trust (the "Trust") as a subsidiary and issued \$7.2 million of floating rate junior subordinated debentures to the Trust. The floating rate junior subordinated debentures pay interest quarterly, and as a result, we may be required to reduce the amount of, or stop paying, dividends on Harbor common stock in order to make such payments of interest and repayment of principal. See "Financial Effects of the Merger; Financing of the Merger," below.

Financial Effects of the Merger; Financing of the Merger. We expect that the purchase of the cashed-out shares in the merger will cost no more than approximately \$387,000 which does not include approximately \$58,000 in professional fees and other expenses we anticipate incurring in the course of the transaction. In addition, we do not expect that the completion of the merger will have any material adverse effect on our capital adequacy, liquidity, results of operations, or cash flow. Because we currently do not know the actual number of shares that will be cashed-out in the merger, we do not know the exact amount of cash we will pay to shareholders in the merger. However, our obligation to consummate the merger under the merger agreement is conditioned on the aggregate number of shares of Harbor common stock owned by shareholders who are to be cashed-out or who have properly perfected their rights as objecting shareholders not exceeding 1.0% of the issued and outstanding shares of Harbor common stock. It is anticipated, however, that, if necessary, we will waive the condition to closing that limits the amount of shareholders being cashed out to 1% of our shares and, therefore, that all shareholders who own 100 or fewer shares will be cashed out. You should read the discussion under "The Merger Agreement—Conditions to the Completion of the Merger" on page 33 for a description of conditions to the obligations of the parties to consummate the merger and "Special Factors—Fees and Expenses" on page 23 for a description of the fees and expenses that we expect to incur in connection with the merger. Funds for the acquisition of shares are expected to be obtained by means of a dividend from the Bank, the funds for which would be obtained from the Bank's general working capital.

Ownership Percentage of Officers and Directors. As a result of the merger, we expect that (a) the percentage of ownership of outstanding common stock of Harbor held by current executive officers and Directors of Harbor and the Bank as a group (16 persons) will increase by less than 1%, from 28.6% to approximately 29.1% (excluding the effect of options); (b) the percentage of beneficial ownership of voting common stock (including shares issuable upon the exercise of stock options that are or will become exercisable within 60 days of May 1, 2006) held by current executive officers will increase from 40.7% to 41.4%; and (c) the collective book value as of December 31, 2005, of the shares of Harbor common stock held by our current officers and Directors, as a group, will decrease from approximately \$17.0 million on a historical basis to approximately \$16.5 million on a pro forma basis; and (d) the collective pro rata interest of our current officers and Directors, as a group, in the net income of Harbor for the year ended December 31, 2005 will increase from \$538,000 on a historical basis (based on the number of outstanding shares beneficially owned by such officers and Directors as of the record date) to approximately \$549,000 on a pro forma basis (based on the number of shares we anticipate such officers and Directors to own beneficially immediately after the merger). For a description of the assumptions used in determining the numbers of shares and related percentages that we expect to be held by executive officers and Directors immediately following the merger, please see footnotes under "The Parties—Security Ownership of Certain Beneficial Owners and Management."

The Board of Directors of Harbor was aware of these interests and considered them in approving the merger agreement. See "Special Factors—Background of the Merger."

No Further Reporting Obligations under the Exchange Act. After the merger and the resulting suspension of our reporting obligations under Section 13 of the Exchange Act, we no longer will file Forms 10-QSB, 10-KSB or 8-K, or any other reports with the SEC.

Effect of the Merger on Shareholders

General. The merger will affect Harbor shareholders as described below (Shareholders who elect to exercise rights as objecting shareholder should refer to "Appraisal Rights of Harbor Shareholders" on page 25.

Shareholders with 100 or fewer shares of Harbor common stock. If you are a shareholder who holds 100 or fewer shares of Harbor common stock before the merger:

- You will receive \$31.00 in cash, without interest, for each share you own at the effective time of the merger.

- You will not have to pay any brokerage commissions or other service charges in connection with the merger.
- All amounts owed to you will be subject to applicable federal, state, and local income taxes.
- You will have no further interest in Harbor with respect to your cashed-out shares. Your only right will be to receive cash for those shares.
- You will receive a letter of transmittal from Harbor as soon as practicable after the merger with instructions on how to surrender your existing certificate(s) in exchange for your cash payment.

If you want to continue to remain a shareholder of Harbor after the merger, you may do so by purchasing a sufficient number of shares of Harbor common stock from other shareholders prior to the effective time of the merger so that you hold more than 100 shares at the effective time of the merger. As described in the section "The Merger Agreement—Conversion of Shares in the Merger," there are specific provisions regarding the treatment of shares held in nominee form, or "street name."

The merger will have the same effect on shareholders regardless of whether they are affiliated or unaffiliated shareholders. As used in this proxy statement, the term "affiliated shareholder" means any shareholder who is a Director or executive officer of Harbor, and the term "unaffiliated shareholder" means any holder of Harbor common stock who is not an affiliate of Harbor. The effects of the merger on a shareholder will vary depending on whether all of the shareholder's shares will be cashed-out in the merger. The determination of whether or not any particular shares of Harbor common stock will be cashed-out in the merger will be based on whether the holder of those shares holds either 100 or fewer shares or more than 100 shares. Since a shareholder may beneficially own shares held by more than one holder of shares, a shareholder may beneficially own both shares that will be cashed-out in the merger and shares that will remain outstanding in the merger.

Cashed-Out Shareholders. Shareholders owning 100 or fewer shares immediately prior to the effective time of the merger will, upon consummation of the merger:

- Receive \$31.00 in cash, without interest, per share;
- No longer have any equity interest in Harbor and therefore will not participate in its future potential earnings or growth, if any, as a shareholder; and
- Be required to pay federal and, if applicable, state and local income taxes on the cash amount received in the merger. See "Special Factors—Certain U.S. Federal Income Tax Consequences" on page 23.

Remaining Shareholders. The effects of the merger on shareholders owning more than 100 shares immediately prior to the effective time of the merger will upon consummation of the merger include:

- Continued Ownership of Shares. Shareholders who own more than 100 shares immediately prior to the effective time of the merger will continue to be shareholders of Harbor and will own the same number of shares after the merger as they owned immediately before the merger.
- Increased Ownership Percentage. Remaining shareholders will have an increased ownership percentage in Harbor as a result of the merger.
- Decreased Access to Information. If the merger is effected, we intend to suspend our reporting obligations to the SEC under the Exchange Act. As a result, we will no longer be subject to the periodic reporting requirements and the proxy rules of the Exchange Act.
- Decreased Liquidity. The liquidity of the shares of our common stock held by remaining shareholders may be further reduced by the merger due to the suspension of our filing requirements under the Exchange Act.
- Reduced Capital. Harbor's regulatory capital ratios will be reduced, including a decrease in Harbor's tier 1 capital to risk-weighted assets ratio from 9.07% on a historical basis to approximately 8.85% on a pro forma basis. Harbor's other regulatory capital ratios will be similarly reduced: its tier 1 to average assets ratio will decrease from 7.31% to approximately 7.13%; and its total risk-based capital ratio will decrease

from 11.67% to approximately 11.45%. It is anticipated that Harbor and the Bank will continue to be “well capitalized” for regulatory capital purposes.

- Reduced Book Value Per Share. The book value per share of Harbor common stock as of December 31, 2005, will be reduced from \$24.73 per share on a historical basis to approximately \$24.57 per share on a pro forma basis.

Interests of Executive Officers and Directors in the Merger

The Board of Directors believes that it has acted in the best interests of Harbor and its shareholders. However, as you consider the recommendation of the Board of Directors, you should be aware that the Directors and officers of Harbor have interests in addition to their interests as shareholders of Harbor. As a result of the merger, we expect that (a) the percentage of ownership of outstanding common stock of Harbor held by current executive officers and Directors of Harbor and the Bank as a group (16 persons) will increase by approximately ½ of 1 percent, from 28.6% to approximately 29.1% (excluding the effect of options); (b) the percentage of beneficial ownership of voting common stock (including shares issuable upon the exercise of stock options that are or will become exercisable within 60 days of May 1, 2006) held by current executive officers will increase from 40.7% to 41.4%; (c) the collective book value as of December 31, 2005, of the shares of Harbor common stock held by our current officers and Directors, as a group, will decrease from approximately \$17.0 million on a historical basis to approximately \$16.5 million on a pro forma basis; and (d) the collective pro rata interest of our current officers and Directors, as a group, in the net income of Harbor for the year ended December 31, 2005, will increase from \$538,000 on a historical basis (based on the number of shares beneficially owned by such officers and Directors as of the record date) to approximately \$549,000 on a pro forma basis (based on the number of shares we anticipate such officers and Directors to own beneficially immediately after the merger). For a description of the assumptions used in determining the numbers of shares and related percentages that we expect to be held by executive officers and Directors immediately following the merger, please see footnotes under "The Parties□Security Ownership of Certain Beneficial Owners and Management" on page 29.

The Board of Directors of Harbor was aware of these interests and considered them in approving the merger agreement. See "Special Factors□Background of the Merger."

Conduct of Harbor's Business after the Merger

Following the merger, Harbor and its subsidiaries, including the Bank, will continue to conduct their existing operations in the same manner as now conducted. The executive officers and Directors immediately prior to the merger will be the executive officers and Directors of Harbor after the merger. The articles of incorporation and bylaws of Harbor will remain in effect and unchanged by the merger. The deposits of the Bank will continue to be insured by the Federal Deposit Insurance Corporation, and Harbor and the Bank will continue to be regulated by the same regulatory agencies as before the merger.

Harbor believes that there are significant advantages in becoming a private company, and Harbor plans to avail itself of any opportunities it may have as a private company, including, but not limited to, making any public or private offering for its shares, or entering into any other arrangement or transaction as it may deem appropriate. Although management does not now have an intent to enter into any such transaction nor is management currently in negotiations with respect to any such transaction, there exists the possibility that Harbor may enter into such an arrangement or transaction in the future and the remaining shareholders of Harbor may receive payment for their shares in any such transaction at amounts lower than, equal to, or in excess of the amount paid to cashed-out shareholders in the merger.

Other than as described in this proxy statement, neither Harbor nor its management has any current plans or proposals to effect any extraordinary corporate transaction, such as a merger, reorganization, or liquidation; to sell or transfer any material amount of its assets; to change its Board of Directors or management; to change materially its indebtedness or capitalization; or otherwise to effect any material change in its corporate structure or business.

[Back to Contents](#)**Fees and Expenses**

Harbor estimates that merger related fees and expenses, consisting primarily of financial advisory fees, SEC filing fees, fees and expenses of attorneys and accountants and other related charges, will total approximately \$55,350, assuming the merger is completed. This amount consists of the following estimated fees:

Description	Amount
Advisory fees and expenses	\$ 8,250
Legal fees and expenses	32,000
Accounting fees and expenses	7,500
SEC filing fee	75
Printing, solicitation and mailing costs	7,500
Total	\$ 55,325

Accounting Treatment

Harbor anticipates that it will account for the purchase of outstanding Harbor common stock in the merger from shareholders as a purchase and retirement of stock.

Material U.S. Federal Income Tax Consequences

The following discussion summarizes the material U.S. federal income tax consequences to the shareholders of Harbor with respect to the merger. The discussion is based upon the Internal Revenue Code, its legislative history, applicable U.S. Treasury regulations, existing administrative interpretations, and court decisions currently in effect. Any of these authorities could be repealed, overruled, or modified at any time after the date of this proxy statement, and any such change could be applied retroactively. This discussion does not address any alternative minimum tax consequences or the tax consequences under state, local, or foreign laws.

The discussion that follows neither binds nor precludes the Internal Revenue Service from adopting a position contrary to that expressed in this document, and we cannot assure you that such a contrary position could not be asserted successfully by the Internal Revenue Service or adopted by a court if the positions were litigated. Harbor has not obtained a ruling from the Internal Revenue Service or a written opinion from tax counsel with respect to the United States federal income tax consequences discussed below.

This discussion assumes that you hold your shares of Harbor common stock as a capital asset within the meaning of Section 1221 of the Internal Revenue Code. This discussion is only for general information and does not address all aspects of federal income taxation that may be important to you in light of your particular circumstances or if you are subject to certain rules, such as those rules relating to shareholders who are not citizens or residents of the United States, financial institutions, tax-exempt organizations and entities (including IRAs), insurance companies, dealers in securities, shareholders, who hold options to acquire shares of our common stock, and shareholders who acquired their shares of common stock through the exercise of employee stock options or similar derivative securities or otherwise as compensation.

Federal income tax consequences to shareholders who do not receive cash in the merger. If you (a) continue to hold shares of Harbor common stock immediately after the merger, and (b) you receive no cash as a result of the merger, then you will not recognize any gain or loss in the merger and you will have the same adjusted tax basis and holding period in your shares of Harbor common stock as you had in such stock immediately prior to the merger.

Federal income tax consequences to shareholders who receive cash in the merger. An exchange of your shares of Harbor common stock for cash pursuant to the merger will be a taxable transaction. If you receive cash in exchange for your Harbor common stock as a result of the merger, the cash you received will be treated as a redemption of your shares of Harbor common stock exchanged therefor under Section 302 of the Internal

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Revenue Code. Under Section 302 of the Internal Revenue Code, a shareholder who exchanges his or her shares of Harbor common stock for cash will be treated as having sold his or her shares of Harbor common stock if the exchange meets one of the following three tests:

- The exchange results in a “complete termination” of his or her equity interest in Harbor;
- The exchange is “substantially disproportionate” with respect to the shareholder; or
- The cash received is “not essentially equivalent to a dividend” with respect to the shareholder.

□ For purposes of these tests, in addition to the shares of Harbor common stock you actually own, you may be deemed to own constructively certain shares of Harbor common stock under the constructive ownership rules of Section 318 of the Internal Revenue Code. Generally, the constructive ownership rules under Section 318 of the Internal Revenue Code treat a shareholder as owning:

(a) Shares of stock owned by certain relatives, related corporations, partnerships, estates or trusts, and

(b) Shares of stock the shareholder has an option to acquire.

Because the constructive ownership rules are complex, each shareholder should consult his or her own tax advisor as to the applicability of these rules.

Cashed-out shareholders who do not actually or constructively own any shares of Harbor common stock after the merger. In general, if you receive cash in exchange for your shares of Harbor common stock as a result of the merger but do not actually or constructively own any shares of Harbor common stock immediately after the merger, you will be treated as having sold your shares of Harbor common stock for the cash received. You will recognize gain or loss on the exchange in an amount equal to the difference between the cash you receive for your cashed-out shares of Harbor common stock and your aggregate adjusted tax basis in such stock. Your gain will be a capital gain provided you held your shares of Harbor common stock as a capital asset within the meaning of Section 1221 of the Internal Revenue Code as of the effective time change effective time of the merger.

Shareholders receiving cash who actually or constructively continue to own any shares of Harbor common stock after the merger. If you receive cash in exchange for your shares of Harbor common stock as a result of the merger and are treated as directly or constructively owning shares of Harbor common stock immediately after the merger, then you will be treated as having sold your shares of Harbor common stock for the cash received only if you meet one of the three tests mentioned above and described below.

You will satisfy the “complete termination” test if you receive cash in exchange for your shares of Harbor common stock pursuant to the merger and you completely terminate your direct and constructive ownership interest in Harbor. If you would otherwise satisfy the complete termination requirement but for your constructive ownership of shares of Harbor common stock held by family members, you may, in certain circumstances, be entitled to disregard such constructive ownership. You should check with your own tax advisor as to whether you would be entitled to disregard such constructive ownership and the required filings with the Internal Revenue Service pursuant to such a decision.

You will satisfy the “substantially disproportionate” test if immediately after the merger you actually and constructively own less than 50% of the total combined voting power of all classes of Harbor stock entitled to vote and your percentage interest in Harbor (i.e., the number of voting shares actually and constructively owned by you divided by the number of voting shares outstanding) is less than 80% of your percentage interest in Harbor immediately prior to the merger.

You will satisfy the “not essentially equivalent to a dividend” test if the reduction in your percentage interest in Harbor, as described above, constitutes a “meaningful reduction of your proportionate interest” given your particular facts and circumstances. The Internal Revenue Service has indicated in published rulings that a minority shareholder whose relative stock interest is minimal (i.e., less than 1%) and who exercises no control with respect to corporate affairs is considered to have a “meaningful reduction” generally if the shareholder has some reduction in the shareholder’s stock ownership percentage.

If you satisfy one of these three tests, you will be treated as having sold your shares of Harbor common stock for the cash exchanged therefor and will recognize gain or loss on the exchange in an amount equal to the difference between the cash you receive for your cashed-out shares of Harbor common stock and your aggregate adjusted tax basis in such stock. Your gain will be a capital gain provided you held your shares of Harbor common stock as a capital asset within the meaning of Section 1221 of the Internal Revenue Code as of the effective time of the merger.

If you do not satisfy one of these three tests, you will be treated as having received a dividend to the extent of our current and accumulated earnings and profits, which we anticipate will be sufficient to cover the amount of any such dividend and will be includible in your gross income as ordinary income in its entirety, without

reduction for the adjusted tax basis of your shares of Harbor common stock exchanged for cash. No loss will be recognized. If the exchange is treated as a dividend, your adjusted tax basis in your shares of Harbor common stock exchanged for cash generally will be added to your tax basis in your remaining shares of Harbor common stock. To the extent that cash received in exchange for your shares of Harbor common stock is treated as a dividend to a corporate shareholder, the corporate shareholder will be: (i) eligible for a dividends-received deduction (subject to applicable limitations); and (ii) subject to the "extraordinary dividend" provisions of the Internal Revenue Code. To the extent, if any, the cash received by you exceeds our current and accumulated earnings and profits, it will be treated first as a tax-free return of your adjusted tax basis in the shares surrendered and thereafter as a capital gain.

Capital gain and loss. For individuals, net capital gain (defined generally as your total capital gains in excess of capital losses for the year) recognized upon the sale of capital assets that have been held for more than 12 months generally are subject to tax at a rate not to exceed 15%. Net capital gain recognized from the sale of capital assets that have been held for 12 months or less will continue to be subject to tax at ordinary income tax rates. In addition, capital gain recognized by a corporate taxpayer will continue to be subject to tax at the ordinary income tax rates applicable to corporations. There are limitations on the deductibility of capital losses.

Backup withholding. If you receive cash in the merger, you will be required to provide your social security or other taxpayer identification numbers (or, in some instances, additional information) in connection with the merger to avoid backup withholding requirements that might otherwise apply. The letter of transmittal will require you to deliver such information when your shares of Harbor common stock certificates are surrendered following the effective time of the merger. Failure to provide such information may result in backup withholding.

As explained above, the amounts paid to you as a result of the merger may result in dividend income, capital gain income, or some combination of dividend and capital gain income to you depending on your individual circumstances. The U.S. federal income tax discussion set forth above is based upon current law, which is subject to change possibly with retroactive effect. You should consult your tax advisor as to the particular federal, state, local, foreign, and other tax consequences of the transaction that are applicable to you in light of your specific circumstances.

APPRAISAL RIGHTS OF HARBOR SHAREHOLDERS

Any shareholder of Harbor who does not vote in favor of the merger and the transactions contemplated by the merger agreement and who has given prior written notice to Harbor of his or her objection to the proposed transaction and who otherwise complies with the procedures set forth in Title 3, Subtitle 2 of the MGCL, will be entitled to receive payment in cash of the fair value of his or her shares of Harbor common stock instead of receiving the merger consideration. A copy of Title 3, Subtitle 2 of the MGCL is included as Appendix C to this proxy statement.

If you want to demand payment of the fair value of your shares of Harbor common stock, you must fully comply with the procedures set out in the MGCL. The required procedures are summarized below. The following summary is not intended to be a complete statement of all aspects of the procedures set forth in the MGCL, and is qualified in its entirety by reference to the text of the statute included in Appendix C. If you intend to exercise your rights as an objecting shareholder, you should be aware that cash paid to you will likely result in receipt of taxable income. (See "Material U.S. Federal Income Tax Consequences").

Only holders of record of shares of Harbor common stock can object to the merger and demand to receive the fair value of the shares in cash. If your shares are not registered in your name, your record holder must follow the procedures to perfect your right to object to the merger and receive cash for the fair value of your shares.

- First, you must submit a written notice to Harbor at or prior to the meeting, stating that you object to the proposed merger. You should send your notice to:

Harbor Bankshares Corporation
25 West Fayette Street
Baltimore, MD 21201
Attention: Teodoro J. Hernandez
Vice President and Treasurer

- You must then not vote your shares in favor of the merger. This means that you should either (a) not return a proxy card and not vote in person in favor of the adoption of the merger agreement, (b) return a proxy card with the "Against" or "Abstain" box checked; (c) vote in person against the approval of the merger agreement; or (d) register in person an abstention from the proposal to approve the merger agreement. Merely voting against the merger or abstaining from or not voting in favor of the merger will not constitute notice of objection or dissent, and will not entitle you to payment in cash of the fair value of your shares.

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- Promptly after the effectiveness of the merger, Harbor will write to objecting shareholders of Harbor, notifying them of the date on which the articles of merger were accepted for record. This notice will be sent by certified mail, return receipt requested, to the address you provide in your notice, or if no address is indicated, to the address which appears on Harbor's shareholder records.
- Within twenty (20) days of the date on which the articles of merger were accepted for record, an objecting shareholder must make a written demand for payment of the fair value of his or her stock, stating the number and class of shares for which payment is demanded. The written demand for payment should be sent to:

Harbor Bankshares Corporation
25 West Fayette Street
Baltimore, MD 21201

Attention: Teodoro J. Hernandez
Vice President and Treasurer

Harbor's notice of the date on which the articles of merger were accepted may contain an offer of payment of the amount which Harbor believes is the fair value of the Harbor common stock, and certain financial disclosures. If you have followed all of the procedural steps required to demand payment of fair value and have not received payment for your shares, you may, or Harbor may, within fifty (50) days of the acceptance of the articles of merger, petition the court for an appraisal of the fair value of your shares of Harbor common stock as of the date of the Harbor shareholder meeting, without including any appreciation or depreciation resulting directly or indirectly from the merger or its proposal.

Any shareholder who files a notice of objection, but fails to file a written demand for the payment of fair value in a timely manner will be bound by the shareholder vote and will not be entitled to receive payment in cash as a holder of objecting shares.

If you demand payment for your stock as an objecting shareholder, you have no right to receive any dividends or other distributions on such shares, or the cash consideration into which such shares would be converted, after close of business on the date of the Harbor shareholder meeting at which the merger is approved, and have no other rights, including voting rights, with respect to such shares, except the payment of fair value.

If you demand payment for your shares, your rights as a shareholder will be restored if the demand for payment is withdrawn, a petition of appraisal is not filed within the time required, a court determines that you are not entitled to relief, or the merger is abandoned or rescinded. A demand for payment may be withdrawn only with the consent of Harbor.

If the court finds that a shareholder is entitled to an appraisal of his or her stock, the court will appoint three disinterested appraisers to determine the fair value of the stock on the terms and conditions the court considers proper. Within sixty (60) days after appointment, or such longer period as the court may direct, the appraisers must file with the court and mail to each shareholder who is a party to the proceeding their report stating their conclusion as to the fair value of the stock. Within fifteen (15) days after the filing of the report, any party may object to the report and request a rehearing. The court, upon motion of any party, will enter an order either confirming, modifying, or rejecting the report and, if confirmed or modified, enter judgment directing the time within which payment must be made.

If the report is rejected, the court may determine the fair value or remit the proceeding to the same or other appraisers. Any judgment entered pursuant to a court proceeding will in