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1ST STATE BANCORP INC  
Form DEF 14A  
December 27, 2002

SCHEDULE 14A INFORMATION  
(RULE 14a-101)  
INFORMATION REQUIRED IN PROXY STATEMENT

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:

- |  |   |
|--|---|
| <input type="checkbox"/> Preliminary Proxy Statement           | <input type="checkbox"/> Confidential, for Use of the |
| <input checked="" type="checkbox"/> Definitive Proxy Statement | Commission Only (as permitted                         |
| <input type="checkbox"/> Definitive Additional Materials       | by Rule 14a-6(e)(2))                                  |
| <input type="checkbox"/> Soliciting Material Under Rule 14a-12 |   |

1st STATE BANCORP, INC.

-----  
(Name of Registrant as Specified in Its Charter)

-----  
(Name of Person(s) Filing Proxy Statement, if Other Than the Registrant)

Payment of Filing Fee (Check the appropriate box):

- No fee required.  
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1. Title of each class of securities to which transaction applies:

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2. Aggregate number of securities to which transaction applies:

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

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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:

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2. Form, Schedule or Registration Statement No.:

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3. Filing Party:

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4. Date Filed:

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[LOGO]  
[1st State Bancorp, Inc. Letterhead]

December 27, 2002

Dear Stockholder:

We invite you to attend the Annual Meeting of Stockholders (the "Annual Meeting") of 1st State Bancorp, Inc. (the "Company") to be held at the main office of 1st State Bank (the "Bank") located at 445 S. Main Street, Burlington, North Carolina, on Tuesday, January 28, 2003, at 5:30 p.m., eastern time.

The attached Notice of Annual Meeting and Proxy Statement describe the formal business to be transacted at the meeting. During the meeting, we will also report on the operations of 1st State Bank, the Company's wholly owned subsidiary. Directors and officers of the Company and the Bank will be present to respond to any questions the stockholders may have.

ON BEHALF OF THE BOARD OF DIRECTORS, WE URGE YOU TO SIGN, DATE AND RETURN THE ACCOMPANYING FORM OF PROXY AS SOON AS POSSIBLE EVEN IF YOU CURRENTLY PLAN TO ATTEND THE ANNUAL MEETING. Your vote is important, regardless of the number of shares you own. This will not prevent you from voting in person but will assure that your vote is counted if you are unable to attend the meeting.

On behalf of the Board of Directors and all the employees of the Company and the Bank, I wish to thank you for your continued support.

Sincerely,

/s/ James C. McGill

James C. McGill

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President

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1st STATE BANCORP, INC.  
445 S. MAIN STREET  
BURLINGTON, NORTH CAROLINA 27215

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NOTICE OF ANNUAL MEETING OF STOCKHOLDERS  
TO BE HELD ON JANUARY 28, 2003

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NOTICE IS HEREBY GIVEN that the Annual Meeting of Stockholders (the "Annual Meeting") of 1st State Bancorp, Inc. (the "Company") will be held at the main office of 1st State Bank (the "Bank"), located at 445 S. Main Street, Burlington, North Carolina, on Tuesday, January 28, 2003, at 5:30 p.m., eastern time.

A Proxy Statement and Proxy Card for the Annual Meeting are enclosed.

The Annual Meeting is for the purpose of considering and acting upon the following matters:

1. The election of three directors of the Company for three-year terms; and
2. The transaction of such other business as may properly come before the Annual Meeting or any adjournment thereof.

The Board of Directors is not aware of any other business to come before the Annual Meeting.

Any action may be taken on any one of the foregoing proposals at the Annual Meeting on the date specified above or on any date or dates to which, by original or later adjournment, the Annual Meeting may be adjourned. Stockholders of record at the close of business on December 17, 2002, are the stockholders entitled to notice of and to vote at the Annual Meeting and any adjournment thereof.

You are requested to fill in and sign the enclosed proxy card which is solicited by the Board of Directors and to mail it promptly in the enclosed envelope. The proxy will not be used if you attend and vote at the Annual Meeting in person.

BY ORDER OF THE BOARD OF DIRECTORS

/s/ A. Christine Baker

A. Christine Baker  
Secretary

Burlington, North Carolina  
December 27, 2002

IMPORTANT: THE PROMPT RETURN OF PROXIES WILL SAVE THE COMPANY THE EXPENSE OF FURTHER REQUESTS FOR PROXIES IN ORDER TO INSURE A QUORUM. A SELF-ADDRESSED ENVELOPE IS ENCLOSED FOR YOUR CONVENIENCE. NO POSTAGE IS REQUIRED IF MAILED IN

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THE UNITED STATES.

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PROXY STATEMENT  
OF  
1st STATE BANCORP, INC.  
445 S. MAIN STREET  
BURLINGTON, NORTH CAROLINA 27215  
-----

-----  
ANNUAL MEETING OF STOCKHOLDERS  
JANUARY 28, 2003  
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-----  
GENERAL  
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This Proxy Statement is furnished to stockholders of 1st State Bancorp, Inc. (the "Company") in connection with the solicitation by the Board of Directors of the Company of proxies to be used at the Annual Meeting of Stockholders (the "Annual Meeting") which will be held at the main office of 1st State Bank (the "Bank"), located at 445 S. Main Street, Burlington, North Carolina, on Tuesday, January 28, 2003, at 5:30 p.m., eastern time, and at any adjournment thereof. The accompanying Notice of Annual Meeting and proxy card and this Proxy Statement are being first mailed to stockholders on or about December 27, 2002.

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VOTING AND REVOCABILITY OF PROXIES  
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Stockholders who execute proxies retain the right to revoke them at any time. Unless so revoked, the shares represented by properly executed proxies will be voted at the Annual Meeting and all adjournments thereof. Proxies may be revoked by written notice to A. Christine Baker, Secretary of the Company, at the address shown above, by filing a later dated proxy prior to a vote being taken on a particular proposal at the Annual Meeting or by attending the Annual Meeting and voting in person. The presence of a stockholder at the Annual Meeting will not in itself revoke such stockholder's proxy.

Proxies solicited by the Board of Directors of the Company will be voted in accordance with the directions given therein. WHERE NO INSTRUCTIONS ARE INDICATED, PROXIES WILL BE VOTED FOR THE NOMINEES FOR DIRECTOR SET FORTH BELOW. The proxy confers discretionary authority on the persons named therein to vote with respect to the election of any person as a director where the nominee is unable to serve or for good cause will not serve, and matters incident to the conduct of the Annual Meeting. If any other business is presented at the Annual Meeting, proxies will be voted by those named therein in accordance with the determination of a majority of the Board of Directors. Proxies marked as abstentions will not be counted as votes cast. Shares held in street name which have been designated by brokers on proxies as not voted will not be counted as votes cast. Proxies marked as abstentions or as broker non-votes, however, will be treated as shares present for purposes of determining whether a quorum is present.

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## VOTING SECURITIES AND SECURITY OWNERSHIP

The securities entitled to vote at the Annual Meeting consist of the Company's common stock, par value \$.01 per share (the "Common Stock"). Stockholders of record as of the close of business on December 17, 2002 (the "Record Date") are entitled to one vote for each share of Common Stock then held. As of the Record Date, there were 2,999,682 shares of Common Stock issued and outstanding. The presence, in person or by proxy, of at least one-third of the total number of shares of Common Stock outstanding and entitled to vote will be necessary to constitute a quorum at the Annual Meeting.

Persons and groups beneficially owning more than 5% of the Common Stock are required to file certain reports with respect to such ownership pursuant to the Securities Exchange Act of 1934, as amended (the "Exchange Act"). The following table sets forth information regarding the shares of Common Stock beneficially owned as of the Record Date by persons who beneficially own more than 5% of the Common Stock, each of the Company's directors, the executive officers of the Company named in the Summary Compensation Table set forth under "Proposal I -- Election of Directors -- Executive Compensation -- Summary Compensation Table," and all of the Company's directors and executive officers as a group.

SHARES OF COMMON STOCK  
BENEFICIALLY OWNED  
AS OF THE RECORD DATE (1)

---

5% Stockholder:

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|   |         |     |
|---|---------|-----|
| 1st State Bancorp, Inc.                           | 316,915 | (3) |
| Employee Stock Ownership Plan ("ESOP")            |         |     |
| 445 S. Main Street                                |         |     |
| Burlington, North Carolina 27215                  |         |     |
| <br>  |         |     |
| 1st State Bank Foundation, Inc.                   | 117,585 |     |
| 445 S. Main Street                                |         |     |
| Burlington, North Carolina 27215                  |         |     |
| <br>  |         |     |
| 1st State Bank Deferred Compensation Plan ("DCP") | 304,066 | (4) |
| 445 S. Main Street                                |         |     |
| Burlington, North Carolina 27215                  |         |     |
| <br>  |         |     |
| Maurice J. Koury                                  | 290,005 | (5) |
| P.O. Drawer 850                                   |         |     |
| Burlington, North Carolina 27216                  |         |     |

Directors

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|                        |         |     |
|------------------------|---------|-----|
| Bernie C. Bean         | 31,675  |     |
| James C. McGill        | 165,134 | (6) |
| Virgil L. Stadler      | 72,440  | (7) |
| James A. Barnwell, Jr. | 61,675  | (6) |
| James G. McClure       | 58,288  | (7) |
| T. Scott Quakenbush    | 72,986  |     |
| Richard C. Keziah      | 65,766  | (6) |
| Richard H. Shirley     | 47,219  | (7) |
| Ernest A. Koury, Jr.   | 1,000   |     |

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Executive Officers

|                     |        |
|---------------------|--------|
| A. Christine Baker  | 95,240 |
| Fairfax C. Reynolds | 82,282 |
| Frank Gavigan       | 32,244 |
| John D. Hansell     | 12,970 |

All directors and executive officers of the Company as a group (13 persons) 798,919

(footnotes on fol

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 PROPOSAL I -- ELECTION OF DIRECTORS  
 -----

GENERAL

The Company's Board of Directors consists of nine members. The Company's Articles of Incorporation require that directors be divided into three classes, as nearly equal in number as possible, with approximately one-third of the directors elected each year. At the Annual Meeting, three directors will be elected for a term expiring at the 2006 annual meeting of stockholders. The Board of Directors has nominated Bernie C. Bean, James C. McGill and Virgil L. Stadler to serve as directors for a three-year period. All nominees are currently members of the Board. Under Virginia law and the Company's Bylaws, directors are elected by a plurality of the votes present in person or by proxy at a meeting at which a quorum is present.

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

The following table sets forth, for each nominee for director and continuing director of the Company, his age, the year he first became a director of the Bank, which is the Company's principal operating subsidiary, and the expiration of his term as a director. All such persons except Mr. Koury were appointed as directors of the Company in 1998 in connection with the incorporation and organization of the Company. Each director of the Company also is a member of the Board of Directors of the Bank.

| NAME  | AGE AT<br>SEPTEMBER 30,<br>2002 | YEAR FIRST<br>ELECTED AS<br>DIRECTOR OF<br>THE BANK | CUR<br>TE<br>TO E |
|-------|---------------------------------|---|-------------------|
| ----- | -----                           | -----   | -----             |

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### BOARD NOMINEES FOR TERMS TO EXPIRE IN 2006

|                   |    |      |    |
|-------------------|----|------|----|
| Bernie C. Bean    | 72 | 1978 | 20 |
| James C. McGill   | 61 | 1988 | 20 |
| Virgil L. Stadler | 66 | 1982 | 20 |

### DIRECTORS CONTINUING IN OFFICE

|                        |    |      |    |
|------------------------|----|------|----|
| James A. Barnwell, Jr. | 62 | 1988 | 20 |
| James G. McClure       | 57 | 1989 | 20 |
| T. Scott Quakenbush    | 71 | 1978 | 20 |
| Richard C. Keziah      | 70 | 1983 | 20 |
| Ernest A. Koury, Jr.   | 48 | 2000 | 20 |
| Richard H. Shirley     | 55 | 1987 | 20 |

Set forth below is information concerning the Company's directors. Unless otherwise stated, all directors have held the positions indicated for at least the past five years.

BERNIE C. BEAN is retired. From 1988 to 1995 he was the President and General Manager of Craftique, Inc., a furniture manufacturer located in Mebane, North Carolina.

JAMES C. MCGILL is the President and Chief Executive Officer of the Company and has been the President and Chief Executive Officer of the Bank since December 1988. He has served on the Boards of Hospice of Alamance and Alamance Community College and in 1997 served as the chairman of the North Carolina Bankers Association. He also serves as a director of 1st State Bank Foundation, Inc. (the "Foundation"), a charitable foundation dedicated to charitable and community service causes within the Bank's community.

VIRGIL L. STADLER retired in October 2001 from his position as Chief Executive Officer of Stadler's Country Hams, Inc. in Elon College, North Carolina. He is active with the Front Street United Methodist Church and Elon Homes for Children.

JAMES A. BARNWELL, JR. is President of Huffman Oil Co., Inc., a petroleum marketer in Burlington, North Carolina. He has served on the advisory board of the Salvation Army Boys & Girls Club and the Alamance County YMCA board. He serves as a director of the Foundation. He also serves on the Board of Directors of the Alamance Regional Medical Center.

JAMES G. MCCLURE is President of Green & McClure, a retail furniture store in Graham, North Carolina. He currently serves as President of the Graham Area Business Association and has served on the zoning board for the city of Graham. He is active in the Graham Presbyterian Church.

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T. SCOTT QUAKENBUSH retired in April 1997 from his position as Vice President and sales manager with Carolina Paper Box Company in Burlington, North Carolina.

RICHARD C. KEZIAH, the Chairman of the Board of Directors of the Company, is President of Monarch Hosiery Mills, Inc. in Burlington, North Carolina. He also serves on the Board of Directors of Elon Homes for Children. He also serves as a director of the Foundation.

ERNEST A. KOURY, JR. is Vice President of Carolina Hosiery Mills, Inc., a hosiery mill in Burlington, North Carolina. He serves as Vice Chairman of the

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Alamance County Planning and Zoning Board and Chairman of the Elon University Board of Visitors.

RICHARD H. SHIRLEY is President of Dick Shirley Chevrolet, Inc., an automobile dealership located in Burlington, North Carolina. He has served as the President of the Alamance County YMCA and as a member and chairman of the Economic Development Committee of the Burlington area Chamber of Commerce.

### EXECUTIVE OFFICERS WHO ARE NOT DIRECTORS

The following sets forth information with respect to executive officers who do not serve on the Board of Directors.

| NAME<br>-----       | AGE AT<br>SEPTEMBER 30,<br>2002<br>----- | TITLE<br>-----   |
|---------------------|--|--|
| A. Christine Baker  | 49                                       | Treasurer and Secretary of the Company and Executive Vice President - Officer of the Bank                        |
| Fairfax C. Reynolds | 49                                       | Vice President and Assistant Secretary of the Company and Executive Vice President of Retail Banking of the Bank |
| Frank Gavigan       | 44                                       | Senior Vice President - Senior Credit Officer of the Bank  |
| John D. Hansell     | 65                                       | Manager - First Capital Services, Inc.   |

A. CHRISTINE BAKER is the Treasurer and Secretary of the Company and served as the Executive Vice President, Secretary and Treasurer of the Bank since April 1985. She currently serves as Treasurer and director of the Women's Resource Center of Alamance County and is active in the First Presbyterian Church of Burlington.

FAIRFAX C. REYNOLDS is the Vice President and Assistant Secretary of the Company and has served as the Bank's Executive Vice President in charge of Commercial and Retail Banking since 1989. He serves on the Boards of Directors of Alamance County YMCA, the Alamance County Arts Council and the United Way of Alamance County.

FRANK GAVIGAN has served as the Bank's Senior Vice President - Senior Credit Officer since 1990. He serves on the Boards of Directors of Hospice of Alamance County and Alamance Eldercare.

JOHN D. HANSELL has served since May 1987 as Manager of First Capital Services Company, LLC and its predecessor, First Capital Services, Inc., entities the Company owns that sell annuities, mutual funds and insurance products on an agency basis. He has served on the small business council of the Alamance Chamber of Commerce and on the Board of Directors of the Financial Planning Association.

### COMMITTEES OF THE BOARD OF DIRECTORS

The Board of Directors of the Company meets monthly and may have additional special meetings. During the year ended September 30, 2002, the Board of Directors of the Company met 12 times and the Board of Directors of the Bank met 12 times. No director attended fewer than 75% in the aggregate of the total



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number of Company Board of Directors meetings held during the year ended September 30, 2002 and the total number of meetings held by committees on which he served during such fiscal year. The Company's Board of Directors has standing Audit and Executive Committees.

The Board of Directors' Audit Committee consists of Directors Keziah, McClure and Stadler, who serves as Chairperson. The members of the Audit Committee are "independent," as "independent" is defined in Rule 4200(a)(15) of the National Association of Securities Dealers listing standards. The function of the Audit Committee is: to review and discuss the audited financial statements with management, internal audit and the independent auditors; to receive disclosures required by SAS No. 61 and the independence letter from the independent auditors; to review and recommend the independent auditors to be engaged by the Company; to review the internal audit function and internal accounting controls; and to review and approve the internal audit plan. The Company's Board of Directors has adopted a written charter for the Audit Committee. The Audit Committee met two times during the year ended September 30, 2002.

The Board of Directors' Executive Committee consists of Directors McGill, Barnwell, Shirley and Keziah and one additional director who serves on a rotating basis for a three-month period. The Executive Committee, among other things, evaluates the compensation and benefits of the directors, officers and employees, recommends changes, and monitors and evaluates employee performance. The Executive Committee reports its evaluations and findings to the full Board of Directors and all compensation decisions are ratified by the full Board of Directors. Directors of the Company who also are officers of the Company abstain from discussion and voting on matters affecting their compensation. The Executive Committee also monitors the performance of the Company's investment portfolio and reviews loans. The Executive Committee is empowered to exercise all of the authority of the Board when the Board is not in session. The Executive Committee met 12 times during the fiscal year ended September 30, 2002.

The Company's full Board of Directors acts as a nominating committee. The Board of Directors met once during the year ended September 30, 2002 for the purpose of considering potential nominees to the Board of Directors. In its deliberations, the Board, functioning as a nominating committee, considers the candidate's knowledge of the banking business and involvement in community, business and civic affairs, and also considers whether the candidate would provide for adequate representation of its market area. The Company's Articles of Incorporation set forth procedures that must be followed by stockholders seeking to make nominations for director. In order for a stockholder of the Company to make any nominations, he or she must give written notice thereof to the Secretary of the Company not less than thirty days nor more than sixty days prior to the date of any such meeting; provided, however, that if less than forty days' notice of the meeting is given to stockholders, such written notice shall be delivered or mailed, as prescribed, to the Secretary of the Company not later than the close of business on the tenth day following the day on which notice of the meeting was mailed to stockholders. Each such notice given by a stockholder with respect to nominations for the election of directors must set forth (i) the name, age, business address and, if known, residence address of each nominee proposed in such notice; (ii) the principal occupation or employment of each such nominee; and (iii) the number of shares of stock of the Company which are beneficially owned by each such nominee. In addition, the stockholder making such nomination must promptly provide any other information reasonably requested by the Company.

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### Overview and Philosophy

The Company's executive compensation policies are established by the Executive Committee of the Board of Directors (the "Committee"). The Committee is responsible for developing the Company's executive compensation policies. The Company's President, James C. McGill, under the direction of the Committee, implements the Company's executive compensation policies. Mr. McGill abstains from voting on and discussions of matters affecting his compensation. The Committee's objectives in designing and administering the specific elements of the Company's executive compensation program are as follows:

- o To link executive compensation rewards to increases in shareholder value, as measured by favorable long-term operating results and continued strengthening of the Company's financial condition.
- o To provide incentives for executive officers to work towards achieving successful annual results as a step in achieving the Company's long-term operating results and strategic objectives.
- o To correlate, as closely as possible, executive officers' receipt of compensation with the attainment of specified performance objectives.
- o To maintain a competitive mix of total executive compensation, with particular emphasis on awards related to increases in long-term shareholder value.
- o To attract and retain top performing executive officers for the long-term success of the Company.

In furtherance of these objectives, the Committee has determined that there should be three specific components of executive compensation: base salary, a cash bonus and stock benefit plans.

**Base Salary.** The Committee makes recommendations to the Board concerning executive compensation on the basis of surveys of salaries paid to executive officers of other bank holding companies, non-diversified banks and other financial institutions similar in size, market capitalization and other characteristics. The Committee's objective is to provide for base salaries that are competitive with the average salary paid by the Company's peers.

**Bonus.** The Company pays a discretionary bonus on an annual basis based on satisfaction of a combination of individual and Company performance objectives. Whether bonuses are paid each year and the amount of such bonuses are determined by the Committee, subject to ratification by the Board of Directors, at year end based on the Company's ability to achieve performance goals established by the Board in each year's Business Plan. Discretionary bonuses for achieving specific performance goals during the year are paid during the next fiscal year.

**Stock Benefit Plans.** In addition, the Committee believes that stock related award plans are an important element of compensation since they provide executives with incentives linked to the performance of the Common Stock. Accordingly, the Board of Directors adopted a stock option plan and a management recognition plan. Stockholders approved these plans at a special meeting held on June 6, 2000.

Under the stock option plan, the Company reserved for issuance a number of shares equal to 10% of the originally issued Common Stock. The Committee believes that stock options are an important element of compensation because they provide executives with incentives linked to the performance of the Common Stock. The Company awards stock options as a means of providing employees the opportunity to acquire a proprietary interest in the Company and to link their interests with those of the Company's stockholders. Options are granted

with an exercise price equal to the market value of the Common Stock on the date of grant, and thus acquire value only if the Company's stock price increases. There are currently no options available for grant under the option plan.

Under the management recognition plan, officers and directors were granted awards of restricted Common Stock, subject to vesting and forfeiture as determined by the Committee. Under this plan, the Company reserved for issuance a number of shares equal to 4% of the originally issued Common Stock. The purpose of a management recognition plan is to reward and retain personnel of experience and ability in key positions of responsibility by providing such employees with a proprietary interest in the Company as compensation for their past contributions to the Company and the Bank and as an incentive to make further contributions in the future. There currently are no shares available for award under this plan.

#### Compensation of the President

Mr. McGill's base salary is established in accordance with the terms of the employment agreement entered into between the Bank and Mr. McGill. See "-- Executive Compensation -- Employment Agreements." The Committee determines the President's compensation on the basis of several factors. In determining Mr. McGill's base salary, the Committee reviewed compensation paid to chief executive officers of similarly situated banks and non-diversified banks and other financial institutions of similar asset size. The Committee believes that Mr. McGill's base salary is generally competitive with the average salary paid to executives of similar rank and expertise at banking institutions which the Committee considered to be comparable and taking into account the Bank's superior performance and complex operations relative to comparable institutions.

Mr. McGill received bonus compensation for fiscal year 2002 pursuant to the same basic factors as described above under "-- Bonus." In establishing Mr. McGill's bonus, the Committee considered the Company's overall performance, record of increase in shareholder value and success in meeting strategic objectives and his personal leadership and accomplishments. These factors were considered in conjunction with the Company's financial results for fiscal 2002 in relation to the established Business Plan and achieving certain annual performance goals, including but not limited to return on assets and return on equity and satisfactory results of regulatory examinations and independent audits.

The Committee believes that the Company's executive compensation program serves the Company and its shareholders by providing a direct link between the interests of executive officers and those of shareholders generally and by helping to attract and retain qualified executive officers who are dedicated to the long-term success of the Company.

#### Members of the Executive Committee

James A. Barnwell  
Richard C. Keziah  
James C. McGill  
Richard H. Shirley

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The graph and table which follow show the cumulative total return on the Common Stock for the period from April 26, 1999 (the day trading began in the Common Stock following completion of the Company's initial public offering) through the fiscal year ended September 30, 2002 with (1) the total cumulative return of all companies whose equity securities are traded on the Nasdaq Stock Market and (2) the total cumulative return of banks and bank holding companies traded on the Nasdaq Stock market. The comparison assumes \$100 was invested on April 26, 1999 in the Company's Common Stock and in each of the foregoing indices and assumes reinvestment of dividends. The stockholder returns shown on the performance graph are not necessarily indicative of the future performance of the Common Stock or of any particular index.

### CUMULATIVE TOTAL STOCKHOLDER RETURN COMPARED WITH PERFORMANCE OF SELECTED INDEXES APRIL 26, 1999 THROUGH SEPTEMBER 30, 2002

[Line graph appears here depicting the cumulative total shareholder return of \$100 invested in the Common Stock as compared to \$100 invested in all companies whose equity securities are traded on the Nasdaq Stock Market and \$100 invested in banks and bank holding companies traded on the Nasdaq Stock Market. Line graph plots the cumulative total return from April 26, 1999 to September 30, 2002. Plot points are provided below.]

|   | 04/26/99<br>----- | 09/30/99<br>----- | 09/30/00<br>----- | 9/30/01<br>----- | 9/30/02<br>----- |
|---|-------------------|-------------------|-------------------|------------------|------------------|
| COMPANY                                       | \$100.0           | \$103.1           | \$119.4           | \$142.2          | \$164.8          |
| NASDAQ  | 100.0             | 104.0             | 138.1             | 56.4             | 44.5             |
| NASDAQ BANKS<br>AND BANK HOLDING<br>COMPANIES | 100.0             | 92.3              | 98.9              | 112.2            | 118.5            |

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### EXECUTIVE COMPENSATION

Summary Compensation Table. The following table sets forth the cash and noncash compensation for the fiscal years ended September 30, 2002, 2001 and 2000 awarded to or earned by the President and the four other executive officers who earned salary and bonus in fiscal 2002, 2001 and 2000 exceeding \$100,000 for services rendered in all capacities to the Company and the Bank .

| NAME                        | FISCAL<br>YEAR | ANNUAL COMPENSATION |           |                                  | LONG-TERM COMPEN                     |
|-----------------------------|----------------|---------------------|-----------|----------------------------------|--------------------------------------|
|                             |                | SALARY              | BONUS     | OTHER ANNUAL<br>COMPENSATION (1) | AWARDS                               |
|                             |                |                     |           |                                  | RESTRICTED<br>STOCK<br>AWARD (S) (2) |
| James C. McGill             | 2002           | \$175,000           | \$404,500 | \$ --                            | --                                   |
| President and Chief         | 2001           | 175,000             | 342,000   | --                               | --                                   |
| Executive Officer of        | 2000           | 175,000             | 433,000   | --                               | 582,750                              |
| the Company and the<br>Bank |                |                     |           |                                  |                                      |

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|                         |      |         |             |    |         |
|-------------------------|------|---------|-------------|----|---------|
| A. Christine Baker      | 2002 | 100,000 | 202,250     | -- | --      |
| Treasurer and           | 2001 | 100,000 | 171,000     | -- | --      |
| Secretary of the        | 2000 | 100,000 | 216,500     | -- | 333,000 |
| Company and the         |      |         |             |    |         |
| Bank and Executive      |      |         |             |    |         |
| Vice President-         |      |         |             |    |         |
| Chief Financial Officer |      |         |             |    |         |
| of the Bank             |      |         |             |    |         |
| Fairfax C. Reynolds     | 2002 | 100,000 | 202,250     | -- | --      |
| Vice President and      | 2001 | 100,000 | 171,000     | -- | --      |
| Assistant Secretary of  | 2000 | 100,000 | 216,500     | -- | 333,000 |
| the Company and         |      |         |             |    |         |
| Executive Vice          |      |         |             |    |         |
| President of the        |      |         |             |    |         |
| Bank                    |      |         |             |    |         |
| Frank Gavigan           | 2002 | 80,000  | 35,000      | -- | --      |
| Senior Vice             | 2001 | 80,000  | 30,000      | -- | --      |
| President-Senior        | 2000 | 80,000  | 35,000      | -- | 83,250  |
| Credit Officer of       |      |         |             |    |         |
| the Bank                |      |         |             |    |         |
| John D. Hansell         | 2002 | 50,000  | 70,640 (4)  | -- | --      |
| Manager-First           | 2001 | 50,000  | 111,803 (4) | -- | --      |
| Capital Services        | 2000 | 50,000  | 100,503 (4) | -- | 55,500  |
| Company, LLC            |      |         |             |    |         |

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Fiscal Year-End Option Values. The following table sets forth information concerning the value as of September 30, 2002 of options held by the executive officers named in the Summary Compensation Table set forth above.

| NAME                | NUMBER OF SECURITIES<br>UNDERLYING UNEXERCISED<br>OPTIONS AT FISCAL YEAR-END |               | VALUE OF UNEXER<br>IN-THE-MONEY OP<br>AT FISCAL YEAR- |      |
|---------------------|--|---------------|---|------|
|                     | EXERCISABLE  | UNEXERCISABLE | EXERCISABLE   | UNEX |
| James C. McGill     | 79,078   | --            | \$638,159   |      |
| A. Christine Baker  | 45,000   | --            | 363,150   |      |
| Fairfax C. Reynolds | 45,000   | --            | 363,150   |      |
| Frank Gavigan       | 11,250   | --            | 90,788  |      |
| John D. Hansell     | 7,500  | --            | 60,525  |      |

No options were exercised during fiscal year 2002, and no options held by any executive officer of the Company repriced during the past ten full fiscal years.

Employment Agreements and Guaranty Agreements. The Bank has entered into employment agreements with James C. McGill, A. Christine Baker and Fairfax C. Reynolds (each individual is referred to herein as an "Employee" and the three individuals are referred to collectively as the "Employees"). The Board believes

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that the employment agreements assure fair treatment of the Employees in their careers with the Company by assuring them of some financial security.

The employment agreements became effective on April 23, 1999 and provide for a term of three years, with an annual base salary equal to the Employee's existing base salary rate in effect on the date of conversion. On each anniversary date of the commencement of the employment agreements, the term of the Employee's employment will be extended for an additional one-year period beyond the then effective expiration date upon a determination by the Bank's Board of Directors that the performance of the Employee has met the required performance standards and that such employment agreements should be extended. The employment agreements provide the Employee with a salary review by the Board of Directors not less often than annually, as well as with inclusion in any discretionary bonus plans, retirement and medical plans, vacation and sick leave and any fringe benefits that become available to senior management, including for example, any stock option or incentive compensation plans and any other benefits commensurate with their responsibilities. If the Board decides not to renew an employment agreement for any reason, and if the Employee remains an employee of the Bank until the Agreement expires, the Bank must pay the Employee an amount equal to two times total compensation if the Employee is later terminated.

The employment agreements terminate upon the Employee's death, may terminate upon the Employee's disability, are terminable for just cause, and no severance benefits are available. If the Bank terminates the Employee without just cause, the Employee is entitled to receive three times total compensation as well as continued medical and dental insurance under any group plan chosen by the Employee from the plans the Bank maintains, unless that coverage is not permitted by the terms of such plan, in which case the Bank will remit to the Employee, not less frequently than monthly, the actual cost to the Employee of equivalent insurance. These provisions are in addition to, and not in lieu of, any other rights that the Employee has under the employment agreement and will continue until the Employee first becomes eligible for participation in Medicare. If the employment agreements are terminated due to the Employee's "disability" as defined in the employment agreements, the Employee will be entitled to a continuation of his or her salary and benefits through the date of termination, including any period prior to the establishment of the Employee's disability. In the event of the Employee's death during the term of the employment agreements, his or her estate will be entitled to receive three times total compensation determined as of the date of death. Each Employee is able to voluntarily terminate his or her employment agreement by providing 90 days' written notice to the Board of Directors, in which case the Employee is entitled to receive only his or her compensation, vested rights, and benefits up to the date of termination.

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The Bank will pay a severance benefit equal to the difference between the product of 2.99 and the Employee's "base amount" as defined in the Internal Revenue Code Section 280G(b)(3) and the sum of any other "parachute payments" as defined under Code Section 280G(b)(2) that the Employee receives on account of the change in control, and (ii) provide long-term disability and medical insurance for 18 months if any of the following occur:

- o the Employee's involuntary termination of employment other than for "just cause" during the period beginning six months before a change in control and ending on the later of the first anniversary of the change in control or the expiration date of the employment agreements (the "Protected Period");
- o the Employee's voluntary termination within 90 days of the occurrence

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of certain specified events occurring during the Protected Period which have not been consented to by the Employee; or

- o the Employee's voluntary termination of employment for any reason within the 30-day period beginning on the date of the change in control.

The Employee will be paid either in one lump sum within ten days of the later of the date of the change in control and the Employee's last day of employment or if prior to the date which is 90 days before the date on which a change in control occurs, the Employee filed a duly executed irrevocable written election, payment of such amount shall be made according to the elected schedule. "Change in control" generally refers to the acquisition, by any person or entity, of the ownership or power to vote more than 25% of the Company's or the Bank's voting stock, the control of the election of a majority of the Company's or the Bank's directors, or the exercise of a controlling influence over the Company's or the Bank's management or policies. In addition, under the employment agreements, a change in control occurs when, during any consecutive two-year period, directors of the Company or the Bank at the beginning of such period cease to constitute two-thirds of the Board of Directors of the Company or the Bank, unless the election of replacement directors was approved by a two-thirds vote of the initial directors then in office. The employment agreements provide that within 10 business days of a change in control, the Company must deposit in a trust an amount equal to the Internal Revenue Code Section 280G maximum. The payments that would be made to Mr. McGill, Ms. Baker and Mr. Reynolds assuming termination of employment under the foregoing circumstances at September 30, 2002 would have been approximately \$1.5 million, \$769,000 and \$769,000, respectively. These provisions may have an anti-takeover effect by making it more expensive for a potential acquiror to obtain control of the Company. In the event that the Employee prevails over the Bank, or obtains a written settlement, in a legal dispute as to the employment agreement, he or she will be reimbursed for legal and other expenses.

In addition to the employment agreements, the Company has entered into guaranty agreements with each of the Employees. The guaranty agreements provide that the Company will perform all covenants and honor all obligations required to be performed or to which the Bank is subject pursuant to the employment agreements in the event that such covenants are not performed or obligations are not honored by the Bank, and that to the extent permitted by law, the Company will be jointly and severally liable with the Bank for the payment of all amounts due under the employment agreements. The guarantee agreements provide the Employee with a salary review by the Board of Directors not less often than annually, as well as with inclusion in any discretionary bonus plans, retirement and medical plans, customary fringe benefits, vacation and sick leave.

### DIRECTOR COMPENSATION

Fees. Each non-employee member of the Bank's Board of Directors receives a monthly retainer fee based on the following schedule:

- o the Chairman of the Board - \$2,000;
- o members of the Executive Committee - \$1,750; and
- o other directors - \$1,500.

In addition, non-employee members of the Company's Board of Directors receive a monthly retainer fee of \$250. This amount will be increased to \$500 effective January 1, 2003. Officers who are directors are not compensated for their service as directors.

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Deferred Compensation Plan. The Bank adopted the DCP for the Bank's directors and select executive officers. Under the DCP, before each fiscal year begins, each non-employee director may elect to defer receipt of all or part of his future fees and any other participant may elect to defer receipt of up to 25% of his or her salary or 100% of his or her bonus compensation for the year. Deferred amounts are credited at the end of the calendar year to bookkeeping accounts in the name of each participant. No amounts were credited to the accounts of nonemployee directors during the year ended September 30, 2002. Each participant is fully vested in his or her account balance under the DCP.

Until distributed in accordance with the terms of the DCP, each participant's account will be credited with a rate of return equal to the Bank's highest rate of interest paid on the Bank's one-year certificates of deposit or the total return on the Company's Common Stock, as elected by each participant. Account balances will normally be distributed in five substantially equal annual installments beginning during the first quarter of the calendar year following the calendar year in which the participant ceases to be a director or employee, with any subsequent distributions being made by the last day of the first quarter of each subsequent calendar year until the participant has received the entire amount of his or her account. Participants may, however, elect to receive their distributions in a lump sum or in installments paid over a period of up to 10 years. In the event of a participant's death, the balance of his plan account will be paid in a lump sum (unless the participant elects to continue the previously designated distribution method) to his designated beneficiary, or if none, his estate.

The Bank has established a trust in order to hold assets with which to pay plan benefits to participants. Trust assets are subject to claims of general creditors. In the event a participant prevails over the Bank in a legal dispute as to the terms or interpretation of the DCP, he or she would be reimbursed for his legal and other expenses.

### TRANSACTIONS WITH MANAGEMENT

The Bank offers loans to its directors and executive officers. These loans were made in the ordinary course of business on substantially the same terms, including interest rates and collateral, as those prevailing at the time for comparable transactions with other persons and did not involve more than the normal risk of collectibility or present other unfavorable features. Under current law, the Bank's loans to directors and executive officers are required to be made on substantially the same terms, including interest rates, as those prevailing for comparable transactions with other persons and must not involve more than the normal risk of repayment or present other unfavorable features. Furthermore, all loans to such persons must be approved in advance by a disinterested majority of the Company's Board of Directors. At September 30, 2002, loans to directors and executive officers and their affiliates totaled \$16.0 million, or 26.0% of the Company's stockholders' equity, at that date.

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### RELATIONSHIP WITH INDEPENDENT AUDITOR

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KPMG LLP was the Company's independent auditor for the 2002 fiscal year. KPMG LLP has been retained by the Board of Directors to be the Company's auditor for the 2003 fiscal year. A representative of KPMG LLP is expected to be present at the Annual Meeting and will have the opportunity to make a statement if he or she so desires. The representative will also be available to answer appropriate questions.



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## REPORT OF THE AUDIT COMMITTEE

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The Audit Committee of the Board of Directors (the "Audit Committee") has:

1. Reviewed and discussed the audited financial statements for the fiscal year ended September 30, 2002 with the management of the Company.
2. Discussed with the Company's independent auditors the matters required to be discussed by Statement of Accounting Standards No. 61, as the same was in effect on the date of the Company's financial statements; and
3. Received the written disclosures and the letter from the Company's independent auditors required by Independence Standards Board Standard No. 1 (Independence Discussions with Audit Committees), as the same was in effect on the date of the Company's financial statements.

Based on the foregoing materials and discussions, the Audit Committee recommended to the Board of Directors that the audited financial statements for the fiscal year ended September 30, 2002 be included in the Company's Annual Report on Form 10-K for the year ended September 30, 2002.

The Audit Committee has reviewed the non-audit services currently provided by the Company's independent auditor and has considered whether the provision of such services is compatible with maintaining the independence of the Company's independent auditors.

Members of the Audit Committee

Virgil L. Stadler, Chairman  
Richard C. Keziah  
James G. McClure

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## AUDIT AND OTHER FEES PAID TO INDEPENDENT AUDITOR

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### AUDIT FEES

During the fiscal year ended September 30, 2002, the aggregate fees for professional services rendered for the audit of the Company's annual financial statements and the reviews of the financial statements included in the Company's Quarterly Reports on Form 10-Q filed for the fiscal year ended September 30, 2002 were \$86,300.

### FINANCIAL INFORMATION SYSTEMS DESIGN AND IMPLEMENTATION FEES

The Company did not engage KPMG LLP to provide advice to the Company regarding financial information systems design and implementation during the fiscal year ended September 30, 2002.

### ALL OTHER FEES

For the fiscal year ended September 30, 2002, the aggregate fees for professional services rendered by KPMG LLP for all other services (other than audit services and financial information systems design and implementation services) were \$21,550, consisting of nonaudit tax compliance services (\$19,350) and audit related agreed upon procedures services (\$2,200).

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SECTION 16(a) BENEFICIAL OWNERSHIP REPORTING COMPLIANCE  
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Pursuant to regulations promulgated under the Exchange Act, the Company's officers and directors and all persons who own more than ten percent of the Common Stock ("Reporting Persons") are required to file reports detailing their ownership and changes of ownership in the Common Stock and to furnish the Company with copies of all such ownership reports that are filed. Based solely on the Company's review of the copies of such ownership reports which it has received in the past fiscal year or with respect to the past fiscal year, or written representations that no annual report of changes in beneficial ownership were required, the Company believes that during fiscal year 2002 all Reporting Persons have complied with these reporting requirements, except that Director Keziah failed to file timely one Form 4 reporting a single transaction. The transaction was reported on a Form 4 filed on September 10, 2002.

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OTHER MATTERS  
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The Board of Directors is not aware of any business to come before the Annual Meeting other than those matters described above in this proxy statement and matters incident to the conduct of the Annual Meeting. However, if any other matters should properly come before the Annual Meeting, it is intended that proxies in the accompanying form will be voted in respect thereof in accordance with the determination of a majority of the Board of Directors.

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MISCELLANEOUS  
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The cost of soliciting proxies will be borne by the Company. The Company will reimburse brokerage firms and other custodians, nominees and fiduciaries for reasonable expenses incurred by them in sending proxy materials to the beneficial owners of Common Stock. In addition to solicitations by mail, directors, officers and regular employees of the Company may solicit proxies personally or by telegraph or telephone without additional compensation.

The Company's 2002 Annual Report to Stockholders, including financial statements, is being mailed to all stockholders of record as of the close of business on the Record Date. Any stockholder who has not received a copy of such Annual Report may obtain a copy by writing to the Secretary of the Company. The Annual Report is not to be treated as a part of the proxy solicitation material or as having been incorporated herein by reference.

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STOCKHOLDER PROPOSALS  
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For consideration at the Annual Meeting, a stockholder proposal must be delivered or mailed to the Company's Secretary no later than January 6, 2003. In order to be eligible for inclusion in the proxy materials of the Company for the

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Annual Meeting of Stockholders for the year ending September 30, 2003, any stockholder proposal to take action at such meeting must be received at the Company's executive offices at 445 S. Main Street, Burlington, North Carolina 27215 by no later than August 29, 2003. Any such proposals shall be subject to the requirements of the proxy rules adopted under the Securities Exchange Act of 1934, as amended.

BY ORDER OF THE BOARD OF DIRECTORS

/s/ A. Christine Baker

A. Christine Baker  
Secretary

December 27, 2002  
Burlington, North Carolina

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ANNUAL REPORT ON FORM 10-K  
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A COPY OF THE COMPANY'S ANNUAL REPORT ON FORM 10-K FOR THE FISCAL YEAR ENDED SEPTEMBER 30, 2002 AS FILED WITH THE SECURITIES AND EXCHANGE COMMISSION WILL BE FURNISHED WITHOUT CHARGE TO EACH STOCKHOLDER AS OF THE RECORD DATE UPON WRITTEN REQUEST TO THE CORPORATE SECRETARY, 1st STATE BANCORP, INC., 445 S. MAIN STREET, BURLINGTON, NORTH CAROLINA 27215.

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REVOCABLE PROXY

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1st STATE BANCORP, INC.  
BURLINGTON, NORTH CAROLINA  
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ANNUAL MEETING OF STOCKHOLDERS  
JANUARY 28, 2003

The undersigned hereby appoints Richard C. Keziah, Ernest A. Koury, Jr. and Richard H. Shirley with full powers of substitution, to act as attorneys and proxies for the undersigned, to vote all shares of the common stock of 1st State Bancorp, Inc. which the undersigned is entitled to vote at the Annual Meeting of Stockholders, to be held at the main office of 1st State Bank (the "Bank") located at 445 S. Main Street, Burlington, North Carolina, on Tuesday, January 28, 2003, at 5:30 p.m. (the "Annual Meeting"), and at any and all adjournments thereof, as follows:

|   | FOR | VOTE<br>WITHHELD |
|---|-----|------------------|
|   | --- | -----            |
| 1. The election as directors of all nominees listed below (except as marked to the contrary below). | [ ] | [ ]              |

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For a term expiring at the 2006 Annual Meeting:  
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Bernie C. Bean  
James C. McGill  
Virgil L. Stadler

INSTRUCTION: TO WITHHOLD YOUR VOTE  
FOR ANY OF THE INDIVIDUALS NOMINATED, INSERT  
THAT NOMINEE'S NAME ON THE LINE PROVIDED BELOW.

- \_\_\_\_\_
2. The transaction of such other business as may properly come before the Annual Meeting or any adjournment thereof.

THE BOARD OF DIRECTORS RECOMMENDS A VOTE "FOR" THE NOMINEES LISTED ABOVE.

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THIS PROXY WILL BE VOTED AS DIRECTED, BUT IF NO INSTRUCTIONS ARE SPECIFIED, THIS PROXY WILL BE VOTED FOR THE ELECTION OF DIRECTORS. IF ANY OTHER BUSINESS IS PRESENTED AT THE ANNUAL MEETING, INCLUDING MATTERS RELATING TO THE CONDUCT OF THE ANNUAL MEETING, THIS PROXY WILL BE VOTED BY THOSE NAMED IN THIS PROXY IN ACCORDANCE WITH THE DETERMINATION OF A MAJORITY OF THE BOARD OF DIRECTORS. AT THE PRESENT TIME, THE BOARD OF DIRECTORS KNOWS OF NO OTHER BUSINESS TO BE PRESENTED AT THE ANNUAL MEETING.  
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THIS PROXY IS SOLICITED BY THE BOARD OF DIRECTORS

Should the undersigned be present and elect to vote at the Annual Meeting or at any adjournment thereof, then the power of said attorneys and prior proxies shall be deemed terminated and of no further force and effect. The undersigned may also revoke his proxy by filing a subsequent proxy or notifying the Secretary of his decision to terminate his proxy.

The undersigned acknowledges receipt from the Company prior to the execution of this proxy of a Notice of Annual Meeting and a Proxy Statement dated December 27, 2002.

Dated: \_\_\_\_\_, 200\_

\_\_\_\_\_  
PRINT NAME OF STOCKHOLDER

\_\_\_\_\_  
PRINT NAME OF STOCKHOLDER

\_\_\_\_\_  
SIGNATURE OF STOCKHOLDER

\_\_\_\_\_  
SIGNATURE OF STOCKHOLDER

Please sign exactly as your name appears on the enclosed card. When signing as attorney, executor, administrator, trustee or guardian, please give your full title. Corporation proxies should be signed in corporate name by an authorized officer. If shares are held jointly, each holder should sign.

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PLEASE COMPLETE, DATE, SIGN AND MAIL THIS PROXY PROMPTLY IN THE ENCLOSED  
POSTAGE-PAID ENVELOPE.