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UNITED STATES DISTRICT COURT
MIDDLE DISTRICT OF PENNSYLVANIA

SOUTHEASTERN PENNSYLVANIA TRANSPORTATION AUTHORITY, on behalf of itself and all others similarly situated,

Plaintiff,

v.

ORRSTOWN FINANCIAL SERVICES, INC., ORRSTOWN BANK, ANTHONY F. CEDDIA, JEFFREY W. COY, MARK K. KELLER, ANDREA PUGH, THOMAS R. QUINN, JR., GREGORY A. ROSENBERRY, KENNETH R. SHOEMAKER, GLENN W. SNOKE, JOHN S. WARD, BRADLEY S. EVERLY, JOEL R. ZULLINGER, JEFFREY W. EMBLY, SMITH ELLIOTT KEARNS & COMPANY, LLC, SANDLER O'NEILL & PARTNERS L.P., and JANNEY MONTGOMERY SCOTT LLC,

Defendants.

Civil Action No. 1:12-civ-00993

THIRD AMENDED COMPLAINT

ECF

THIRD AMENDED CLASS ACTION COMPLAINT FOR VIOLATIONS OF §§ 11, 12(a) and 15 OF THE SECURITIES ACT OF 1933 AND §§ 10(b) and 20(a) OF THE SECURITIES EXCHANGE ACT OF 1934

DEMAND FOR JURY TRIAL

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THIRD AMENDED COMPLAINT

From at least 2008 through April 2012, the top management of Orrstown Bank (or "Bank"), directors, and external auditors Smith, Elliott, Kerns & Company ("SEK") misportrayed the true financial condition of the Bank and the effectiveness of the Bank's internal controls over financial reporting, particularly as to the Bank's large commercial real estate loan portfolio. During and after the financial crisis that began in 2007-2008 Orrstown Bank's commercial real estate borrowers struggled to make payments and regularly sought loan modifications while the value of the collateral underlying their loans plummeted. Due to the Bank's deficient internal controls, however, Orrstown Bank failed to recognize these loans as impaired, failed to report individual modifications as a Troubled Debt Restructuring ("TDR"), and failed to properly calculate its Allowance for Loan and Lease Losses ("ALLL") consistent with Generally Accepted Accounting Principles ("GAAP") and the Bank's own Loan Policy, among other failures. SEK, the Bank's auditor, who also served as accountant for many of the Bank's largest commercial real estate borrowers, discovered that the Bank failed to properly record impaired loans, failed to appropriately risk rate loans, and failed to properly calculate ALLL (among other things), but nevertheless improperly certified the Bank's financial statements and internal controls. In fact, SEK regularly provided bogus borrower financial information that the bank used to

justify modifications to loans, and in some instances SEK urged the Bank to modify loans to these borrowers which should have been but were not recorded as TDRs.

In March 2010, the Bank's parent Orrstown Financial Services, Inc. ("Orrstown" or "Company") raised nearly $40 million in investor capital (the "Offering") by touting its "enviable record regarding its control of loan losses," "loan loss history [that] has been much better than peer standards," and "ample" allowance for loan losses "given the current composition of the loan portfolio." Most critically, Orrstown and SEK assured investors that Orrstown maintained effective "internal control over financial reporting." In reality, Orrstown and the Bank did not have "enviable … control of loan losses, nor "ample" ALLL, but rather simply failed to recognize impaired loans, failed to calculate ALLL in compliance with GAAP, and failed to adequately risk rate loans. In short, Orrstown did not maintain effective internal control over financial reporting, and as a result its financial statements were materially false and misleading. In fact, just prior to the Offering the Bank unjustifiably removed several large loans from its ALLL reserves with the result that its ALLL was materially understated and failed to reflect the true declining trajectory of the Bank's loan portfolio. Moreover, the Company's Offering documents misrepresented that the Bank's loans to its 50 largest borrowers were "performing according to their original

terms," but this was simply not true. In reality many of these loans had matured – some more than once – and the Bank had modified and/or extended them to prevent defaults.

Federal and state banking regulators, who had prior to the $40 million Offering notified the Bank's management of the marked decline in the quality of its loan portfolio, soon after the Offering initiated a series of special, undisclosed "targeted" examinations of the Bank and the Company resulting in increasingly critical assessments of every aspect of the Bank's operations, identifying material deficiencies in internal controls for financial reporting and questioning the competency of the Bank's management. In the months following the Offering, the Bank Defendants and SEK knew that loan losses and necessary reserves would skyrocket as the bank examiners became impatient with ineffective or non-existent operational reforms.

After the Offering, the Bank Defendants and SEK forestalled the day of reckoning by:

(a) in the case of the Bank Defendants, continuing a systemic practice, begun in 2007 and 2008, of modifying and restructuring loans of the Bank's largest borrowers, but failing to re-classify the loans, as required by GAAP and OCC regulations, as impaired and TDRs, and failing properly to calculate additions to ALLL that would have reflected the true condition of the loan

portfolio and the likely losses that the Bank would likely (and ultimately did) suffer as a result of borrower defaults; and

(b) in the case of SEK, performing fundamentally flawed or fraudulent audits of Orrstown's 2009 and 2010 financial statements and deficient reviews of the 2011 quarterly results by continuing a practice going back to 2008 and 2009 of not testing or including in its audit sampling the loans to certain of the Bank's largest borrowers who were also SEK's accounting clients, the consequence of which was to avoid scrutinizing bogus financial compilations prepared by SEK for its clients to provide to the Bank. SEK was also complicit in supporting and orchestrating a strategy in August 2011 to have Orrstown not issue an immediate disclosure to investors that there was a material weakness in internal controls for financial reporting, concealment of which withheld critical information from the public until the end of the Class Period.

The house of cards collapsed when the bank regulators took the highly unusual step in March 2012 of compelling the Bank Defendants to enter into stringent supervisory agreements, one of which remained in place until 2015, and the other, with the state banking commission, is still in effect as a Memorandum of Understanding ("MOU"). In 2016, four senior Bank officers were cited by the Securities and Exchange Commission ("SEC") for securities law violations in connection with systemic false and misleading disclosures about the holding

company's banking operations, the condition of the Bank's loan portfolio, and its financial condition. In the meantime, the financial crisis ended, stock markets rebounded (NASDAQ, on which Orrstown trades, more than doubled), the real estate market in the Bank's market areas again flourished, but the investors in the Offering never recovered their investment and purchasers of the holding company's common stock suffered losses that will only be recovered through this Action.

Lead Plaintiff Southeastern Pennsylvania Transportation Authority ("SEPTA" or "Plaintiff"), individually and on behalf of all other persons similarly situated, makes the allegations contained in this federal securities class action complaint upon information and belief (except as to those allegations specifically pertaining to Plaintiff and Plaintiff's counsel, which are made with personal knowledge), and based upon the discovery conducted in this action to date. The investigation conducted by Plaintiff's counsel included: a review of the SEC filings by Orrstown as well as filings and reports relating to Enforcement Actions taken against the Company and Orrstown Bank by federal and state banking regulators, securities analysts' reports and advisories about the Company, press releases and other public statements issued by the Company, and media reports about the Company; a record review of the recorder of deeds in Maryland and Pennsylvania; a review of state and federal civil and bankruptcy court filings involving the

Company and the Bank; interviews of individuals who possess relevant information regarding the Company, the Bank and Defendants (defined herein) including, but not limited to, Confidential Witnesses ("CWs"); and discovery conducted in this action to date, including review of documents produced by Orrstown and third parties.[1] Based upon the results of Plaintiff's investigation to date, it is anticipated that additional evidentiary support for the allegations set forth below will be further developed through discovery.

I. SUMMARY OF FACTS

1. From at least 2008 through 2012, Orrstown failed to maintain an adequate system of internal controls over financial reporting, rendering its certifications filed with the SEC pursuant to §302 of the Sarbanes-Oxley Act of 2002 ("Sox Certifications") and quarterly and yearly financial statements false and misleading. Most critically, the Bank's internal controls were materially inadequate to: (1) accurately risk rate loans; (2) identify impaired loans; (3) identify TDRs; and (4) accurately and properly calculate loan loss reserves, all of which rendered its financial reporting materially false and misleading. Among

[1] Orrstown's productions to date have been disorganized and in many respects incomplete, particularly with respect to Board and Committee meeting materials. Orrstown's record keeping was also seriously lacking. Just as an example, Orrstown employees discovered in 2011 that roughly six months of packets from 2008 Executive Committee Meetings were missing and minutes from 2001 had been stored in a janitor's closet.

other things, the Bank routinely failed to obtain updated borrower financial information, ignored negative information, and failed to follow its own Loan Policy with respect to obtaining updated appraisals, to name just a few of its internal control failures. Just two years after raising $40 million from investors in a March 2010 public offering of Orrstown stock, Defendants were forced to publicly reveal Orrstown's systemic and long-standing internal control failures, and Orrstown's stock price plummeted.

2. In its 2011 10-K, Orrstown admitted:

> "As of December 31, 2011, the Company ***did not maintain effective internal control over the process to prepare and report information related to loan ratings and its impact on the allowance for loan losses.*** This control deficiency . . . ***constitutes a material weakness. . . . we have concluded that the Company did not maintain effective internal control over financial reporting as of December 31, 2011 . . . .*** (emphasis added)

As alleged herein, these material weaknesses were not new in 2011 but, rather, existed at least as early as 2008, well before Orrstown's March 2010 public offering. Indeed, at least as early as 2008 Orrstown regularly failed to follow GAAP and its own internal policies with respect to risk rating loans and calculating its ALLL, which is one of the most critical financial metrics for a bank, by, *inter alia*, failing to obtain updated real estate appraisals as required by its Loan Policy. Orrstown's reliance on outdated information in performing risk ratings for its loan portfolio and calculating ALLL was particularly problematic given the drastic

changes that occurred in real estate markets during the financial crisis from 2008 to 2011. Indeed, rather than recognize its rapidly growing portfolio of impaired loans during the financial crisis, the Bank's common practice was to "pretend and extend." When loans matured or when interest-only periods ended and the borrowers could not make required payments due to insufficient cash flow, Orrstown Bank would extend the maturities and/or refinance the loans on terms that the borrowers would not have been able to obtain from other lenders instead of recognizing those loans as impaired, calculating required reserves or losses, and identifying the modifications as TDRs. As a result of these and related failures of internal controls the Bank failed to adequately perform risk ratings, failed to timely and accurately identify impaired loans, and failed to properly calculate ALLL.

3. Moreover, as discussed herein, Orrstown's auditor SEK discovered during its audits that the Bank failed to maintain adequate internal controls or even follow critical elements of its own Loan Policy but nevertheless issued unqualified audit opinions stating that Orrstown maintained effective internal control over financial reporting. SEK knew that the Bank was relying on outdated financial information and appraisals in performing its ALLL calculations in contravention of Orrstown's Loan Policy. SEK also knew that Orrstown failed to disclose impaired loans in its SEC filings even though SEK audited the Bank's ALLL schedule that identified them as impaired. Not surprisingly, the Public Company Accounting

Oversight Board ("PCAOB") has repeatedly chastised SEK for its auditing work with respect to "the failure to perform sufficient procedures to test the allowance for loan losses," as discussed below. Moreover, SEK served as auditor for Orrstown and the Bank while simultaneously serving as the accountant for many of the Bank's largest commercial borrowers. SEK knew that these borrowers were experiencing financial difficulty, and also knew that the Bank had failed to properly classify loans to them as impaired in the midst of the financial crisis. SEK never disclosed to Orrstown's Audit Committee that it was serving as accountant to many of the Bank's largest borrowers while simultaneously representing the Orrstown and the Bank as auditor, a failure that was both unethical and inimical to SEK's duties as an auditor of a publicly held company.

4. Orrstown Bank's internal control failures were pervasive and substantial, eventually resulting in investigations and the entry of consent orders by SEC, and the Federal Reserve Bank of Philadelphia and the Pennsylvania Department of Banking (the "Regulators"). Orrstown was forced, among other things, to replace top executives, revise its policies, retain numerous consultants to take over processes formerly handled by Bank personnel, and address material weaknesses in internal controls identified by the SEC and the Regulators. These same material weaknesses in internal controls existed at least as early as 2008 and 2009, as discussed herein.

5. On September 27, 2016, more than four years after the filing of this Action, the SEC issued an Order Instituting Administrative and Cease-and-Desist Proceedings Pursuant to Section 8A of the Securities Act of 1933, Sections 4C and 21C of the Securities Exchange Act of 1934 and Rule 102(e) of the Commission's Rules of Practice, Making Findings and Imposing Remedial Sanctions and Cease-and-Desist Orders ("SEC Order") against Orrstown, Thomas R. Quinn ("Quinn"), Bradley S. Everly ("Everly") and Jeffrey W. Embly ("Embly"). The SEC Order found that Orrstown, and each of these individual Defendants violated, and caused Orrstown to violate, the Securities Act and Exchange Act. The SEC issued the following findings of fact:

> **(i)** ***Internal Control Failures Over Financial Reporting****:* Orrstown did not devise and maintain a sufficient system of internal accounting controls over which Defendants Quinn, Everly and Embly were ultimately responsible and for which Defendants Quinn and Everly were responsible for certifying as adequate in SEC filings (SEC Order, ¶¶50-56);
>
> **(ii)** ***Impaired Loans.*** Orrstown failed to implement effective internal control over risk management to disclose impaired loans which caused it to make materially misstated SEC Filings. Orrstown publicly understated to investors its impaired loans by 215% to over 360%. (*Id.*, ¶¶35-36);
>
> **(iii)** ***Loan Review Process.*** As part of its Loan Review Process, Orrstown failed to timely incorporate material adverse information about borrowers, relied on stale data, and incorrectly risk rated loans. The internal controls for risk management and underwriting that were supposed to ensure the accuracy of risk ratings set by the Loan Review Officer (who was supervised by Defendant Embly and Orrstown's Credit Administration Committee, whose meetings were

regularly attended by Defendants Quinn, Everly and Embly) were ineffective to prevent or correct the incorrect risk ratings. (*Id.,* ¶¶22-25);

(iv) ***Failure to Disclose Impaired Loans to Orrstown's Largest Borrowers.*** Orrstown failed to record and disclose impaired loans made to several of its "largest lending relationships." The impairments were discussed at meetings attended by Defendants Quinn, Everly and Embly and the loans were materially modified in 2010, but no corresponding disclosures of the impaired loans were made as required by GAAP. (*Id.,* ¶¶26-29; *see also* 13-15);

(v) ***Other Impaired Commercial Loans***. In violation of GAAP, Orrstown also failed to record and disclose other impaired commercial loans even though Orrstown had recognized impairment losses, and the calculation of such impairment losses was distributed to and reviewed by Orrstown's Credit Administration Committee. Defendants Everly and Embly were notified in 2010 of such failures but took no corrective action. (*Id.,* ¶¶30-34);

(vi) ***Failed Impairment Analyses.*** The impairment analyses conducted on certain loans did not comply with the Loan Policy because they used: stale appraisals (in excess two and five years); and inappropriate inputs for the collateral valuation models (2004 discount rates). Defendants Quinn, Everly and Embly as members of the Loan Committee were ultimately responsible for ensuring that the loans were supported by updated information and calculated in accordance with GAAP, and Embly, in particular, was ultimately responsible for regulatory compliance regarding appraisals. (*Id.*, ¶¶44-49);

(vii) ***Failure to Recognize and Properly Account for TDRs***. Orrstown failed to properly account for TDRs that were restructured in 2010, and then failed to comply with GAAP when it calculated impairment losses on certain TDRs in 2011 (Id., ¶¶ 37-43).

6. The SEC's findings are also corroborated by two Written Agreement and Consent Orders (collectively the "Enforcement Actions") Orrstown entered into, respectively, with the Federal Reserve Bank of Philadelphia and the Pennsylvania Department of Banking, which were disclosed by Orrstown in its SEC filings on March 23, 2012. *See* Written Agreement, dated 3/22/2012, and Consent Order, filed 3/23/2012, attached hereto as Exhibits A-B.

7. The Enforcement Actions were the culmination of the Regulators' on-site involvement with and examination of Orrstown since 2009. The Enforcement Actions were an indictment of Orrstown's historical, imprudent banking practices, and its management's lack of effective internal controls permeating, among other things, the Bank's underwriting processes, credit administration, management, problem loan identification and monitoring, and loan loss reserves.

8. Unfortunately for investors who purchased Orrstown stock in the Company's March 2010 Offering and in the public market thereafter, the 2012 public revelation came too late. Defendants had misled and concealed from the investors material information about the lack of effectiveness of the Bank's internal processes and controls that had existed at and prior to the time the investors purchased Orrstown stock. Such misstatements and omissions of material facts caused investors to purchase Orrstown stock at inflated prices and lose millions of dollars when the truth was eventually revealed.

9. The Regulators identified staggering failures of the Bank's internal controls and processes; far-reaching, material deficiencies that had existed throughout the Class Period. The Enforcement Actions charged Orrstown with deficient controls and procedures in all material aspects of its business, including Board Oversight; Management Structure and Competency; Lending and Credit; Allowance for Loan and Lease Losses; Dividends and Payments; and Compliance with Laws and Regulations.

10. As demonstrated by the following excerpts, the Written Agreement and the Consent Orders read like a primer on how to start and prudently run a bank, pinpointing precisely how far from that primer were the Bank's existing, systemic practices, and identifying specific actions needed to address and remedy such failures:

a. "The actions that the [Board] will take to ….maintain effective control over, and supervision of, the Bank's major operations…" Exhibit A at ¶2(a).

b. "[R]esponsibility of the [Board] to monitor ***management's adherence to approved policies and procedures, and applicable laws and regulations and to monitor exceptions to approved policies*** and procedures" Exhibit A at ¶ 2(b) (emphasis added).

c. “[D]evelop a suitable management structure that is adequately staffed by qualified and trained personnel.” Exhibit A at ¶3 (a).

d. “[I]dentif[y] the type and number of senior officers needed to manage and supervise ***properly*** the affairs of the Bank.” Exhibit A at ¶ 3(b)(i) (emphasis added).

e. “[Implement] procedures for the ***timely and accurate identification of problem loans***” Exhibit A at ¶ 5(b) (emphasis added).

f. “Loan underwriting and credit administration procedures that include and provide for, at a minimum, ***documented analysis of:*** (i) the borrower’s repayment sources….; and (ii) the value of any collateral.” Exhibit A at ¶ 6(a) (emphasis added).

g. “[E]nsure that appraisals conform to accepted appraisal standards.” Exhibit A at ¶6(b).

h. “[M]inimize and monitor underwriting and document exceptions.” Exhibit A at ¶ 6(e).

i. “[N]ot, directly or indirectly, extend, renew, or restructure any credit to or for the benefit of any borrower, including any related interest of the borrower, whose loans or other extensions of credit are criticized in the [Joint Examination].” Exhibit A at ¶7.

j. “[R]evise its ALLL [allowance for loan and lease losses] methodology consistent with relevant supervisory guidance.” Exhibit A at ¶9.

k. “[S]hall adopt policies and procedures to minimize and monitor loan documentation exceptions as well as to identify and correct outstanding exceptions noted in the Report of Examination.” Exhibit B at ¶ 6(a).

l. “[S]hall develop and submit to the Bureau [of Commercial Institutions, a part of the Pennsylvania Department of Banking] for review… a written plan to identify, limit and manage the Bank’s commercial real estate (“CRE”) loan concentration of credit to an amount which is commensurate with the Bank’s business strategy, management expertise, size and location (“CRE Concentration Plan”).” Exhibit B at ¶ 7(a).

m. “[E]liminate, correct and prevent unsafe and unsound banking practices, violations of law or regulations, and all contraventions of regulatory policies or guidelines cited in the Report of Examinations.” Exhibit B at ¶ 14.

11. The foregoing comprise a wholesale indictment of the Bank’s management and its failed systems and internal controls. That these internal control failures existed in at least 2009 through 2012 is corroborated by the statements of Confidential Witnesses (*see infra* Part VII.A-D) who provide

examples of precisely these types of systemic failures that they personally observed throughout 2009 to 2012, including: the absence of sufficient and competent lending officers and supervisors (*see infra* Part VII.C.1); the senior management's ignoring of credit analyst recommendations and violations of Bank Loan polices (*see infra* Part VII.C.2); the failure to maintain current loan documentation (including appraisals) (*see, e.g. infra* ¶¶117,118, 122-125, 128-131, 135); improper restructuring and extensions of credit to existing borrowers (*see infra* Parts VII.C.3, VII.D); the modification of existing loans in order to avoid classification of such loans as criticized or in default (*see infra* Parts VII.B.4, VII.C.3); the failure to stress test or undertake any meaningful risk management measures with respect to criticized loans; the failure to timely identify adequate loan loss reserves (*see infra* Parts VII.C.3(a), X.B); the failure to follow regulatory guidance and regulations (*see infra* ¶¶ 191-193); and the failure to timely assess the financial impact of the bad loans and timely make exponential increases in loan loss reserves and to take write-offs (*see infra* Part X.B).

12. That these internal control failures existed in 2008 through 2012 is further corroborated by discovery in this case to date, as discussed herein.[2] For

[2] While the SEC Order found that Orrstown's financial statements were misstated from its 10-Q for the second quarter of 2010 through its 2011 10-K, this was not an endorsement of Orrstown's prior (or subsequent) SEC filings because the SEC did not request or conduct a review of any of the Bank's internal documents prior to

example, the Bank regularly failed to obtain updated appraisals for its commercial loan portfolio beginning at least as early as 2008 and 2009 during the height of the financial crisis when real estate markets were in free fall. Likewise, Orrstown failed to properly recognize and account for impaired loans under GAAP from at least as early as 2008 and 2009 through 2012. For many of its largest borrowers, rather than recognize impairment, the Bank repeatedly modified their loans and many, if not most, of those modifications should have been, but were not, recognized as TDRs. Further, the Bank removed loans from its ALLL calculation that should have been included under its own policies and even when SEK expressly disagreed with the treatment of those loans.

13. By way of further example, in August 2011, Michael A. Moore became Senior Vice-President, Chief Credit Officer of the Bank. In a December 2011 interview conducted by FinPro, a management consulting firm the Regulators required be retained by the Bank and reported to the Regulators and the Board in January 2012, Moore is reported to have said: "[when] he joined the bank there [were] not any controls over documentation, tracking for documentation exceptions, tracking over construction loans, tracking of financial statements, or

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2010. The SEC requested and received only the Bank's internal documents in the January 1, 2010 to June 1, 2012 time frame. Plaintiffs here, however, requested and received documents from earlier time periods, which show that the material weaknesses identified by the SEC (and to the extent they vary, those discussed herein) existed at least as early as 2008.

tracking of loan advances. Mr. Moore indicated there were not any TDR/nonaccrual processes, no Board level credit metrics, no portfolio level analyses, and virtually no effective loan review process.

14. The Bank knew many of its largest borrowers were experiencing financial difficulties at least as early as 2008-2009, a time when the broader economy and real estate in particular were also in serious decline, yet failed to accurately risk rate its loans, resulting in material misstatements in its financial reports, including its 2009 10-K (which was incorporated in its Offering Documents) and subsequent financial statements. Instead, Orrstown Bank extended the maturity of their loans when they came due for repayment without in many cases making any changes to the loan terms (increasing interest rate, obtaining further collateral or other guarantees) to reflect the higher risk to the Bank, and ignored the serious deterioration in credit quality and collateral value that had occurred. These loans to some of the Bank's largest borrowers, many of whom were also SEK clients, should have been, but were not, identified as TDRs.

15. The Bank's material weaknesses in internal controls in 2008-2012 are also highlighted by Orrstown's failure to timely recognize impairment and other failures with respect to one of its largest borrowers, Yorktown Funding, Inc. ("Yorktown"), which declared bankruptcy just prior to Orrstown's March 2010 Offering. As discussed below, the Yorktown loans failed to meet the Bank's loan

policy, and Yorktown suffered losses in 2008 and 2009, yet the bank maintained a relatively safe rating on the loans up through January 22, 2010, less than a month before Yorktown declared bankruptcy. Even then, Orrstown failed to timely recognize impairment of the Yorktown loans, maintaining an irrationally optimistic assessment despite knowing that Orrstown had never filed the necessary paperwork to perfect Orrstown's security interest in the Yorktown loans in connection with line of credit extensions. Orrstown eventually wrote off the entire $8.6 million loan balance.

16. Following their investigation the Regulators required Orrstown to completely revamp every aspect of its banking processes and operations to create, develop and enhance internal controls for its future operations. In addition, the Regulators prohibited Orrstown from conducting certain of its business without prior approval, including payment of a dividend, incurring or increasing of debt, or redeeming any outstanding shares.

17. Further, the Pennsylvania Department of Banking made the Bank affirm that it would act to eliminate all violations of law or regulations and contraventions of regulatory policies or guidelines that were cited in the Report of Examinations:

> Corrective Action: The Bank shall take all steps necessary, consistent with other provisions of this Order and sound banking practices, ***to eliminate, correct and prevent unsafe and unsound banking practices, violations of law or***

> ***regulations, and all contraventions of regulatory policies or guidelines*** cited in the Report of Examinations.

Consent Order, ¶14 (emphasis added). This is striking. Regulators do not lightly charge bank managers and banks with having such inadequate internal controls so as to characterize the bank as having "unsafe and unsound banking practices" and needing to "eliminate, and prevent . . . violations of law, and all regulations and contraventions of regulatory policies or guidelines cited in the Report of Examinations." Indeed, since 2010, the Pennsylvania Department of Banking has only issued this type of enforcement action on two other Pennsylvania banks. Further, banks and bank managers do not lightly acknowledge such misconduct and promise "to eliminate, correct and prevent" such misconduct.

18. In Orrstown's periodic reports and Defendant Quinn and Everly's SOX Certifications Defendants (falsely) certified the effectiveness of Orrstown's internal controls. Prior to the time of the March 2010 Offering and through May, 10, 2011 (the time the Company filed its Form 10-Q for the first quarter 2011), investors were told that Orrstown maintained effective internal control procedures, and had not made changes "in the Company's internal control over financial reporting or in the factors that have materially affected, or are reasonably likely to materially affect, such controls during the quarter." This was consistent with the certifications made by the Company that its internal controls were effective in the Company's 2010 Annual Report Form 10-K filed in March 2011, even as the

Regulators were on-site and identifying the measures the Company needed to take to revamp its internal controls in order to address the material deficiencies that their existing (and previously certified as unchanged) internal controls had fostered.

19. Some of the specific undisclosed deficiencies that existed during the Class Period, and their magnitude, were only publicly revealed by Defendants in March 2012, on the eve of the disclosure of the Joint Examination. Using guarded wording, Defendants revealed that:

- "The Credit Administration department, processes and procedures have been greatly enhanced to address gaps noted."
- "The Company failed to implement a structured process with appropriate controls to ensure that updated loan ratings were incorporated timely into the calculation of the Allowance for Loan Losses."
- "As of the end of the period covered by this report, however, the Company has not fully remediated its material weakness in its internal control over financial reporting relating to loan ratings and its impact on the allowance for loan losses."

20. On the eve of the public announcement of the Enforcement Actions, Orrstown publicly revealed for the first time in its 2011 Annual Report on Form 10-K its material weakness in internal control:

> ***the Company did not maintain effective internal control over the process to prepare and report information related to loan ratings and its impact on the allowance for loan losses.*** This control deficiency results in a reasonable possibility that a material misstatement to the annual or interim Consolidated Financial Statements will not be prevented or detected. Accordingly, management has determined that this condition constitutes a material weakness. ***Because of this material weakness, we have concluded that the Company did not maintain effective internal control over financial reporting.*** (emphasis added)

21. Orrstown's auditor, Defendant SEK also was forced to follow suit, and publicly reveal in its "Report of Independent Registered Public Accounting Firm" that Orrstown's internal controls suffered from material weaknesses:

> … ***The Company did not have a timely and effective process to prepare and report information related to loan ratings and the allowance of loan losses allocations*** . . . . ***In our opinion, because of the effects of the material weakness described above on the achievement of the objectives of the control criteria, Orrstown Financial Services, Inc. and its wholly-owned subsidiary has not maintained effective internal control over financial reporting…*** (emphasis added)

22. As confirmed by the Confidential Witnesses and Regulators, and as also supported by discovery in this action to date, the Company's financial and operational material weaknesses rendered the Company's financial reporting for each of the annual reporting periods of 2008, 2009, 2010 and 2011, and each of the

quarterly reporting periods in 2010 and 2011 false and misleading, as well as Orrstown's quarterly report for the first quarter of 2012.

23. The Regulators' control and oversight did not end with the announcement of the Enforcement Actions. It took nearly four (4) years from the date the Joint Examination commenced for the Federal Reserve's Written Agreement to be terminated, and the Bank still remains subject to a MOU with the PA Department of Banking.[3]

24. Plaintiff and other shareholders incurred significant losses as a result of Defendants' federal securities law violations. From the time of the March 2010 Offering, in which its common stock was sold for $27.00 per share, to the point at which the market fully digested the Bank's curative disclosures that its internal controls were ineffective, the Bank's stock price dropped by 70% to close at $8.20 per share on April 5, 2012.

25. Plaintiff would not have incurred these losses but for Defendants' false and misleading statements that certified the effectiveness of Orrstown's internal controls. For the Orrstown executives, however, the concealment of, and

[3] The Federal Reserve's Written Agreement terminated on April 2, 2015. The Pennsylvania Department of Banking's Consent Order terminated on April 21, 2014 and was replaced with a MOU. An MOU is a regulatory action that the Pennsylvania Department of Banking considers a lower level of regulatory action than the Consent Order. *See*, Form 8-K Current Reports filed 4/22/2015, 4/2/2015. The MOU is still in effect.

delay in such revelations becoming public, permitted them in 2010 to double their prior-year bonuses, increase their salaries for 2011, and, for several, to hold onto their jobs until the Regulators' mandatory "management review" resulted in ousters and resignations.

II. NATURE OF THE ACTION

26. This is a federal securities class action brought pursuant to the Securities Act of 1933 ("Securities Act") and the Securities Exchange Act of 1934 ("Exchange Act").

27. The "Securities Act Class" consists of all persons and/or entities who purchased Orrstown common stock pursuant to, or traceable to, Orrstown's February 8, 2010 Registration Statement and March 24, 2010 Prospectus Supplement (collectively these, and the documents incorporated therein by reference, the "Registration Statement" or "Offering Documents") issued in connection with Orrstown's secondary stock offering in March 2010 Offering. The Securities Act Class seeks remedies under Sections 11, 12(a) and 15 of the Securities Act, 15 U.S.C. §§ 77k, 77l(a)(2) and 77o, against Orrstown, certain of its officers and/or directors, the Bank, its auditor SEK, and the Offering's underwriters Sandler O'Neill & Partners, L.P. ("Sandler O'Neill") and Janney Montgomery Scott LLC ("Janney") (collectively the "Securities Act Defendants")

for the materially false and misleading statements contained in the Offering Documents.

28. Pursuant to the Securities Act, the Securities Act Defendants are strictly liable for material misstatements in or the omission of material facts from the Offering Documents issued in connection with the March 2010 Offering, and the Securities Act claims and allegations are not based on any reckless or intentionally fraudulent conduct by or on behalf of Defendants – *i.e.*, the Securities Act claims do not allege, arise from, or sound in, fraud. Plaintiff specifically disclaims any allegation of fraud, scienter, or recklessness in these non-fraud claims.

29. The "Exchange Act Class" consists of all persons or entities who purchased Orrstown common stock on the open market between March 15, 2010 and April 26, 2012, inclusive (the "Class Period"), seeking remedies under Sections 10(b) and 20(a) of the Exchange Act, 15 U.S.C. §§ 78j(b) and 78t(a), and SEC Rule 10b-5 promulgated thereunder, 17 C.F.R. § 240.10b-5, against Orrstown, the Bank and certain of its officers and/or directors, and auditor SEK (collectively the "Exchange Act Defendants").

30. The claims asserted herein arise from a series of materially false and misleading statements made by Defendants in the Offering Documents and throughout the Class Period pertaining to the effectiveness of the Company's

internal controls over financial reporting, including false and misleading statements concerning impaired loans, ALLL, and TDRs, as well as compliance with banking regulations.

III. JURISDICTION AND VENUE

31. The Securities Act claims asserted herein arise under and pursuant to Sections 11, 12(a)(2) and 15 of the Securities Act, [15 U.S.C. §§ 77k and 77o] and rules promulgated thereunder by the SEC.

32. The Exchange Act claims asserted herein arise under and pursuant to Sections 10(b) and 20(a) of the Exchange Act, [15 U.S.C. § 78j(b) and 78t(a)], and Rule 10b-5 promulgated thereunder by the SEC [17 C.F.R. § 240.10b-5].

33. This Court has jurisdiction over the subject matter of this action pursuant to 28 U.S.C. §§ 1331 and 1337, Section 22 of the Securities Act [15 U.S.C. § 77v] and Section 27 of the Exchange Act [15 U.S.C. § 78aa].

34. Defendants named herein have sufficient minimum contacts with this District, the Commonwealth, and the United States so as to render the exercise of jurisdiction permissible under traditional notions of fair play and substantial justice.

35. Venue is proper in this District pursuant to 28 U.S.C. §§ 1391(b) and (c), and Section 22 of the Securities Act [15 U.S.C. § 77v] or Section 27 of the Exchange Act [15 U.S.C. § 78aa]. Defendants Orrstown and Orrstown Bank

maintain their principal place of business in this District and the acts and practices complained of herein, including the dissemination to the public of the false and misleading statements of material facts, occurred in this District.

36. In connection with the acts and conduct alleged in this complaint, Defendants, directly or indirectly, used the means and instrumentalities of interstate commerce, including, but not limited to, the mails, interstate wire and telephone communications, and the facilities of the national securities markets.

IV. PARTIES

A. Lead Plaintiff

37. Lead Plaintiff **SEPTA** is a regional transportation authority that operates various forms of public transit serving Bucks, Chester, Delaware, Montgomery, and Philadelphia counties in Pennsylvania. SEPTA is headquartered at 1234 Market Street, Philadelphia, Pennsylvania. As confirmed by SEPTA's investment manager and trading data and set forth in the attached certificate which was filed with Plaintiff's initial complaint (Dkt. #1), Plaintiff acquired Orrstown common stock pursuant to the Offering Documents for the March 2010 Offering from the Offering's underwriters, and also purchased Orrstown common stock on the open market during the Class Period. SEPTA was harmed as a result of Defendants' wrongdoing as alleged in this complaint.

B. Securities Act Defendants

1. The Orrstown Securities Act Defendants

38. Defendant **Orrstown** is the holding company for its wholly owned subsidiary Orrstown Bank. Orrstown is incorporated in Pennsylvania, and its executive offices are located at 77 East Kings Street, Shippensburg, Pennsylvania. The Company was organized on November 17, 1987, for the purpose of acquiring the Bank. On March 8, 1988, in a bank holding company reorganization transaction, the Company acquired 100% ownership of the Bank. In 2006, Orrstown acquired First National Bank of Newport to diversify the Bank's loan portfolio with residential mortgage loans. Orrstown's primary activity consists of owning and supervising the Bank. Orrstown's five officers conduct the day-to-day management of the Company, and they are the Company's only employees. As a holding company, Orrstown's operating revenues and net income are derived primarily from the Bank through the payment of dividends. As of March 31, 2015, Orrstown had total assets of $1.18 billion, a loan portfolio totaling $727 million, total shareholders' equity of $131 million, and total deposits of approximately $945 million.

39. Defendant **Orrstown Bank**, a state-chartered Pennsylvania bank, was founded in 1919 and provides community banking and bank related services in South Central Pennsylvania region. The Bank has twenty-two banking offices and

two remote service facilities located in Cumberland, Franklin, Lancaster and Perry Counties as well as one banking office in the town of Hagerstown, Maryland. The Bank's Operations Center houses loan operations, EFT department, deposit operations, information technology, human resources and other support staff, and is located at North Pointe Business Center, 2605-2695 Philadelphia Avenue, Chambersburg, Pennsylvania. The Bank's commercial banking and trust business involve accepting demand, time and savings deposits, and making loans. The Bank makes commercial, residential, consumer and agribusiness loans within its geographic market. Approximately 65% of the Bank's loan portfolio is concentrated in commercial loans.

40. Defendant **Thomas R. Quinn, Jr.** ("Quinn") is, and during the Class Period was, the President and Chief Executive Officer of the Company and the Bank. Quinn joined the Bank in May 2009, and, at all times material to the issues raised in the complaint, he served on the ***Enterprise Risk Management Committee***, which was formed in 2009, and on the Bank's ***Loan Committee.*** Quinn signed each of the ***SOX Certifications*** in the periodic filings with the SEC beginning with the second Quarter 2009 Form 10Q and during the Class Period. Quinn was responsible for the administration of Orrstown's loan policy. Quinn was also responsible for certifying in its periodic filings that Orrstown had adequate internal controls to provide reasonable assurance regarding the reliability of

financial reporting and preparation of financial statements in accordance with GAAP.

41. Defendant **Bradley S. Everly** ("Everly") was during the Class Period the Executive Vice President, Chief Executive Officer and Chief Financial Officer of the Bank. He started with the Bank in 1997 and resigned on May 16, 2012. At all times material to the issues raised in the complaint, Everly was an officer of the Bank and served on the Bank's ***Loan Committee***. Everly signed each of the ***SOX Certifications*** in the periodic filings with the SEC prior to and during the Class Period. Everly was responsible for ensuring that Orrstown's financial reporting was materially accurate, complete and prepared in accordance with GAAP. Earlier in his career, prior to 1978, Everly was an accountant with SEK.

42. Defendant **Joel R. Zullinger** ("Zullinger") is, and during the Class Period, was the Chairman of the Boards of Directors of the Company and the Bank. He has been a Director since 1981, and, at all times material to the issues raised in the complaint, he served on the ***Enterprise Risk Management Committee***.

43. Defendant **Jeffrey W. Coy** ("Coy") was during the Class Period, the Vice Chairman of the Boards of Directors of the Company and the Bank. He was a Director since 1984, and, at all times material to the issues raised in the complaint, he served on the ***Enterprise Risk Management Committee***.

44. Defendant **Kenneth R. Shoemaker** ("Shoemaker") was during the Class Period, President Emeritus of the Bank, a Director and the Secretary of the Company and Bank. Shoemaker was a director from 1986 to 2012, and, at all times material to the issues raised in the complaint, he served on the ***Enterprise Risk Management Committee***. He also served as President and Chief Executive Officer of the Company and Bank from 1987 to his retirement in May 2009. While Chief Executive Officer of the Bank, Shoemaker served on the Bank's ***Loan Committee***.

45. Defendant **Anthony F. Ceddia** ("Ceddia") was during the Class Period, a Director of the Company and Bank. He was a Director since 1996, and at the time of the March 2010 Offering was a member of the Board's ***Audit Committee***.

46. Defendant **Mark K. Keller** ("Keller") is, and during the Class Period was, a Director of the Company and Bank. He has been a Director since 2008.

47. Defendant **Andrea Pugh** ("Pugh") was during the Class Period, a Director of the Company and Bank. She was a Director since 1996, and at the time of the March 2010 Offering was a member of the Board's ***Audit Committee***.

48. Defendant **Gregory A. Rosenberry** ("Rosenberry") was during the Class Period, a Director of the Company and Bank. He was a Director since 1997.

49. Defendant **Glenn W. Snoke** ("Snoke") is, and during the Class Period was, a Director of the Company and Bank. He has been a Director since 1999. At all times material to the issues raised in the complaint, Snoke was an officer of the Bank, served on the Bank's ***Loan Committee***, and prior to Defendant Everly's appointment to Chief Credit Officer, Snoke chaired the Loan Committee.

50. Defendant **John S. Ward** ("Ward") was, during the Class Period, a Director of the Company and Bank. He became a Director in 1999, and at the time of the March 2010 Offering was a member of the ***Audit Committee***.

51. Defendant **Jeffrey W. Embly** ("Embly") was during the Class Period, the Senior Executive Vice President and Chief Operating Officer of the Company. During parts of the Class Period, Embly served as Executive Vice President of the Bank and Chief Credit Risk Officer of the Bank. Embly resigned on September 18, 2012. At all times material to the issues raised in the complaint, Embly was an officer of the Bank and served on the Bank's ***Loan Committee***. Embly was responsible for credit underwriting, loan work out and loan administration, including supervision of the loan review process and ensuring that material adverse information concerning borrowers was timely incorporated into the loan ratings.

52. Defendants Quinn, Zullinger, Shoemaker and Coy were members of the Board of Directors' ***Enterprise Risk Management Committee,*** created in 2009 to provide additional oversight over seven risk areas: credit, operations,

transaction, liquidity, market/interest rate, legal/compliance, strategies and reputation.

53. Defendants Zullinger, Ceddia, Coy, Keller, Pugh, Rosenberry and Ward, as directors, each filled at some point during the Class Period the monthly rotating director seat on the Bank's ***Loan Committee***. Defendant Snoke was the permanent board member on the Loan Committee throughout the Class Period.

54. Defendants Quinn, Everly, Zullinger, Shoemaker, Ceddia, Coy, Keller, Pugh, Rosenberry, Snoke and Ward are referred to herein as the "**Individual Securities Act Defendants**."

55. The Individual Securities Act Defendants and Defendant Embly, as senior executive officers and/or directors of Orrstown and the Bank (the "**Individual Orrstown Defendants**"), were privy to confidential, non-public information concerning the Bank's internal operations, controls and financial condition. They had access to material and adverse non-public information which, as discussed in detail below, revealed the failures of the Bank's internal controls over underwriting of loans, risk management procedures and financial reporting. Because of their positions, the Individual Securities Act Defendants and Defendant Embly were required to critically review the Offering Documents to ensure accuracy and adequate disclosure.

56. Each of the Individual Securities Act Defendants signed the materially untrue and misleading Registration Statement. They were responsible to assure the accuracy and completeness of the statements made in the Registration Statement and Class Period SEC filings, and are therefore primarily liable for the false and misleading statements contained therein.

2. The Underwriter Defendants

57. Defendants **Sandler O'Neill & Partners, L.P.** ("Sandler O'Neill"), headquartered in New York City, and **Janney Montgomery Scott, LLP** ("Janney"), headquartered in Philadelphia, acted as underwriters of the March 2010 Offering and signed the Registration Statement. In the March 2010 Offering, Sandler O'Neill and Janney (collectively the "Underwriter Defendants") organized the distribution of at least 1,481,481 shares of Company common stock to investors and received $2,415,000 in underwriting commissions and expenses. The Company's agreement with the Underwriter Defendants provided that the Underwriters would be paid as much as $1.485 per share in connection with the sale of these common shares. The Underwriter Defendants therefore were indirectly paid approximately $2.2 million in fees by purchasers of the Orrstown shares.

	Per Share	Total Without Over-Allotment Exercise	Total With Full Over-Allotment Exercise
Public offering price	$ 27.00	$39,999,987	$45,999,981
Underwriter discount	$ 1.485	$ 2,199,999	$ 2,529,998
Proceeds to Orrstown (before expenses)	$25.515	$37,799,988	$43,469,983

58. The $2.2 million in combined fees were paid in part to compensate the Underwriter Defendants for conducting a reasonable due diligence investigation into Orrstown in connection with the March 2010 Offering. The Underwriter Defendants' due diligence investigation was a critical component of the March 2010 Offering intended to provide investors with important safeguards and protections.

59. It was incumbent on the Underwriter Defendants to perform due diligence that investigated not only the Company's reported performance but also a qualitative analysis of the processes, procedures and assumptions underlying the reported performance with respect to all aspects of the organization, including Orrstown's loan portfolios, books, records, accounting, financial reporting, and operation and internal controls.

60. In preparing the Offering Documents, the Underwriter Defendants were to conduct due diligence of Orrstown and the Bank. The Underwriter Defendants had the opportunity to review the work of the Internal Review, (*see infra* Part VII.C.3(a)), and had access to management to make inquiries about the

Bank's loan portfolio and loan practices. The Underwriter Defendants had access to the Company's financial and SEC filings made within the period that the Offering Documents were being prepared and disseminated. Indeed, the SEC filings were incorporated by reference into the Offering Documents. Specifically, the Underwriter Defendants had access to the Form 10-K 2009 Annual Report, filed on March 15, 2010, which disclosed, *inter alia*, that the Internal Review resulted in management increasing provisions for loan losses over the prior year. Similarly, the Underwriter Defendants were aware of and had the opportunity to discuss with management the Form 8-K, filed on March 22, 2010, announcing Orrstown's unsecured nonpriority claim for over $8.5 million in the Yorktown bankruptcy.

61. One of the primary purposes of underwriters to an offering is to work with management to set a realistic, marketable price for the offered shares.

62. In addition to Sandler O'Neill and Janney serving as underwriters in the March 2010 Offering, they performed prior advisory and investment banking services to Orrstown for which they received compensation. Janney is also the only investment banking firm to have an analyst who has continually followed Orrstown since the March 2010 Offering up to the present.

3. The Auditor Defendant

63. Defendant **Smith Elliott Kearns & Company, LLC.** ("SEK" or "Auditor Defendant") is a regional independent registered public accounting firm providing professional services to individuals and businesses, including public companies, in the Shenandoah and Cumberland Valleys which include parts of Pennsylvania, Maryland, Virginia and West Virginia. With three offices in Pennsylvania and one in Hagerstown, Maryland, SEK has 150 employees. Since 1963, SEK has been providing professional accounting services to independent community financial institutions and currently represents approximately 25 such community financial institutions. SEK holds itself out as a firm providing the "highest quality" auditing services with a "Culture for Excellence" to foster the "highest professional and ethical standards."[4]

64. From at least 2006 and through the Class Period SEK has audited the consolidated balance sheets of Orrstown and the Bank and the related consolidated statements of income, changes in shareholders' equity, and cash flows. As part of its audits SEK also audited Orrstown's and the Bank's internal controls over financial reporting. On June 16, 2014, the Company dismissed SEK as the Company's independent registered public accounting firm.

[4] SEK website, http://www.sek.com/about-sek-co/.

65. During the Class Period, SEK issued audit reports on Orrstown's financial statements for calendar years December 31, 2008, 2009, 2010 and 2011. All received "unqualified" audit reports on the financial statements until 2011, when SEK rendered an adverse opinion on the Company's internal financial controls. The Registration Statement incorporated by reference the financial statements audited by SEK and SEK's unqualified audit reports for calendar years 2008 and 2009. SEK signed the Registration Statement and certified that the financial statements contained therein and incorporated by reference were free of material misstatements and presented in conformity with GAAP. The Registration Statement also, upon authority of SEK, designated SEK as an expert in auditing and accounting.

66. SEK is a registered accounting and auditing firm with the PCAOB. As required by the Sarbanes-Oxley Act of 2002, SEK as an auditor of U.S. public companies is subject to oversight by the PCAOB and the SEC.[5] In conducting its audits in calendar years 2009, 2010 and 2011, SEK purportedly applied the standards of the PCAOB and the Internal Control – Integrated framework issued by the Committee of Sponsoring Organizations of the Treadway Commission ("COSO"). Plaintiff's claims asserted against SEK as alleged herein focus on

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[5] *See* PCAOB's website for oversight responsibilities: http://pcaobus.org/About/Pages/default.aspx .

SEK's unqualified audit reports for calendar years 2008, 2009, 2010 and its partially unqualified audit report for 2011.

67. Orrstown, the Bank, the Individual Securities Act Defendants, Defendant Embly, the Underwriter Defendants, and Auditor Defendant SEK are sometimes collectively referred to herein as the "**Securities Act Defendants**" with respect to Plaintiff's Securities Act claims.

C. Exchange Act Defendants

68. In addition to being Securities Act Defendants, Quinn, Everly, Embly, Zullinger, Shoemaker, Coy, Snoke, Orrstown, the Bank (collectively the "**Orrstown Exchange Act Defendants**") and auditor SEK are also collectively "**Exchange Act Defendants**."

69. During the Class Period, Defendants Quinn, Everly and Embly, as senior executive officers and directors of Orrstown, were privy to confidential, non-public information concerning the Bank's internal operations, controls and financial condition. Defendants Quinn, Zullinger, Shoemaker and Coy, as members of the Enterprise Risk Management Committee, developed risk management protocols and were privy to confidential, non-public information concerning the bank's internal operations, controls and financial condition. Defendant Snoke was on the Bank's Loan Committee throughout the Class Period and was, therefore, intimately involved in the loan approval process. Similarly,

the very nature of an audit demanded that SEK have access to confidential, non-public information concerning the Bank's internal operations, controls and financial condition. Moreover, SEK also served as the accountant for several of the Bank's largest borrowers, and therefore had access to additional non-public financial information of those borrowers at the same time it was auditor for Orrstown. Each of the Exchange Act Defendants had access to material and adverse non-public information which, as discussed in detail below, revealed the failures of the Bank's internal controls and the Regulators' comprehensive review, strong criticism and compulsory call for corrective action. Because of their positions, Defendants Quinn, Everly, Embly, Zullinger, Shoemaker and Coy were able to and did control the content and timing of the various SEC filings, corporate press releases and other public statements pertaining to the Company at the time of the Offering and throughout the Class Period. Further, Defendants Quinn and Embly signed each of the SOX Certifications that were included in the Company's periodic filings with the SEC during the Class Period.

V. OTHER RELEVANT PERSONS[6]

70. **Confidential Witness #1** ("CW#1") is a former Bank employee who worked from February 2008 to August 2011 at the Bank's Operations Center in

[6] As discussed *infra*, the SEC subpoenaed certain of the Confidential Witnesses, and at least one other potential Confidential Witness who had previously contacted Plaintiff's counsel.

Chambersburg, Pennsylvania. CW#1 was a Credit Analyst in the Credit Department and later became a Loan Underwriting Officer.

71. CW#1 has personal knowledge of the Bank's internal controls pertaining to the Bank's credit review and underwriting process that were in effect before and during the Class Period. CW#1 has personal knowledge of the Bank's practice of restructuring loans to forestall classifying them as Substandard, impaired, or Risk Assets.[7] CW#1 has personal knowledge of the credit review process for the loans initiated by loan officer Terry Reiber in the Hagerstown, Maryland market. CW#1 has personal knowledge of certain borrowers' loan applications such as the Azadis and Shaool family, *discussed infra* Part VII.D.2, because CW#1 personally evaluated their creditworthiness from 2008 through 2011. Lastly, CW#1 has personal knowledge about the loans that were extended to the Chambersburg Borrowers, *discussed infra* Part VII.D.4, between 2008 and 2011.

72. **Confidential Witness #2** ("CW#2") is a former Bank employee who worked from April 2010 to May 2011. CW#2 reported directly to the Chief Credit

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[7] At all times relevant to the issues raised in the complaint, the Company defined "Risk Assets" as including nonperforming loans, nonaccrual loans, and loans past due 90 days and still accruing. As alleged herein, Defendants used this purposefully narrow definition to avoid capturing the performing loans within the commercial portfolio that were inherently risky and show indicia of future impairment, *i.e.*, troubled loans.

Officer who at the time of CW#2's employment was Defendant Embly. CW#2 was hired to fill a newly created position of Vice President, Credit Officer. CW#2 supervised the Credit Department which encompassed the Credit Analyst Group, had credit approval and was a voting member of the Loan Committee which in April 2010 consisted of the Chief Executive Officer, Chief Credit Officer, Chief Commercial Officer, Chief Financial Officer, one permanent board member and one rotating board member.

73. CW#2 has personal knowledge of the Bank's internal controls, credit review and underwriting process, and loan approval procedures between April 2010 and May 2011.

74. **Confidential Witness #3** ("CW#3") is a former Bank employee who worked from 2007 through February 2012 at the Bank's Operations Center in Chambersburg, Pennsylvania. Prior to joining Orrstown Bank, CW#3 prepared tax returns for certified public accounting firms and then was a credit analyst with First National Bank of Newport, the community bank that Orrstown acquired in 2006. Upon hiring CW#3 as a Credit Analyst in 2007, Defendant Embly told CW#3 that he was impressed with CW#3's critical evaluation of loan applicants' creditworthiness while at Newport Bank. In 2009, CW#3 was promoted to Senior Credit Manager. CW#3 supervised three credit analysts and attended Loan Committee meetings until CW#2 was hired. CW#3 and his group of credit

analysts were charged with critically assessing a potential borrower's credit worthiness and making specific recommendations to the Loan Committee as to whether the loans should be approved. CW#3 was present during Loan Committee meetings and was required to present his group's recommendations and field any questions concerning the creditworthiness of the loan applicant.

75. CW#3 has personal knowledge of the Bank's internal controls pertaining to credit review, underwriting process, and loan approval process during the Class Period. Specifically, CW#3 has personal knowledge of the credit analysis performed on the Shaool Family loan applications, *discussed infra* Part VII.D.3. CW#3 also has personal knowledge of the Regulators' investigation of Orrstown's underwriting processes and the loan portfolios and some of the modifications to the Bank's risk management and troubled loan restructuring mandated by the Regulators, *discussed infra* Part VII.C.

76. **Confidential Witness #4** ("CW#4") is an owner of rental and commercial properties and is a current borrower of the Bank. CW#4's properties and rental office are located in Hagerstown, Maryland.

77. CW#4's initial Orrstown Bank loan officer was Terry Reiber. CW#4 has personal knowledge of the Bank's management of lending relationships in Hagerstown and the Bank's restructuring of Risk Assets.

78. **Confidential Witness #5** ("CW#5") is the president of a company that was a borrower of the Bank. CW#5's company is located in Hagerstown, Maryland, and its initial Orrstown Bank loan officer was Terry Reiber.

79. CW#5 has personal knowledge of the Bank's management of lending relationships in Hagerstown, and of the Regulators' oversight of the Bank's current affairs.

80. **Confidential Witness #6** ("CW#6") is a former Bank employee who worked from January 2, 2011 through April 2012 at the Bank's Operations Center in Chambersburg, Pennsylvania as the Consumer Compliance Officer. Prior to joining Orrstown Bank, CW#6 worked with federal banking regulators and a firm that provided compliance consultation to banking institutions.

81. CW#6 has personal knowledge concerning the Special Asset Group and the independent firm the Bank retained in 2011 to provide assistance with the loan review process.

82. **Ash Azadi** and his father **Morris Azadi** are professional commercial pilots (collectively the "Azadis"). Through their various entities, they were involved in commercial real estate development projects in Hagerstown, Maryland. They were borrowers of Orrstown Bank, and Terry Reiber was their initial loan officer. The Azadi's are "Lending Relationship B" described in the SEC Order. On February 3, 2012, Orrstown Bank filed a Complaint for Confession of

Judgment and Breach of Contract in the United States District Court of Maryland against each of the Azadis and their entities alleging that their loans were in default and the Bank was owed a total amount of $16,379,954.44. The matter is docketed at *Orrstown Bank v. Ares Investment Group, et al.*, Civil No. 1:12-cv-00345 (D. Md.) ("Azadi Litigation"). The pleadings in the Azadi Litigation provide verified statements about the lending relationship that existed between Orrstown Bank and Ash Azadi, Morris Azadi and the Azadis' various business entities.[8] Further, on August 3, 2012, Ash Azadi was interviewed by Plaintiff's counsel.

VI. RULE 23 CLASS ALLEGATIONS

83. Plaintiff brings this action as a class action pursuant to Federal Rule of Civil Procedure 23(a) and (b)(3) on behalf of the Securities Act and Exchange Act Classes.

84. The Securities Act Class consists of all those who purchased or otherwise acquired the common stock of Orrstown pursuant to, or traceable to, the Company's March 2010 Offering, who were damaged thereby.

[8] On December 17, 2012, the Bank and ACM Thornell IV B Azadi LLC ("ACM"), an investor group, filed a joint motion for substitution to substitute ACM as the plaintiff and judgment creditor in the matter because on June 29, 2012, the Bank sold its interest in the Azadi loans to ACM.

85. The Exchange Act Class consists of all those who purchased or otherwise acquired Orrstown common stock during the Class Period, and who were damaged thereby.

86. Excluded from the Securities Act and Exchange Act Classes are Defendants, the officers and directors of the Company at all relevant times, members of their immediate families and their legal representatives, heirs, successors, or assigns, and any entity in which Defendants have or had a controlling interest.

87. The members of the Securities Act and Exchange Act Classes are so numerous that joinder is impracticable. Throughout the Class Period, Orrstown common stock shares were actively traded on the NASDAQ. As of April 26, 2012 (the last day of the Class Period), the Company had approximately 8,000,000 shares of common stock issued and outstanding and approximately 3,100 shareholders of record. While the exact number of Class members is unknown to Plaintiff at this time and can only be ascertained through appropriate discovery, Plaintiff believes that there are thousands of members in the proposed Securities Act and Exchange Act Classes. Record owners and other members of the Securities Act and Exchange Act Classes may be identified from records maintained by Orrstown or its transfer agent and may be notified of the pendency

of this action by mail, using the form of notice similar to that customarily used in securities class actions.

88. Plaintiff's claims are typical of the claims of the members of the Securities Act and Exchange Act Classes as all members of each class are similarly affected by Defendants' conduct in violation of federal law that is complained of herein.

89. Plaintiff will fairly and adequately protect the interests of the members of the Class and have retained counsel competent and experienced in class and securities litigation.

90. Common questions of law and fact exist as to all members of the Securities Act and Exchange Act Classes and predominate over any questions solely affecting individual members. Among the questions of law and fact common to the Classes are:

a. Whether the federal securities laws were violated by Defendants' acts and omissions as alleged herein;

b. Whether the Registration Statement issued by Orrstown misrepresented or omitted material facts regarding the effectiveness of Orrstown's internal controls;

c. Whether the Exchange Act Defendants participated in and pursued the common course of wrongful conduct complained of herein;

d. Whether the Exchange Act Defendants had a duty to disclose certain material information;

e. Whether the Exchange Act Defendants acted knowingly or recklessly in making materially false and misleading statements during the Class Period;

f. Whether the Exchange Act Defendants' statements made during the Class Period misrepresented or omitted material facts about the effectiveness of Orrstown's internal controls;

g. Whether the market price of Orrstown's common stock during the Class Period was inflated due to the misrepresentations and omissions of material fact as well as failures to correct the false and misleading statements complained of herein; and,

h. The extent to which the members of the Securities Act and Exchange Act Classes have sustained damages and the proper measure of damages.

91. A class action is superior to all other available methods for the fair and efficient adjudication of this controversy since joinder of all members of the classes is impracticable. Furthermore, as the damages suffered by some individual Securities Act and Exchange Act class members may be relatively small, the expense and burden of individual litigation make it impossible for members of the

Securities Act and Exchange Act Classes to individually redress the wrongs done to them. There will be no difficulty in the management of this action as a class action.

VII. BACKGROUND AND FACTS

A. The Critical Role of an Effective System of Internal Controls.

92. The development and implementation of a system of internal controls is legally required for all financial institutions. Internal controls are vital for the operation of a bank. The process of internal controls ensures effective banking operations through safeguarding assets, accurate financial reporting, and legal compliance. A system of internal controls that is well-implemented will assist the bank in meeting goals and objectives, achieve long-term profit, decrease the risk of losses or damage to the bank's reputation, and ensure compliance with laws, regulations, policies, plans and procedures. All systems of internal controls are run by bank management.

93. The Office of the Comptroller of the Currency ("OCC") attributes weak internal controls to causing, among other things, inaccurate records, audits, and loan reviews, having contributed to operational loss and failures of banks. The OCC has also stated that "effective internal controls form the foundation for a bank's system of risk management," and helps to safeguard assets, prevent fraud

and financial mismanagement, and ensure legal compliance as well as compliance with the bank's own policies.

94. Unequivocally, internal controls and the Bank's representations about its internal controls are material to investors.

95. Specifically COSO, which has developed an internal control framework that stresses the importance of internal controls on banking operations, defines "internal control" in Chapter 1 of its Framework as follows:

> Internal control is a process, effected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories: (i) Effectiveness and efficiency of operations; (ii) Reliability of financial reporting; (iii) Compliance with applicable laws and regulations.

Orrstown is required to adhere to the criteria established by COSO in making its disclosures in SEC filings concerning the effectiveness of its internal controls.

96. The COSO further defines these three categories of objectives which allow organizations to focus on the various aspects of internal control:

- Operations Objectives – These pertain to effectiveness and efficiency of the entity's operations, including operational and financial performance goals, and safeguarding assets against loss.
- Reporting Objectives – These pertain to internal and external financial and non-financial reporting and may encompass reliability, timeliness,

transparency, or other terms as set forth by regulators, recognized standard setters, or the entity's policies.

- Compliance Objectives – These pertain to adherence to laws and regulations to which the entity is subject.

97. For each internal control that is designed to address one or more of these objectives, the COSO Framework Executive Summary requires that the system of internal controls consists of five integrated components:

- Control Environment – the set of standards, processes, and structures that provide the basis for carrying out internal control across the organization.
- Risk Assessment – a dynamic and interactive process for identifying and assessing risks to the achievement of objectives, *i.e.*, determining how risks will be managed.
- Control Activities – the actions established through policies and procedures that help ensure that management's directives to mitigate risks to the achievement of objectives are carried out.
- Information and Communication – the continual, iterative process of providing, sharing, and obtaining necessary information.
- Monitoring Activities – the use of ongoing evaluations, separate evaluations, or some combination of the two to ascertain whether each of

the five components of internal control, including controls to effect the principles within each component, is present and functioning.

98. COSO makes clear that "an internal control is most effective when controls are built into the entity's infrastructure and are a part of the essence of the enterprise."

99. Orrstown, as confirmed by the Confidential Witnesses and Regulators, suffered from ineffective and utterly deficient internal controls and misled investors about the effectiveness of its internal controls throughout the Class Period.

B. Orrstown's Material Failures Of Internal Controls Over Financial Reporting

1. Orrstown's ALLL Calculation Process

100. One of the most critical financial metrics for a bank is its Allowance of Loan and Lease Losses, or ALLL. In essence, ALLL is a reserve to account for the probability that loans will not be fully repaid. ALLL is an account on a bank's balance sheet that is netted against gross loans. Each quarter the ALLL reserve rises by the amount of the "loan loss provision," which is the amount of new reserve added to ALLL, and is reduced by any charge offs of loans for which a reserve had previously been created.

101. As summarized by the Federal Reserve, "The purpose of the ALLL is to reflect estimated credit losses within a bank's portfolio of loans and leases.

Estimated credit losses are estimates of the current amount of loans that are probable that the bank will be unable to collect given the facts and circumstances since the evaluation date (generally the balance sheet date)."

102. As explained by the Federal Reserve in its Interagency Policy Statement on the Allowance for Loan and Lease Losses:

> The ALLL represents one of the most significant estimates in an institution's financial statements and regulatory reports. Because of its significance, each institution has a responsibility for developing, maintaining, and documenting a comprehensive, systematic, and consistently applied process for determining the amounts of the ALLL and the provision for loan and lease losses (PLLL). To fulfill this responsibility, each institution should ensure controls are in place to consistently determine the ALLL in accordance with GAAP, the institution's stated policies and procedures, management's best judgment and relevant supervisory guidance.

103. Generally speaking, the ALLL consists of reserves calculated two ways, an understanding of which is necessary to understand the nature of many of Orrstown's internal control failures.

A. First, a reserve, or estimated loss amount, should be calculated on all individual loans that are determined to be "impaired." Under Financial Accounting Standards No. 114 ("FAS 114"), an individual loan is impaired when, based on current information and events, it is probable that the bank will be unable to collect all amounts due according to the contractual terms of the loan agreement. As used in FAS 114 "all amounts due according to the contractual terms means

that both the contractual interest payments and the contractual principal payments of a loan will be collected ***as scheduled in the loan agreement***" (emphasis added). As discussed herein, Orrstown's material failures with respect to internal controls over financial reporting derived in significant part from its failure to recognize loans as impaired, and to calculate appropriate reserves for such loans. FAS 114 requires a bank to evaluate each loan individually to determine a reasonable estimate of the amount that can be realized or recovered. If the value of an impaired loan is less than its recorded balance the bank must recognize the impairment that was not previously provided for through a provision to its allowance. Relevant here, the value of a collateral-dependent loan should be determined by the fair market value of the collateral securing the loan.[9] Thus, for loans secured by collateral, identifying impaired loans and calculating ALLL requires accurate and up-to-date appraisals of the collateral. Orrstown's own credit policy recognized the importance of accurate and up-to-date appraisals and required appraisals to be updated at least every two years and more frequently in a declining market. As discussed below however, Orrstown regularly failed to update its collateral appraisals, which resulted in failure to recognize tens-of-millions of dollars in impaired loans, and failure to calculate appropriate ALLL on

[9] A loan is collateral dependent if repayment of the loan is expected to be provided solely by the underlying collateral.

those loans. Moreover, Orrstown frequently extended mature loans in circumstances when the borrowers were experiencing financial difficulty and/or the real estate collateral securing the loans had declined in value, but failed to calculate required reserves on such loans. In addition, just prior to the Offering Orrstown unjustifiably removed several large loan balances from its ALLL, thereby creating a materially misleading picture of the trajectory of its ALLL in its 2009 10-K.

B. Second, in calculating ALLL, all loans for which a reserve is not calculated under FAS 114 should be placed into pools in which estimated credit losses should be calculated in accordance with Financial Accounting Standards No. 5 ("FAS 5"). The reserves on pools of loans are intended to account for the fact that even loans that are not currently impaired can sometimes go bad. In accordance with FAS 5, when measuring estimated credit losses these loans are grouped into homogenous pools (groups of loans with similar risk characteristics), and evaluated collectively considering both quantitative (e.g., historical losses) and qualitative (e.g., environmental adjustment) measures, in order to determine appropriate reserve levels. When estimating credit losses on a group of loans with similar risk characteristics, a bank should consider its historical loss experience on the group, "*adjusted for changes in trends, conditions, and other relevant factors* that affect repayment of the loans as of the evaluation date." *Interagency Policy*

Statement on the Allowance for Loan and Lease Losses (emphasis added). As discussed further below, Orrstown's ALLL calculated under FAS 5 was understated by virtue of the fact that it utilized historic loss factors that relied on lengthy look back periods that bore no relationship to current financial conditions in 2008, 2009, and beyond. For example, as discussed below, in 2009 Orrstown used a *five year* look back period for its historic loss factor when calculating ALLL for pooled loans, but historic losses in 2004, 2005, 2006, and 2007 were uninformative at best when applied during the financial crisis beginning in 2008.

104. A bank must periodically analyze the collectability of its loans held for investment and maintain an ALLL at a level that is appropriate and determined in accordance with GAAP. "An institution's failure to analyze the collectability of the loan portfolio and maintain and support an appropriate ALLL in accordance with GAAP and supervisory guidance is generally an unsafe and unsound practice." Interagency Policy Statement on the Allowance for Loan and Lease Losses, at 5.

105. Critical to the ALLL calculation process is the bank's internal loan review and grading system. Internal loan review and rating is a first step in determining whether a loan is impaired and, therefore, whether an FAS 114 reserve amount must be taken. In other words, a bank must establish a system and controls to regularly review its loan portfolio to identify loan problems in an

accurate and timely manner. "To be effective, the institution's loan review system and controls must be responsive to changes in internal and external factors affecting the level of credit risk in the portfolio." *Interagency Policy Statement on the Allowance for Loan and Lease Losses*, at 6. "[I]t is essential that institutions maintain effective loan review systems …to ensure the accuracy of internal credit classification or grading systems and, thus, the quality of the information used to assess the appropriateness of the ALLL." *Id.*, at 8. If a bank's loan review rating system is ineffective, impaired loans can go unrecognized and ALLL can be materially misstated, which is precisely what happened in the case of Orrstown.

106. As discussed herein, Orrstown's loan review process failed to take into account material adverse information about both its borrowers and the broader financial crisis impacting real estate markets beginning by 2008. Indeed, as described herein, even when large borrowers expressly informed Orrstown they were short on money, were struggling with cash flow, and sought loan modifications, Orrstown granted modifications and extensions without recognizing their loans as impaired or TDRs, and without increasing the ALLL reserve to properly recognize the higher risk of loss on the loan.

2. Orrstown's Loan Review Rating System

107. Orrstown's loan review rating or grading system, sometimes called the Internal Risk Rating system (or "IRR"), was set forth in its Loan Policy. During most of the Class Period, the loan review function was performed internally by a Loan Review Officer, Chad Rydbom, who was supervised by Embly and the Credit Administration Committee. In early 2011, as a result of deficiencies found by the Regulators, Orrstown began outsourcing the loan review function to a consultant, Solomon Edwards Group ("SEG"), who promptly reduced many of the ratings, as discussed below.

108. Orrstown maintained an 8-point IRR scale. The first three ratings, "Excellent," "Good," and "Acceptable," applied to loans that possessed acceptable credit quality and average or better than average risk of loss.

109. The fourth category, "Pass/Watch," applied to loans that possessed minimally acceptable credit quality and which needed to be monitored more closely. As stated in the Loan Policy:

> Loans in this category are current, however, information has been received that indicate that the borrower is experiencing declining financial performance or unfavorable industry conditions, which could, if not corrected, lead to a further downgrade of the credit. This rating serves as an early warning system that the credit needs to be monitored more closely. While ***payment in full is generally expected when combining cash flow, collateral, and facility-specific features***, the potential risk of loss significantly exceeds normal levels.

(emphasis added.) Critically, loans assigned this risk rating should "generally possess": "average or above average asset quality with strained liquidity," and "[c]ash flow may be strained," but the loans "**are secured with adequate [collateral] value to protect against any potential losses**," with "[c]ommercial real estate [loans having] loan to value of 75% or less" (emphasis added). In reality, as discussed below, Orrstown improperly assigned loans to this category where the borrower had strained cash flow ***and*** insufficient collateral, and/or where Orrstown had failed to obtain updated appraisals to ascertain if the collateral was sufficient.

110. The fifth category, "Other Assets Especially Mentioned" ("OAEM" or "Special Mention"), was for loans that had "potential weaknesses that may, if not checked or corrected, weaken the asset or inadequately protect the institution's position at some future date," but did not present sufficient risk to warrant adverse classification. These had "elevated risk, but their weakness does not yet justify a substandard classification." Critically, OAEM was "not a compromise between pass and substandard and should not be used to avoid exercising such judgment."

111. The sixth category, "Substandard," was for loans considered "inadequately protected by the sound worth and paying capacity of the obligor ***or*** of the collateral pledged, if any." (Emphasis added). Specifically, the loan policy described Substandard loans as follows:

> A substandard asset is inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Assets so classified must have a well-defined weakness, or weaknesses, that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the bank will sustain some loss if the deficiencies are not corrected.
>
> Substandard assets have a high probability of payment default, or they have other well-defined weaknesses. They require more intensive supervision by bank management. Substandard assets are generally characterized by current or expected unprofitable operations, inadequate debt service coverage, inadequate liquidity, or marginal capitalization. Repayment may depend on collateral or other credit risk mitigants. For some substandard assets, the likelihood of full collection of interest and principal may be in doubt; such assets should be placed on non-accrual. Although substandard assets in the aggregate will have a distinct potential for loss, an individual asset's loss potential does not have to be distinct for the asset to be rated substandard.

As explained more fully below and as found by the SEC, during the Class Period Orrstown failed to properly rate loans as Substandard loans and also failed to correctly calculate required ALLL reserves on the loans that it did rate Substandard.

112. The seventh category, "Doubtful," was for loans that "ha[ve] all the weaknesses inherent in one classified substandard with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable." Under the Loan Policy:

> A doubtful asset has a high probability of total or substantial loss, but because of specific pending events that may strengthen the asset, its classification as loss is deferred. Doubtful borrowers are usually in default, lack adequate liquidity or capital, and lack the resources necessary to remain an operating entity. Pending events can include mergers, acquisitions, liquidations, capital injections, the perfection of liens on additional collateral, the valuation of collateral, and refinancing. Generally, pending events should be resolved within a relatively short period and the ratings will be adjusted based on the new information. Because of high probability of loss, non-accrual accounting treatment is required for doubtful assets.

113. Finally, the eighth category, "Loss", was for loans "considered uncollectible and of such little value that their continuance as bankable assets is not warranted." Even though they may have had some recovery or salvage value, Loss loans were written off immediately.

3. Orrstown's Internal Control Failures Resulted In Improper Calculation of ALLL

114. Orrstown's ALLL calculation was performed quarterly by Chad Rydbom, the loan review officer, and was then sent to Embly and Everly for review and approval of the overall reasonableness of the calculation and the factors used. The calculation was then presented to the Credit Administration Committee for approval. Orrstown's internal controls suffered from numerous material weaknesses, resulting in materially under-reserved ALLL and repeated failure to recognize impaired loans, both of which are required to be disclosed in SEC filings.

115. **First**, until the final quarter of 2010, Orrstown evaluated only Substandard loans for impairment and calculated specific reserves only on the Substandard loans that it found impaired. By limiting its evaluation of impairment to loans that were rated Substandard, Orrstown artificially limited its evaluation. Moreover, as discussed below, Orrstown's internal risk ratings failed to accurately identify material weaknesses; by using the inaccurate loan ratings as a filter and only evaluating impairment on loans identified as Substandard, Orrstown simply failed to correctly identify all impaired loans. Orrstown was criticized by the SEC and also by its own consultants for this failure of internal controls.

116. **Second**, from at least 2008 through 2010, Orrstown routinely failed to identify as impaired in its SEC filings all of the Substandard loans for which it had calculated collateral deficits under FAS 114, in contravention of its own Loan Policy and GAAP. As discussed above, a specific reserve should have been calculated on all individual loans that are determined to be "impaired" under FAS 114. Orrstown's Loan Policy provided that "All commercial substandard rated credits are evaluated for impairment based on the 'Fair Value of Collateral' method. … If any analysis results in a deficit the credit is considered impaired and the deficit will be added to the FAS 114 allocation." In other words, if the collateral was worth less than the loan balance, the loan should have been considered impaired and a specific reserve created. Orrstown however regularly

failed to identify loans as impaired in its SEC filings even when it found collateral deficiencies under FAS 114. In 2008 and 2010 Orrstown calculated collateral deficits on loans but simply failed to identify those loans as impaired in its SEC filings, resulting in material understatements in its impaired loan disclosures. Orrstown was criticized by the SEC, the Regulators, and also by its own consultants for this failure of internal controls.

117. **Third**, in conducting its analysis of the collateral for Substandard, collateral-based loans, Orrstown failed to obtain updated appraisals. Since the existence and amount of impairment under FAS 114 depends on the value of the collateral pledged, obtaining updated appraisals is critical to determining impairment and assuring adequate reserves. Indeed, Orrstown's Loan Policy provided that appraisals should be updated, but due to its materially weak internal controls Orrstown regularly failed to follow its own policy. Its Loan Policy provided:

> All real estate loans should be supported by current appraisals or evaluations. The current status of an appraisal is dependent upon a number of factors. **In a stable real estate environment, an appraisal may remain valid for no more than two years. In a rapidly escalating or deteriorating market, a value may be valid for only a few months** (emphasis added).

In many cases, Orrstown utilized appraisals that were older than two years, and often older than five years. These appraisals were virtually worthless and resulted in a failure to accurately identify impaired loans and calculate ALLL. In the

rapidly deteriorating environment during the financial crisis beginning in 2008 even real estate appraisals less than two years old were stale. Most of the appraisals relied on by the Bank pre-dated the financial crisis. Orrstown was criticized by the SEC, the Regulators, and also its own consultants for this failure of internal controls.

118. **Fourth**, rather than obtain updated appraisals that took into account current circumstances during the financial crisis, Orrstown applied discount factors to old appraisals, which was improper under GAAP. Specifically, Orrstown applied a 22% discount (and later added an additional 15% discount) to old appraisals based on a 2004 study that, as found by the SEC, had "no bearing on the current real estate market as of 2010." The SEC also found that Orrstown's use of a universal discount factor did not comply with GAAP. Orrstown was also criticized by the Regulators and its own consultants for this failure of internal controls.

119. **Fifth**, Orrstown failed to calculate a reserve on loans other than those rated Substandard (except to the extent that the Bank's exposure to a particular industry exceeded 25% of the Bank's total equity). As noted above, for all loans not subject to FAS 114, the Bank should have calculated reserves under FAS 5 based on pools of loans with similar characteristics using historical loss factors. But Orrstown only calculated an FAS 5 reserve for *Substandard* loans for which a

FAS 114 reserve was not calculated, instead of the entire loan portfolio by segment. This practice was contrary to generally accepted industry practice and also improperly assumed that the Bank only incurs losses through its Substandard and lower rated loans, which was not accurate. Orrstown was criticized by the SEC and also by its own consultants for this failure of internal controls.

120. **Sixth**, for the pooled loans for which it did calculate an FAS 5 reserve (*i.e.*, Substandard that were not impaired under FAS 114 and loans to the extent that the Bank's exposure to a particular industry exceeded 25% of the Bank's total equity), Orrstown used improper historical loss factors, which resulted in understated reserves. In its 2009 Loan Policy, for example, Orrstown specified that the reserve would be calculated using a **five year** average charge-off rate. In other words, the bank averaged its historical losses over the past five years. Five years was far too long of a time period to yield a reasonable average charge-off rate, particularly in the rapidly deteriorating environment during the financial crisis. Further, the charge-offs were equally weighted, such that older charge-off rates, under very different economic circumstances, received the same weighting as more recent time periods. In December 2010, the Loan Policy was changed to provide for a rolling 8-quarter weighted average, with 25% weighting to the oldest year and 75% to the most recent year. Even then however Orrstown failed to comply with industry standards because, as later found by one of the Bank's

consultants, it failed to annualize the quarter-end loss rates, resulting in underestimating the loss allowance reserve by a material amount. The industry-accepted practice was to annualize the losses and divide the amount by the average loan balances to provide a more representative picture of the loan loss ratio in that segment. Orrstown was criticized by the SEC, the Regulators, and also by its own consultants for this failure of internal controls.

121. All of the above material failures of internal controls existed at least as early as 2008 and resulted in materially misstated financial statements during the Class Period. Some specific examples of these deficiencies are described below:

(a) 2008

122. For example, in evaluating Substandard loans for impairment and calculating ALLL reserves on them for the year ended 2008, approximately **62%** of the loans evaluated had real estate appraisals more than two years old and **15%** had appraisals over five years old. Utilizing stale appraisals did not comply with the Bank's Loan Policy, did not comply with GAAP because Orrstown incorporated inappropriate inputs into its collateral valuation methods, and resulted in a failure to accurately calculate ALLL and identify impaired loans. The total outstanding balance for these loans was approximately $14.2 million, which was about **81%** of the loans evaluated. Given the financial crisis and impact on real

estate markets beginning in 2008, these outdated appraisals were completely unreliable. If Orrstown had utilized updated appraisals, as required, it would have had to calculate a materially higher ALLL.

123. Moreover, despite calculating a collateral deficiency on many of these Substandard loans for 2008 year end, meaning they were impaired under FAS 114, the Bank inexplicably failed to identify those loans as impaired in its financial statements filed with SEC. In its 2008 10-K, Orrstown stated that at December 31, 2008, its total recorded investment in impaired loans was only $1,830,000. In reality, as least approximately $7.5 million loans were impaired under Orrstown's own FAS 114 analysis, which was a 416% understatement. Moreover, because 62% of the loans evaluated for impairment under FAS 114 had appraisals more than two years old and 15% were more than five years old, the amount of impaired loans would have been much higher using updated appraisals since, by the end of 2008 real estate markets had already tumbled due to the financial crisis.

(b) 2009

124. Similarly, in evaluating Substandard loans for impairment and calculating ALLL reserves on them for the year ended 2009, approximately **56%** of the loans evaluated had real estate appraisals more than two years old and **14%** had appraisals over five years old. Utilizing stale appraisals did not comply with the Bank's Loan Policy, did not comply with GAAP because Orrstown

incorporated inappropriate inputs into its collateral valuation methods, and resulted in a failure to accurately calculate ALLL and identify impaired loans. The total outstanding balance for these loans was approximately $20.4 million, which was about 54% of the loans evaluated. Once again, these outdated appraisals were completely unreliable. If Orrstown had utilized updated appraisals, as required, it would have had to calculate a materially higher ALLL.

125. Moreover, the 2009 10-K repeated the same material error with respect to impaired loans reported in 2008. Specifically, the 2009 10-K stated that the Bank's total recorded investment in impaired loans for 2008 was only $1,830,000, when Orrstown had actually found that at least approximately $7.5 million in loans were impaired at the end of 2008.

126. Further, as discussed more fully in Section X.A.4 below, the Bank's ALLL calculation reported in the 2009 10-K improperly excluded at least three significant loans that had been identified as Substandard, and for which ALLL reserves totaling around $2.8 million had been calculated, but were removed without legitimate basis from the Bank's ALLL calculation at the eleventh hour. Specifically, despite internally identifying over $8.7 million in loans to Antonio Mourtil, J&S Enterprises, and Marvin Windows as "Substandard," and including them in drafts of the ALLL calculation as of December 31, 2009, the Bank excluded those loans from its ALLL reported in the 2009 10-K (which was

incorporated in the Offering Dcouments). As set forth below, these loans had not improved in quality to justify their removal. To the contrary, they were all rated Substandard and the Bank had considered them Substandard at year end. In fact, SEK specifically disputed the Bank's removal of J&S from the ALLL calculation, but the Bank ignored SEK's opinion. The Bank's own November 2009 internal loan review ("November Loan Review"), which was touted in the 2009 10-K to reassure investors about the quality of the Bank's loan portfolio as discussed more fully below, resulted in a recommendation to rate the Marvin Window loan Substandard, which means a reserve was required, but the final ALLL in the 10-K simply ignored it. None of the loans were fully secured by collateral. The Bank had calculated a collateral deficit of $1.33 million for Mourtil, a collateral deficit of around $600,000 for J&S, and a deficit of $800,000 for Marvin Window. If those three loans had been included in the ALLL reported in the 2009 10-K as they should have been, the Bank's reported ALLL would have increased roughly by 131%, and its reported net income would have dropped by roughly 25%. Those loans also should have been identified as impaired, which would have increased the bank's disclosure of impaired loans by nearly 127%. By failing to include these loans in the ALLL calculation and disclose necessary reserves on them, and also by failing to disclose them as impaired, the 2009 10-K financial statements

were materially misstated, all of which derived from the Bank's materially deficient internal controls over financial reporting.

(c) 2010-2011

127. Throughout 2010, Orrstown once again utilized stale appraisals, which did not comply with the Bank's Loan Policy, did not comply with GAAP because Orrstown incorporated inappropriate inputs into its collateral valuation methods, and resulted in a failure to accurately calculate ALLL and identify impaired loans.

128. In evaluating Substandard loans for impairment and calculating reserves on them for the first quarter of 2010, approximately **53%** of the loans evaluated had real estate appraisals more than two years old and **20%** had appraisals over five years old. Once again, these outdated appraisals were completely unreliable. If Orrstown had utilized updated appraisals, as required, it would have had to calculate a materially higher ALLL.

129. Similarly, in the second quarter of 2010, approximately **40%** of the loans evaluated for impairment were supported by real estate appraisals more than two years old and **14%** were supported by appraisals over five years old.

130. In the third quarter of 2010, approximately **29%** of the loans evaluated for impairment were supported by real estate appraisals more than two years old and **10%** were supported by appraisals over five years old.

131. These stale appraisals meant that the Bank's ALLL calculation and identification of impaired loans was materially misleading and unreliable.

132. Moreover, in its quarterly statements for Q2 and Q3 Orrstown both failed to disclose specific loans that should have been identified as impaired, and also failed to disclose loans that were actually identified by the bank as impaired. As found by the SEC, Orrstown failed to disclose approximately $46.6 million in impaired loans in its 10-Q for the second quarter of 2010. Of those, Orrstown had actually determined that $5.6 million were impaired under FAS 114 but nevertheless omitted them from its disclosures of impaired loans. Similarly, the SEC found that in Q3 2010 Orrstown failed to disclose approximately $69.5 million in loans that should have been identified as impaired, of which Orrstown had *actually* calculated an FAS 114 impairment for $18.5 million but nevertheless omitted them from its disclosures in violation of GAAP. In other words, Orrstown's disclosures concerning impaired loans in the Q2 and Q3 SEC filings were materially incorrect for two independent reasons, both of which derived from Orrstown's deficient internal controls over financial reporting: (1) First, Orrstown failed to accurately identify impaired loans due to its practice of "pretending and extending" loans that should have been identified as Substandard and impaired (discussed more fully below), and (2) Second, even when Orrstown correctly

identified loans as impaired, it inexplicably failed to include them in its disclosures of impaired loans in its SEC filings.

133. In its 2010 10-K, filed March 11, 2011, Orrstown similarly understated impaired loans. As found by the SEC, Orrstown disclosed $14.1 million in impaired loans, but failed to disclose an additional $51 million of loans that should have been identified as impaired. This misstatement was also repeated in footnotes to financial statements in Orrstown's 10-Qs for the second and third quarters of 2011, as well as the 10-K for 2011.

134. As found by the SEC, in its 10-Q for the first quarter of 2011, filed May 10, 2011, Orrstown likewise disclosed $14.1 million in impaired loans but failed to disclose an additional $51 million of loans that should have been identified as impaired.

135. As members of the Loan Committee, Quinn, Everly, and Embly were ultimately responsible for ensuring that each loan was supported by recent appraisals, and Embly in particular was responsible for regulatory compliance regarding appraisals.

4. Orrstown Failed To Properly Risk Rate Loans, Failed To Identify and Disclose TDRs, and Failed To Identify Impaired Loans For Its Largest Borrowers

136. Orrstown's internal controls were materially deficient for the six reasons discussed above, but Orrstown's internal control failures did not begin or

end there because Orrstown also regularly engaged in a "pretend and extend" course of conduct to avoid rating loans Substandard, calculating necessary reserves on specific borrowers' loans, and identifying loans as impaired and loan extensions and modifications as TDRs.

137. As noted above, the first step in Orrstown's process for calculating ALLL required Orrstown to rate the loans in its portfolio under the IRR scale. Only Substandard loans were evaluated for impairment by Orrstown between 2008 and September 2010 and only those that were not impaired were placed into an FAS 5 pool. Both of these procedures were fundamentally improper procedurally, but Orrstown also failed to accurately risk rate its loans and ignored negative information from borrowers, meaning many more loans should have been identified as Substandard and impaired but were not.

138. As noted above, under the Loan Policy a Substandard loan was one that was "inadequately protected by the sound worth and paying capacity of the obligor or of the collateral pledged, if any." Beginning as early as 2008, many of Orrstown's largest commercial borrowers had notified the Bank that they were suffering financial trouble and had requested extensions and/or modifications to their loans. Further, in virtually every instance the value of the collateral securing those loans had declined due to the financial crisis and concomitant decline in real estate values. The Bank regularly failed to identify them as Substandard however,

and instead frequently extended or modified them in order to forestall recognizing the loans as Substandard or impaired, and without recognizing the extensions as TDRs.

139. These loans should have been classified as Substandard under the IRR. They also should have been identified and disclosed as impaired, and the modifications and extensions should have been identified and disclosed as TDRs (this was also noted in the SEG review conducted in Q1 2011). But they were not. Instead, Orrstown would "pretend and extend," meaning it would extend or modify the loans to defer required losses or reserves, sometimes lending additional money intended solely to cover interest payments. As a result, Orrstown's financial statements materially understated the true risks inherent in its commercial loan portfolio and consequently portrayed Orrstown's financial condition as more stable and robust than the reality. Numerous loans fell into this category, representing many of the bank's largest borrowers, several of which are discussed in detail in Section VII.D, below.

C. Material Weaknesses Identified by the Regulators

140. Many of the above material weaknesses of internal controls were identified by the Regulators when they began to examine Orrstown more closely beginning in 2010.

141. The Enforcement Actions were the culmination of the Regulators' on-site involvement with and examination of Orrstown since the 2009 examination.

a. CW#2, who recalls that outside of the ordinary examinations done by the Regulators, the Federal Reserve was on-site at the Bank's Operations Center in or about November-December of 2010.

b. After August of 2010, the following statement no longer appeared in Orrstown's Form 10-Qs issued during the Class Period:

> ***Management is not aware of any current recommendations by regulatory authorities which, if implemented, would have a material effect on the Corporation's liquidity, capital resources or operations.***

Form 10-Q 1Q 2010, filed on 5/7/2010, at 24; *see also* Form 10-Q 2Q 2010, filed on 8/5/2010, at 26 (same). Defendants did not note or provide any explanation for the omission of this material statement.

142. The Joint Examination scrutinized every aspect of the Company's internal controls over operations, reliability of financial reporting, and compliance with applicable banking laws and regulatory guidelines.

143. Specifically, the Regulators examined:

(i) The board's supervision of the Bank's major operations,

(ii) The adequacy of the Bank's management structure and the competency of senior officers;

(iii) Efficacy of the Bank's credit risk management practices;

(iv) Timeliness of the Bank's loan portfolio reports submitted to the board;

(v) Efficacy of the Bank's loan underwriting and credit administration procedures;

(vi) Conformance of appraisals with generally accepted appraisal standards;

(vii) Efficacy of the Bank's loan workout process;

(viii) Reliability of the Bank's loan grading system; and

(ix) The acceptability of the Bank's volume of criticized loans, concentrations of credit, and levels of Risk Assets.

See 8-K Current Report, filed on 3/23/2012; Exhibit A at 2-8.

144. The Regulators identified approximately 11 areas of the Bank's internal controls that required complete remediation and corrective action, and the need to design, implement, enhance and improve the internal controls to the processes that had been in place and remained unchanged from at least December 2009.

145. Each of the 11 areas was material to and constituted a significant part of Orrstown's internal controls, and Defendants' false and misleading statements which failed to timely and substantively describe the deficiencies in each internal control rendered actionable each false and misleading statement. Plaintiff focuses on the following categories of pervasive and long-standing deficiencies that

rendered Orrstown's internal controls ineffective requiring "corrective action" as described below with respect to, among others, the following areas:

- *Board Oversight and Management Competency*
- *Loan Underwriting*
- *Credit Administration*
- *Allocation of Loan Losses*
- *Concentrations of Credit*

1. Corrective Action – Develop and Execute Board Oversight and Management Competency Plans

146. The Regulators determined that prior to and throughout the Class Period, the Bank had no effective board oversight and management of operations. Therefore, the Regulators required the Bank to develop and execute effective plans for board oversight and management of operations.

147. Implementing this mandate, the Federal Reserve required the Bank to retain an independent consultant to "conduct a review of all management and staffing needs of the Bank and the qualifications and performance of all senior management (the 'Management Review'), and to prepare a written report of findings and recommendations (the 'Report')." Ex. A, Written Agreement at 2. The Management Review was to consider several factors, including but not limited to the following:

> An evaluation of each senior officer to determine whether the individual possesses the ability, experience, and other qualifications ***to competently perform*** present and anticipated duties, ***including their ability to: . . . restore and maintain the Bank to a safe and sound condition***. . . .

Id. at 3-4 (emphasis added). The Bank was to report its findings and recommendations within 30-days after the issuance of the independent consultant's Report.

148. In its Consent Order, the Department of Banking also required the Bank to take affirmative steps to revamp management through a review conducted by an independent consultant "who is acceptable" to the Department of Banking. Form 8-K Department of Banking Consent Order, filed 3/23/2012, at 3-5 The independent consultant was to provide, *inter alia*,

> An evaluation of each existing director and senior officer to determine ***whether these individuals possess the ability***, experience, and other qualifications required to perform present and anticipated duties, including adherence to the Bank's established policies and practices, and ***restoration and maintenance of the bank in a safe and sound condition.*** . . .

Id. at 4 (emphasis added).

149. Each of these Individual Defendants served on the board and/or in senior management positions in 2009, prior to the March 2010 Offering, and at all other relevant times. Each Individual Defendant was aware of or recklessly disregarded the absence or material deficiencies in internal control over financial

reporting discussed herein. They were responsible for developing or overseeing the internal controls over the underwriting of loans, risk management and financial reporting that were found to be in place in 2009 through 2011 which were found to be materially deficient and ineffective by the Regulators and the Bank's bevy of consultants.

150. Defendant Everly signed all of the SOX Certificates that were filed with the SEC during the Class Period. Defendants Everly and Embly were members of the Loan Committee at all relevant times. In fact, in September 2009 Defendant Embly was appointed as Chief Credit Officer to purportedly "enhance [the Bank's] processes and controls, as well as clearly delineate independence between sales and credit." Form 424B5 Prospectus Supplement, filed 3/24/2010, at S-2. Defendants Everly and Embly participated in the preparation of the Company's false and misleading SEC filings.

151. Defendants Everly and Embly are implicated in the Company's ineffective and deficient internal controls that existed prior to and continued into 2012:

a. CW#1 confirmed that in 2008 and into early 2009, Everly and Embly permitted Terry Reiber, a former loan officer, to perform his own appraisals on some of the commercial loans he originated in Hagerstown, Maryland, and these loans were often approved despite their failure to

comply with the Loan Policy. These loans were part of the Bank's loan portfolio at the time of the 2010 Offering and during the Class Period.

b. CW#1 and CW#3 confirmed that in 2008 and into early 2009, Everly and Embly permitted commercial loans in Hagerstown, Maryland that were originated by Reiber to be approved even though no due diligence was done on them. These Reiber-approved loans were in the Bank's loan portfolio in March 2010 and during the Class Period.

c. CW#1 confirmed that beginning in 2008, CW#1 worked on the credit analyses for three of the Bank's largest borrowers – the Azadis, the Shaool Family and two Chambersburg real estate developers Bob Hickey and Tom Mongold ("Chambersburg Developers"). CW#1 recalled that the cash flows often did not support the loans these borrowers requested, but that the loans were approved anyway by Everly and Embly who sat on the Loan Committee. These Everly/Embly approved credits were in the Bank's loan portfolio in March 2010 and during the Class Period.

d. CW#1 also explained that often new loans were extended to "bail out" these borrowers from a bad financial situation in 2008 through 2011.

e. CW#3 confirmed that the credit analysts' recommendations throughout the 2008 to 2011 period to not extend credit were often overruled

by the Loan Committee, whose approvals of the loan applications were based upon an "exception" to the Loan Policy. These improperly approved credits were in the Bank's loan portfolio in March 2010 and/or during the Class Period.

f. CW#3 confirmed that Everly and Embly violated banking regulations in late 2010 or early 2011 by exceeding the Bank's legal lending limit of $19 million to the Chambersburg Developers (*discussed infra* Part VII.D.4). (As discussed below, the Bank also exceeded the lending limit with respect to Ben Shaool in 2009.) CW#3 recalled that Everly and Embly explored whether they needed to do "work arounds" to restructure the loans so that the loans could be reissued without either the Chambersburg Developers being identified as guarantors of the loans or by concealing the relationship between the Chambersburg Developers and each of their related entities that had obtained loans from Orrstown.

152. In the wake of the Enforcement Actions, several officer and senior level "resignations" occurred:

> "On May 14, 2012, ***Bradley S. Everly*** resigned as Executive Vice President, Treasurer and Chief Financial Officer of Orrstown Financial Services, Inc. and its wholly-owned subsidiary, Orrstown Bank (the "Bank"). The resignation was not due to any disagreement with the Company or the Bank on any matter relating to the Company's or the Bank's accounting principles or practices." Form 8-K Other Events, filed 5/14/2012 (emphasis added).

> "On June 29, 2012, ***Terry W. Miller*** resigned as Senior Vice President and Director of the Special Assets Group of Orrstown Bank (the "Bank"), the Registrant's wholly-owned banking subsidiary." Form 8-K Other Events, filed 7/16/2012 (emphasis added).

> "On September 18, 2012, ***Jeffrey W. Embly*** resigned as Executive Vice President and Chief Operating Officer of Orrstown Financial Services, Inc. and Orrstown Bank, to pursue other business opportunities." Form 8-K Other Events, filed 9/18/2012 (emphasis added).

153. As Orrstown and the Bank were announcing Everly's and Embly's departures they were also announcing additions to management which were intended to fulfill the Regulators' mandate that management "restore and maintain the Bank to a safe and sound condition." The Company filed these announcements with the SEC:

> "On August 14, the Company announced ***Jeffrey M. Seibert*** was appointed Executive Vice President and Chief Operating Officer of the Bank." Form 8-K Other Events, filed 8/14/2012 (emphasis added).

> "On August 29, 2012, ***David P. Boyle*** was appointed as Executive Vice President and Chief Financial Officer of the Orrstown and the Bank." Form 8-K Other Events, filed 8/29/2012 (emphasis added).

> "On September 15, 2012, the Company announced ***David D. Keim*** joined the Bank as Executive Vice President, Chief Risk Officer. Mr. Keim will ***oversee the Enterprise Risk Management function of the Bank and in this role will be responsible for the leadership, innovation, governance, and management necessary to identify, evaluate, mitigate, and***

> ***monitor the Bank's operational and strategic risk***." Form 8-K Other Events, filed 9/25/2012 (emphasis added).

154. Of these new hires, Mr. Keim is the most telling given that he was tasked with developing and executing an ***entirely new*** risk management process. that the reason is because the existing risk management processes that existed prior to and during the Class Period were inadequate and the Enterprise Risk Management Committee, formed in 2009 and on which Defendants Quinn, Zullinger, Coy and Shoemaker sat, failed to implement effective and adequate controls and oversight of the Bank's risk areas, such as credit, operations, liquidity and compliance with regulatory guidelines.

155. The foregoing demonstrates, along with other facts discussed herein, that Everly and Embly engaged in reckless banking practices in 2009 through their departures and were among those responsible for the Bank's internal control failures.

2. Corrective Action – Develop and Execute a New Process for Loan Underwriting

156. Throughout the Class Period, the Bank lacked effective internal controls with respect to loan underwriting. The Enforcement Actions very specifically outline the deficiencies that needed to be remediated through the implementation of new policies and procedures in Orrstown's loan underwriting.

157. From at least 2007 through 2011 the Bank regularly disregarded and violated the loan policies in extending and restructuring credit to borrowers with existing commercial loans that, in CW#3's words, "didn't work" from the day they were made. Many if not most of these loans were extended and restructured and should have been identified as TDRs and therefore impaired loans.

158. As described in the Offering Documents, the Bank's "credit approval process is structured in a manner such that all major decisions regarding loans need to be approved by a committee of senior management and board members." Form 424B Prospectus Supplement, filed 3/24/10, at S-2 (emphasis added). As reported in the Offering Documents, the loan review process had the following levels of involvement by executive officers and directors of Orrstown, including all of the Individual Defendants:

a. Oversight and management of the process by the Chief Credit Officer;

b. No individual lender had a maximum lending authority exceeding $350,000;

c. The Chief Commercial Officer had a maximum lending authority limit of $500,000;

d. The Chief Credit Officer had a maximum lending authority limit of $1 million with no single credit over $500,000;

e. All other loans had to be reviewed and ratified by the Loan Committee consisting of the Chief Executive Officer, Chief Credit Officer, Chief Commercial Officer, Chief Financial Officer and rotating two directors;

f. The Credit Administration Committee, consisting of four independent directors, provided ongoing credit oversight and annually reviewed all loan relationships with an aggregate committed exposure of greater than or equal to $750,000; and

g. The Loan Review Officer, under the supervision of the Credit Administration Committee, rated all loan relationships with aggregate committed exposure of less than or equal to $1,000,000. *Id.*

159. Depending upon the size of the loan, the "packets" would go to the Loan Committee for approval. After loans were approved, the Loan Review Officer was to periodically monitor and perform stress tests on the loans. The loan officers were to assist in securing updated financial data, *e.g.*, financial statements, on all lending relationships that would indicate the financial condition of each borrower and guarantor.

160. In 2008 through the end of March 2010 the Credit Department's Credit Analyst Group consisted of three credit analysts and a Senior Credit Manager. The Credit Analyst Group was charged with analyzing the credit

quality of every loan that was generated by the Bank's loan officers, including the commercial loans for borrowers in the Hagerstown market.

a. CW#3 explained that credit analysts would review a loan applicant's loan application, personal and business tax returns, and appraisals; perform a collateral valuation; prepare cash flows; and then submit the loan "packet" to the loan officer who would provide his analysis of the creditworthiness of the loan applicant. The Credit Analyst Group was to make a recommendation whether to approve the loan application.

b. Despite the fundamental and crucial role credit analysts play in determining the creditworthiness of a borrower, the Bank's junior credit analysts were inexperienced and the Bank, according to CW#1, refused to send them and the senior credit analysts, such as CW#3, to formalized training seminars.

c. In addition, from 2006 through 2012 the Bank's Loan Review Officer had no formal or practical training for this position, but rather was a 2003 college graduate with a marketing degree who went to work directly for the Bank as a credit analyst, and then after only three years was appointed in December 2006 to the position of Loan Review Officer.

161. The Department of Banking specifically identified the Bank's deficiencies and failures in its loan underwriting process by requiring "[w]ithin 60

days of this Order, the Bank shall adopt policies and procedures to minimize and monitor loan documentation exceptions as well as identify and correct outstanding exceptions noted in the Report of Examination." Ex. B, Consent Order at ¶ 6(a). This deficiency was identified as existing during the relevant time period of 2009 through 2011 by the Confidential Witnesses, who as credit analysts were often working with incomplete loan packets while handling a volume of loans excessive for a staff of three.

a. According to CW#3, tax returns are the most important piece of data for credit analysts because they were used by credit analysts to construct the borrower's cash flow and derive a Debt Service Coverage Ratio.

b. CW#3 stated that the credit analysts' work suffered from a huge volume of loan applications and either missing or outdated credit data, such as tax returns and appraisals, needed for their credit review. CW#1 and CW#3 recall that more often than not during the Class Period they were working with either outdated appraisals or no appraisals.

c. According to CW#1, the loan officer would review and in some cases modify the presentation of information in the "packets," especially as to the applicant's cash flow. These modifications often resulted in the

applicant appearing to be more creditworthy. CW#1 specifically recalls Hagerstown loan officer Terry Reiber either modifying "packets" prepared by the credit analysts or independently preparing the "packets" himself These doctored packets resulted in the approval of unsustainable credits that were in the Bank's loan portfolio at the time of the March 2010 Offering, and thereafter during the Class Period.

162. The Bank's Loan Policy required the Loan Committee to stress test loans and carefully manage risks taken by the Bank when extending credit and conducting restructurings. The Loan Policy specifically condemned taking excessive risks in approving loans. According to CW#1 and CW#3, the Loan Committee routinely approved loans, restructurings and the extension of credit from late 2009 through 2011 that failed to satisfy the credit standards of the Loan Policy. Although CW#1 and CW#2 were not in the Loan Committee meetings during the voting in 2009 through 2011, they personally saw the loans that were approved during that period that did not satisfy the Loan Policy.

163. Prior to the close of the March 2010 Offering the Loan Committee consisted of the Chief Credit Officer, Chief Executive Officer, Chief Financial Officer, director Defendant Snoke and one rotating director. Prior to and throughout the Class Period, Defendants Quinn, Everly, Embly and Snoke were

consistently members of the Loan Committee. The weekly Loan Committee meetings were attended by members of the Loan Committee, the loan officers and a representative of the Credit Analyst Group.

164. In 2008, 2009 and up and until April 2010 CW#3 participated in the Loan Committee meetings to answer questions and comment on the Credit Analyst Group's recommendation as reflected in the "packets." According to CW#3, Defendant Embly was the most influential member of the Loan Committee. The allegations set forth in paragraphs 165 to 171 reflect actions and conditions that were personally observed by CW#3 prior to and during the entire Class Period.

165. Under Embly, in the years 2008 through 2011 CW#3 recalls commercial loans continued to be approved by the Loan Committee contrary to the Credit Analyst Group's "Do Not Recommend Approval" statements. CW#3 confirmed that the Loan Committee, contrary to Loan Policy, took unwarranted or excessive risk in approving commercial loans generated by Terry Reiber in the Hagerstown market and loans in which the applicant was part of the "Old Boys Club" of Chambersburg, *see infra* Part VII.D.4. In these cases, the Loan Committee would approve the loans based upon an often frivolous "exception." While Loan Committees can approve loans notwithstanding a "do not approve" recommendation by the Credit Analyst Group, it is standard market practice to document such approvals in the Committee minutes with details on the specific

facts that the Committee considered in granting approval. No evidence of such process has been found. CW#3 was not present in the Loan Committee meetings during the actual voting, but CW#3 learned of the Loan Committee's decisions after the loans were approved.

166. In the years 2008 through 2011 CW#3 recalls that the Loan Policy allowed for "exceptions" in approving credits to borrowers who did not satisfy the Loan Policy's standard credit requirements. According to CW#3, Defendant Embly appeared to have full discretion on identifying and justifying an exception. CW#3 said that exceptions were only to be used as a justification for approving a loan if the borrower had an excellent credit history with the Bank, if the loan would be over-collateralized, or if the borrower satisfied other recognized exceptions listed in the Loan Policy. Importantly, the Loan Policy indicated that ***more than one*** of the listed exceptions should be met before a credit extension was approved.

167. One of the Loan Policy's basic underwriting criteria for commercial loans is that the borrower's income must satisfy the loan's debt service. According to CW#3, the Loan Policy required that the loan applicant or prospective borrower's generated cash flow exceed ***at a minimum*** 1.20 times the annual debt service. CW#3 confirmed that in 2008 through 2011, loans were regularly approved even though the applicant failed to satisfy the 1.20 Debt Service Ratio.

CW#3 specifically recalls where the Debt Service Ratio was as low as 1.1 and 1.0 on loan applications yet the Loan Committee would approve the loan based upon an "exception." From CW#3's credit analyst perspective, the exceptions rarely – if ever – justified approval of the loans. And, equally concerning to CW#3, the exception of a Debt Service Ratio of 1.1 and 1.0 became the norm. By lowering the Debt Service Ratio, throughout 2007 and into 2011 the Loan Committee was approving very risky loans in the Hagerstown and Chambersburg markets that CW#3 confirmed "didn't work" from a cash flow standpoint.

168. The Hagerstown commercial loans generated by loan officer Terry Reiber in 2007 through 2009 often had below Loan Policy level Debt Service Ratios. Yet the loans would be approved without any justification for the Loan Committee allowing this exception beyond than Reiber's vacuous response of, "It is what it is." In one telling Loan Committee meeting that occurred in 2007 or 2008, CW#3 recalls the Loan Committee was reviewing a loan application submitted by Reiber on behalf of existing Hagerstown commercial borrower Dustin Shaool, *see infra* Part VII.D.3. Despite the Credit Analyst Group's recommendation to "not approve loan," Defendant Embly lobbied for the loan stating, "Dustin's loans won't go bad – his dad won't let them." While CW#3 was not present when this loan was voted upon, he confirms it was approved. A reasonable inference can be made that the Loan Committee was swayed by Embly

assertion that the unenforceable expectation about Dustin's dad was a valid basis for an exception to the criteria set forth in the Bank's Loan Policy. (In 2012, Dustin's loan was ultimately sold together with other Shaool family loans for $.39 on the dollar.)

169. Aside from inadequate Debt Service Ratios, the Hagerstown commercial loans that were made in 2007 through mid-2009 were often outside of the Loan Policy's credit requirements because the loan to value ratios ("LTV") were unacceptably high for the loan collateral. Yet, again according to CW#3, Reiber's "It is what it is" statements were enough for the Loan Committee to approve the loans notwithstanding the LTV. According to CW#3 this occurred even at times when the Loan Committee did not have current appraisals for the collateral that was to be reviewed by the Bank's Staff Appraiser.

170. CW#1 and CW#3 confirmed that Reiber cultivated the relationships and influenced the credit review and approval process on the loan applications that were processed in 2007 through 2009, *see infra* Part VII.D, and that the Bank extended large commercial loans to risky borrowers, who in many cases simply did not have the wherewithal to satisfy the debt service on the loans. CW#3 confirmed this fact and stated that by mid-2009 Brian Selders, who was hired in replace Reiber, had made known within the Bank that the vast majority of Hagerstown commercial loans Reiber "had left him" were of very poor quality.

171. CW#1 and CW#3 recall the Loan Committee approved loans in 2008 through 2010 from loan applicants who were well-known businessmen Bob Hickey and Tom Mongold (collectively the "Chambersburg Developers"), but whose loan applications did not satisfy the credit requirements of the Loan Policy. CW#3 specifically recalls the Loan Committee making invalid lending exceptions for the Chambersburg Developers. *See infra* Part VII.D.4. From CW#3's observations, the Loan Committee over-extended the Bank and violated the Loan Policy just because, in Embly's words, "Bob [Hickey] needs this."

172. In September of 2009, Defendant Embly was appointed as Chief Credit Officer to purportedly "enhance [the Bank's] processes and controls, as well as clearly delineate independence between sales and credit." Form 424B5 Prospectus Supplement, filed 3/24/2010, at S-2. Because of his influence over the loan review process both before and after becoming the Chief Credit Officer, according to CW#6, Orrstown employees believed that Embly was the primary person responsible for the Bank's extension of loans that were not creditworthy and later became assets where the bank ultimately took credit losses.

173. Another aspect of the Bank's loan process is the role of the Bank's Credit Administration Committee in the "administration and supervision over the lending process." Form 10-K 2009 Annual Report, filed 3/15/2010, at 5. The Credit Administration Committee consists of board members who are charged with

safeguarding the Company from taking excessive credit risks, ensuring loans are adequately and effectively stress tested to trigger accurate classifications of loans as Risk Assets, and designating adequate provisions for loan losses. Throughout the Class Period, the Credit Administration Committee failed to fulfill its duties as evidenced by the Bank's excessively risky commercial loan portfolio, delayed classification of Risk Assets and understatement of loan loss reserves, *see infra* Part VII.B, VII.D.4, X.B.

174. As confirmed by CW#1, CW#2 and CW#3, the aggressive, non-conservative lending undertaken by Reiber and the Bank with respect to the borrowers discussed herein, as well as the dozens of other loans concentrated in the Hagerstown market totaling tens of millions of dollars as of March 2010, left Orrstown in a compromised operational and financial state by the time of the March 2010 Offering. The Regulators' involvement and scrutiny within months of the March 2010 Offering caused the Bank to classify over $113.7 million of these loans as Risk Assets as of December 31, 2011. *See* Form 10Q 1Q2012, filed 5/9/2012, at 44. In July 2012, Defendant Quinn admitted that there were still 20 troubled loans in Hagerstown. He then brokered two significant sales of the loans for pennies on the dollar including most of the Hagerstown troubled loans which

collectively had a carrying balance of approximately $74.2 million after prior charge off of tens of millions of dollars.[10]

175. The Regulators presumably started to put the brakes on Orrstown's reckless underwriting practices during the course of the Joint Examination because in July 2011 the Bank disclosed without explanation that it had outsourced its loan review process to an independent firm. Form 8-K 2Q2011 Operation Results, filed on 7/28/2011. Specifically, the Bank retained a credit review consulting firm which, among other things, was to assist the Bank with "identify[ing] gaps in the underwriting process." Form 10-K 2011 Annual Report, filed 3/15/2012, at 125. According to CW#6, the credit review consulting firm provided at least one lengthy training session for the Bank's commercial lenders in which Defendant Embly participated. CW#3 recalled that as the result of the independent consultant's involvement, by the end of 2011, there was a "new process flow" for credit and "everyone was given new binders." As discussed below, one of the

[10] Marcus Rauhut, "Orrstown Bank Sells 65 commercial loans to improve balance sheet," *Public Opinion*, July 30, 2012. *See also* Form 8-K Press Release, 2Q2012 Operating Results, filed on 7/27/2012 (announcing sale of 65 commercial real estate loans with a carrying balance of $28.6 million); Form 8-K Press Release, filed 12/20/2012 (announcing sale of 172 distressed commercial loans with balance of $45.6 million); Andy Peters, "Pennsylvania Bankers Give Crash Course in Biting the Bullet," *American Banker*, December 24, 2012 (interview of Defendant Quinn and the Bank's new Chief Financial Officer David Boyle). The first of these two sales included the sale of the Azadi loans (*see infra* Part VII.D.2) to investor group ACM.

primary services performed by the consulting firm, Solomon Edwards Group, LLC ("SEG"), was to review the risk ratings for Orrstown's loan portfolio. SEG determined that a material number of loans had been improperly risk-rated by the bank and recommended to **downgrade** 47% of the client relationships they examined (69 out of 146).

176. The unsafe and unsound underwriting practices described by CW#1, CW#2, CW#3 and CW#6 are precisely the practices that prevailed and characterized the Bank's lending realities during 2008, 2009, 2010 and the better part of 2011.

3. Corrective Action – Develop and Implement a New Process for Credit Administration, Determining Proper Allowance for Loan Loss Reserves, and a Plan for Identifying Concentrations of Credit

177. Throughout the Class Period, the Bank lacked effective internal controls with respect to its allowance for loan loss reserves, identifying concentrations of credit, and its credit administration.

178. The Enforcement Actions very specifically delineate the types of new policies and procedures Orrstown needed in order to develop sound banking practices with respect to credit administration and devising the methodology for determining the proper allowance for loan loss reserves. The need for a complete overhaul of the internal controls addressing credit administration and loan loss

reserves was warranted given that from at least 2008 through early 2011, the Bank failed to effectively risk rate loans and then adequately provide for loan losses. Also during this time period, the Bank had ***no process*** in place for managing concentrations of credit.

(a) November 2009 Internal Review

179. In November 2009 after Orrstown created the position of Chief Credit Officer, the Bank initiated the November Loan Review. The Bank described it as "an expanded review of the Bank's commercial loan portfolio, in a proactive attempt to identify potential weaknesses and deterioration in the portfolio." Form 10-K 2009 Annual Report, filed 3/15/2010, at 33. The November Loan Review was first announced in the Offering Documents and then in the 2009 Annual Report which were filed within weeks of each other.

180. The November Loan Review mirrored the Bank's Loan Review Officer's responsibilities of calculating the allocation of loan loss reserves for the loans rated as impaired, as well as monitoring and evaluating loan customers by "utilizing risk-rating criteria established in the Loan Policy in order to spot deteriorating trends and detect conditions which might indicate potential problem loans." Form 10-K 2009 Annual Report, filed 3/15/2010, at 5; Form 10-K 2010 Annual Report, filed 3/11/2011, at 5.

181. The November Loan Review was touted in the Offering Documents (which included the 2009 10-K) to create the impression that Defendants were carefully scrutinizing and assessing the Bank's loan portfolio. In fact, the Internal Review was an utter failure as confirmed by CW#1, CW#3, the Enforcement Actions, and the SEC Order. It was never structured to nor capable of exposing the weaknesses and deterioration in the Bank's portfolio or the Bank's imprudent and high risk lending. At bottom the November Loan Review, rather than exemplify internal controls, demonstrated that the Bank lacked effective internal controls or the ability to assess, using well recognized metrics, the quality of its loan portfolio.

182. The November Loan Review was done by those who were at least, in part, responsible for the Bank's internal controls and the poor quality of the loan portfolio. In fact, the November Loan Review team included one or more of the loan officers who brokered the very lending relationships under review. The November Loan Review team consisted of three employees and two contract employees. CW#2 stated that none of the review team members were "credit minded" which, of course, was one of the fundamental problems at Orrstown – a lack of focus on sound credit requirements needed to prevent the extension of risky loans and then identify when a loan had become impaired. This structural bias enabled the Bank to limit its recognition of impairment through the November Loan Review because the team was neither capable nor motivated to delve into the

adverse credit data for each commercial loan and make determinations that would directly implicate themselves or their supervisors as having pushed through or extended risky loans, .

183. The Bank disclosed the following in its 2009 10-K concerning the review:

> In November of 2009, management undertook an expanded review of the Bank's commercial loan portfolio, in a proactive attempt to identify potential weaknesses and deterioration in the portfolio. This review was in addition to the normal loan review process conducted by our loan review officer and the Bank's Credit Administration Committee. A review team, which consisted of 3 employees and 2 contract employees, reviewed all commercial loan relationships with an aggregate committed exposure greater than or equal to $750,000. The review team focused on the global cash flow of the borrower, global debt service coverage ratios of the borrower, LTV ratios when collateral values decreased by 10% and 20%, borrower's liquidity and guarantor's overall cash flow and liquidity. The review covered a total of approximately $526,000,000 in outstanding loans and loan commitments. Following the review process, management increased the allowance by $3.1 million in order to better reflect the deterioration in local, regional and national economic conditions. All economic allocations were increased during 2009.

184. As stated in the 10-K, the Bank "shocked" collateral values by 10% and 20%, but the 10-K failed to disclose that the values used were the collateral values as of the *loan closing date*, rather than current values. The majority of loans were several years old, meaning in most cases the collateral had already declined more than 20% due by November 2009 to the financial crisis. In November 2009

it was meaningless to shock a 2 or 3-year old collateral valuation by 10% or 20% because real estate markets had already fallen more than that since the time the collateral valuation had been performed and further many of the development projects being valued had been stopped dead in their tracks as a result of the financial crisis.

185. While the Bank has produced in this litigation virtually no documentation of this special expanded internal loan review, internal schedules demonstrate that the Bank almost always failed to keep appraisals up to date. For example, on a schedule of 75 "Land Acquisition and Development Loans over $500,000" as of December 31, 2009, of the loans with listed appraisal dates 28% were more than 2 years old in violation of the Bank's loan policy, and another 29% were more than one year old, meaning the appraisals preceded the height of the financial crisis, and some of the appraisals were merely "drive-by" appraisals (see e.g., Dwight Martin, discussed below).

186. Moreover, the Bank has produced no documentation reflecting that borrower cash flows were actually tested as stated in the 10-K, and in reality the Bank did not maintain or collect the data necessary to adequately perform such an analysis, as the Bank routinely failed to collect up-to-date borrower financial information. As consultant SEG later found, many of the Bank's estate developer borrowers had multiple entities (LLCs, joint ventures, partnerships), and an

assessment of their liabilities, monthly debt service, and other data necessary for global cash flow analysis was not possible, rendering reliance on such borrowers' net worth to be reckless and baseless.

187. Further, the November Loan Review included real estate development loans whose debt service repayment was dependent on one or more of the following sources:

a. Cash flow that was, in turn, dependent on unit sales or rentals, but sales were meager or non-existent and the review team did not review or demand access to rent rolls or lease agreements to confirm phantom numbers provided by borrowers.

b. Borrowers' and guarantors' net worth that was largely illiquid and dependent on successful real estate developments, which at the end of 2009 was a condition that did not exist and was unachievable for the foreseeable future. Moreover, the review team lacked loan documents necessary to assess guarantor structure, support or strength. Absent such information and assessment, reliance on guarantors in the loan review process was inherently flawed and deficient.

c. Credits that were collateral dependent, where such collateral was not valued in accordance with the Bank's loan policy or banking regulations.

d. The November Loan Review included loans that should have been categorized in late 2009 as TDRs since they met the banking industry's criteria for such classification. As such, those TDRs required an ALLL provision, but none was taken, recommended or disclosed.

188. This expanded internal review is alleged to have occurred in November 2009, but in fact the summary report of that review reveals that loans were still being reviewed as late as late-February and early-March 2010.

189. The November Loan Review resulted in a mere $3.1 million in increased ALLL for the $526 million in loans the review team "reviewed." Within 12 months (fiscal year 2010), $12 million in charge-offs were taken with respect to these loans, and in the next 12 months (fiscal year 2011) an additional $68 million in charge-offs were taken by the Bank for these loans. This was followed in the first six months of 2012 by an additional $87 million in charge-offs taken with respect to loans that were "reviewed" by the review team during the November Loan Review. In sum, the November Loan Review missed nearly $170 million in losses on loans that were part of the review portfolio. The November Loan Review was a charade.

190. The November Loan Review's mere $3.1 million increase in the ALLL was reported in the Company's 2009 Annual Report filed one week prior to the March 2010 Offering. In making such an allowance however the Company

failed to disclose that its internal controls were wholly inadequate to accurately reflect the true level of impaired loans and the overall weakness and high risk in the Bank's commercial portfolio because, in addition to the reasons discussed below with respect to specific borrowers, by mid-2009, (i) Brian Selders had put the Bank on notice of wide-spread weaknesses in a majority of the Hagerstown commercial loans; (ii) CW#1 and CW#3 confirmed that the Bank did not secure from borrowers "new information regarding existing loans" or possess current, reliable appraisals; (iii) no allowance was timely made for the Yorktown loan despite the fact the Bank's management should have known in 2009 that the loan was impaired, months before Yorktown filed for bankruptcy; and (iv) no allowance was made for the Azadis, Shaools, Chambersburg Developers and numerous other real estate developer loans in 2009 when again the Bank should have known they were experiencing financial difficulties and their cash flow was drying up.

(b) Credit Concentration

191. At the time the Regulators issued the Enforcement Actions, they noted that the Bank had no plan or process in place "to identify, limit and manage the Bank's commercial real estate ("CRE") loan concentration of credit to an amount which is commensurate with the Bank's business strategy, management expertise, size and location ("CRE Concentration Plan")" and required Orrstown to "develop and implement" such a plan within 90-days from the effective date of the Consent

Order. Ex. B, Consent Order at ¶ 7(a); *see also* Ex. A, Written Agreement at ¶ 5(a). Orrstown's submitted plan was to be in accordance with the Federal Reserve's Interagency Guidance on Concentrations in Commercial Real Estate Lending ("Interagency Guidance").

192. The Federal Reserve issued the Interagency Guidance on December 6, 2006 and developed it "to reinforce sound risk management practices for institutions with high and increasing concentrations of commercial real estate loans on their balance sheets."[11] The Interagency Guidance applied to Orrstown, and Orrstown's internal controls with respect to CRE loan concentrations should have comported with the Interagency Guidance.

193. Despite the Bank's heavily weighted commercial loan portfolio, Orrstown failed to create or implement a CRE Concentration Plan at any time prior to or during the Class Period. The investing public was never informed at any relevant time that the Bank lacked a CRE Concentration Plan. The Bank's failure to adopt and adhere to a CRE Concentration Plan constitutes failures of internal controls over credit management.

[11] Board of Governors of the Federal Reserve System, Supervisory Policy and Guidance Tips, "Real Estate," http://www.federalreserve.gov/bankinforeg/topics/real_estate.htm.

D. Lending Relationships that Illustrate Orrstown's Lack of Effective Internal Controls.

194. The Bank's lending practices with respect to four of its largest borrowers – ***Yorktown,*** the ***Azadis***, the ***Shaool Family,*** and the ***Chambersburg Developers*** – serve to illustrate that from 2008 through the first quarter of 2012, Orrstown lacked the requisite internal controls over underwriting, risk management, credit administration and financial reporting. These borrower stories are merely illustrative of the Bank's pervasive failures over internal controls, including failures to identify impaired loans, calculate adequate reserves, and accurately risk rate loans. As will be shown at summary judgment and/or trial, there are numerous borrower relationships like these, where the Bank engaged in a "pretend and extend" course of conduct, extending matured loans and extending more credit in order to forestall inevitable losses.

1. Yorktown

195. ***Yorktown*** provided interim construction financing to residential developers. The Bank initially extended a $4 million line of credit to Yorktown in 2001. Orrstown subsequently provided three extensions to increase the line of credit: on November 30, 2004, the Bank increased the line of credit to $5 million; on September 16, 2005, the Bank increased the line of credit a second time to $7.5 million; and on July 24, 2006, extended it a third time to $9.5 million. This placed

Yorktown within Orrstown's top 10 largest lending relationships by total loan amount.

196. At the inception of the lending relationship and in connection with each modification to extend additional credit, the Bank was required to file UCC-1 financing statements in order to perfect and/or continue its security interests in the underlying collateral for Yorktown loans. However, despite the importance and size of the Yorktown loan, the Bank failed to take the necessary steps to perfect its security interest in the Yorktown loans, and at all times relevant to this litigation, up to and including the time that Yorktown filed for bankruptcy protection in February 2010, the Yorktown loan was unsecured.

197. Orrstown had knowledge of the unsecured status of the loan, but concealed it from investors prior to its public 8-k filing announcing Yorktown's bankruptcy. Indeed, Orrstown was alerted to the unsecured status of the Yorktown loan by outside counsel as early as August 2005, and again in July 2006, but failed to remedy the defects or confirm that the necessary paperwork had been filed to secure the loan, and failed to incorporate the loan's unsecured status into the Bank's risk rating metrics or impairment analyses.

198. At all relevant times, Orrstown's Loan Policy specified that documents evidencing the Bank's security interest in its loans must be maintained in the account's loan file, and further specified that "[c]ollateral will be monitored

on a regular basis to ensure the adequacy of loan coverage." Orrstown's Loan Policy further required the Credit Administration Committee to review the risk rating for all loans over $750,000 on an annual basis, which would include a review of the loan file. Under Orrstown's Loan Policy, a loan with inadequate or absent collateral should have been given a Substandard rating, even if the borrower was paying as agreed. Despite these clear guidelines, the Yorktown credit received a safe rating of "2" at all times prior the Bankruptcy filing.

199. In addition to concealing the unsecured status of the Yorktown loan, Orrstown also ignored significant red flags concerning the decline of Yorktown's portfolio in the midst of the housing crisis in 2008 that crippled residential developers, which was Yorktown's principal source of income. For example, a credit quality review of the Yorktown loan performed by Orrstown in January 2010 before the March 2010 Offering acknowledged that Yorktown's business suffered a loss in 2008, that additional losses were expected in 2009, and that the current cash flow generated did not satisfy the Bank's debt ratio requirements. Despite these red flags and the unsecured status of the loan, the Credit Administration Committee maintained the favorable rating of [between] "2" and "3" for the Yorktown loan up until a month *after* Yorktown filed for bankruptcy protection.

200. CW#1 and CW#3 analyzed Yorktown's loans in 2008-2009 and concluded that the loans failed to satisfy the Loan Policy, but their assessments were disregarded by the Chief Credit Officer, Loan Committee and Credit Administration Committee, which included Defendants Quinn, Embly, Everly, Snoke and Shoemaker. Moreover, the structurally deficient November Loan Review conducted in late 2009 did not identify Yorktown as impaired, nor was any reserve calculated, despite the fact that: (i) the Yorktown loan was unsecured, (ii) Yorktown's cash flow was unable to satisfy the debt service on the loans; (iii) Yorktown was heading for bankruptcy; and (iv) the Bank should have increased the risk rating on this loan and taken a loan loss provision well before Yorktown filed for bankruptcy.

201. On February 9, 2010, Yorktown filed for bankruptcy protection. Instead of promptly disclosing the bankruptcy, which would have had a significant negative impact on Orrstown as it was in the midst of promoting its Offering, the Bank waited until March 22, 2010 to disclose this via an 8-k filing. The announcement came after the March 2010 Offering had been announced on March 15, 2010 and after the road show had started on March 17, 2010.

202. Even after Yorktown had filed for bankruptcy protection, Orrstown's internal Loan Reviews continued to view the loan favorably, ignoring the bankruptcy filing, the Bank's unsecured status, and Yorktown's diminishing

business prospects in order to keep the loan in a favorable status on Orrstown's books and avoid disclosing a loss to investors. Shockingly, a March 12, 2010 internal Loan Review memorandum, written over a month after the initial bankruptcy filing, makes no mention of the bankruptcy whatsoever. Indeed, despite the credit scoring worksheet recommending a risk rating of "4" (without factoring the bankruptcy or unsecured status), Orrstown's credit review officer recommended only a 1-step increase in rating from "2" to "3," based solely on one guarantor's personal net worth. The problem with that rationale is that the guarantor's assets were not the subject of a secured interest in favor of the Bank, rendering the net worth analysis hollow at best.

203. Despite the March 22, 2010 8-k's announcement that Orrstown would be moving the Yorktown loan to nonperforming status as of March 31, 2010, Orrstown was slow to increase the risk rating of the Yorktown Loan and did not make timely or appropriate adjustments to the Loan Loss provisions. The credit was not moved up into the special mention "5" category until March 12, 2010, over a month after the bankruptcy filing, and did not move into the substandard "6" category until April 30, 2010. Even then, Orrstown did not make appropriate adjustments to the Loan Loss reserve commensurate with the Bank's unsecured status and likely outcome in the bankruptcy; waiting over a year and a half to charge off the loan balance.

204. By April 17, 2010, following the first meeting of creditors the Bank internally acknowledged that the pool of unsecured creditors was larger than expected, and that Orrstown was likely to lose at least $5.1M of its $8.5M exposure upon liquidation. However, the Bank did not make commensurate adjustments to its reserves to account for this expected charge-off, in violation of GAAP standards. Rather, email traffic amongst Orrstown's top executives demonstrates prioritization of earnings results over appropriate Loan Loss provisions for the Yorktown credit.

205. Rather than make appropriate adjustments to its loan loss provisions to account for the unsecured Yorktown loan, the Bank attempted to loan additional funds to Yorktown through a debtor-in-possession ("DIP") financing arrangement in an effort to gain additional collateral and salvage their unsecured status, but concealed these initial efforts from investors. As with their initial treatment of the Yorktown loan, the Bank's attempts at providing DIP financing similarly demonstrated a startling lack of internal controls. Orrstown ignored early warnings from its counsel regarding the possibility that Yorktown might no longer qualify as a mortgage lender in Pennsylvania, and the loan presentation presented to the Board of Directors in February 2011 lacked updated financial statements for the guarantors, among other failures.

206. Over a year after Yorktown's bankruptcy filing, after Orrstown had still not made appropriate loan loss adjustments and/or charge-offs commensurate with the Bank's unsecured status in the Bankruptcy, the SEC began to ask Orrstown specific questions about the Yorktown credit. Correspondence in connection with SEC comment letters of March 25, 2011 and May 5, 2011 called out the Yorktown credit specifically, questioning whether the loans was ever actually secured and requesting a detailed ALLL activity with explanations of why the ALLL analysis was consistent with the Bank's unsecured status in the bankruptcy. Upon information and belief, the Federal Reserve's ongoing exam was also specifically questioning the Bank's treatment of the Yorktown credit.

207. On May 11, 2011, after over a year of volatile and troubled negotiations, the Bank publicly announced its participation as the lead bank in a DIP financing agreement with several other Yorktown creditor banks, increasing the Bank's exposure to $8,998,000 with additional advances of $7,800.000 under a new credit facility.

208. As the SEC and Federal Reserve's scrutiny of the Yorktown loan increased and Orrstown began the due diligence that it should have been doing all along with respect to the Yorktown credit and the proposed DIP financing, the DIP deal quickly fell apart. On July 8, 2011, shortly after informing the SEC that the Bank had successfully entered into a DIP financing agreement with Yorktown, the

Bank informed Yorktown that it, in fact, it was unable to provide such financing and instead was exiting the agreement.

209. At the July 14, 2011 Credit Administration Committee meeting the Bank internally reported that its exit from the financing agreement was due to, among other things, Yorktown's operation as a mortgage lender in Pennsylvania without a license (an issue which Orrstown's executives had been warned about by counsel on at least two occasions many months prior to entering the agreement), as well as declining consumer loans and loan-to-value ratios well in excess of the conditions outlined in the commitment letter.

210. On July 14, 2011, The Bank publicly disclosed that it would not be able to extend the commitments outlined in the DIP financing agreement, and was writing off Yorktown's entire $8.3 loan balance. No press release was filed with the SEC in connection with this filing despite the enormity of the charge-off, a move which internal emails suggest was done deliberately to minimize the attention it received. Rather than disclosing the startling lack of due diligence behind the Bank's exit from the agreement, the 8-k was noticeably vague concerning the DIP financing debacle, informing investors only that the Bank had informed Yorktown it was unable to extend its commitments, and that the agreement had expired.

211. Following the charge-off announcement, in August 2011 the Bank conducted its own internal investigation of the Yorktown debacle, concluding that there had been a significant deficiency in internal controls surrounding the Yorktown credit, among others. A second report prepared for the Audit Committee on or about November 2011 further details the deficiency.

212. In an acknowledgement that proper UCC-1 financing statements had never been filed in connection with the Yorktown loan to perfect the Bank's security interest, the Bank attempted to shift blame to its outside counsel, filing a malpractice suit against the law firm in Cumberland County Court in 2012. The law firm's responses highlight the various instances in which the firm notified Orrstown of its unsecured status, and confirmed that Orrstown never took action to direct the law firm to file the appropriate financing statements. Orrstown gave its malpractice suit the same kind of inattention to which it gave all other matters concerning the Yorktown loan, ignoring it completely for many years. On February 18, 2019, the law firm's motion for judgment on account of non-prosecution was granted, and judgment was entered in favor the law firm in an opinion highlighting a startling lack of diligence on the part of Orrstown in pursuing its own claims.

213. The Yorktown loan exemplifies the absence of internal controls at the Bank with respect to loan underwriting and the prudent periodic monitoring and

assessment of loan quality. Moreover, as discussed below, SEK deliberately failed to examine the Yorktown loan during its audits in 2008 or 2009.

2. The Azadis

214. Mohammad (aka Morris or Mo) and Ash Azadi are father and son, both commercial airline pilots, who speculated heavily in real estate during the height of the real estate market from 2004 to 2008, particularly in various real estate development projects in the Hagerstown, MD area. They were also the landlord for the bank's Hagerstown MD branch location. Several of the Azadis' loans were intended to fund development of three projects: (1) conversion of a former hotel into residential units (the "Hamilton Building"); (2) development of a bowling alley, night club, and entertainment complex ("Oak Hill"); and (3) construction of townhomes ("Northwind Townhouses"). They are identified as "Lending Relationship B" in the SEC Order.

215. From at least December 2008 through 2011, the Azadis were among the Bank's top 10 borrowers. As of December 2009, they had borrowed over $11 million, and by June 2011 the total had swelled to over $15 million. Ultimately, their projects failed or were never completed and never generated sufficient cash flow to service their debt.

216. As early as January 2009, the bank was aware of issues with certain of the Azadis' properties. For example, in a January 2009 email, in connection with

the Azadis' request for financing for the Oak Hill bowling alley and night club project, which they had initially requested in 2008, Embly stated "I don't trust them," due to a situation involving, *inter alia*, "questionable leases," which had been submitted in connection with an appraisal. Tellingly, the original appraiser refused to perform the appraisal due to lease issues, and Azadi tried to persuade Orrstown to allow him to hire his own appraiser. Loan officer Terry Rieber confided to Azadi that Embly was "not sure" about the Oak Hill project and noted that the "last club did not make it."

217. Around the same time that the Azadis were seeking funding for the Oak Hill project, the Bank was negotiating to lease store front space for a Bank branch location from the Azadis. On January 27, 2009, Ash Azadi told loan officer Terry Reiber that the Azadis would accept whatever the bank proposed for rent: "we will accept a [lease] rate that Orrstown proposes that is within the market value of the Downtown area…." Signaling the Azadis' cash flow difficulties, Ash said "we would prefer if Orrstown does their own fit out, thus the space would be leased in 'as is' condition."

218. Embly was concerned that the Oak Hill loan would, when combined with the Azadis' other loans, exceed the bank's legal lending limit. The Azadis already had loans with Orrstown totaling more than $9 million, and were seeking almost $2 million more, which Embly believed could exceed the legal lending

limit. In February 2009 Orrstown proposed that the Azadis should refinance the pre-existing Hamilton Building loans with another bank so that the Bank could provide the Oak Hill loan.

219. Ash Azadi kept pressing, assuring loan officer Terry Reiber in February 2009 that "this area is going to prosper once we are out of this economic crisis." The Azadis stood to lose a $310,000 deposit if they did not close the Oak Hill deal by June 2009, and "need[ed] Orrstown to work with us on this deal to make it happen as soon as practic[able] … we need to do whatever it takes."

220. Notwithstanding the concerns raised by Embly, in March 2009, the Bank's [Loan Committee] agreed to loan additional money to the Azadis for the Oak Hill bowling alley project. The project almost immediately began to fall apart, and it should have been identified as Substandard right from the beginning.

221. By July 2009, the Azadis were also seeking additional funding for their Hamilton building project. The Hamilton Hotel project involved conversion of an historic hotel into a mixed use building (i.e., residential and commercial), with retail and commercial space on the first floor and second floors, and residential condominiums on the third and fourth floors. The Bank initially loaned the Azadis $2.75 million for the Hamilton project in March 2007 based on an appraisal of prospective value after completion of $4.53 million. But the actual appraisal of the property at the time of the loan was only $1.86 million, nearly

$900,000 less than the loan balance on day one! Thus, the loan was in trouble and should have been identified as Substandard from the start.

222. The Hamilton Hotel loan terms provided for 24 months of interest-only, and then payment of principal and interest over 25 years. Just before principal and interest became due, in March 2009 the Azadis sought an extension from the Bank. The Bank granted a change in terms agreement to extend the interest-only payments for another 18 months, but the Bank already knew the loan was in serious trouble.

223. Terry Reiber wrote to Ash Azadi in July 2009 that "the bank wants out of the financing for Hamilton Plaza. … Orrstown bank thinks in this market this project is very high risk. … [P]lease finance the Hamilton Project elsewhere." The Azadis did not follow that instruction, leaving Orrstown saddled with the Hamilton Project loan.

224. In September 2009 Orrstown began to further question the viability of its financing of the Hamilton Building condos, and reached out to the listing agent, who Orrstown determined "has the same concerns as us" about the prospects of selling the condominiums. On a rental basis, the condominiums would not generate sufficient cash flow to service the debt. In fact, in 2009 *all* of the Azadis' projects generated negative cash flow.

225. Moreover, by October 2009 Embly was aware of major issues concerning the Oak Hill bowling alley project that jeopardized township approval of the project, including required parking and access problems.

226. In December 2009 the Azadis asked for modifications to their loans to provide for an interest-only period, stating they "need some help until the Oak Hill construction project is complete," while at the same time seeking a $767,000 bridge loan to finance construction on the Hamilton Hotel project. The confluence of all the facts about the financial travails of the Azadis outlined above were known to Orrstown's senior management and revealed a compelling and mandatory Substandard classification of the Azadis' by no later than December 2009. Thus, the 2009 10-K, which was incorporated in the Offering Documents, should have included ALLL reserves for these loan and identified them as impaired, but it did not. In order to conceal the true financial condition of the Azadi loans, the Bank Defendants did nothing to recognize the loans as impaired, reduce the risk ratings, or take a provision for anticipated losses that the Bank had already or likely would suffer on account of the Azadi loans.

227. The Azadis' financial condition crumbled further as 2010 began. In connection with the Oak Hill bowling project, the Azadis had borrowed $800,000 from Brunswick Corporation for bowling equipment. By January 2010, the bank knew that the Azadis intended to pay off that loan, which would be due in late

2010, by borrowing more money from Orrstown. Embly sent an email to Brian Selders, the then-current loan officer, suggesting that he coach the Azadis on how to get another bank to give them additional loans. Recognizing the Azadis' perilous financial position, Embly said ""If we can get them to move other deals to Tower [bank], that would be great!" Selders responded that he too did "not have a comfort level" with the Azadis. He reported that the Azadis had "mentioned several weeks ago that they will be requesting a loan in 2010 to assist with debt carry," in addition to their request to pay interest only on existing loans.

228. Not surprisingly Tower bank refused to lend money to the Azadis. In fact, Selders expressly reported to Embly, "I'm not surprised." As a result in May 2010 the Azadis came back to Orrstown for additional loans. May 2010 internal Bank documents show that the Bank knew that the Azadis were showing "high cash deficits."

229. Further, the projects were going nowhere. In a June 2010 email to Embly, Selders noted that the Hamilton building construction had been going for "3 ½ years with little progression," and Tower bank's refusal to "[take Orrstown] out on Oak Hill certainly changes our strategy."

230. In June 2010 the Azadis once again pressed for modifications of their loans, referencing the fact that their properties were experiencing negative cash flow after debt service due to the declining real estate market, and "decline in

business in general, which has led to a number of tenants either vacating … or in the best case scenario … re-negotiat[ing] … leases in order to retain [the tenant].” The Azadis requested “immediate loan modifications.” At the same time, the Azadis sought additional funding to complete their Hamilton and Oak Hill projects.

231. Selders forwarded the request to Embly, stating “this is their very unimpressive plan” and “the Azadi’s don’t get it!” Selders commented that his “take on all this is that they’re communicating that they can’t pay what they currently owe to [Orrstown] and, oh by the way, we need Orrstown Bank to finance two other projects that have stalled.” Joseph Sigle, an Orrstown Vice President & Credit Officer, commented “I think this house of cards will tumble at some point,” and “what a disaster.”

232. In seeking funding for the Hamilton building project, the Azadis informed the Bank that they would be receiving a $767,000 grant from the State of Maryland. In reality however, in June 2010 the Bank learned that the grant was a tax credit, and that it hinged on numerous contingencies that might never be met. In an email to Embly and Sigle, Selders advised that Orrstown should walk away from the Hamilton project:

> There's no guarantee that we'll ever get this amount or any Amount for that matter. This negatively impacts cash flow / DCR for this project. I would recommend that we walk away and concentrate on the Oak Hill project but there's potential for

> huge losses. There's no way we'll get the $2,300M that we're currently owed at a liquidation sale. Damned if we do and damned if we don't.

233. In another email, Selders made clear that the Bank knew it would lose money on the Azadi loans, asking Sigle, "when will we lose less? Cut & run now or throw more money at the projects?"

234. Moreover, because the Bank knew that "the Azadi's can't pay interest from their normal cash flow," in connection with the loan modifications and additional lending, they planned to build in an "interest-carry" on the requested refinancing, *i.e.*, additional loan amounts which were intended solely to pay the first six months interest.

235. In another June 2010 email to Embly and Sigle, Selders noted that the Azadis had mentioned the possibility of bankruptcy several times, and he advised Embly and Sigle, "I seriously think OTB needs to evaluate the overall situation very closely to make sure throwing additional large dollars into the two projects makes sense."

236. Incredibly, in July 2010, SEK, who was both the Bank's auditor and also the personal accountant to the Azadis, intervened with the Bank on behalf of the Azadis to try to counteract Selders' sound advice to not loan additional money. Specifically, Jefry Bohn, a partner and CPA at SEK, emailed Embly directly stating, "I met with Ash and Mo this morning. They need your assistance to get

involved and to assist Brian [Selders] in providing a lending solution which will put the Azadi real estate in a better cash flow situation." This was incredible for several reasons. First, as the Bank's independent auditor, SEK had a serious conflict of interest when it intervened to influence the Bank's lending decisions, particularly on behalf of a large borrower who SEK knew had insufficient cash flow to service its debt. Yet SEK sought to influence Embly to structure additional financing after Selders had recommended cutting off additional financing. Second, as the Bank's auditor, SEK knew that the Bank had not identified the Azadis' loans as Substandard or impaired, which they clearly were since, as SEK knew, the Azadis had insufficient cash flow to service their debt. Moreover, when the Bank eventually restructured the loans in December 2010, SEK knew that they had not been identified as TDRs.

237. Despite knowing that the Azadis' properties were not generating sufficient cash to finance their debt, and despite the dismal real estate market, in August 2010, Orrstown nevertheless loaned an additional nearly $3.9 million to the Azadis to refinance prior debt and provide additional financing. The new loans also included a $150,000 "interest carry" to fund the interest payments due for approximately 1 year. But, despite knowing that the Azadis had insufficient cash flow to service the debt, the Bank never evaluated, identified, or disclosed these loans as impaired as required by GAAP, nor did it rate them as Substandard

internally, meaning it did not create a specific reserve for these loans which were highly unlikely to be paid. Orrstown also failed to identify the modifications as TDRs, which they clearly were.

238. On December 23, 2010, the Bank agreed to further modify the loans and also approved a $767,000 bridge loan to complete construction at the Hamilton building, based in part on an anticipated $767,000 Maryland Historical tax credit. By December 2010, however, the tax credit was still not approved and an appraisal of the property came in lower than expected. Despite believing that the Azadis may have jeopardized the tax credit the Bank allowed the bridge loan to close with no guarantee of the tax credit. Moreover, while the Azadis had initially planned to sell the 24 residential condominiums at the Hamilton building, as a result of the declining real estate markets the Azadis and the Bank were "keenly aware" that they would likely need to rent the units, which would seriously impair their ability to pay back the loans, as the cash flow from rentals would not be sufficient to service the debt. In fact, the Bank's analysis was that the Azadis could not support the debt payments absent sales of the condominiums. Further, the Bank knew that the Azadis overall global cash flow from investment properties was "weak" and the Azadis had "limited liquidity." Yet, recognizing that the bank had significant exposure to the project already, the Bank modified the Azadis' loans despite the dismal prospects of repayment.

239. Once again, despite knowing that the Azadis had insufficient cash flow to service the debt, the bank never evaluated, identified, or disclosed these loans as impaired as required by GAAP, nor did it rate them as Substandard internally, meaning it did not create a specific reserve for these loans which were highly unlikely to be paid.

240. Incredibly, the Bank never calculated an ALLL reserve on the Azadi loans during 2010 or the first two quarters of 2011. Clearly, the Bank knew these loans were Substandard at least as early as 2009, but failed to recognize them as such, failed to calculate required reserves, and failed to identify these loans as impaired in its SEC filings.

241. Not surprisingly in 2011, after doing everything in their power to forestall Azadi defaults including throwing good money after bad, the house of cards completely fell apart. On August 26, 2011, the Bank issued default notices to the Azadis in the amount of $16.3 million.

242. The Hamilton building was still "not close to completion a year after the final draw [of the loan]." A consultant retained by the Bank as a result of the Regulators Orders commented that, among other things, "There appears to have been little to no oversight on the project, the approval noted draws to be based on third party inspections, which were not found in file." By July 2011, the Azadis had also defaulted on the bowling alley loan due to failure to make interest

payments. In the third quarter of 2011 took $5.8 million in charge offs on the Azadi loans, and the Bank finally calculated an ALLL reserve for the Azadi loans of a $908,000. By March 2012, the bank had charged off $6,722,137 of the Azadi loans, and had initiated litigation to try to collect as much as possible. In June 2012, the bank sold its Azadi loans for pennies on the dollar. As a result of the Bank's failure to accurately rate loans to the Azadis as Substandard, calculate required ALLL reserves, identify the loans as impaired, and identify the modifications as TDRs, Orrstown's SEC filings were materially false and misleading during the Class Period.

3. The Shaools

243. The ***Shaool Family*** and their entities borrowed millions from the Bank from 2005 through 2011 for residential development projects in Hagerstown, Maryland CW#1 and CW#3 personally worked on the Shaool Family's credit analyses between 2008 and 2011, and concluded that their loan applications did not satisfy the Loan Policy. These findings were ignored and the Bank extended at least around $20 million to the Shaool Family between 2005 and 2011.

244. The Shaool family, identified in the SEC Order as "Lending Relationship A,"[12] were developers in the Hagerstown area, and some of the

[12] It should be noted that the Shaool loans were specifically identified and discussed in the initial complaint in this case well before public disclosure of that

bank's largest borrowers. The relationship included Ben Shaool, and his two sons Dustin and David Shaool, and numerous entities owned by them. From at least 2009 through 2011, the Shaools were among the Bank's top 10 borrowers.[13]

245. The first loan Orrstown Bank issued to Ben Shaool occurred in December 2006 in the amount $3.4 million. Despite the deteriorating conditions that existed in the real estate markets over the next 2 years the Bank committed to lend Ben Shaool and his sons $13.2 million in 2007 and $3.4 million in 2008, a total commitment of $19,990,000. The collateral for these loans was projects under development and raw land, two of the most negatively impacted segments of the real estate industry, and the Shaools holdings were no exception.

246. Ben Shaool and his sons also borrowed heavily from other banks. Contemporaneous with the Bank's expanding exposure to the Shaools, the Shaools were increasing their borrowings from other banks to fund newly completed projects and projects under development that were already experiencing severe cash flow deficits. The table below lists personal guarantees on loans to lenders other than Orrstown bank.

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loan family's involvement in the near collapse of Orrstown and prior to the SEC's Order dated September 27, 2016.

[13] Relatedly, Ben's brother, Mansoor Shaool (aka Manny), and his two sons Sassan and Adam Shaool, and entities owned by them were also among the Bank's largest borrowers. In 2012, the Bank forgave over $2.5 million in loans to Mansoor.

Apt Complex Lenders	2009	2008	2007
Cortpark LLC	$ 19,217,604	12,374,995	$ 3,839,135
Cortpark II LLC	17,701,972	17,904,812	17,548,141
Shaool Brookmeade Development LLC	8,266,872	8,493,919	8,374,900
	45,188,457	$ 38,775,734	$ 29,764,183
Other Non - Income Producing Loans			
Personal Residence	3,000,000		
18823 Fountain Terrace	350,000		
Undeveloped Land/Lots	2,320,000		
Total Gurantees at 12/31/2009	$ 50,858,457		

247. From 2007 through 2009 while Orrstown Bank was committing $20 million to the Shaools, Ben Shaool's personal guarantees to commercial lenders other than Orrstown Bank increased by an additional $15.4 million from $29.8 million to $45.2 million. The Bank and also SEK were aware of these other commitments, as they were reported to the Bank in the Shaool's financial statements, which SEK compiled.

248. By at least 2008, the Bank was aware that the Shaools were facing financial difficulty. In August 2008, Ben Shaool requested a reduced interest rate on at least $4 million in loans "because he cannot afford this high [interest] rate and will be unable to make payments at this rate."

249. Any banker with even a rudimentary understanding of a borrower's financial information should have realized that the Shaools' net worth was almost entirely illiquid and was based on inflated, if not fantasy, real estate value, and further that the Shaools' guarantees out-stripped by multiples the debt amounts owed to Orrstown and the other lenders. SEK fully understood those facts given

its role in compiling statements reflecting, and being fully familiar with the details of the Shaools' financial condition.

250. Then in October 2008 Ben Shaool sought a loan to refinance another Bank loan that had become due on undeveloped real estate in Hagerstown for the express purposes that he needed additional time in hopes that "the economic market [would] change in favor of future development."

251. By January 2009, the Bank realized it had exceeded the legal lending limit to Ben Shaool. In order to rectify that problem, and conceal the lending limit violation from the Regulators, the Bank simply released Ben as guarantor from roughly $4 million in loans to Ben's construction company, Progress Homes LLC, in order to get below the legal lending limit, even though Progress Homes was showing ***negative net cash flow***. A senior credit manager wrote to Embly, questioning whether Embly really wanted to present the release to the Board "considering the ongoing investigation [by the Regulators]," but Embly responded, "we have no choice." By releasing Ben as guarantor, and relying for payment solely on Progress, which had negative cash flow, this modification should have been recognized as a TDR and the loan should have immediately been recognized as an impaired loan and rated Substandard, but it was not. Incredibly, the Bank did not even identify it as Substandard or calculate a specific reserve on it.

252. WASHCO Development, Inc. was an entity owned and controlled by various Shaool family members, specifically Sasson Emral-Shaool and Adam Shaool, and Mansoor & Janet Emral-Shaool. At a March 20, 2009 Executive Committee meeting, a development loan in the amount of $2,350,000 was approved for the purposes of the "build out of the last 25 town homes" at a project called Avalon Town Homes. This loan, which provided for interest-only payments for 18 months, was approved based on an appraisal dated March 1, 2007 (a two-year old appraisal rendered before the financial crisis) which valued the project at $16,170,000.

253. During the same meeting, the Executive Committee approved the restructuring of two other loans secured by Avalon Town Homes totaling $6,875,000 (a $1.875M development loan and a $5 million revolving line of credit), extending the interest-only period by 12 months for both loans, with the interest-only period expiring on July 20, 2010. Both approvals cited the $16,170,000 appraised value of the Avalon Town Homes project in support of the approvals.

254. Three months later, on June 9, 2009, the Executive committee approved the restructuring of a previously made loan in the amount of $1,675,000 to WASHCO collateralized by the Avalon Town Homes project. Specifically, the Executive Committee approved the extension of the interest-only payment period

by 18 months, but in doing so was provided an updated (as of May 20, 2009) appraisal showing the collateral value at $10,950,000, nearly one-third lower than the appraisal used in support of the March 2009 loan and restructuring approvals.

255. Also noteworthy is that the June 9, 2009 minutes reflect the re-approval of the March 2009 restructurings with the new appraisal information being cited. Inexplicable was how the Avalon project's $10,950,000 appraised value, which was clearly inflated, would support $11 million in loans collateralized by the project.

256. By the summer of 2009, the Shaool family's financial position continued to deteriorate. In September 2009, the Bank sought to obtain a guarantee from Ben on one of Dustin's existing loans after an appraisal showed that the property value had declined. Ben refused, saying he could not guarantee the loan. Embly suggested to loan officer Terry Reiber that the Bank should "call the loan or put it into a repayment plan right away." But neither action was taken.

257. In desperation in November 2009 Ben, Dustin, and David Shaool requested modifications to all of their loans to provide for interest only payments for an unspecified amount of time based only on the sentiment that "hopefully the market will change." In December 2009, in the midst of negotiating modifications for the Shaools, Jeffrey Gayman, Senior VP and Chief Commercial officer, wrote to Embly regarding the Shaools, "I have a bad feeling about all of this crap."

258. In connection with the Shaool's November 2009 loan modification requests, Selders spoke with Jeff Gayman, SVP & Chief Commercial Officer and a member of the Disclosure Committee. Selders reported back to Reiber concerning that discussion, stating "The bank really doesn't want to honor an interest only period unless it's a dire situation. From a regulatory standpoint, we have to write down a portion of the loan (loan loss reserves?) and downgrade the risk rating."

259. Despite knowing that the Shaool's financial situation had deteriorated to the point where they requested interest-only modifications, in preparing its financial statements for the 2009 10-K, the Bank failed to calculate *any* ALLL reserve on the Shaool loans, failed to rate them internally as Substandard, and failed to identify the loan extensions as TDRs. As a result, Orrstown's 2009 10-K (incorporated in the Offering Documents) was materially false and misleading.

260. Moreover, SEK as Ben Shaool's accountant, knew about his financial difficulty, but when performing its audit of the Bank for the year ended 2009 failed to take any steps to ensure that Ben's loans were properly rated or that reserves had been calculated on them. To the contrary, SEK carefully avoided reviewing the Shaool loans during its 2008, 2009, or 2010 audits of the Bank despite the fact that the Shaools were among the Bank's largest borrowers. If SEK had reviewed their loans, it would have been forced to recognize the Bank's improper risk rating and

accounting. But SEK knew that the Bank had not taken any reserve on any of the Shaool's loans in 2009.

261. In March 2010, the Bank approved modifications to four existing loans to Dustin Shaool and his business Empire Construction to provide an interest-only period for several loans. The Loan Presentation materials presented to, *inter alia*, the Bank's Board of Directors, stated that the modifications were sought as a result of the "failure of Mr. Shaool's construction business and related real estate entities." In fact, the materials stated that Dustin had "basically thrown in the towel in all of his business interests and real estate holdings." The loan-to-value ratios of the loan exceeded the Bank's Loan Policy, and in one case the loan exceeded 100% of the value of the property. Nevertheless the Bank granted the modifications without recognizing them as TDRs, and also failed to disclose the loans as impaired.

262. The bank also granted modifications to Ben Shaool's loans in March 2010, including a one year interest-only period. The loan presentation provided to, *inter alia*, the Bank's Board of Directors stated that Shaool was "struggling with cash flow … due to the continuous battle with rental delinquencies … [and that] the economy has hit the rental portfolio hard." Nevertheless the Bank granted the modifications without recognizing them as TDRs, and once again failed to disclose the loans as impaired, rate them substandard, or calculate any reserve on them in

its SEC filings. The Bank inexplicably rated these loans a "3" or "Acceptable," despite previously acknowledging that the modifications would require risk rating downgrades and creation of a reserve.

263. Likewise, in early 2010 David Shaool sought interest-only modification to his loans for his Pangborn Heights Development. The presentation materials stated that the "borrower's [sic] do not produce sufficient cash flow to support their debt service and the cash deficit from the investment property." Yet, the Bank did not identify the loans as impaired or calculate any reserve on them in 2009 or 2010, nor did it rate them Substandard.

264. Moreover, a "Problem Loan Report" created in 2011 for the Shaool loans reflect that *all* of the Shaool loans (including Ben, David, and Dustin), totaling over $18 million, were rated Substandard (i.e., "6") as of March 12, 2010. Thus, the bank recognized that these modified loans were substandard, as required based on the fact that they were TDRs, yet failed to disclose them as impaired or include all of the loans in the ALLL calculation. That document also admits that the 2010 modifications constituted TDRs, even though they were never disclosed as such.

265. In July 2010, Ben Shaool sought further modifications, asking for three years of interest-only payment instead of the originally approved one year. The Loan Presentation materials presented to, *inter alia*, the Bank's Board of

Directors, stated that Shaool was "uncooperative" and threatened to "surrender the properties" if the Bank was unwilling to restructure his debt. In fact, David and Dustin Shaool had also threatened to "surrender" their properties and "drop off the keys" to the Bank if these modifications were not granted. The Bank recognized that the modifications were "not the ideal structure" for the Bank, and described the modifications as "concessions," but nonetheless granted them again without recognizing them as TDRs and without disclosing the loans as impaired. Moreover, the bank once again failed to rate Ben Shaool's loans as Substandard and did not calculate an ALLL reserve on them.

266. The credit analyst's recommendation was to approve the request to place all of the existing loans in an interest-only structure for three years based on the strength of their "cash flow and net worth." This, in turn, was based on financial statement compiled by SEK. These financial statements were bogus, however, and SEK had a serious conflict of interest in serving as the Bank's auditor and at the same time preparing financial compilations for one of the Bank's largest and most financially-distressed borrowers, the Shaools.

267. To ascertain the Shaools' net worth the Bank relied entirely on Personal Financial Statements compiled by SEK. For each of the years 2007, 2008 and 2009 SEK prepared Statements upon which SEK knew the Bank would rely in matters regarding its lending relationship with the Shaools. As their accountant,

SEK was acutely aware of or recklessly disregarded Shaools' financial condition, and the conflict inherent in the dual role as auditor and accountant for the borrower. SEK never disclosed its dual-relationship to the Audit Committee of the Board of Directors.

268. For the years 2007, 2008 and 2009 the Statements prepared by SEK reported Ben and Kathy Shaool's net worth at $53,822,000, $26,769,000, and $26,944,000, respectively. It was primarily this net worth upon which the Bank based its loan modification decisions. The primary component of this net worth was their investments, which in all cases in the Statements were reported not based on their historical cost, which is the standard for financial statement prepared in accordance with GAAP, but rather their Estimated Fair Market Value ("EFMV"). The tables below show the impact on the statements for 2007 and 2008 as the result of using EFMV rather than historical cost.

2007	**Investments per B/S**	**Historical Cost**	**Shaool Est of Value**	**Value over Hist. Cost**
Sadorvan Properties LLC	$ 7,600,000	$ 6,552,079	$ 17,125,000	10,572,921
Shaool Southview Development LLC	3,100,000	5,683,298	7,250,000	1,566,702
Shaool Edgewood Development LLC	8,200,000	3,270,572	11,500,000	8,229,428
Cortpark LLC	6,900,000	8,189,941	16,095,680	7,905,739
Cortpark II LLC	16,500,000	17,580,482	34,370,000	16,789,518
Shaool Brookmeade Development LLC	3,800,000	9,330,922	13,200,000	3,869,078
Shaool Walnut Point Development	470,000	2,909,494	4,981,000	2,071,506
Shaool Hickory School Raod Developmer	750,000	590,616	1,200,000	609,384
Progress Homes LLC 20% interest	270,000	3,810,859	5,010,000	1,199,141
Total Estimated Value Over Cost	$ 47,590,000	$ 57,918,263	$ 110,731,680	$ 52,813,417

269. The 2007 Statement valued the Shaools' investment in the entities that held their apartment complexes at $49,590,000. This was entirely due to the $110,731,680 estimation of value which was $52.8 million in excess of cost. Such assumptions were unsupportable. The Brookmeade project valued at $13.2 million ($3.9 million over its cost) hadn't even been completed as of the end of 2007. The gross rental income of $719,347 for the newly completed Cortpark II property was not even sufficient to pay the debt service on its $17.5 million mortgage, yet it was valued at almost double its $17.6 million cost. Cortpark LLC, which up until the issuance of the 2007 Statement hadn't even been completed or partially begun rental operations, was also valued at almost double its cost. These assumptions were absurd on their face and should have caused SEK great concern, knowing the Statements would be used to support the Shaools' relationship with the Bank.

270. The 2008 Statement acknowledged to some extent the impact the financial downturn had on the real estate industry by reducing the value of some of the properties, but the reductions were minimal and intended to convey a bogus conservative approach to valuation, since the values included in the Statements continued to be blatantly unsupportable.

2008	Investments per B/S	Historical Cost	Shaool Est of Value	Value over Hist. Cost
Sadorvan Properties LLC	$ 4,230,000	$ 6,767,657	$ 12,000,000	5,232,343
Shaool Southview Development LLC	2,890,000	5,467,166	7,000,000	1,532,834
Shaool Edgewood Development LLC	8,320,000	3,109,585	11,500,000	8,390,415
Cortpark LLC	1,040,000	15,020,230	15,500,000	479,770
Cortpark II LLC	7,330,000	18,937,858	27,000,000	8,062,142
Shaool Brookmeade Development LLC	1,830,000	9,859,807	12,000,000	2,140,193
Shaool Walnut Point Development	375,000	2,862,894	4,950,000	2,087,106
Shaool Hickory School Raod Developmer	130,000	516,546	600,000	83,454
Progress Homes LLC 20% interest	480,000	7,510,056	9,890,000	2,379,944
	$ 26,625,000	$ 70,051,799	$ 100,440,000	$ 30,388,201

271. As shown, the entirety of the Shaools' net worth was the result of the unsupportable estimate of fair market values ascribed to their recently completed projects whose units could not be sold or rented sufficiently to generate adequate revenue to meet debt service, or to support more than a fraction of the values attributed to them.

272. Moreover, the July 2010 loan presentation included numerous iterations of cash flow projections predicated on dated information derived from the Shaools' 12/31/08 tax returns and the Statement of Financial Condition as of 12/31/2008. Four of the five analyses, one of which included the additional obligations of Dustin, showed cash flow ranging from $2.1 million to $2.5 million after servicing $9.5 million of personal debt payable to Susquehanna Bank, Bank of America and Orrstown. Each of these projections of cash flow incorporated as cash flow $3.2 million of capital gains which, according to the Bank, was a three-year average of capital gains resulting from the sales of the 100 unit Chesterfield House in 2006, and the 450 unit Park Place Towers, the Foxwood Apartments, the

Pinewood Apartments, and Park place Towers in 2007. All these properties were depreciable meaning that a significant portion, if not all of the gains were the result of recapturing depreciation; the reported gains were in no way indicative of either actual financial gain or, more importantly, a recurring cash flow or an income stream. By the end of 2007 all the assets included in the Shaool's portfolio were either 100% or more leveraged in the case of income producing properties or non-income producing raw land. By 2009 it was readily apparent that the Shaool's were seriously overextended, not only with respect to their loans with Orrstown but also with respect to loans with other banks. For example, the Shaool's financial statements examined by Orrstown Bank showed that the Shaools had approximately $37 million in debt on two "Cortpark Apartments" properties. Occupancy rates were extremely low, as "delinquent tenants are vacating as fast as the new units are occupied," which created a "vicious cycle and occupancy rates have been stuck in neutral." The combined debt on the two troubled Cortpark properties at 12/31/09 was approximately $37 million, all of which was personally guaranteed by Ben Shaool. In short, there was no question Orrstown's loans to the Shaools were troubled.

273. While the Bank rated Dustin's loans as "Substandard" in 2010, it did not identify the modifications to those loans as TDRs, nor did it include those in its disclosure of impaired loans. Moreover, the Bank failed to identify Ben or David's

loan as impaired, TDRs, or Substandard, and never even calculated a reserve on them in 2010, rendering its SEC filings materially false and misleading. Ultimately, in 2012 the Shaool loans were sold for pennies on the dollar. As a result of the Bank's failure to accurately rate loans to the Shaools as Substandard, calculate required ALLL reserves, identify the loans as impaired, and identify the modifications as TDRs, Orrstown's SEC filings were materially false and misleading during the Class Period.

4. The Chambersburg Developers - Mongold & Hickey

274. The Chambersburg Developers Bob Hickey and Tom Mongold are real estate agents and developers in the Chambersburg area. Mongold was identified as "Lending Relationship C" in the SEC Order. Hickey and Mongold worked on real estate development projects together and separately, and both borrowed heavily form the Bank. Hickey was Defendant Embly's next-door neighbor and, according to CW#1 and CW#3, the two had a close friendship. Hickey also sat on the Bank's Chambersburg-Greencastle Advisory Council. See Schedule 14A Additional Definitive Proxy Materials, filed 3/30/2012, at 10. According to CW#1, CW#2, and CW#3, the Chambersburg Developers and their entities were given preferential treatment by the Loan Committee, especially by Defendant Embly, such that their loans were approved throughout 2008 to 2010 despite adverse credit information and the failure to meet the standards set out in

the Company's Loan Policy. By late 2010 the Bank's Loan Committee approved over $21 million in loans to the Chambersburg Developers. At the time Orrstown reported that its loan lending limit was $19,000,000. Form 10-K 2010 Annual Report, filed 3/11/11, at 42. According to CW#3, Defendants Everly and Embly realized sometime in late 2010 or early 2011 that they might have gone over the Bank's legal lending limit with respect to the Chambersburg Developers, and they began restructuring the loans.

275. In 2009, Hickey and Mongold were among the Bank's top 10 borrower relationships, with loans of $12.2 million and $10.2 million, respectively. By 2010, Hickey and Mongold were Orrstown's two largest borrowers.

276. Hickey and Mongold were equal members of Divinity Investments, LLC, a real estate development enterprise with several projects for which Orrstown was the lender.

277. Hickey also had loans with OTB individually and through wholly or partially owned entities including RJH Investments, LLC; Garden State Holdings, LLC; Quad State Investments, LLC; and Atrium Meadows, LLC.

278. Mongold also had individual loans with OTB as well through a number of partially owned entities including DELM Developers, LLC; Saddle Rock Homes, LLC; Landmark Homes & Acquisitions, LLC; and MLM Properties, LLC.

279. Mongold began to experience the effects of the declining real estate market as early as 2007, and sought loan modifications and extensions from the Bank as a result inability to sell building lots. For example, in May 2007, Mongold sought extensions of loans for the Betteker and Hykes Road properties owned by Saddle Rock because he was having trouble selling lots in Betteker and he was unable to flip the Hykes Road property as he had planned.

280. As early as November 2008 internal emails reflect that the Bank was concerned about extending a matured loan to Saddle Rock due to loan-to-value ratios which, while within the Bank's guidelines, could present future problems due to "declining real estate values." A December review of Saddle Rock noted that another "concern continues to be the current housing market."

281. In January 2009, as the economic crisis worsened, internal emails concerning Saddle Rock loans expressed concern over the bank's large exposure to Mongold, apparently in response to comments made by federal regulators, i.e., "the Fed thing." Thus by early 2009 the Bank was well aware of its large exposure to Mongold and Hickey, the Bank expressed concern about "declining real estate values," and the Regulators had expressed concern about the Bank's large exposure to individual borrowers, like Mongold. Nevertheless, the Bank continued to extend more credit to Mongold.

282. By the end of 2009, several Hickey and Mongold loans had matured and required extensions, and Embly intervened on their behalf. Orrstown was desperate to restructure the matured loans in order to avoid taking charge offs or required reserves.

283. In a November 18, 2009 email, Embly told Orrstown VP and Business development Director Steve Szady, "I need you to do everything in your power to get DELM [a Mongold entity] … off of the matured listed by 11/30." Given the Bank's knowledge of the financial crisis, and the necessity to extend these matured loans, the bank should have identified the modifications as TDRs and rated the loans as Substandard and calculated an ALLL reserve on them, but it did not. As a result, the Bank's 2009 10-K (which was incorporated in the Offering Documents) was materially false and misleading.

284. In January 2010, Embly sent a similar message about an extension for a matured Quad State (Hickey) loan, instructing Peter Thompson, "We need to make this happen Peter."

285. In February 2010, the bank extended over $3 million in matured loans to two of Hickey's entities, Quad State and Antrim Meadows. The Antrim Meadows loan of $2,273,000 was originally granted to fund 100% of the purchase price of a residential development lot from Mongold. But by the time the loan matured in February 2010, the Bank knew that the economy had long-ago turned

and that Quad State/Hickey had not even filed the final development plan with the township necessary to begin construction. Hickey informed the Bank he was seeking an extension because he was waiting "until the market turns" to "sell the development as is." In other words, real estate markets had tanked, and he had no plan to develop the lots but was hoping to sell the project if and when the real estate market turned around. Incredibly, the Bank extended the loan without recognizing any impairment.

286. A March 2010 loan review prepared by Chad Rydbom showed that Quad State/Hickey was "highly leveraged" relative to their peers, and that many of Hickey's loans showed significant collateral deficits. Further, the Bank's analysis of cash flows showed serious problems, with several of Hickey's entities showing negative cash flow, and others just barely above Bank policy limits.

287. In March 2010 internal emails reflect further awareness of potential debt service problems for Mongold. At that time, Saddle Rock/Mongold was seeking a loan extension of an existing loan plus additional financing to purchase development lots in Greencastle, PA, which another developer was trying to offload quickly (presumably due to the devastated economy). Mongold informed the Bank that one of the projects for which the original loan had been taken, a development on Hykes Road in Greencastle, had "grown less desirable" as a result of the failing economy, and he had stopped construction. The Bank also knew that

the Hykes Road project was "over 100% financed." Mongold planned to obtain additional financing from Orrstown to refinance the existing Hykes Road loan, which was over 100% financed and which he had no intention of continuing to develop, and also to purchase additional lots that he would develop to try to pay off both loans. In other words, his first bet failed and he was asking the Bank to give him more money so he could double-down.

288. Steve Szady wrote to Jay Gayman, Chief Commercial Officer, "I cannot overemphasize the importance of current and continuing operating income for Mongold/Danny Nabati and Saddle Rock. Without it we could begin to see debt service problems. If we disallow them to 'develop' underpriced real estate, we cut off their air supply."

289. Once again, the Bank doubled down, granting more loans to Mongold in hope that the he would be able to pay off the prior loan with a greater than 100% loan-to-value ratio. Moreover, while the Bank was relying on Mongold's personal net worth and guarantee the Bank knew his income had dropped dramatically from $2.7 million in 2006 to just $327,000 in 2008. Yet, once again, the Bank failed to recognize the loans as impaired.

290. Given the declining real estate markets, Hickey and Mongold's loans were in trouble, and soon the bank was forced to modify even more loans.

291. The cozy relationship between Orrstown and Hickey and Mongold was no more evident than when the Bank approached them to take over a failing project from another borrower, Briarpatch LLC. Briarpatch had been developing a residential subdivision, called Woodbriar, when its principal passed away. The Bank was forced to take charge-offs and was desperate to get rid of Briarpatch loans. In order to get a non-performing loan to Briarpatch, LLC for the Woodbriar subdivision "off its books," in June 2010 Embly approached Hickey and Mongold, and eventually negotiated a sweetheart deal whereby Divinity Investments, with $1.1 million of OTB money (floating interest at WSJ Prime), would purchase the subdivision and be granted a $1 million construction line of credit for spec homes on the site. In addition, OTB agreed to provide interest rate modifications to 18 existing, unrelated loans to Hickey, Mongold and any entities owned solely or jointly by them resulting in projected $200,000 annual rate reductions, in order to entice them to agree to acquire Briarpatch.

292. Around the same time in June 2010 OTB asked Hickey's partner in Quad State, Hoover, to agree to a proposed mortgage modification in order to help an unrelated debtor avoid a default. In return Hoover negotiated a reduction in a Quad State loan interest rate from 7.35% fixed to a floating Prime with no floor.

293. In essence, entities associated with Hickey became a clearing house for the Bank's bad loans and stalled development projects, and the Bank was

transformed from being a conventional lender into a partner and co-investor with Hickey and Mongold.

294. By September 8, 2010, Saddle Rock was unable to sell many homes it had built due to the soft real estate market, and it was forced instead to rent those homes. Mongold and Nabatti sought modification of the Saddle Rock loans to reduce interest and provide an interest-only period, and informed the Bank of their "serious cash flow deficiencies." They also promised to divest assets in an effort to generate cash and reduce their debt loads. The Bank acknowledged that modifying the loans was "not the most optimal structure for the bank," but nevertheless modified the loans due to the troubled financial conditions of the borrowers in September 2010.

295. In November 2010, another Mongold entity, DELM, was unable to make interest payments and had requested that the bank make payments from an escrow reserve which was used as collateral for the loans.

296. Despite knowing by 2010 that the "borrowers continue to struggle," and experienced sales declines and significant cash deficits, the Bank still had not recognized the Saddle Rock loans as impaired in late 2010, nor did it identify the modifications as TDRs. The Bank did move DELM to Substandard, but still did not recognize the loans as impaired, or the modifications as TDRs.

297. In late 2011, SEG, who had been engaged as a consultant to evaluate the Bank's loan portfolio, summarized the "main concern" with Hickey's loans were "the upcoming maturities of obligations which either have or are expected to have large collateral shortfalls. Mr. Hickey does not have the liquidity to payoff those loans." SEG noted that Hickey offered a 43% settlement to walk away. Moreover, "the bank [was] not well secured."

298. Eventually, the Bank took significant charge-offs on Hickey and Mongold's loans. These loans should have been recognized as impaired by at least late 2009, but they were not. As a result of the Bank's failure to accurately rate loans to the Chambersburg Developers as Substandard, calculate required ALLL reserves, identify the loans as impaired, and identify the modifications as TDRs, Orrstown's SEC filings were materially false and misleading during the Class Period.

5. Additional Examples

299. The Yorktown, Azadi, Shaool, and Hickey/Mongold relationships are some of the largest borrower examples of the Bank's failures of internal controls over financial reporting, but Plaintiffs will demonstrate at trial the Bank's failures to properly account for many additional borrower relationships as well, resulting in the Bank's failure to properly calculate ALLL and failure to identify additional

impaired loans and TDRs. Just a few more summary examples demonstrating material deficiencies in internal controls over financial reporting are provided here:

300. **Oscar Benisek**, a real estate developer in Chambersburg and Hagerstown, MD, had approximately 15 loans totaling $3.3 million as of December 31, 2009. Each loan was secured by a home constructed on a building lot. The appraisals of the various properties ranged from nearly six years old to more than a year old, with the average appraisal date being 2006, or 3+years old. The loans were classified as "6" or "substandard", thereby having "a high probability of payment default," which was appropriate, but the FAS 114 special reserve taken for this aggregate group of loans was a mere $15,000, which was wholly inadequate. Ultimately the Bank charged off approximately 60% of these loans (over $1.7 million) when the loans were sold in mid-2012. The Benisek loans did not deteriorate in any appreciable way between early 2010, when the $14,000 FAS 114 reserve was made for those loans, and mid-2012 when the loans were off-loaded at a loss of nearly $2 million. At December 31, 2009, the loans were secured by property interests that had nearly $1 million in other senior liens placed on them. Moreover, the review team was aware that the appraisals they used for "valuing" the properties were so out-of-date as to be useless and imprudent to use as a basis for valuation purposes.

301. The **Dahbura Family Limited Partnership** was another one of the Bank's largest borrowers. By 2009 the Dahbura loan exceed $7.8 million, and had been extended twice on an interest-only basis due to the economy, making it a TDR. In its 2008 audit, SEK found that Dahbura's cash flows were not adequate to service the debt and that it was having difficulty finding tenants. SEK agreed with the Bank's position that the loan was not Substandard, solely because "Collateral appears adequate and guarantors appear strong," but candidly acknowledged "[e]ven though collateral appears adequate and guarantors, there have been extensions due to inability to find renters." However, the collateral value was based solely on a January 1, 2006 appraisal – i.e., more than two years prior and before the financial collapse. Given the poor cash flow and inability to find renters, as well as the grossly stale appraisal, the Dahbura loan should have been identified as Substandard and the extensions identified as TDRs at least at the time of the 2008 10-K. By the following year, the Dahbura loan had been extended a third time and the property was still not fully rented. In its 2009 audit, SEK noted that "Bank management ran various analysis of cash flow scenarios to determine cash flow ability and the only way cash flow would be sufficient is if 20,000 sq. ft. of available space were to be rented out. Interest only payments have been extended several times to allow time to rent this space out, but it still has not been rented." At that time SEK recommended that the Bank should "classify as

substandard now due to uncertainty and above factors," and that "Management also needs to obtain more current financial information for continued analysis." The collateral appraisal at that point was more than 3 years old, and predated the financial crisis. The Bank however apparently ignored SEK's opinion and once again failed to calculate an FAS 114 reserve or identity the extensions as TDRs as required. SEK's disagreement with management was never publicly disclosed in Orrstown's SEC filings.

302. As also discussed more fully in Section X.A.4, the Bank lent **Antonio Mourtil** over $3 million for a "Cleveland Avenue Commons" project to build 14 townhomes near one of the Bank's branch locations in Hagerstown, but after the financial crisis hit Mourtil was unable to sell the units and had to rent them instead. The loan became due in July 2009 and Mourtil requested a two year extension. The bank knew that rents from the properties were not sufficient to support the debt. The appraisal on the property was over three years old at that time and the bank knew "it is likely that the properties have decreased in value." An updated appraisal, dated August 21, 2009, showed collateral value of just $2.2 million, on a more than $3 million loan. Mourtil told the Bank, "all of their projects are under water and … they are having difficulty keeping the units fully occupied and with the inconsistency in rental income, they are pulling cash from their personal accounts to service the debt." As of December 31, 2009, the Loan was obviously

Substandard, required an FAS 114 reserve, and should have been identified as impaired and a TDR. On January 12, 2010, Chad Rydbom conveyed to defendant Embly an ALLL schedule that showed Mourtil's loan with a reserve of $1.33M under FAS 114. But, the Bank removed the required reserve from its ALLL schedule prior to filing its 2009 10-K, which was incorporated in the Offering Documents. Removing this was unjustifiable, and had a material impact on the Bank's reported net income and ALLL, as discussed more fully below.

303. As also discussed more fully in Section X.A.4 below, **J&S Enterprises** borrowed $2 million from the Bank in August 2006, and the loan was rated Substandard shortly thereafter (at least by 2007) due to, *inter alia*, "weak cash flow" and insufficient collateral. As of December 31, 2008, the Bank calculated a collateral deficit (i.e., FAS 114 reserve) of $606,416, although even that was understated since the latest appraisals were from 2006, meaning the true collateral deficit as of December 31, 2008 was much greater given the collapse of real estate markets. J&S remained Substandard throughout 2009 but, when calculating ALLL for the 2009 10-K, Orrstown removed J&S from the ALLL calculation despite the fact that internal documents show it was still rated Substandard as of December 31, 2009. During its audit of the 2009 financials, SEK expressly disagreed with the Bank's upgrading of the J&S loan and removal of it from the ALLL calculation. SEK believed the loan should have remained

rated Substandard, and the 2009 ALLL calculation should have included at least an FAS 114 reserve of $483,577 due to the deficient collateral. Given that an FAS 114 reserve was required, the loan should also have been identified as impaired. In its 2009 10-K, however, the Bank simply ignored the opinion of its auditor. Rather than include the necessary FAS 114 reserve for J&S, Orrstown's 10-K ignored SEK's opinion and presented the ALLL as the Bank had initially calculated it, without any specific reserve for J&S. SEK's disagreement with management was never publicly disclosed in Orrstown's SEC filings.

304. **Dwight Martin**, a real estate flipper, was another of the Bank's largest borrowers, with loans totaling over $3.7 million as of December 31, 2009. In 2007, Martin borrowed $2.4 million to fund the acquisition of raw land, which he intended to re-sell, and in 2008 and 2009 Martin took two more loans totaling $300,000 to fund carrying costs for the land. All three loans matured in December 2009, but Martin had been unable to sell the land due to the poor economy. Martin sought a three year interest-only extension. The Bank's Loan Presentation for the extension noted that "most potential buyers are currently waiting until the economy shows signs of life," and that Martin had already "conceded on the asking price for the acreage." Moreover, the Loan Presentation noted that the appraisal on the land was only a "drive-by" appraisal, meaning it was not a formal appraisal, and the value of the other collateral pledged (residential real estate) was based solely on

the borrower's stated value. Martin's loans should have been identified as Substandard and an ALLL reserve calculated on them using appropriate appraisals for the 2009 10-K. Moreover, the extensions granted on the loans in the first quarter of 2010 should have been identified as TDRs. In July 2012, Orrstown sold all of Martin's loans at a loss of nearly $1 million.

305. By year end 2009, **Marvin Windows**, and its principal, Robert Slagle, had borrowed approximately $3.75 million from the Bank. One of the recommendations of the November Loan Review, discussed above, was to rate the Marvin Windows loan as Substandard, at which point the Bank's policies required it to be added to the ALLL calculation. Internally, the Bank projected an $800,000 reserve was required for the Marvin Windows loan, but Marvin Windows was never identified on the final ALLL calculation, and no reserve was allocated to it in the 2009 10-K, despite the recommendations of the internal review. Immediately following the March 2010 Offering in the first quarter of 2010 the Bank added a $1.57 million reserve for Marvin Windows.

306. In short, as demonstrated by all of the above examples (and additional examples that will be presented at trial), material financial accounting failures were the rule, not the exception, at Orrstown due to its materially weak internal controls. Orrstown's SEC filings (including the Offering Documents) were materially false and misleading during the Class Period because, *inter alia*, they failed to

accurately state ALLL reserves that were required by GAAP and the Bank's own Loan Policy, they failed to identify impaired loans, they failed to identify TDRs, and they falsely assured investors that the Bank maintained adequate internal controls over financial reporting.

6. Orrstown's Sales of Bad Loans

307. Ultimately, in 2012 the bank sold approximately $115 million in bad loans for pennies on the dollar, including loans to the Azadis, Mansoor Shaool, Ben Shaool, Hickey, Mongold, and other top borrowers discussed above.

308. Specifically, on June 29, 2012 the Bank sold two packages of loans secured by commercial real estate ("CRE"), the first of which represented investment in loans of $51,591,250 and the second $63,499,969, for a total of $115,091,219.

309. The first tranche consisted of a total of 67 loans issued to 8 borrowers and the entire package was purchased for $20 million or 38.7 cents on the dollar as shown below. Three of these clients, Azadi, Ben and Kathy Shaool and Mansoor Shaool, were among the Banks top 10 borrowers, and $32 million of their loans were included in the first tranche of loans sold for $.39 on the dollar, as shown below.

	Upaid Principal at June 13, 2012	Purchase Price	Cents on $
Morris and Ash Azadi	$ 15,744,700.76		
Ben and Kathy Shaool	18,586,072.07		
Mansoor Shaool	914,404.58		
	35,245,177.41		
Ben Musser	7,435,807.25		
Big Dog Investments, including			
State Capital Investment			
Thrush Lane	4,828,730.75		
State Line LC	1,278,419.31		
Oscar Benisek	2,803,115.55		
	$ 51,591,250.27	$ 20,000,000.51	$0.39

310. The second tranche consisted of 155 loans issued to approximately 50 borrowers and it was sold for 50 cents on the dollar, however three borrowers, including the two Chambersburg Developers, were among the Banks top 10 customers at 6/30/11 and have been isolated to show the discount at which their loans were sold. As shown below while the entire portfolio was sold for 50 cents on the dollar, loans issued to some of its top ten borrowers were sold for only 26 cents on the dollar.

EXHIBIT A			
	Upaid Principal at June 13, 2012	**Purchase Price**	**Cents on $**
Hickey	$ 4,129,746.00	$ 1,321,803.00	$0.32
Mongold	2,971,177.00	537,850.00	$0.18
Rine	8,690,812.00	2,301,825.00	$0.26
	15,791,735.00	4,161,478.00	$0.26
All Others	47,708,234.00	27,888,522.00	$0.58
	$ 63,499,969.00	$ 32,050,000.00	$0.50

E. SEK's Audits and Audit Failures

311. SEK was the Bank's auditor from at least 2006 through 2013.

312. During that time frame, SEK also served at various times as accountant for many of the Bank's largest borrowers, including Ben Shaool, David Shaool, Mansoor and Janet Shaool, Morris and Ash Azadi, Tom Mongold, DELM Development, Curtis Rine, Dawood Engineering, and Joshua Nabatkhorian (aka Danny Nabatti). SEK never disclosed to the Audit Committee of the Bank that it simultaneously served as auditor for the Bank and accountant for many of the Bank's largest borrower relationships, and SEK's dual-role created a conflict of interest, nowhere more apparent than when SEK intervened with the Bank on behalf of Azadi by entreating Embly to coerce Selders to modify Azadi's loans.

313. Of Orrstown's Top 20 Customers as of 12/31/2009, SEK's Clients ranked as follow;

		Total Commited	Current Balance
#1	Mansoor and Janet Shaool	$13.6 million	$12.3mllion
#2	Bony Dawood	$13 million	$11.9 million
#5	Tom Mongold	$12.6 million	$10.2 million
#6	Ash/ Morris Azadi	$12.5 million	$11.3 million
#7	Ben and Kathy Shaool	$12.2 million	$11.9 million
#9	Darrin/Curtis Riine	$10.0 million	$7.7 million

314. As accountant to these borrowers, SEK had access to material information concerning their financial positions, and knew or should have known that their loans were impaired. In the cases of Ben Shaool and Mansoor Shaool

SEK compiled personal financial statements that were relied upon by the Bank to provide assurances as to their creditworthiness as borrowers. These financial statements were also used to secure modifications to loans and the significant net worth that they reflected was one reason the bank did not devalue these loans in years prior.

315. At December 31, 2011 the total capital of the Bank was $122 million and the loss realized in the 2012 loans sale that was attributable to SEK clients was around $33 million, **27% of the Banks total capital**.

316. In the course of its audits from at least 2008 through 2011 SEK discovered material weaknesses in Orrstown's internal controls over financial reporting, but nevertheless issued clean audit opinions, including for Orrstown's 2009 10-K, which was incorporated into the Bank's Offering Documents. As noted above, the Bank's internal controls over financial reporting, particularly ALLL and its disclosure of impaired loans, were materially deficient in respects that were readily apparent to SEK in conducting its audits.

317. **First**, SEK knew that until the final quarter of 2010 Orrstown evaluated only Substandard loans for impairment and, by limiting its evaluation to loans that were rated Substandard, Orrstown artificially limited its evaluation of impairment and failed to comply with GAAP. Further, because the Bank failed to accurately risk rate loans, its evaluation of impaired loans was materially flawed.

SEK, as auditor, knew but failed to correct the Bank's noncompliance in this regard. In fact, SEK discovered that the Bank had improperly risk rated loans, but the Bank nevertheless ignored SEK's conclusions.

318. **Second**, from at least 2008 through 2010, SEK knew that Orrstown routinely failed to recognize as impaired Substandard loans for which it calculated collateral deficits, in contravention of its own Loan Policy and GAAP. In other words, the Bank would calculate an FAS 114 collateral deficiency, but inexplicably fail to identify those loans as impaired in its SEC filings. SEK audited the Bank's ALLL calculations and its impaired loans list, and thus knew that the Bank had failed to identify as impaired loans for which it had calculated an FAS 114 deficit.

319. **Third**, SEK knew that in conducting its analysis of the collateral for Substandard, collateral-based loans, Orrstown routinely failed to obtain updated appraisals. SEK also knew that this failed to comply with Orrstown's own Loan Policy and, given the financial crisis, had a material impact on the Bank's ALLL calculations and identification of impaired loans.

320. **Fourth**, SEK knew that, rather than obtain updated appraisals that took into account current circumstances during the financial crisis, Orrstown applied discount factors to old appraisals that were totally improper under GAAP. SEK audited these ALLL calculations in detail. As found by the SEC, Orrstown's

use of a universal discount factor did not comply with GAAP and was a factor in supporting the SEC's determination that securities law violations had occurred.

321. **Fifth**, SEK knew that Orrstown failed to calculate a reserve on loans other than those rated Substandard (except to the extent that the Bank's exposure to a particular industry exceeded 25% of the Bank's total equity). As noted above, for all loans not subject to FAS 114, the Bank should have calculated reserves under FAS 5 based on pools of loans with similar characteristics using historical loss factors. But Orrstown only calculated an FAS 5 reserve for *Substandard* loans for which a FAS 114 reserve was not calculated, instead of the *entire* loan portfolio by segment. This practice was contrary to generally accepted industry practice and also improperly assumed that the Bank only incurs losses through its Substandard and lower rated loans, which was not accurate and in contrast to basic, elementary credit theory and practice (for example, even the highest rated AAA loans have a probability of default and Moodys and S&P publish quarterly historical losses and probability of defaults for investment grade loans).

322. **Sixth**, SEK knew that Orrstown used improper historical loss factors for the pooled loans for which it did calculate an FAS 5 reserve. In its 2009 Loan Policy, Orrstown specified that the reserve would be calculated using a **five year** average charge-off rate. Five years was far too long of a time period to yield a reasonable average charge-off rate, particularly in the rapidly deteriorating

environment during the financial crisis beginning in 2008. Further, the charge-offs were equally weighted, such that older charge-off rates, under very different economic circumstances, received the same weighting as more recently time periods. In December 2010, the Loan Policy was changed to provide for a rolling 8-quarter weighted average, with 25% weighting to the oldest year and 75% to the most recent year. Even then, however, Orrstown failed to comply with industry standards because, as later found by one of the Bank's consultants, it failed to annualize the quarter-end loss rates. The industry accepted practice was to annualize the losses and divide the amount by the average loan balances to provide a more representative picture of the loan loss ratio in that segment. SEK knew from its audits that Orrstown was utilizing these improper historical loss factors, which resulted in understated ALLL.

323. In addition, for reasons that can only be rooted in an intent to turn a blind eye, SEK scrupulously omitted from its audit loan testing program virtually any loan of a borrower for which SEK was performing accounting services, effectively omitting from its audit upwards of $50 million in loans to the Bank's largest borrowers in 2008 and 2009. The conflict of interest and ethical quagmire that SEK created for itself by seeking to serve both Orrstown as auditor and more than a dozen of Bank borrowers as their accountant is irreconcilable. SEK had one choice – to resign as auditor of Orrstown or resign the accountant relationships

with the borrowers. SEK choose neither option rendering its audit work inherently unreliable, a fact that was not disclosed to the investing public.

324. Moreover, as accountant to several of the Bank's largest borrowers, SEK knew that they were experiencing financial difficulty and that their real estate collateral values had plummeted, and SEK also knew that the Bank had failed to rate these relationships as Substandard. SEK was also well aware of failures with respect to the Bank's application of the IRR system, which affected its ALLL and identification of impaired loans.

1. 2008 Audit

325. SEK's year-end audit for 2008 suffered at least the six deficiencies identified above.

326. For example, as discussed above, in the 10-K for the year ended 2008, approximately 62% of loans evaluated for impairment were supported by real estate appraisals more than two years old and 15% were supported by appraisals over five years old. The total outstanding balance for these loans was approximately $14.2 million, which was about 81% of the loans evaluated. Given the financial crisis and its impact on real estate markets beginning in 2008, these outdated appraisals were completely unreliable, based on stale appraisals that failed to comply with the Bank's own Loan Policy. These failures were

transparently obvious to SEK, who reviewed the Bank's ALLL calculation in detail and saw the outdated appraisal date on which it relied.

327. Moreover, despite the fact that the Bank had calculated a collateral deficiency on 11 of these Substandard loans for the 2008 year end, SEK knew that Orrstown failed to identify those loans as impaired in accordance with FAS 114 in its disclosure of impaired loans. In its 2008 10-K, Orrstown stated that at December 31, 2008, its total recorded investment in impaired loans was only $1,830,000. In reality, as least approximately $7.5 million in loans were impaired under Orrstown's own FAS 114 analysis, which was a 416% understatement. Moreover, because 62% of the loans evaluated for impairment under FAS 114 had appraisals that were more than two years old, and 15% more than five years old, the amount of impaired loans would have been much higher using updated appraisals since, by the end of 2008, real estate markets had already tumbled due to the financial crisis. Once again, these issues were transparently obvious to SEK in performing its audit.

328. In a letter to management upon completion of the 2008 audit, SEK also noted that several of the Bank's largest relationships "did not have current financial information (2007 or later) on file," and that "three files … had appraisal worksheets in the loan files, but there were no appraisal reports in the files to support the amounts on the worksheets." These comments related directly to

several of the borrower relationships discussed herein, including the Shaools and Dahbura. Of course, these deficiencies were just the tip of the iceberg. SEK noted that "regular evaluation of the Bank's larger borrowers is particularly important given the country's current economic conditions…."

329. In connection with its audit of Orrstown's 2008 ALLL calculation, SEK also noted that "[]the Bank's regulatory examiners have indicated that they would like to see the allowance at around 1% of loans to ensure the allowance is adequate to absorb unanticipated losses within the loan portfolio." The Bank's ALLL was only .87%, "below the Bank's regulatory examiner's expectations," and also well below the 1.56% for the bank's peer group.

330. The reason for Orrstown's low ALLL was obvious -- it was based on the six deficiencies noted above, and particularly the Bank's failure to accurately identify Substandard loans through its IRR ratings.

331. SEK audited some of the bank's IRR ratings, but SEK deliberately employed selection criteria that avoided reviewing most of the Bank's large borrower relationships, principally those being SEK clients. In its 2008 audit, SEK did not review the Yorktown, Azadi, Mongold, Hickey, or Manny Shaool relationships, even though these were among the Bank's largest borrower relationships.

332. SEK's failure to review the Yorktown loans in particular is inexplicable. SEK's Loan Loss Reserve Calculation memo states that SEK "judgmentally selected 3 of the largest commercial lines of credit" for review but SEK skipped over Yorktown, which was by far the largest credit – nearly double the next highest. A note on the list states, with respect to Yorktown, "not practical for selection and little risk." There was no basis for that conclusion. Within just over a year Yorktown declared bankruptcy.

333. Neither statement was true at the time it was made in SEK's Workpapers. Yorktown, among all the Bank's borrowers, was likely the most difficult to assess in terms of creditworthiness. Although Yorktown was the borrower, its ability to repay the loan was totally dependent on the financial performance of Yorktown's underlying developer borrowers. In other words, it was not really Yorktown, the middleman, whose business performance that would dictate if the loan could be repaid. As auditor, SEK understood that this two-tier borrowing structure was different from the more conventional single-tier borrower situation. That did not render an auditor's review of the Yorktown borrowing relationship "not practical"; it just required more work. If SEK had scrutinized the Yorktown loan, it would have readily ascertained in 2008 and 2009 that the loan would not be repaid, and a significant provision for loan loss would have been required, increasing ALLL and negatively impacting earnings. SEK's audit failure

was clear and compounded by its baseless and unsupported conclusion that the Yorktown loan presented "little risk."

334. Moreover, by failing to aggregate all loans in a particular borrower relationship, SEK failed to review the loans of many of the Bank's largest borrowers, including SEK's own clients Azadi, Mongold, Hickey, and Manny Shaool, for whom the bank subsequently suffered tens of millions in charge offs.

2. 2009 Audit

335. SEK's year-end audit for the 2009 suffered the same deficiencies identified above, as well as others. In fact, in early 2010 the PCAOB issued a report citing SEK for "a deficiency [in its audits] of such significance that it appeared the Firm did not obtain sufficient competent evidential matter to support its opinion…[and the] deficiency was the failure to perform sufficient procedures to test the allowance for loan losses…" Upon information and belief, this related to SEK's audit of Orrstown.

336. Once again, SEK knew the Bank's ALLL calculation relied on outdated appraisals, and thus was materially understated. For the year ended 2009, approximately 56% of loans evaluated for impairment were supported by real estate appraisals more than two years old and 14% were supported by appraisals over five years old. The total outstanding balance for these loans was approximately $20 million, which was about 54% of the loans evaluated. SEK

knew that if Orrstown had utilized updated appraisals, as required, it would have had to calculate materially higher ALLL.

337. In addition, while Orrstown's 2009 10-K reported the impaired loans the Bank had identified in performing its FAS 114 analysis for 2009, the 2008 misstatement of impaired loans was repeated in the 2009 10-K. The 2009 10-K stated that the Bank's total recorded investment in impaired loans for 2008 was only $1,830,000, when Orrstown had actually found that at least approximately $7.5 million in loans were impaired at the end of 2008. SEK knew this from its 2008 audit.

338. Further, Orrstown's ALLL calculation had failed to include required reserves on the Mourtil, J&S Enterprises, and Marvin Window loans. As discussed herein, SEK specifically criticized the Bank for upgrading the J&S rating from Substandard to Watch, as doing so did not meet the bank's own Loan Policy, but the Bank ignored SEK's advice. As a result, the ALLL in the 2009 10-K did not include a required FAS 114 reserve for J&S. Failure to include that reserve, which was nearly 5% of the total ALLL, resulted in a materially skewed ALLL. Thus, at minimum SEK knew that the final ALLL reported in the 2009 10-K was misleading because it excluded the required reserve on J&S. Moreover, since SEK had calculated an FAS 114 reserve on the J&S loans, SEK knew that J&S should have been identified as impaired.

339. Similarly, as discussed in paragraph 301 above, in its 2009 audit SEK recommended that the Dahbura loan should have been rated Substandard and also noted that "Management also needs to obtain more current financial information for continued analysis," but the Bank did not rate the loan Substandard, did not calculate any required reserve, and did not identify the loan extensions as TDRs. J&S and Dahbura represented 7.5% of the loans SEK reviewed in its 2009 audit, yet despite finding that the loans were incorrectly rated, which had a material impact on ALLL, SEK issued a clean audit opinion and no disagreement between Orrstown and SEK was disclosed in the 2009 10-K.

340. Upon information and belief, Orrstown also discussed the Marvin Windows loan with SEK, and SEK knew that the Bank had improperly failed to create a specific reserve for it as required under the Bank's own policies.

341. SEK also knew that the Bank had failed to maintain updated borrower financial information, which was particularly problematic given the rapidly declining economy and real estate markets. In its March 10, 2010 Management Letter to the Audit Committee of the Board of Directors, just like the prior year's letter, SEK again noted that "some of the Bank's large credits did not have current financial information (2008 or later) on file." They went on to suggest "management should also enhance procedures to ensure there is continual monitoring of financial information received and consistent follow-up with

customers (particularly large relationships) to ensure up-to-date financial information is regularly requested, received, and properly filed in the central customer financial files."

342. More tellingly, in its "Control Deficiency Comment and Management Point Development Worksheet," SEK specifically noted that "During our review of loan files, we noted some older appraisals in the loan files and some stale financial information. … Appraisals have not been updated and more recent financial information has not been obtained from customers. … **With deteriorating real estate values in recent years, some older appraisal values may no longer be valid and without updated financial information, management has no way of determining the current financial condition of business customers**" (emphasis added). SEK discussed this issue with Embly, who informed SEK that "updated appraisal values are generally not obtained unless there is a problem developing with the loan, management feels the property value has deteriorated, or the customer wants to obtain a new credit." This statement made by the Chief Credit Officer of a bank at the heights of the real estate financial crisis is ludicrous and shows intent from Embly to deceive the bank investors on the real financial condition of the Bank. Furthermore SEK knew that the bank was not doing this, and that it was contrary to the Bank's own Loan Policy and defied basic credit assessment standards as well as sound banking practice. The fact that SEK

accepted such a blatant statement is an indication of SEK's disregard for basic professional standards. As noted, most of the appraisals the Bank used to determine impairment and/or calculate reserves were more than two years old, which were essentially worthless given the financial crisis impacting real estate in the 2008-2009 time frame.

343. A few additional examples illustrate the depth of the control failures at Orrstown, which SEK directly witnessed in connection with its audit of IRR ratings during the audit of Orrstown's 2009 financial statements.

344. For example, SEK reviewed the loans of Thomas and Christine Ahrens, who owed the bank a total of about $1.2 million as of December 31, 2009. Orrstown identified the Ahrens loans as Substandard and also impaired, but did not calculate any specific impairment under FAS 114, or any other specific reserve amount, because, according to the Bank, their collateral value exceeded the balance of the secured loans. This was absurd. The appraisal for the most valuable piece of collateral, a property in Mechnicsburg, PA, had been performed in 2005, over four years prior, near the height of the real estate market. It was patently improper to rely on a four year old appraisal in 2009. Moreover, both properties were scheduled for sheriff's sales at the time of SEK's review. According to SEK's summary in its loan review,

> Customer is an attorney who gave advice on a ponzi scheme in which investors lost millions, so he is being sued by these

> investors. Customer filed chapter 7 bankruptcy in April 2009. Both properties are scheduled for sheriff sale in March 2010. Loans are seriously delinquent and are considered impaired by management, which is appropriate based on the circumstances. Collateral appears adequate even though the one appraisal is 4 years old now and should be updated, but LTV is 61% with $1.1 million value. Management has discounted the collateral values and no allocation to the reserve is deemed necessary as the discounted values are more than the loan balances. Considered substandard and impaired, but no specific allowance based on value of collateral. Reviewed 9/30/09 calculations in PBC allowance calculation and appears reasonable based on the information reviewed. An updated appraisal should be obtained by management to determine a more up-to-date value of the one property.

Despite the fact that the owner had been charged in a Ponzi scheme and declared bankruptcy, the properties were scheduled for a Sherriff's sale, and the appraisals were over four years old, ***the Bank did not calculate any specific reserve for these $1.2M in loans***. Within just a few months the Bank charged off a significant portion of the loans. It was transparently obvious at the time of the audit that the Bank had failed to abide by its own Loan Policy in calculating ALLL and impairment.

345. Similarly, SEK audited the IRR rating of the loans of the Burt J. Asper American Legion Post (the "Post"), which owed the bank just over $1 million as of December 31, 2009. The Bank identified the Post loan as Substandard, but not impaired based on the value of the property, which supposedly exceeded the loan balance. Once again, however, the appraisal was

over four years old, from September 2005, and was therefore worthless in determining the post-real estate crash value of the property. In its comments to the loan review, SEK noted that the Post had been "closed for 156 days during 2009 of which 80 days were for gaming violations." Further, "the Legion has stated that they may not be able to sustain the current payments due to decreased revenue," and that any purchaser of the building would not be able to continue the special use of the building under zoning regulations. Moreover, the Post had "not provided annual or regular monthly financial information as required in the commitment letter." SEK admitted that "The bank is uncertain of the property's value and has not had a recent appraisal … The Bank needs to obtain current financial information and properly evaluate the collateral to determine if the loan is impaired." This loan was obviously impaired, but once again the Bank failed to identify it as impaired and failed to calculate any specific reserve amount, issues which were obvious to SEK in the course of its audit.

346. These are just a few representative examples of the failures over internal controls at Orrstown that SEK discovered in the course of its 2009 audit but failed to disclose and instead issued clean audit opinions. Failures like these were pervasive.

347. Further, in conducting the 2009 audit SEK again failed to review many of the loan relationships with the Bank's largest borrowers, including

Yorktown and SEK's clients Azadi, Mongold, Hickey, Ben Shaool and Manny Shaool. SEK deliberately employed selection criteria that avoided reviewing most of the Bank's large borrower relationships, thereby turning a blind eye to those borrowers' financial problems and inability to meet debt obligations. Had SEK reviewed the Bank's loan relationships with these SEK clients, as shown above, significant increases in ALLL would have been required and further evidence of material weaknesses in internal controls over financial reporting would have been identified. The Bank subsequently suffered tens of millions in charge offs from these loans.

348. SEK's failure once again to review the Yorktown loans in 2009 was also inexplicable. SEK's Loan Loss Reserve Calculation memo states that SEK selected for review "all commercial lines of credit approved over $5 million (regardless of balance)" but SEK skipped over Yorktown, which was approved for $9.5 million and represented the second biggest line of credit at the bank. Within months Yorktown declared bankruptcy.

349. Further, SEK knew that the Bank had provided incorrect reports, which resulted in SEK failing to select certain larger loan relationships for review. SEK's Loan Loss Reserve Calculation memo stated, "The reports … that management originally gave us to pick our samples from had incorrect data, which was not discovered until our review was almost complete, so some larger loans that

could have been selected were not on our original report and were not selected for review…." This was yet another internal control failure, which had a direct impact on SEK's audit, yet SEK issued a clean audit opinion despite it awareness of the numerous material weaknesses in internal controls over financial accounting described herein.

350. These material internal control weaknesses of which SEK was well-aware by the time it completed its 2009 audit were particularly material because of the Bank's March 2010 Offering. The Offering documents incorporated the 2009 10-K and SEK's clean audit opinion, but none of these documents disclosed any issue concerning material internal control weaknesses described herein.

3. __2010__

351. SEK's audits in 2010 suffered similar deficiencies.

352. As discussed above, in the first quarter of 2010 approximately 53% of loans evaluated for impairment were supported by real estate appraisals more than two years old and 20% were supported by appraisals over five years old.

353. In the second quarter of 2010, approximately 40% of the loans evaluated for impairment were supported by real estate appraisals more than two years old and 14% were supported by appraisals over five years old.

354. In the third quarter of 2010, approximately 29% of the loans evaluated for impairment were supported by real estate appraisals more than two years old and 10% were supported by appraisals over five years old.

355. All of these deficiencies were readily apparent to SEK, who audited the Banks ALLL and impaired loans.

356. Further, as found by the SEC, in its 2010 form 10-K Orrstown disclosed $14.1 million in impaired loans but failed to disclose an additional $51 million in impaired loans. This misstatement was also repeated in footnotes to financial statements in Orrstown's 10-Qs for the second and third quarters of 2011, as well as the 10-K for 2011. (In its 10-Q for the first quarter of 2011, filed May 10, 2011, Orrstown likewise disclosed $14.1 million in impaired loans but failed to disclose an additional $51 million in impaired loans.) Once again, these deficiencies were readily apparent to SEK, who audited the Banks ALLL and impaired loans.

357. By the fourth quarter of 2010, the Regulators had already demanded significant changes to the Bank's accounting practices and operations. For example, the Bank began calculating ALLL on all loans in the bank's portfolio, broken down by segment.

358. SEK's Loan Loss Reserve Calculation Memo for the year-end 2010 audit also evidences an absurdly optimistic outlook for the Yorktown loan, which in roughly six months would be completely written off. SEK commented:

> If the loans are rewritten as anticipated, the Banks should come out of this relationship with no loss other than accrued interest, which has been on nonaccrual anyway. If the new loans would fall through for some reason, Jeff [Embly] is anticipating the Bank could potentially lose up to $3 million in a worst case scenario. At December 31, 2010, the Bank recorded an estimated allowance for Yorktown of $2.9 million based on an estimated calculation of discounting the value of the non-performing loans by 40% and then estimating another $1.5 million to be conservative given the imprecision of the estimate for a total of $2.9 million. **While the estimate is based on a calculated value of the loss that is an imprecise estimate and not solid appraisal values**, the likelihood of the new refinancing happening is very probable with any potential loss being considered remote. In the unlikely event that the refinancing does not happen, management has allocated an estimate of the loss, which is about 35% of the balance and is considered adequate at 12/31/10 based on the circumstances.

Once again, however, SEK knew that the Bank had failed to identify Yorktown as an impaired loan in its impaired loan list, that it had no current appraisals, and failed to search for or review the underlying UCC-1 filings for the Yorktown loan during its auditing engagements, which would have revealed the Bank's unsecured status and the Bank's internal estimate that based on the amount of unsecured debt it would likely lose more than $5 million of loan principal, plus accrued interest. (As noted, the Bank ultimately took a charge of $8.3 million for the Yorktown loan).

359. Despite all of the above material weaknesses in internal controls over financial reporting that SEK discovered during the course of its audits, SEK issued clean audit opinions for Orrstown from 2008 through the end of 2011.

360. SEK was the subject of three PCAOB inspections and reports issued on March 14, 2007, January 21, 2010 (just prior to the Orrstown Offering) and May 23, 2013 (on the heels of the Regulators' intervention and the Enforcement Actions). Two PCAOB reports in particular cite material failures of SEK and its audits that mirror the deficiencies alleged here, and thus Plaintiff believes it is likely one or more of these PCAOB reports refer specifically to SEK's audit of Orrstown. The 2010 PCAOB Report calls out SEK for "a deficiency of such significance that it appeared the Firm did not obtain sufficient competent evidential matter to support its opinion…[and the] deficiency was the failure to perform sufficient procedures to test the allowance for loan losses…" The 2013 PCAOB Report similarly identifies "deficiencies of such significance that it appeared that the Firm, at the time it issued its audit report, had not obtained sufficient appropriate audit evidence to support its opinion on the issuer's financial statements…and fail[ed] to perform sufficient procedures to test the allowance for loan losses."

F. Orrstown Begins to Take Remedial Measures As A Result of the Regulators' Examinations

361. As a result of the examinations and investigation by the Regulators, Orrstown was forced to institute a Self Improvement Plan and retain numerous consultants to address its weaknesses in internal controls.

362. Orrstown retained FinPro, Inc. to, *inter alia*, conduct a review of all management and staffing needs of the Bank and the qualifications and performance of all senior Bank management (the "Management Review"), and to prepare a written report of findings and recommendations. The primary purpose of the Management Review was to aid in the development of a suitable management structure staffed by qualified and trained personnel. Upon information and belief, Embly and Everly terminated their employment as a result of the Management Review.

363. Orrstown also retained SEG in 2011 to conduct a loan review, thereby outsourcing the IRR ratings that it had previously handled in-house. As a result of SEG's review, Orrstown was forced to downgrade a substantial portion of its loan portfolio, often times downgrading loans by two or more levels at a time. Another consultant, Promontory Financial Group, LLC, who was retained by the Bank to try to improve the Bank's standing with the Regulators, commented that "rating changes less than 5% would be considered acceptable … [but] the fact that the outside loan review folks downgraded about a third is catastrophic." In an August

3, 2011 email, Promontory commented, "It's clear that the [Bank's] governance structure is completely ineffective."

364. In conducting its review, in March 2011 SEG commented that, particularly with respect to Terry Reiber's loans, "[t]here were numerous instances where new monies were advanced to projects that reflected nominal or negative cash flow positions at the time of approval", to customers who were "highly leveraged, do not demonstrate alternative sources of repayment and have limited liquidity in comparison to their leverage position. Many of these credits were underwritten using junior lien positions in lieu of cash down payments for real estate acquisitions and appear to have resulted in potential violations of law related to Regulation 363." SEG also noted "instances where the loan officer advanced new monies that were applied to bring past due loan payments current."

365. Moreover, in March 2011, SEG commented that the bank's practice of only requiring annual reporting for loan rated "4" and "5" did "not provide sufficient, timely data for management to proactively respond and address higher risks to the bank's capital." SEG recommend at minimum quarterly financial reporting by the borrowers. SEG also recommended that the bank's risk rating should be handled by individual line lenders, who have the "most detailed and current information regarding the borrowers" rather than the bank's then current internal loan review personnel.

366. Orrstown hired another consultant in 2011, Accume Partners, to conduct an internal audit of numerous aspects of the bank's business, including its ALLL calculation. Although the Bank had by that time had already revised its practices as a result of the Regulators investigation and comments, Accume found numerous continuing deficiencies with respect to the ALLL calculation, including that the bank was calculating FAS 5 reserves through historical loss factors only on loan classified Substandard and below, instead of the entire portfolio, in contravention of generally accepted practice. Accume also found that the bank failed to annualize the quarter end loss rate when applying its new 8 quarter rolling average historical loss factor, again in contravention of generally accepted practice. Accume further found numerous basic calculation errors, and commented that the "preparation and update of the ALLL Summary and supporting schedules should be performed by an individual with appropriate expertise to update the model."

367. Orrstown also retained CFO Consulting Partners, LLC to assist in implementing corrective actions required by the Regulators, and Treliant Risk Advisors to conduct an evaluation of the Company's Enterprise Risk Management function and the efficacy of its loan stress testing.

368. All of these consultants were necessary because of the Bank's completely ineffective controls during the Class Period.

G. The Material Weaknesses In Internal Controls Are Made Public.

369. On March 15, 2012, the Company filed its 2011 Annual Report admitting that the Company had a "material weakness" in its internal controls. Form 10-K 2011 Annual Report, filed 3/15/2012, at 74-75. Further, the Bank informed investors that in the third quarter of 2011, it formed the Special Assets Group ("SAG"). *Id*. at 125. SAG, the Bank's loan workout department, was staffed with "12 employees actively engaged in the identification and work out of problem credits in the most favorable manner to the Company." *Id*. Despite the "enhancements" in the "underwriting, credit administration and problem loan identification and monitoring" by SAG and the credit review consulting firm, the Company ***for the first time admitted*** that throughout 2011 it had "***failed to implement a structured process with appropriate controls to ensure that updated loan ratings were incorporated timely into the calculation of the Allowance for Loan Losses***." *Id*. (emphasis added). The Company further admitted that as of March 2012, it had failed to "***fully remediate its material weakness in its internal control over financial reporting relating to loan ratings and its impact on the allowance for loan losses***." *Id*. (emphasis added). The Company also pledged to "improve its internal controls over financial reporting" by continuing to implement remedial actions. *Id*. Then, one week later after these dramatic disclosures, the

investing public was told about the Regulators' Joint Examination and resulting Enforcement Actions against the Bank.

370. On March 23, 2012, Orrstown disclosed the Consent Order and Written Agreement. Form 8-K Current Report, filed on 3/23/12. These Enforcement Actions mirror each other. As summarized by the Company:

> Pursuant to the Agreement, the Company and the Bank agreed to, among other things, (i) adopt and implement a plan, acceptable to the Reserve Bank, to ***strengthen oversight of management and operations***; (ii) adopt and implement a plan, acceptable to the Reserve Bank, to ***reduce the Bank's interest in criticized or classified assets***; (iii) adopt a plan, acceptable to the Reserve Bank, to ***strengthen the Bank's credit risk management practices***; (iii) adopt and implement a program, acceptable to the Reserve Bank, for the ***maintenance of an adequate allowance for loan and lease losses***; (iv) adopt and implement a written plan, acceptable to the Reserve Bank, to ***maintain sufficient capital on a consolidated basis for the Company and on a stand-alone basis for the Bank***; and (v) ***revise the Bank's loan underwriting and credit administration policies***. The Bank and the Company also agreed not to declare or pay any dividend without prior approval from the Reserve Bank, and the Company agreed not to incur or increase debt or to redeem any outstanding shares without prior Reserve Bank approval.
>
> The Agreement will continue until terminated by the Reserve Bank. . . .
>
> Additionally, on March 22, 2010 [sic], the Board of Directors of the Bank entered into a Consent Order (the "Order") with the Commonwealth of Pennsylvania, Department of Banking, Bureau of Commercial Institutions (the "Department of Banking"). Pursuant to the Order, the Bank has agreed to, among other things, subject to review and approval by the Department of Banking, (i) adopt and implement a plan to ***strengthen oversight of management and operations***; (ii) adopt

> and implement a plan to ***reduce the Bank's interest in criticized or classified assets***; (iii) adopt and implement a program for the ***maintenance of an adequate allowance for loan and lease losses***; (iv) and adopt and implement a ***capital plan which include specific benchmark capital ratios to be met at each quarter end***; and (v) adopt a plan to strengthen the Bank's ***credit risk management practices***. The Bank also agreed not to declare or pay any dividend without prior approval of the Department of Banking.
>
> The Order will continue until terminated by the Department of Banking . . .
>
> Additional regulatory restrictions require prior approval before appointing or changing the responsibilities of directors and senior executive officers, entering into any employment agreement or other agreement or plan providing for the payment of a "golden parachute payment" or the making of any golden parachute payment. Also, the Bank's FDIC assessment will increase.
>
> Thomas R. Quinn, Jr., President and Chief Executive Officer, stated "our Board of Directors and management ***have already taken, and are continuing to take,*** all steps necessary to ensure we have strong and fully compliant plans, policies and programs that address the items contained in these agreements. ***We understand that the environment and the economy are mandating enhancements to prior industry norms. These agreements are not related to any new findings by our regulators and we believe we have already initiated actions and made substantial progress with many of their provisions."***

Form 8-K Current Report, filed on 3/23/12 (emphasis added).

371. Even though Orrstown admitted that there were material weaknesses in internal controls in 2011 and that they persisted until June 2012, these systemic problems were not, as Quinn admitted, ***"new"***, but existed long before the Joint Examination began. In addition to the overwhelming evidence presented herein

(and additional evidence that will be presented at trial), this is also evidenced by the Company's admissions in a November 2012 letter that Regulators had required the Bank to ***"discontinue a number of practices, . . ."*** for the ***"[s]tabilization of our risk management process, including the re-engineering of process involved in loan origination, credit administration and loan work out."*** Quinn Letter to SEC, dated 11/5/2012 (emphasis added).

H. The SEC Investigation and Order

372. Beginning in March 2011, the SEC began scrutinizing Orrstown's disclosures concerning its underwriting of loans, risk rating of loans, and methodology for allocating loan losses. Specifically, the SEC made a series of comments on the 2010 Form 10-K; and in 2012, the SEC made a series of comments on the 2011 Form 10-K, and the Form 10-Q for the Period Ended June 30, 2012. Orrstown responded to each of these comments and in so doing made several notable admissions concerning its internal control failures in 2010 and 2011.

373. Orrstown admitted that it failed to obtain current credit data to accurately rate and evaluate loans during 2010 and 2011:

a. The four lending relationships referenced in the 2010 Form 10-K had outstanding balances that may have exceeded the appraised values of the collateral, and the Bank ***did not have current appraisals*** for each of

these loans. Quinn Letter to SEC, dated 5/19/2011 (responding to questions on 2010 Form 10-K) (emphasis added).

b. Two lending relationships that the Bank was marketing for sale had received purchase proposals with prices far below the Bank's asking prices. Quinn wrote to the SEC: "Based on this proposal, it was determined that there was significant decline in the observable market values of these loans, which existed in December 31, 2011, resulting in an additional combined charge of $6 million." Quinn Letter to SEC, dated 9/14/2012 (responding to questions on 2011 Form 10-K). The statement indicates that had the Bank secured current appraisals, it would have been timely aware of the changed market value.

c. Similarly, in response to questions about two other borrowers that were unable to repay their loans, Quinn's response indicated that Orrstown would have known this sooner if it had complied with its own Loan Policy by updating appraisals because the "collateral [was] not sufficient to pay off the loans" and the "inability to pay-off loans represented a ***culmination of conditions that existed prior to*** December 31, 2011." Quinn Letter to SEC, dated 9/14/2012 (responding to questions on 2011 Form 10-K) (emphasis added).

374. Orrstown also admitted that it had material weaknesses in internal controls over financial reporting relating to risk management and allocations of loan losses in 2011 and 2012:

a. "Disclosure Committee noted that the material weaknesses in internal controls over financial reporting remained at March 31, 2012 and June 30, 2012." Quinn Letter to SEC, dated 11/5/2012 (concerning questions on 2011 10-K and 1Q -2Q 2012 10-Qs).

b. Quinn responded to the SEC that beginning in 2012, Orrstown "[c]ontracted a third party service provider specializing in corporate governance matters (Treliant Risk Advisors) to review existing policies and procedures pertaining to credit administration, finance and other banking areas to determine ***if additional gaps in internal controls were noted***." Quinn Letter to SEC, dated 11/5/2012 (concerning questions on 2011 10-K and 1Q -2Q 2012 10-Qs) (emphasis added).

c. Quinn responded to the SEC that in the first quarter of 2012, the Regulators told the Bank that its current "risk profile would suggest higher capital ratios be maintained." Quinn Letter to SEC, dated 11/5/2012 (concerning questions on 2011 10-K and 1Q -2Q 2012 10-Qs).

375. The SEC launched a formal investigation into Orrstown's financial reporting and controls from January 1, 2010 to the present.

376. Orrstown's and Quinn's responses to the SEC were incomplete and calculated to forestall focus on the true extent and duration of the material weaknesses in internal controls over financial reporting. As Michael Moore, the Chief Credit Officer stated to FinPro during its management review, when he took that position at the Bank in August 2011 there were no internal controls over some of the most critical financial reporting mechanisms at the Bank. That condition did not begin in 2010; it was a continuation of the risk management internal control failures that had been noted by the Regulators' examiners when they conducted their federal and state examinations for the year ending December 31, 2009, as noted in the FinPro report. The fact that Orrstown's internal controls over financial reporting were wholly absent or materially weak prior to 2010 is further exemplified by the recitation of the loan history of specific borrows set forth above.

377. The SEC's investigation tracked the issues asserted this (earlier-filed) lawsuit. For example, the SEC subpoenaed:

> All documents and communications concerning accounting policies, procedures, and internal controls in effect at Orrstown reflecting or relating to Orrstown's loan approval, loan review, and/or credit administration policies and procedures;
>
> All documents relating to any communications between any auditors and Orrstown's senior management, Board of Directors, Audit Committee, Loan Committee and/or Enterprise Risk Management Committee regarding the accounting treatment of any loan losses from 2005 forward;

> All communications sent or forwarded from your Orrstown email account to any personal email account(s) to which you have access (jointly or solely), regarding or relating to Orrstown's loan policy, allowance for loan losses, Orrstown's March 2010 offering, regulatory examinations and/or the quality of Orrstown's loan portfolio.

SEC Subpoena, dated 6/3/2015.

378. The SEC "interviewed" former Orrstown employees, including at least one CW. Orrstown's counsel is representing some of these witnesses.

379. On September 27, 2016, the SEC issued a Cease and Desist Order making findings of fact and imposing sanctions. A copy of the SEC's Order is attached hereto as Exhibit C. The SEC's Order was based on an offer of settlement and confirms many of the allegations set forth herein. As noted above however, the SEC sought discovery only beginning with 2010, and therefore did not discover that the material weaknesses in internal controls over financial reporting had existed as early as 2008.

380. The SEC's findings of fact include the following:

A. In calculating ALLL, "the Loan Review Officer evaluated only 'Substandard' loans to determine if they were impaired and whether a provision for loan loss was required to be recorded in the financial statements," and because "Orrstown did not timely incorporate material adverse information regarding certain borrowers' financial difficulties into the risk rating component

of its loan review process and instead relied largely on stale data… loans were incorrectly risk rated." "Moreover, the processes and controls in place to ensure the accuracy of risk ratings set by the Loan Review Officer were ineffective to prevent or correct the incorrect risk ratings."

B. "In 2010, three of the Bank's largest customers [Azadi, Shaool, and Mongold] approached Orrstown requesting to modify the terms of their loans, each claiming they had insufficient cash flow to repay their existing loans with Orrstown," but their loans were not timely disclosed as impaired.

C. "In addition to [the Azadi, Shaool, and Mongold loans], Orrstown incorrectly did not disclose the value of other impaired loans in its quarterly filings on Form 10-Q for the periods ended June 30, 2010 and September 30, 2010. … As a result, the Q2 and Q3 2010 Forms 10-Q disclosures incorrectly omitted impaired loans in the amounts of approximately $5.6 million as of June 30, 2010 and approximately $18.5 million as of September 30, 2010."

D. "Everly and Embly were directly notified that the Loan Review Officer did not appropriately record as impaired in Orrstown's books and records loans that had been assigned impairment losses. Specifically, in October 2010, Barton reviewed the Loan Review Officer's ALLL schedule, which included the impairment loss analysis discussed above, and informed Everly

and Embly that failing to disclose loans with impairment losses as impaired was inconsistent with the accounting guidance. No one took corrective action."

E. In its Q2 2010 Form 10-Q "Orrstown did not disclose approximately $46.6 million of additional impaired loans, an understatement of approximately 215%."

F. In its Q3 2010 Form 10-Q "Orrstown did not disclose approximately $69.5 million of additional impaired loans, an understatement of approximately 308%."

G. In its 2010 Form 10-K "Orrstown did not disclose approximately $51.0 million of additional impaired loans, an understatement of approximately 346%."

H. In its Q1 2011 Form 10-Q "Orrstown did not disclose approximately $51.0 million of additional impaired loans, an understatement of approximately 362%."

I. "In connection with the preparation of its Q2 2011 Form 10-Q, Orrstown elected to early adopt the provisions of ASU 2011-02. … As a result of its implementation of ASU 2011-02, Orrstown disclosed in its Q2 2011 Form 10-Q that approximately $34 million of restructured loans qualified as TDRs. However, at least $22 million of these loans were restructured in 2010 and were thus outside of ASU 2011-02's retroactive scope. … Barton was responsible for

Orrstown's implementation of ASU 2011-02 and knew or should have known that retroactive application of this pronouncement to restructurings that occurred prior to January 1, 2011 was not in accordance with GAAP. … Additionally, Quinn, Everly and Embly knew or should have known that Orrstown was not permitted to retroactively apply ASU 2011-02 to restructurings before January 1, 2011. Nonetheless, Quinn, Everly, and Embly participated in and agreed to the decision to apply ASU 2011-02 to loans that were restructured in 2010, inconsistent with GAAP."

J. "In connection with Orrstown's recognition of approximately $34 million of TDRs in Q2 2011, Barton performed an impairment analysis to determine if impairment losses needed to be recorded for any of these TDRs – which, under GAAP are deemed impaired loans. For a majority of the $34 million in loans, Barton utilized a discounted cash flow model ("DCF Model") to calculate impairment losses. But rather than using the expected future cash flows and each loan's effective interest rate in his DCF Model, as required by GAAP, Barton used each loan's contractual cash flows which he then discounted at a 'market rate' to arrive at the net realizable value of the loans. This approach did not comply with ASC 310-10- 35-22. … On or around September 2, 2011, Barton informed Quinn, Everly and Embly that this

methodology was 'not technically within the accounting rules' but none of them took any action to alter the DCF Model to conform to GAAP."

K. "[D]uring Q2 and Q3 2010, when the Bank performed an impairment analysis on certain classified loans, its analysis did not comply with its loan policy because it utilized stale real estate appraisals. Moreover, the Bank's analysis did not comply with GAAP because it incorporated inappropriate inputs into its collateral valuation models."

L. In short, "During the Relevant Period, Orrstown did not maintain a system of internal accounting controls sufficient to provide reasonable assurances that transactions were recorded as necessary to permit preparation of financial statements in accordance with GAAP. Orrstown's lack of internal accounting controls resulted in: (1) incorrect loan risk ratings; (2) incorrect disclosures of impaired loans; (3) incorrect calculations and disclosures of loan losses; (4) incorrect application of newly issued accounting pronouncements; and (5) the lack of action to remedy accounting problems after being alerted to them."

VIII. SECURITIES ACT SUBSTANTIVE ALLEGATIONS: MATERIALLY FALSE & MISLEADING STATEMENTS CONTAINED IN THE OFFERING DOCUMENTS

381. Plaintiff incorporates by reference all paragraphs above except to the extent such paragraphs allege scienter or intent to defraud. The Securities Act

claims contained in this portion of the Complaint specifically exclude any allegations of scienter, and any allegation that could be construed as alleging fraud or intentional or reckless misconduct. The Securities Act claims are rooted exclusively in theories of strict liability and negligence.

382. Plaintiff's Securities Act allegations stem from materially false and misleading statements contained in Orrstown's Offering Documents concerning the existence and effectiveness of the Company's internal controls over the underwriting of loans, risk management and financial reporting.

383. Where any materially untrue and misleading statement is deemed to be a statement of opinion not verifiable by objective facts, each Securities Act Defendant is alleged to have known at the time that the subjective statement(s) was made that it was untrue or to have lacked a reasonable basis for the statement(s).

384. On April 29, 2009, Orrstown was listed on the NASDAQ and shortly thereafter Defendant Quinn replaced retiring Defendant Shoemaker to serve as the Company and Bank's President, Chief Executive Officer and Director.

385. The March 2010 Offering represented Orrstown's first offering since the Company was listed on the NASDAQ exchange.

386. Throughout March 2010, Orrstown's common stock was trading in the low to mid-$30s. After the 2009 Annual Report was filed on March 15, 2010, and

the Yorktown bankruptcy was announced on March 23, 2010, the stock price dropped as summarized by the following chart:

Date	Average Daily Stock Price ($)	Closing Stock Price
3/15/2010	35.10	35.68
3/16/2010	32.76	32.94
3/17/2010	32.43	36.69
3/18/2010	32.15	32.17
3/19/2010	31.62	31.84
3/22/2010	31.82	34.50
3/23/2010	30.00	30.50

Source: Yahoo Finance.

387. Subsequent to the concurrent announcements about the additional provisions for loan losses and the Yorktown situation (*supra* Part VII.D.1), the Underwriter Defendants and Orrstown Securities Act Defendants priced Orrstown common stock at $27 for the March 2010 Offering that commenced on March 24, 2010. The sale of Orrstown stock at that price however did not accurately reflect the value of Orrstown stock which was materially inflated by false and misleading statements about the quality of the Bank's internal controls over financial reporting, including the Bank's ALLL, the quality of the Bank's commercial loan portfolio, and the Bank's internal review processes, to name a few. *See infra* Part VIII.A.

388. On March 29, 2010, Orrstown announced that it had completed its Offering of 1,481,481 shares of common stock, sold to the public at a price of

$27.00 per share, to raise net proceeds (after underwriting commissions and expenses) of $37.5 million.

A. The Offering Documents' Materially False and Misleading Statements Regarding the Existence and Effectiveness of the Company's Internal Controls

389. The Offering Documents for the March 2010 Offering made a series of false and misleading statements about the quality of the Bank's internal controls over financial reporting, the quality of the Bank's commercial loan portfolio, and the Bank's internal review processes.

390. The Prospectus for the Offering touted the Bank's "enviable" loan portfolio and assured investors that the Bank maintained effective internal controls over financial reporting, but in reality Orrstown's financial statements were materially false and misleading because the Bank's ALLL and disclosures of impaired loans and TDRs simply failed to reflect the the facts that many of Orrstown's commercial borrowers were experiencing dire financial circumstances and had requested loan modifications, the value of their collateral had plummeted, and the Bank failed to properly account for impaired loans, calculate ALLL, and accurately risk rate loan. On the contrary, while acknowledging that "certain borrowers have come under stress due to economic conditions affecting our markets," Orrstown reassured prospective investors that "we have proactively moved to address any problem credits and ensure that we are adequately reserved

for any potential losses." In reality, as discussed above, the Bank's ALLL was materially understated and failed to comply with GAAP and the Bank's own loan policy. Further, the Bank had modified troubled loans without creating any reserve for them as required.

391. As discussed above, the Bank's ALLL and disclosure of impaired loans and TDRs in the 2009 10-K were materially false and misleading because, inter alia, the Bank's ALLL failed to comply with GAAP and its own loan policy, and excluded loans for which reserves were required, resulting in a materially understated ALLL and failure to identify impaired loans and TDRs.

392. The Offering Documents also made false and misleading statements about the November Loan Review. The Prospectus told potential investors that "[i]n November 2009, we undertook an expended review of our loan portfolio which covered $526 million in outstanding and committed balances." The 2009 10-K, which was incorporated by reference in the Offering Documents, likewise referred to this "expanded review," stating:

> In November of 2009, management undertook an expanded review of the Bank's commercial loan portfolio, in a proactive attempt to identify potential weaknesses and deterioration in the portfolio. This review was in addition to the normal loan review process conducted by our loan review officer and the Bank's Credit Administration Committee. A review team, which consisted of 3 employees and 2 contract employees, reviewed all commercial loan relationships with an aggregate committed exposure greater than or equal to $750,000. The review team focused on the global cash flow of the borrower, global debt

> service coverage ratios of the borrower, LTV ratios when collateral values decreased by 10% and 20%, borrower's liquidity and guarantor's overall cash flow and liquidity. The review covered a total of approximately $526,000,000 in outstanding loans and loan commitments. Following the review process, management increased the allowance by $3.1 million in order to better reflect the deterioration in local, regional and national economic conditions. All economic allocations were increased during 2009.

Thus, the Offering Documents assured investors that, despite the financial crisis, the Bank had recently conducted an expansive review of its loan portfolio and its reserves were more than adequate.

393. In reality, as discussed above, the November 2009 "expanded" loan review was little more than the standard, deficient review the Bank regularly performed pursuant to its Loan Policy, which required the Bank to review all loans over $750,000 at least yearly, and all loans rated 4 or less at least quarterly. In fact, the evidence suggests the November Loan Review touted in the Offering Documents was less rigorous that the Bank's standard review process. In an email to the Credit Administration Committee, Embly described the review merely as a "summary" review, and despite agreeing to produce documents related to the November Loan Review in this litigation, Orrstown has been able to produce almost no documentation substantiating the November 2009 review process. The only documentation of the review supporting the statement in the Offering Documents is a two page summary memorandum which does not provide

important details on the review, such as who conducted it, how, what they reviewed, or the review criteria. That summary memorandum does show however that 16.5% of the loans reviewed were downgraded, a fact which is nowhere disclosed in the Offering Documents.

394. Although the Offering Documents stated that the November 2009 review examined "LTV ratios when collateral values decreased by 10% and 20%," in reality only 75% of the loans were reviewed for LTV when shocked at 10% and 20%. Further, this statement in the Offering Documents was materially misleading since the vast majority of the collateral valuations used were stale. As reflected in the summary memorandum, the Bank used the collateral value as of the *loan closing date* the loan for this LTV testing. But most of those loans were several years old. The Offering Documents were therefore materially misleading because, while they stated that the Bank had examined "LTV ratios when collateral values decreased by 10% and 20%," the Offering Documents failed to disclose that this testing was performed on stale valuations, rendering the Bank's review of LTVs meaningless with respect to current valuation.

395. Far from a "proactive attempt to identify potential weaknesses," the November 2009 loan review was at best a fly-by, without any substantiating documentation, that failed to uncover all of the numerous deficiencies discussed above, including that loans were supported by outdated appraisals and the Bank's

key borrowers were in dire financial condition and had requested and received loan modifications. The November 2009 loan review would have examined the Shaool, Azadi, Hickey, Mongold, and Yorktown loans discussed herein, yet failed to result in an identification of those loans as impaired, the creation of required reserves on them, or accurately rating them as Substandard or less. Moreover, the loan review would have identified at least $41 million in loans that had been restructured, extended, or modified as of December 31, 2009 (and at least $55 million as of March 15, 2010), but failed to result in identification of these as substandard or creation of required reserves.

396. Further, as noted above, the Loan Review resulted in a recommendation to drop the rating for $3.7 million in loans to Marvin Windows to Substandard, which would have required calculating an ALLL reserve under the Bank's Loan Policy, but the Bank failed to do so in its 2009 10-K, while at the same time touting its November Loan Review. Internal memoranda show that the Bank projected an $800,000 reserve was necessary as of December 31, 2009. However, the final ALLL schedule used for the 2009 10-K, which was audited by SEK and should have shown every Substandard loan, did not include any calculation or specific reserve for Marvin Windows. Thus, the Bank excluded from its ALLL the substantial Marvin Windows balance even though the November Loan Review recommended that it should be rated Substandard. After

the March 2010 Offering took place the Bank added a $1.5 million reserve for Marvin Windows in its first quarter 2010 financial statements.

397. The Prospectus and 10-K also assured potential investors as to the quality of the Bank's portfolio by stating, "at December 31, 2009, we had 50 loan relationships, aggregating $307.5 million that were ***performing according to their original terms*** with outstanding balances that exceeded $3.0 million." (emphasis added) This was patently untrue, and neither the Bank nor SEK actually reviewed the loans to determine whether they were performing according to their original terms. In reality, *at least* over $40 million of those loans had been modified or extended prior to December 31, 2009, and another more than $15 million had been modified prior to March 23, 2010, the date of the final Prospectus. Upon information and belief, this sentence, with blanks for the dollar amounts, was drafted and recommended to be added to the Prospectus by Sandler O'Neill. When Orrstown filled in the blanks, it merely used the total number of outstanding loans over $3 million, without actually confirming that all of those were "performing according to their original terms." In truth, many were not performing according to their original terms because they had been modified or extended, including, as discussed above, loans to the Azadis, Shaools, Mongold, Dwight Martin, Dahbura, Mourtil, and many others.

398. The 10-K also said, “The Corporation’s loan loss history has been much better than peer standards and analysis of the current credit risk position is favorable. The allowance for loan losses is ample given the current composition of the loan portfolio and adequately covers the credit risk management sees under present economic conditions.” Once again, these statements were materially false and misleading. The Bank did not actually have a better loan loss history than peers, it was merely forestalling recognition of losses by “pretending and extending.” Rather than recognize impaired loans, the Bank simply ignored them or extended and/or modified loans with recognizing impairment as required. For the same reasons the Banks’ ALLL was not really “ample,” rather it was materially understated because it was based on stale appraisals, violations of GAAP with respect to calculating ALLL, failure to accurately risk rate loans, and all of the other reasons discussed herein.

399. Moreover, many of the Bank’s loans to large borrowers continued to decline after December 31, 2009, but before the Offering. For example, prior to the March 2010 Offering that same month the Shaool’s obtained loan modifications of over $18M in loans, which constituted TDRs and should have resulted in the Bank writing down the loans and creating new reserves. The Bank was obligated to, but did not, provide updated, corrective information in its Prospectus to inform investors that the bank was aware deterioration of its

commercial loan portfolio subsequent to December 31, 2009, but prior to the date of the Offering.

400. Fundamentally, all of the above failures are examples of the Bank's material weakness of internal controls over financial reporting. Yet, the Bank and SEK both told investors that the bank had no such weaknesses and that its financial reporting was accurate.

401. With respect to internal controls, the 2009 10-K, which was filed nine days before the March 2010 Offering and incorporated by reference in the Offering Documents, made the following false and misleading statement:

> **Management's Report on Internal Control** – "Under the supervision and with the participation of the Corporation's management, including its Chief Executive Officer and Chief Financial Officer, the Corporation has evaluated the effectiveness of its internal control over financial reporting as of December 31, 2009, using the Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based upon this evaluation, management has concluded that, at December 31, 2009, ***the Corporation's internal control over financial reporting is effective based on the criteria established in Internal Control-Integrated Framework***.

Form 10-K 2009 Annual Report, filed 3/15/2010, at 45 (emphasis added).

402. Also, appended to the 2009 Annual Report Form 10-K were the SOX Certifications made by Defendants Quinn and Everly. As the CEO and CFO, respectively, Quinn and Everly certified that:

1. I have ***reviewed*** this annual report on Form 10-K of Orrstown Financial Services, Inc.

2. Based on my knowledge, the annual report ***does not contain any untrue statement of a material fact or omit to state a material fact*** necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this annual report.

3. Based on my knowledge, the financial statements, and other financial information included in this annual report, ***fairly present, in all material respects, the financial condition***, results of operations and cash flows of the registrant as of, and for, the periods presented in this annual report.

4. The registrant's other certifying officer and I are ***responsible for establishing and maintaining disclosure controls and procedures*** (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act rules 13a – 15(f) and 15d – 15(f)) for the registrant and we have:

(a) ***designed*** such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision to ***ensure*** that material information relating to the registrant, including its consolidated subsidiaries, is ***made known to us by others*** within those entities, particularly during the period in which this annual report is being prepared;

(b) ***designed*** such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide ***reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements*** for external purposes in accordance with generally accepted accounting principles;

> (c) ***evaluated*** the effectiveness of the registrant's disclosure controls and procedures and ***presented, in this annual report, our conclusions about the effectiveness*** of the disclosure controls and procedures, as of the end of the period covered by this annual report based on such evaluation; and
>
> (d) ***disclosed***, in this annual report, any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter that has ***materially affected, or is reasonably likely to materially affect,*** the registrant's internal control over financial reporting.
>
> 5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent function):
>
> (a) ***all significant deficiencies and material weaknesses*** in the design or operation of the internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
>
> (b) ***any fraud, whether or not material***, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Form 10-K 2009 Annual Report, filed 3/15/2010, Section 320 – CEO/CFO Certification (emphasis added).

403. Beginning in 2002, officers of public companies were required under Rules 302 of the Sarbanes-Oxley Act to provide assurances relating to the Company's internal controls over the effectiveness of operations, reliability of financial reporting and compliance with applicable laws and regulations.

Management's assessment of internal control is a critical metric for investors because it provides assurance that the Company is in compliance with financial reporting regulations and its operations are effectively managed and regularly stress test to reduce exposures to risk.

404. In making this SOX Certification, the Orrstown Securities Act Defendants were first required to assess the effectiveness of the Company's internal control structure and financial reporting procedures and, if necessary, publicly report all material weaknesses in the Company's internal controls. This assessment was to be done using the criteria established in the Internal Control-Integrated Framework issued by COSO.

405. Given the COSO standards that Defendants Quinn and Embly were bound to follow when evaluating the Company's internal controls, the SOX Certification and "Management's Report on Internal Control" in the 2009 Annual Report (for the period ending December 31, 2009) were false and misleading in that they omitted material information about the effectiveness of Orrstown's internal controls over financial reporting because at the time the Certifications were made because, as described above, Orrstown failed to comply with GAAP and its own Loan Policy, including by failing to obtain updated appraisals, failing to accurately identify and disclose impaired loans, failing to accurately risk rate loans and ignoring negative information regarding borrowers' ability to pay, failing

to identify TDRs, failing to calculate reserves on all loans in the portfolio, failing to accurately state the Bank's investment in impaired loans, and using improper discount factors.

406. The Orrstown Securities Act Defendants did not properly assess the Company's internal controls over financial reporting and, therefore, they violated the "Internal Control-Integrated Framework" issued by the COSO and various other requirements found in the SEC regulations and the Sarbanes-Oxley Act.

407. Further, after the Class Period and pending the issuance of the Regulators' Enforcement Actions, Orrstown was forced to admit that as of December 31, 2011, the disclosure controls and procedures were not effective and that a material weakness existed pertaining to its internal controls over financial reporting as it related to loan ratings and their impact on the allowance for loan losses. *See* Quinn Letter to SEC, dated 11/5/2012. Orrstown's internal controls that were deficient and ineffective in 2011 mirrored the internal controls that were in place for the reporting periods ending December 31, 2009 and March 31, 2010.

B. Auditor Defendant SEK's Statements in the 2009 10K Were False, Misleading and Lacked a Reasonable Basis

408. Auditor Defendant SEK "consented" to the designation as an accounting "expert" in the Offering Documents. *See* S-3 Registration Statement, Exhibit 23.1. The Offering Documents incorporate by reference the Company's Annual Report on Form 10-K for the year ended December 31, 2009 that SEK.

See Form 424B5 Prospectus, filed 3/24/2012, at 25-26. SEK's statements in the 2009 Annual Report were false, misleading, and lacked a reasonable basis.

409. In its Report of Independent Registered Accounting Firm dated March 15, 2010, SEK stated, in part, as follows:

> The management of Orrstown Financial Services, Inc. and its wholly-owned subsidiary (the "Corporation") is responsible for these financial statements, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management's Report on Internal Control. ***Our responsibility is to express an opinion on these financial statements and an opinion on the Corporation's internal control over financial reporting based on our audits.***
>
> ***We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects.*** Our audits of the financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. ***Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk.*** Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

> A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles ["GAAP"]. . . .
>
> ***In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Orrstown Financial Services, Inc. and its wholly-owned subsidiary as of December 31, 2009 and 2008***, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2009 in conformity with accounting principles generally accepted in the United States of America. Also, ***in our opinion, Orrstown Financial Services, Inc. and its wholly-owned subsidiary maintained, in all material respects, effective internal control over financial reporting as of December 31, 2009***, based on criteria established in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

Form 10-K 2009 Annual Report, filed 3/15/2010, at 46 (emphasis added).

410. The Sarbanes-Oxley Act of 2002 authorized the PCAOB to establish auditing and related professional standards to be used by registered pubic accounting firms. Rule 3100 issued by PCAOB (*see* PCAOB Release No. 2003-009) generally requires all registered public accounting firms to adhere to PCAOB's standards in connection with the preparation and issuance of any audit report on the financial statements of an issuer. Further, on July 27, 2007, PCAOB adopted and continued to refine Auditing Standard No. 5 ("AS No. 5") which,

> establishes requirements and provides direction that applies when an auditor is engaged to perform an audit of management's assessment of the effectiveness of internal control over financial reporting ("audit of internal control") that

> is integrated with an audit of the financial statements. Risk assessment underlies the entire audit process described in AS No. 5, including the determination of significant accounts and disclosures and relevant assertions, the selection of controls to test, and the determination of the extent of audit evidence necessary for a given control.

PCAOB Release No. 2012-006, 12/10/2012, at 1.

411. In conducting its audit SEK was required to evaluate the reasonableness of the Company's provisions for loan loss reserves, and ultimately whether the Company's financial statements incorporating the loan loss reserves were prepared in accordance with GAAP. To do so, SEK in accordance with AS No. 5 was to apply PCAOB standard AU Section 342, Auditing Accounting Estimates. This standard provides in relevant part the following guidance:

> In evaluating reasonableness, the auditor should obtain an understanding of how management developed the estimate. Based on that understanding, the auditor should use one or a combination of the following approaches:
>
> a. Review and test the process used by management to develop the estimate.
> b. Develop an independent expectation of the estimate to corroborate the reasonableness of management's estimate.
> c. Review subsequent events or transactions occurring prior to the date of the auditor's report.

Additionally,

> Review and test management's process. . . . The following are procedures the auditor may consider performing when using this approach:

> a. Identify whether there are controls over the preparation of accounting estimates and supporting data that may be useful in the evaluation.
> b. Identify the sources of data and factors that management used in forming the assumptions, and consider whether such data and factors are relevant, reliable, and sufficient for the purpose based on information gathered in other audit tests.
> c. Consider whether there are additional key factors or alternative assumptions about the factors.
> d. Evaluate whether the assumptions are consistent with each other, the supporting data, relevant historical data, and industry data.
> e. Analyze historical data used in developing the assumptions to assess whether the data is comparable and consistent with data of the period under audit, and consider whether such data is sufficiently reliable for the purpose.
> f. Consider whether changes in the business or industry may cause other factors to become significant to the assumptions.
> g. Review available documentation of the assumptions used in developing the accounting estimates and inquire about any other plans, goals, and objectives of the entity, as well as consider their relationship to the assumptions.
> h. Consider using the work of a specialist regarding certain assumptions (section 336, Using the Work of a Specialist).
> i. Test the calculations used by management to translate the assumptions and key factors into the accounting estimate.

AU Section 342.10-11.

412. SEK was also obligated to follow FAS 114 and FAS 5, which are the primary guidance on the accounting and reporting impaired loans and loss contingencies, including credit losses. FASB's Summary of Statement No. 5 explains that under this standard, if a credit loss exists, "the likelihood that the future event or events will confirm the loss or impairment of an asset or the incurrence of a liability can range from probable to remote." Statement No. 5 uses

the terms probable, reasonably possible, and remote to identify three areas within that range:

> ***Probable*** – the future event or events are likely to occur;
> ***Reasonably possible*** – the chance of the future event or events occurring is more than remote but less than likely; and
> ***Remote*** – the chance of the future event or events occurring is slight.

The allowance for loan loss should be appropriate under GAAP, without any material misstatements, so as to cover probable credit losses related to specifically identified loans as well as probable credit losses inherent in the remainder of the Bank's loan portfolio. Whether a credit loss is probable, reasonably possible or remote takes into consideration all available credit data on a borrower. Thus, in calculating loan loss reserves for purposes of GAAP, all material factors, *i.e.*, past and present credit information must be considered.

413. As early as 2008 SEK failed to follow Rule 3100 issued by PCAOB, AS No. 5, AU Section 342, and FASB Statement No. 5 in connection with its audit. SEK failed to verify that Orrstown had used accurate source data, had made reasonable assumptions, and had accounted for known or knowable past and present information when calculating its loan loss reserves, and therefore failed to ensure that Orrstown's financial statements, incorporated into the Registration Statement, complied with GAAP.

414. SEK was also obligated to follow FAS 114 in auditing the Bank's identification of impaired loans and calculation of impairment. SEK failed to verify that the Bank's disclosures of impaired loans accurately reported the Bank's investment in impaired loans.

415. SEK's statement that, "In our opinion, the financial statements referred to above present fairly, in all material aspects, the financial position of Orrstown Financial Services, Inc. and its wholly-owned subsidiary as of December 31, 2009 and 2008," was false, misleading and lacked a reasonable basis.

416. As set forth above, SEK discovered numerous failures to comply with GAAP, and FAS 114 and FAS 5, during the course of its audits, and that the Bank lacked adequate controls over financial reporting. Among other things, SEK knew that: (a) Orrstown evaluated only Substandard loans for impairment, which failed to comply with GAAP, and because Orrstown failed to accurately risk rate loans its identification of Substandard loans was vastly under inclusive; (b) Orrstown failed to disclose as impaired loans for which it had actually calculated an impairment amount; (c) Orrstown regularly failed to obtain updated appraisals in its analysis of impairment and calculation of ALLL, which, in addition to rendering the Bank's disclosures of ALLL and impaired loans false and misleading, violated the Bank's own Loan Policy; (d) rather than obtain updated

appraisals, Orrstown applied discount factors to old appraisals that were totally improper under GAAP; (e) Orrstown failed to calculate a reserve on loans other than those rated Substandard (except to the extent that the Bank's exposure to a particular industry exceeded 25% of the Bank's total equity), which was contrary to generally accepted industry practice and also improperly assumed that the Bank only incurs losses through its Substandard and lower rated loans, which was not accurate; (f) Orrstown used improper historical loss factors in its FAS 5 calculation; (g) Orrstown improperly risk rated loans and failed to calculate reserves or identify them as impaired, including because as accountant to several of the Bank's largest borrowers, SEK knew that they were experiencing financial difficulty, and that real estate collateral values had plummeted, and also knew that the Bank had failed to rate the relationships as Substandard. Moreover, in connection with its audit SEK failed to examine several of the Bank's largest lending relationships, including Yorktown and several of SEK's own clients.

417. SEK's material auditing failures are consistent with those of other auditing firms registered with the PCAOB. The PCAOB issued a report that provided "information about the nature and frequency of deficiencies in firms' audits of internal control over financial reporting detected during the PCAOB's 2010 inspections." PCAOB Release No. 2012-006, 12/10/2012, at i. The PCAOB found in its inspections significant incidences of deficiencies in firms'

audits of internal controls and financial statements ("integrated audits") for public company issuers' for the year ending 2009 which, the PCAOB concluded, indicates that auditing firms are not following the methodologies and standards required of them. *Id*. at ii.

418. The PCAOB found the "most pervasive" deficiencies in integrated audits related to firms' failures to:

a. Identify and sufficiently test controls that are intended to address the risks of material misstatements;

b. Sufficiently test the design and operating effectiveness of management review controls that are used to monitor the results of operations. . . . ;

c. Sufficiently test the system-generated data and reports that support important controls;

d. Sufficiently perform procedures regarding the use of the work of others;

e. Sufficiently evaluate identified control deficiencies and consider their effect on both the financial statement audit and on the audit of internal control.

Id. at ii-iii. The PCAOB also found that in providing integrated audit opinions, two or more of the above deficiencies were found in 70% of these audits such that

firms failed to obtain sufficient audit evidence to support the opinions on the effectiveness of internal controls. *Id*. at iii.

419. As stated above, in a 2010 report the PCAOB specifically found that SEK failed to "obtain sufficient competent evidential matter" and failed to "perform sufficient procedures to test the allowance for loan losses" for a public company, and reached a similar conclusion in a 2013 report, finding ""deficiencies of such significance that it appeared that the Firm, at the time it issued its audit report, had not obtained sufficient appropriate audit evidence to support its opinion on the issuer's financial statements…and fail[ed] to perform sufficient procedures to test the allowance for loan losses." Plaintiff believes one or both of these reports likely refer to SEK's audit of Orrstown.

2. The Underwriter Defendants

420. The Underwriters were very experienced in bringing stock offerings of banking institutions to the marketplace. In fact, Sandler O'Neill touted its having "completed 39 bank and thrift capital raises in a bookrunning or co-manager role" over the 12 months prior to the offering with "offerings rang[ing] from $11 million to $1.4 billion."

421. Sandler was actively involved in drafting portions of the 2009 10-K, which was intended by the Bank Defendants and UWs to be filed with the SEC just prior to the Offering. In particular, Sandler O'Neill commented on and drafted

sections of the 10-K and Prospectus Supplement dealing with the loan portfolio, including the November Loan Review performed in March 2009. And, as noted above, Sandler O'Neill suggested inclusion of the materially false and misleading statement concerning the Bank's 50 largest loans relationships "performing according to their original terms."

422. Sandler O'Neill conducted final due diligence on March 15, 2009, before the 2009 10-K was filed with the SEC.

423. Sandler O'Neill was aware, in particular, before the pricing of the Offering, that Yorktown had filed for bankruptcy, that Orrstown's exposure to Yorktown was nearly $8.6 million, and that Orrstown's assertion that it was a secured creditor was in serious question because of documentation and recording foul-ups by Orrstown and/or its counsel.

424. Despite this knowledge, the Underwriter Defendants failed to conduct any additional due diligence with respect to Orrstown's exposure to Yorktown or, more broadly, whether the Yorktown debacle signaled more widespread internal control problems. For example, the Underwriter Defendants either did not conduct any or sufficient due diligence into the following obvious areas of inquiry:

a. Whether the Yorktown loan had been the subject of the November Loan Review, and the outcome of that review with respect to the Yorktown loan;

b. Whether the Yorktown loan had been the subject of any consideration for an ALLL allocation prior to its filing for bankruptcy protection, and if not, why not;

c. When was the last time the Yorktown loan had been the subject of an in-depth internal or external loan review, and the results of such review(s);

d. Whether the Yorktown loan, given its size, had been among the loans reviewed by SEK in its 2008 or 2009 audits, and if not, why not (in fact, inexplicably, SEK did not sample the Yorktown loan because it was a complex loan, being composed of and dependent on the creditworthiness of the many borrowers of Yorktown);

e. Whether the absence of virtually any recognition by Orrstown of any impairment or troubled condition of the Yorktown loan denoted a material weakness of ICFP.

425. The Underwriter Defendants' utter failure to pursue obvious avenues of due diligence and prudent inquiry was a material underwriting failure that rendered the March 2010 Offering to be fraught and highly risky. If the Underwriter Defendants had made even a modicum of inquiry they would have at minimum learned that due to internal loan review weakness and incompetency the Yorktown loan, despite its magnitude, was virtually ignored by Orrstown and its external auditor, SEK. Instead, the Underwriter Defendants treated the Yorktown

bankruptcy to be an 11th hour annoyance that they did not want to interfere with the predetermined schedule for taking the March 2010 Offering to market. The Underwriter Defendants dealt with this by simply encouraging Orrstown to file a Form 8-K with the SEC, making no special effort to investigate how the demise of such a significant loan could elude senior management if internal controls over financial reporting were functioning in the same universe of acceptable levels. Indeed, even the March 19, 2010, bankruptcy court determination that Orrstown was an unsecured creditor of Yorktown instead of a secured creditor as it had professed to the Underwriters did not prompt obvious and necessary investigation by or cause the Underwriters to interrupt or delay the March 2010 Offering for fear that their commissions would be in jeopardy if the Offering did not get marketed on the original timetable.

426. Among other things, the Underwriter Defendants' due diligence failed to address adequately, or at all:

a. The loan review function despite being aware that the Bank had only a single loan review staff member;

b. The adequacy and function of internal controls over financial reporting; and

c. SEK's relationship with some of the Bank's principal borrowers.

C. Borne of Desperation, the Stage is Set for the Offering

427. The Offering was necessary in order raise capital to withstand losses that Bank management (and the Regulators) knew would materialize if the financial crisis and real estate market did not bail out the Bank's reckless lending and concealment of loan portfolio deterioration.

428. The Philadelphia Federal Reserve Board's President, Charles Plosser, and Senior Vice President, Bill Stone, met on October 30, 2009, with Defendants Quinn, Embly and Shoemaker at the Federal Reserve offices in Philadelphia. This was not a social visit; the subjects discussed included "capital and risk management."

429. This meeting with the federal regulators coincided with Orrstown's Executive Management Team retreat and a Board of Directors Strategic Planning retreat held in September and October 2009 where the need to raise capital was addressed. The Bank Defendants and their legal and financial advisors accelerated consideration of various capital-raising options, and by December 9 the Bank's senior management and directors had decided to proceed with a public offering to raise $40 million in capital.

430. The Offering Documents did not convey in any way the true reason for raising the $40 million in equity proceeds. Indeed, the Offering Documents and "road show" presentation preceding the March 2010 Offering portrayed

Orrstown as a financial institution that uniquely had weathered the financial crisis, performed better than its peers, and saw lending opportunities created by the financial crisis that other institutions could not exploit. Little did the Investors realize they were being led by Pied Pipers into an abyss from which their investments would not recover, and that the new capital would be used to provide the additional equity that the bank executives knew was going to be necessary to fund the expected material credit losses in the forthcoming quarter which were likely to reduce current capital below regulatory ratios.

IX. SECURITIES ACT CLAIMS FOR RELIEF

COUNT I
(For Violations of § 11 of the Securities Act Against Orrstown and the Bank)

431. This Securities Act claim expressly excludes and disclaims any allegation that could be construed as alleging fraud or intentional or reckless misconduct.

432. Plaintiff brings this Claim on behalf of itself and all members of the Securities Act Class against Orrstown and the Bank.

433. As result of each of the statements and omissions alleged above in the Section entitled "Securities Act Allegations: Materially Untrue & Misleading Statements and/or Omissions Contained in the Offering Documents," the

Registration Statement was materially untrue and/or misleading and omitted to state other facts necessary to make the statements made not misleading.

434. Orrstown and the Bank are strictly liable for the material misstatements and omissions in the Registration Statement issued by them.

435. Less than three years elapsed from the time the securities upon which this Claim is bought were sold to the public to the time of the filing of this action. Less than one year elapsed from the time Plaintiff discovered or reasonably could have discovered the facts upon which this Claim is based to the time of the filing of this action.

436. Plaintiff did not know, or in the exercise of reasonable diligence could not have known, of the untruths and omissions contained in the Registration Statement.

437. By reason of the conduct herein alleged, Orrstown and the Bank violated Section 11 of the Securities Act.

COUNT II
(For Violations of § 11 of the Securities Act Against the Individual Securities Act Defendants, Underwriter Defendants and the Auditor Defendant)

438. This Securities Act claim expressly excludes and disclaims any allegation that could be construed as alleging fraud or intentional or reckless misconduct.

439. This claim is brought by Plaintiff on behalf of itself and other members of the Securities Act Class against the Individual Securities Act Defendants, the Underwriter Defendants and the Auditor Defendant.

440. Each of the Individual Securities Act Defendants signed the Registration Statement.

441. The Underwriter Defendants each served as an underwriter with respect to Orrstown's securities and each permitted their names to be included on the cover of the Registration Statement as the Underwriters.

442. The Auditor Defendant served as auditor and/or account with respect to the management prepared financial statements that were incorporated in the Registration Statement and was named as such with its consent as having certified or prepared portions of the Registration Statement.

443. The Individual Securities Act Defendants, the Underwriter Defendants and the Auditor Defendant owed to the purchasers of the stock, including Plaintiff and the members of the Securities Act Class, the duty to make a reasonable and

diligent investigation of the statements contained in the Registration Statement at the time it became effective to assure that those statements were true, and that there was no omission to state material facts required to be stated in order to make the statements contained therein not misleading.

444. The Individual Securities Act Defendants, the Underwriter Defendants and the Auditor Defendant each failed to make a reasonable and diligent investigation and/or did not possess reasonable grounds for the belief that the statements contained in the Registration Statement were true and without omissions of any material facts and were not misleading. The Individual Securities Act Defendants, the Underwriter Defendants and the Auditor Defendant named in this Count acted negligently in issuing the Registration Statement which made materially false and misleading written statements to the investing public and misrepresented or failed to disclose, inter alia, the facts set forth above.

445. Plaintiff and the Securities Act Class purchased shares of Orrstown pursuant to the March 2010 Offering and were damaged when revelations about Orrstown's risky loan portfolio, inadequate underwriting standards, material understatement of loan loss reserves, and material weaknesses in internal controls were revealed and resulted in the stock price dropping as alleged herein.

446. This action is brought within three years from the time that the securities upon which this claim is brought were sold to the public, and within one

year from the when Plaintiff discovered or reasonably could have discovered the facts upon which this claim is based.

447. Plaintiff did not know, or in the exercise of reasonable diligence could not have known, of the untruths and omissions contained in the Registration Statement.

448. By reason of the conduct herein alleged, the Individual Securities Act Defendants, the Underwriter Defendants and the Auditor Defendant violated Section 11 of the Securities Act.

COUNT III
(For Violations of §12(a)(2) of the Securities Act Against Orrstown, the Bank, the Individual Securities Act Defendants, Defendant Embly and the Underwriter Defendants)

449. This Securities Act claim expressly excludes and disclaims any allegation that could be construed as alleging fraud or intentional or reckless misconduct.

450. This claim is brought by Plaintiff on behalf of itself and all other members of the Securities Act Class against Orrstown, the Bank, the Individual Securities Act Defendants and the Underwriter Defendants. These Defendants were sellers, offerors, and/or solicitors of purchasers of the shares offered pursuant to the Registration Statement.

451. The Registration Statement contained untrue statements of material facts, omitted to state other facts necessary to make the statements made not misleading, and concealed and failed to disclose material facts. Orrstown, the Bank, the Individual Securities Act Defendants, Defendant Embly and the Underwriter Defendants' actions of solicitation include participating in the preparation, review and dissemination of the materially untrue and misleading Registration Statement.

452. Orrstown, the Bank, the Individual Securities Act Defendants, Defendant Embly and the Underwriter Defendants owed to the purchasers of Orrstown's common stock, including Plaintiff and other members of the Securities

Act Class, the duty to make a reasonable and diligent investigation of the statements contained in the Registration Statement to ensure that such statements were true, and that there was no omission to state a material fact required to be stated in order to make the statements contained therein not misleading.

453. Orrstown, the Bank, the Individual Securities Act Defendants, Defendant Embly and the Underwriter Defendants should have known, in the exercise of reasonable care, of the material misstatements and material facts omitted from the Registration Statement.

454. Plaintiff and other members of the Securities Act Class purchased or otherwise acquired Orrstown's securities pursuant to and/or traceable to the defective Registration Statement. Plaintiff and members of the Securities Act Class did not know, or in the exercise of reasonable diligence could not have known, of the material misstatements and material facts omitted from the Registration Statement.

455. Plaintiff, individually and representatively, hereby offers to tender to the Defendants that stock which Plaintiff and other Securities Act Class members continue to own, on behalf of all members of the Securities Act Class who continue to own such stock, in return for the consideration paid for the stock together with interest thereon. Securities Act Class members who have sold their Orrstown stock are entitled to rescissory damages.

456. By reason of the conduct alleged herein, Orrstown, the Bank, the Individual Securities Act Defendants, Defendant Embly and the Underwriter Defendants violated and/or controlled a person who violated § 12(a)(2) of the Securities Act. Accordingly, Plaintiff and members of the Securities Act Class who hold Orrstown securities purchased in the March 2010 Offering have the right to rescind and recover the consideration paid for their Orrstown securities, and hereby elect to rescind and tender their Orrstown securities to Defendants sued herein. Plaintiff and Securities Act Class members who have sold their Orrstown securities are entitled to recessionary damages.

457. This action is brought within three years from the time that the securities upon which this claim is brought were sold to the public, and within one year from the time when Plaintiff discovered or reasonably could have discovered the facts upon which this claim is based.

458. Plaintiff did not know, or in the exercise of reasonable diligence could not have known, of the material misstatements and material facts omitted from the Registration Statement.

459. By reason of the conduct herein alleged, Orrstown, the Bank, the Individual Securities Act Defendants and the Underwriter Defendants violated Section 12(a)(2) of the Securities Act.

COUNT IV
(For Violations of § 15 of the Securities Act Against the Individual Securities Act Defendants)

460. This Securities Act claim expressly excludes and disclaims any allegations that could be construed as alleging fraud or intentional or reckless misconduct.

461. This claim is brought by Plaintiff on behalf of itself and all other members of the Securities Act Class against the Individual Securities Act Defendants, each of whom was a controlling person of Orrstown and/or the Bank by virtue of their position as directors and/or senior officers of the Company and Bank.

462. The Company and Bank are liable under Section 11 of the Securities Act as set forth above in Count I.

463. The Individual Securities Act Defendants by virtue of their position as directors and/or senior offices of the Company and Bank had the requisite power to directly or indirectly control or influence the specific corporate policy that resulted in the unlawful acts and conduct alleged in Count I.

464. The Individual Securities Act Defendants were culpable participants in the violations of Section 11 of the Securities Act alleged in Count I above based on their having signed the Registration Statement and having otherwise participated in the process that allowed the March 2010 Offering to be successfully

completed. These Defendants, by virtue of their managerial and/or board positions with the Company, controlled the Company as well as the contents of the Registration Statement at the time of the March 2010 Offering. These Defendants should have been provided with unlimited access to copies of the Registration Statement and therefore had the ability to either prevent issuance of the Registration Statement or cause it to be corrected.

465. For their failures to issue a materially true, complete and non-misleading Registration Statement, the Individual Securities Act Defendants are liable under Section 15 of the Securities Act for the Company's primary violation of Section 11 of the Securities Act.

466. Plaintiff and the Securities Act Class were damaged when they purchased shares of Orrstown in the March 2010 Offering, and harmed when Orrstown's shares dropped as a result of the truth about the status of Orrstown's inadequate internal controls and underwriting standards, impaired loan portfolio, understatement of loan loss reserves and charge-offs, and overall deteriorating financial condition.

X. EXCHANGE ACT ALLEGATIONS: THE EXCHANGE ACT DEFENDANTS' FRAUDULENT CONDUCT AND COURSE OF BUSINESS

467. Plaintiff incorporates by reference all paragraphs above, including allegations as to scienter and intent to defraud.

468. The Orrstown Exchange Act Defendants and Auditor Defendant are liable for: (1) making false material statements; or (2) failing to disclose adverse material facts known by them about Orrstown. Defendants' fraudulent scheme and course of business that operated as a fraud or deceit on purchasers of Orrstown common stock on the open market was a success, as it: (1) deceived the investing public regarding the quality of Orrstown's internal controls over underwriting of loans, risk management and financial reporting; (2) artificially inflated the prices of Orrstown common stock; and (3) caused the Exchange Act Class to purchase Orrstown at inflated prices.

469. Throughout the Class Period, the Orrstown Exchange Act Defendants maintained and perpetuated the artifice of a Company operated in accordance with effective internal controls. The Auditor Defendant also maintained and perpetuated the deceit by issuing unqualified or "clean" auditor reports included in the Company's 2009, 2010 and 2011 Annual Reports when the Auditor Defendant knew for those years that there was a material weakness in the Company's internal controls over financial reporting and that, as a result, the Company's financial

statements failed to conform to GAAP due primarily in part to the material understatements of loan loss reserves and impaired loans.

A. The Orrstown Exchange Act Defendants' Fraudulent Material Statements and Omissions in the 2009 Annual Report, Form 10-K

470. The 2009 10-K was materially false and misleading for the reasons discussed above. First, Orrstown failed to maintain adequate internal controls over financial reporting, including with respect to its identification of impaired loans, ALLL, and Risk Assets, and the Orrstown Exchange Act Defendants knew, or were at least reckless as to their knowledge, that the relevant SOX certifications and representations regarding the effectiveness of internal control over financial reporting were false at the time they were made, but nevertheless perpetrated this falsehood in order to obtain additional capital through the Offering in order to fund the massive charge-offs that would result from the deteriorated loan portfolio. Second, the Orrstown Exchange Act Defendants, and Embly in particular, deliberately manipulated the Bank's ALLL in the 2009 10-K by removing certain substandard loans without justification in order to conceal deterioration in the Bank's portfolio. Third, the 2009 10-K reassured investors that the Bank's 50 largest loans were "performing according to their original terms, which was completely false, as the Orrstown Exchange Act Defendants knew. The Bank included this statement for the purpose of reassuring investors as to the quality of the bank's portfolio, but in reality a substantial number of those loans had been

modified and extended due to the deteriorating financial condition of the borrowers, stalled real estate development projects, and the declining real estate market.

1. Material Weaknesses of Internal Controls Over Financial Reporting

471. At least by the end of 2009, Quinn, Everly, and Embly in particular were aware of the material weaknesses in internal controls, as well as the Bank's growing portfolio of impaired loans, but failed to disclose them in order to ensure the success of Orrstown's offering.

472. Quinn, who joined the Bank in May 2009, was responsible for the administration of Orrstown's Loan Policy. Quinn was also responsible for certifying in its periodic filings that Orrstown had adequate internal controls to provide reasonable assurance regarding the reliability of financial reporting and preparation of financial statements in accordance with GAAP. In its 2009 10-K Orrstown failed to accurately disclose impaired loans and failed to calculate adequate ALLL due to the material weaknesses in controls over financial reporting discussed herein. By the end of 2009 Quinn knew, or was reckless in not knowing, that the procedures specified in the Bank's Loan Policy for calculating ALLL (including, as examples, that reserves were not calculated on the entire loan portfolio, the Bank utilized improper discount factors to modify stale appraisals rather than obtain updated appraisals, and the Bank's FAS 5 calculations were

based on unreasonable historic loss factors) were deficient, and further that Orrstown regularly failed to comply with its Loan Policy by failing to obtain updated appraisals, rendering the Bank's identification of impaired loans and ALLL calculations in particular materially false and misleading.

473. Everly was responsible for ensuring that Orrstown's financial reporting was materially accurate, complete and prepared in accordance with GAAP. By at least the end of 2009, Everly knew, or was reckless in not knowing, that the procedures specified in the Bank's Loan Policy for calculating ALLL failed to comply with GAAP, and further that Orrstown regularly failed to comply with its Loan Policy by failing to obtain updated appraisals, rendering the Bank's identification of impaired loans and ALLL calculations in particular materially false and misleading.

474. Embly was responsible for credit underwriting, loan work out and loan administration, including supervision of the loan review process and ensuring that material adverse information concerning borrowers was timely incorporated into the loan ratings. As discussed above, by the end of 2009 Embly was aware of serious problems with several of the Bank's largest borrowers, but nevertheless failed to ensure that the loans were identified as impaired, that reserves were calculated on them, or that modifications and extensions to them were identified as TDRs. Instead, Embly directed a scheme to "pretend and extend" in order to

forestall recognition of Orrstown's deteriorating credit quality, its growing list of impaired loans, and the high likelihood of significant charge-offs.

475. Moreover as members of the Loan Committee Quinn, Everly and Embly were ultimately responsible for ensuring that each loan was supported by updated information, and Embly in particular was ultimately responsible for regulatory compliance regarding appraisals. Each of them knew, or were reckless in not knowing, that the vast majority of the bank's loans were not supported by updated appraisals, which meant that the Bank could not, and did not, accurately identify impaired loans and calculate ALLL. Quinn, Everly and Embly knew or should have known that the Bank's use of stale appraisals in connection with the measurement of impairment loss, and its use of a universal discount rate, did not comply with GAAP and Orrstown's own Loan Policy.

476. Further, Quinn, Everly and Embly were members of committees that reviewed borrowers' requests for loan modifications and in the course of those meetings received information regarding the borrowers' financial difficulties. Thus each knew, or was reckless in not knowing, that many of the bank's largest borrowers were suffering poor cash flow, that their collateral values had seriously declined as a result of the financial crisis, and that modifications to their loan should have been identified as TDRs, and reserves and/or impairments should have been calculated.

477. As early as September 2009, the Orrstown Exchange Act Defendants were confronting the failures in the credit review and loan approval process discussed above. The Bank created the position of Chief Credit Officer to purportedly "enhance [credit] processes and controls, as well as clearly delineate independence between sales and credit." Then in November 2009 the Bank in the November Loan Review initiated its internal review of 60% of the Bank's commercial loan portfolio. Through this internal review, *see supra* Part VII.C.3(a), the Orrstown Exchange Act Defendants were presented with additional adverse credit data revealing the Bank's need to reclassify loans as impaired and allocate additional loan loss reserves. The Orrstown Exchange Act Defendants however were preparing for the March 2010 Offering and sought to obscure the extent to which the loan portfolio was impaired so as to avoid dramatic increases in loan loss reserves. To do otherwise would have revealed to the investing public that the Company's internal controls were failing and the stock was neither a safe nor sound investment.

478. On March 15, 2010, the Company filed its 2009 Annual Report. The Orrstown Exchange Act Defendants made false and misleading statements in certifying the effectiveness of the Company's internal controls over underwriting loans, risk management and financial reporting:

> **Management's Report on Internal Control** – Under the supervision and with the participation of the Company's management, including its Chief Executive Officer and Chief Financial Officer, the Company has evaluated the effectiveness of its internal control over financial reporting as of December 31, 2010, using the Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based upon this evaluation, management has concluded that, at December 31, 2010, the Company's internal control over financial reporting is effective based on the criteria established in Internal Control-Integrated Framework.

Form 10-K 2010 Annual Report, filed 3/11/2011, at 65 (emphasis added). Also, appended to the 2009 Annual Report Form 10-K were the false and misleading SOX Certifications made by Defendants Quinn and Everly. As the CEO and CFO, respectively, Quinn and Everly certified that:

> 1. I have ***reviewed*** this annual report on Form 10-K of Orrstown Financial Services, Inc.
>
> 2. Based on my knowledge, the annual report ***does not contain any untrue statement of a material fact or omit to state a material fact*** necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this annual report.
>
> 3. Based on my knowledge, the financial statements, and other financial information included in this annual report, ***fairly present, in all material respects, the financial condition***, results of operations and cash flows of the registrant as of, and for, the periods presented in this annual report.
>
> 4. The registrant's other certifying officer and I are ***responsible for establishing and maintaining disclosure controls and procedures*** (as defined in Exchange Act Rules 13a-15(e) and

15d-15(e)) and internal control over financial reporting (as defined in Exchange Act rules 13a – 15(f) and 15d – 15(f)) for the registrant and we have:

(a) ***designed*** such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision to ***ensure*** that material information relating to the registrant, including its consolidated subsidiaries, is ***made known to us by others*** within those entities, particularly during the period in which this annual report is being prepared;

(b) ***designed*** such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide ***reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements*** for external purposes in accordance with generally accepted accounting principles;

(c) ***evaluated*** the effectiveness of the registrant's disclosure controls and procedures and ***presented, in this annual report, our conclusions about the effectiveness*** of the disclosure controls and procedures, as of the end of the period covered by this annual report based on such evaluation; and

(d) ***disclosed***, in this annual report, any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter that has ***materially affected, or is reasonably likely to materially affect,*** the registrant's internal control over financial reporting.

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent function):

(a) ***all significant deficiencies and material weaknesses*** in the design or operation of the internal control over financial

> reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
>
> (b) ***any fraud, whether or not material***, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Form 10-K 2009 Annual Report, filed 3/15/2010, Section 320 – CEO/CFO Certification (emphasis added).

479. These statements as to the quality and effectiveness of Orrstown's lending practices were materially untrue or misleading when made or omitted material facts necessary to make the statements made not misleading. In addition to the facts set forth above demonstrating the Bank's material weaknesses in internal controls, Orrstown's 2009 credit review and ALLL process was wholly inadequate and failed to comply with Orrstown's Loan Policy. As confirmed by CW#1, CW#2 and CW#3, in 2009 the credit review for every loan that went through the Bank was carried out by only three analysts, who like CW#1, had been given no formal training and often hindered by an overwhelming work load and a lack of necessary credit data. Further, as confirmed by CW#1 and CW#2, in 2009 the loan officers who had brokered the loans unduly influenced the loan approval process such that borrowers were often portrayed as being more creditworthy than they actually were. This lack of independence between the sales and credit functions adversely affected the quality of loans extended.

480. The statements in the Form 10-K were also false and misleading because, as CW#1, CW#2 and CW#3 confirmed and as discussed above, throughout 2009 large commercial loans were extended in order to forestall recognition of impairment and inevitable charge-offs, such as in Hagerstown and to the Chambersburg Developers (*see supra* Part VII.D.4), which did not receive the type of loan approval scrutiny necessary to adequately evaluate the credit risks to the Bank. CW#1, CW#2 and CW#3 stated that the multi-million dollar loans extended to the Azadis (*see supra* Part VII.D.2) in 2011, even after the Azadis told Defendant Embly and Orrstown that they were having problems, are just one example of the Bank's Loan Committee extending credit to borrowers who did not satisfy the credit requirements of the Bank's Loan Policy.

481. As members of the Loan Committee, Exchange Act Defendants Quinn, Everly, Embly and Snoke were actively involved with the deficient loan approval process and the troubled loans, as discussed above, as were Exchange Act Defendants Zullinger, Shoemaker and Coy who were members of the Enterprise Risk Management Committee. CW#3 explained that management periodically generated a chart that tracked troubled loans against the recommendations originally made by the Credit Analyst Group to the Loan Committee. Accordingly, the Orrstown Exchange Defendants knew throughout the Class Period that the Bank's internal controls were failing because the charts were

revealing that the Loan Committee was disregarding the Credit Analyst Group's recommendations and instead making arbitrary exceptions to the Loan Policy for poor quality commercial loans.

482. These statements in the 2009 Form 10-K were also materially untrue or misleading when made, or omitted a material fact necessary to make the statements made not misleading, because at the time that the Orrstown Exchange Act Defendants made these statements or caused them to be made Orrstown had completed the structurally biased November Loan Review (*see supra* Part VII.C.3(a)).

483. The result of all of the above was that the loan loss reserve of $4,267,000 as of December 31, 2009, was materially understated, failing to account for commercial loans that were troubled and needed reclassification based upon past and present credit information. By way of example, the Orrstown Exchange Act Defendants knew or recklessly disregarded information gathered but ignored by the Internal Review team and recent communications from large commercial borrowers, including the Azadis, Shaools, Chambersburg Developers and Yorktown, and other discussed herein, that necessitated significant additional loan loss reserves. The Orrstown Exchange Act Defendants however did not want to sabotage the March 2010 Offering by taking an impairment and properly increasing the loan loss reserve for these.

484. These statements in the 2009 Form 10-K were also materially untrue or misleading when made, or omitted a material fact necessary to make the statements made not misleading, because at the time Orrstown's practices were also in violation of banking regulations and guidelines as determined by the Federal Reserve and Reported in the Consent Order. Exhibit B at ¶ 14.

2. ***The November 2009 Loan Review***

485. Orrstown's 10-K touted the Bank's November 2009 Loan Review in order to assure investors in the Offering (and the investing public thereafter) that the Bank's loan portfolio was sound and not affected by the broader conditions affecting the economy due to the recession. Relatedly, the 2009 10-K assured investors that the Bank "has had an enviable record regarding its control of loan losses," and that after conducting the special review the "allowance is an amount that management believes will be adequate to absorb possible losses on existing loans that may become uncollectible, based on evaluations of the collectability of loans and prior loan loss experience," taking into account "factors as changes in the nature and volume of the loan portfolio, charge-offs and recoveries in total, overall portfolio quality, review of specific problem loans, recent examinations, and current economic conditions that may affect the borrowers' ability to pay."

486. In reality, the November 2009 Review was a sham used to portray a false and misleading picture of the Bank's loan portfolio for all of the reasons

noted above. Tellingly, despite touting this review, the Bank has almost no documentation of it, and the documentation produced to date shows that it was at best perfunctory. Among other deficiencies noted above the November Loan Review looked at collateral values at the time the relevant loans were written, which in almost all cases meant the collateral values were stale.

487. Further, despite the fact that the November Loan Review resulted in a recommended downgrade to the $3.7 million Marvin Windows/Robert Slagle loans, the Bank's ALLL schedule used for the 1009 10-K did not include any specific reserve for these loans. Thus despite touting the November Loan Review, the Bank deliberately or recklessly ignored its recommendations and/or failed to properly account for Substandard loans identified by it.

488. Moreover, as discussed above, many of the loans reviewed had matured and been extended or modified, and these should have been identified as TDRs. For example, effective March 12, 2010, the entire Shaool family of loans, totaling more than $18 million, was identified as "substandard", yet no contemporaneous ALLL reserve allocation or provision was made for such loans.

489. Within 12 months (fiscal year 2010), $12 million in charge-offs were taken with respect to these loans; in the next 12 months (fiscal year 2011), an additional $68 million in charge-offs were taken by the Bank with respect to these loans; and in the first six months of 2012 an additional $87 million in charge-offs

were taken with respect to loans that were "reviewed" by the November Loan Review team. In sum, the "November Loan Review team" missed nearly $170 million in losses on loans that were part of the review portfolio.

490. The Exchange Act Defendants knew, or were reckless in not knowing, that the November Loan Review was a charade perpetrated on the investing public to conceal losses inherent in the Bank's portfolio just long enough to consummate the public Offering.

3. The Loans "Performing According to the Original Terms"

491. In addition to concealing the material weaknesses in internal controls, and misleading the public by misrepresenting the meaningless and grossly deficient November Loan Review, the 2009 10-K and Prospectus also misrepresented the true nature of the bank's loan portfolio by telling prospective investors and the investing public that "at December 31, 2009, we had 50 loan relationships, aggregating $307.5 million t**hat were performing according to their original terms** with outstanding balances that exceeded $3.0 million." (emphasis added) This was patently untrue, and neither the Bank nor SEK actually reviewed the loans to determine whether they were performing according to their original terms. In reality, at least over $40 million of those loans had been modified or extended prior to December 31, 2009, and another more than $15 million had been modified prior to March 23, 2010, the date of the final

Prospectus. Upon information and belief, this sentence, with blanks for the dollar amounts, was recommended to added to the Prospectus by Sandler O'Neill. When Orrstown filled in the blanks, it merely used the total number of outstanding loans over $3 million, without actually confirming that all of those were "performing according to their original terms." In truth, the Exchange Act defendants knew or were reckless in not knowing that a substantial percentage were not performing according to their original terms because they already had been modified or extended, but included this false statement in the 2009 10-K and the March 10 Offering documents to falsely assure prospective investors in the offering that the Bank's loan portfolio was sound when in reality they knew that absent new capital the Bank would soon shock the market with its growing defaults and losses.

4. Deliberate Manipulation of the Bank's ALLL in the 2009 10-K

492. The Exchange Act defendants knew that the Bank's loan portfolio was rapidly deteriorating, and that the Bank need to raise capital to cover impending losses. So, in addition to the material misstatements above, the Exchange Act defendants, and in particular Defendant Embly, also perpetrated a deliberate manipulation of the Bank's ALLL calculation for purposes of the 2009 10-K by removing at least two large borrowers from the ALLL calculation, Antonio Mourtil and J&S, without any valid justification, and by failing to include a known,

required reserve for Marvin Windows/Robert Slagle, in order to hide the declining quality of the Bank's loan portfolio and impending losses.

493. As described above when calculating ALLL the Bank analyzed any loans rated Substandard (i.e., "6") and determined whether there was a collateral deficiency. If there was a collateral deficiency, the Bank created a specific FAS 114 reserve for that loan. Any FAS 114 reserve for a loan meant that it was impaired, and the loan loss provision for that reporting period would be increased and added to the ALLL. Increasing the provision decreased net income for that period.

494. On January 6, 2010, the Bank learned that a large borrower, called Windy Heights, was having problems and its $5.65 million loan would become non-performing in the first quarter. The 2009 10-K specifically referenced this loan, although not by name:

> During January 2010 we were informed that a commercial credit aggregating approximately $5.0 million that was current and performing at December 31, 2009 was having problems and would become nonperforming during the first quarter of 2010. We have specifically allocated $2.0 million of the December 31, 2009 allowance for loan losses to this credit. This allocation is reflected in the accompanying financial statements at December 31, 2009.

495. Given the size of the loan, the bank needed to disclose this information in its 10-K and calculate a reserve on this loan. Doing so would materially impact the Bank's ALLL however, since the required additional reserve

would represent a material increase in the Bank's total ALLL of $11 million. Ultimately in February 2010 the $5.65M Windy Heights loan was sold for $3.7M, and the Bank suffered a loss of $2M. The $2M FAS 114 reserve was recognized as of December 31, 2009.

496. Rather than increase its ALLL substantially by adding the needed reserve for Windy Heights, the Bank *removed* from the ALLL reserves two other large reserves for loans to (1) Antonio Mourtil and (2) J&S Enterprises, totaling about $2 million. As set forth below, these loans had not improved in quality and there was no justification for their removal. To the contrary, they were both clearly Substandard and the Bank had considered them Substandard at year end. Moreover, they were both not fully secured by collateral. As such, they should have been included in the ALLL calculations for 2009, and reserves of roughly $2 million should have been maintained on them. But by removing them from the ALLL the Bank was able to add the $2 million ALLL provision for Windy Heights without changing the total ALLL. Furthermore, in the 2009 10-K the Bank failed to include any specific reserve on the $3.7 million Marvin Windows/Slagle loans that the November Loan Review had identified as Substandard. Embly knew and discussed in internal memos that the Marvin Windows/Slagle loans required at least an $800,000 reserve, but the ALLL in the 2009 10-K did not include any reserve allocated to these loans. Thus, the ALLL in the 2009 10-K was materially

misleading because it failed to include reserves which Embly and the other Exchange Act Defendants knew were required.

497. All of this was a deliberate scheme orchestrated by Embly to understate ALLL and misportray the Bank's declining portfolio in light of the Offering.

498. Antonio Mourtil was a real estate developer who sometimes worked on development projects with Tom Mongold. Among other projects, the Bank lent Mourtil over $3 million for a "Cleveland Avenue Commons" project to build 14 townhomes near one of the Bank's branch locations in Hagerstown. Although originally intended to be sold, after the financial crisis hit Mourtil was unable to sell the units and had to rent them instead.

499. The loan became due in July 2009. Because Mourtil was unable to sell the homes, which according to the Bank's internal documents were "affected by the bad market," Mourtil requested a two year extension at the same interest rate. The bank knew that rents from the properties were not sufficient to support the debt. An internal Loan Presentation from August 2009 noted that "without a new appraisal, we do not know how deeply we are positioned today." The appraisal on the property was over here years old at that time and the bank knew "it is likely that the properties have decreased in value."

500. An internal Loan Presentation from November 2009 reflected that an updated appraisal, dated August 21, 2009, showed collateral a value of just $2.2 million on a more than $3 million loan. Moreover, the presentation reported that Mourtil "says all of their projects are under water and … they are having difficulty keeping the units fully occupied and with the inconsistency in rental income, they are pulling cash from their personal accounts to service the debt." Internally Orrstown stated "we either want re-payment to begin or we want a large balance reduction to continue interest only."

501. Obviously this loan was Substandard, impaired, and required a specific ALLL reserve. That is precisely what Chad Rydbom conveyed to Embly.

502. On January 12, 2010, Chad Rydbom conveyed to defendant Embly an ALLL schedule that showed Mourtil's loan with a 12/31/09 balance of $2.96M, for which a reserve of $1.33M was taken under FAS 114. The Mourtil reserve amount was by a factor of 2.5 the largest FAS 114 reserve amount on the 1/12/10 schedule.

503. The 1/12/10 schedule did not yet list the Windy Heights loan, but as noted above the Bank knew by January 6, 2010 that Windy Heights would also need to be rated Substandard and a reserve calculated.

504. In order to provide the required reserve for Windy Heights without materially increasing the ALLL, the Bank simply excluded Mourtil, J&S, and Marvin Windows from the ALLL calculation. Embly oversaw creation of a new

reserve schedule that removed the Mourtil and J&S loans entirely, thereby eliminating nearly $2 million in FAS 114 allocated reserve amounts. That removal made it possible to add the Windy Heights loan and reserve amount without substantially increasing the entire ALLL by $2.0M, which would have resulted in an 18% increase in ALLL and a 15% decrease in net income.

505. The removal of the Mourtil and J&S loans from the substandard list and the consequent decrease of the FAS 114 reserve was a calculated and manipulative action taken at the behest of Embly, and it thereby resulted in an understatement of the loan loss provision by $2M and the overstatement of net income. The Bank's 2009 reported net income was $13.37M; if the $2M reserve for Mourtil and J&S had not been removed, net income would have been $2M less, or 15% lower than reported. Further, if Marvin Windows had been added as required by virtue of the fact that it had been rated Substandard, the ALLL would have been higher by at least $800,000, and more likely $1.5 million. That manipulation was material to the reported 2009 financial results. In total, if the required reserves for Mourtil ($1.33M), J&S ($484,000), and Marvin Windows ($1.57M) had been included in the ALLL reported in the 2009 10-K, Orrstown's reported ALLL would have been 31% higher, and Orrstown's net income would have been 25% lower.

506. There was no change in the risk profile of the Mourtil loan that would explain its evaporation from the substandard loan list or the removal of the largest FAS 114 reserve that had been attributed to it. Indeed, its loan-to-value metrics were among the worst of the Bank's largest loans. The removal of the Mourtil loan subsequent to the 1/12/10 schedule of substandard loans was especially improper in light of the following:

a. The Mourtil loan came due on July 16, 2009, at which time the entire principal amount was due and owing. The principal amount was not paid on or after July 16, 2009, in accordance with the demand note, and thus the loan was in default. It was for this reason the Mourtil loan was listed on the "matured" loans report beginning shortly at or about July 2009.

b. The matured loans report was a source of considerable concern to the Bank's senior management. On November 18, 2009, an e-mail was sent to a group of lending officers along with the current matured loans list stating that "The matured loan listing is growing, again." Defendant Embly later that day, using the same e-mail string, sent to loan officer Steve Szady an e-mail: "I need you to do everything in your power to get DELM and Anton [Mourtil] off of the matured list by 11/30."

c. As to Mourtil, despite a 11/24/09 loan presentation to the CAC seeking approval of a restructuring of Mourtil's loan, there was no resolution reached because the borrower and his co-investors co-guarantors in Cleveland Avenue Commons, LLC were unwilling to adopt any of the options presented to them by the Bank, including making a significant ($1 million) principal payment.

d. The Bank ultimately capitulated in late-December, agreeing to extend the interest-only payments for 36 months (retroactively to 7/16/09), with the borrower making a 3% payment ($100,000) on the principal balance, bringing the outstanding principal to $2,960,000.

507. Subsequent to the Mourtil loan being in default, the Bank obtained an appraisal that valued the collateral as of August 2009 at 47% of the value ascribed to it in 2006 when the loan was initially made. By any measure, the Mourtil loan was a TDR at 12/31/09, but was not so identified except on the 1/12/09 substandard loans schedule (which schedule was later doctored to remove the loan).

508. Neither the borrower (Antonio Mourtil) nor his co-investors/co-guarantors provided any credible information about their financial condition as confirmed by the fact that the Bank did not even have information about the financial institutions where these borrowers/guarantors deposited their cash.

509. Likewise, there was no legitimate basis to remove the J&S loan from the ALLL calculation. Even SEK disagreed with the Bank when it discovered that the Bank had changed the rating for J&S and removed it from the ALLL calculation.

510. J&S Enterprises was the real estate holding company for a commercial seller of trailers and truck equipment. The Bank loaned $2 million to J&S in August 2006, and the loan had been rated substandard since at least 2007 due to, *inter alia*, "weak cash flow" and insufficient collateral.

511. As of December 31, 2008, J&S had an outstanding loan balance of nearly $1.9 million, and the Bank calculated a collateral deficit (i.e., FAS 114 reserve) of $606,416. Moreover, much of the collateral consisted of real estate, and the latest appraisals were from 2006, meaning the true deficit as of December 31, 2008 was much greater given the collapse of real estate markets that occurred after 2006. Notably, the Bank's ALLL schedule reported that J&S had $1,440,559 in inventory but the discounted value of the inventory was less than other outstanding liens on the inventory, meaning it was essentially worthless as security for the Bank. During its audit of the 2008 financials SEK reviewed the J&S loan and agreed with the Substandard rating and the calculation of an FAS 114 reserve of $606,000.

512. J&S remained Substandard throughout 2009, but when calculating ALLL for the 2009 10-K Orrstown removed J&S from the ALLL calculation despite the fact that internal documents show it was still rated Substandard as of December 31, 2009.

513. During its audit of the 2009 financials, SEK reviewed the J&S loan and disagreed with the Bank's upgrading of the J&S loan and removal of it from the ALLL calculation. In its "Loan Loss Reserve Calculation Memo" to the Bank, SEK noted:

> J & S Enterprises was classified as substandard in 9/30/09 calculation, but is not included in the calculation at 12/31/09. This had been graded as substandard previously due to high inventory, but new information was received that shows inventory has decreased and sales have increased, so therelationship was upgraded to watch in the 4th quarter by management. See management's evaluation at D.01.1a. From discussion with Jeff Embly, this relationship has been classified as substandard for the past 18-24 months due to inventory and some turmoil within the entity, but cash flow has continuedto be adequate and loan has remained current, so this was looked at more than the collateral as a factor in the classification upgrade as management does not feel there are any issues with this relationship that will cause concerns. While we agreed that cash flows are adequate for this relationship, **collateral is still deficient and due to insufficient collateral, the relationship does not meet the definition of "watch" classification according to the Bank's loan review policy.** Management used different discount factors in their evaluation at D.01.1a, which doesn't make the collateral deficit look as bad, but if you use the discounts used in the allowance calculation and a 12/31/09 account balance of $1,835,399, collateral is deficient by $483,577, which would be added to the calculation if it was

> classified as substandard. We will include this in our evaluation at D.01.3.

(emphasis added). In other words, SEK believed the loan should have remained rated Substandard, should not have been moved to "Watch" (i.e., a 4), and the 2009 ALLL calculation should have included at least an FAS 114 reserve of $483,577 due to the deficient collateral. Given that an FAS 114 reserve was required, the loan should also have been identified as impaired. Moreover, the Bank's stated reason for increasing the rating to Watch -- i.e., "[t]his had been graded as substandard previously due to high inventory, but new information was received that shows inventory has decreased and sales have increased, so the relationship was upgraded to watch in the 4th quarter by management" -- was transparently false. SEK's Loan Review and Evaluation Form showed J&S's inventory as of December 31, 2008 was $1,250,000, which was a mere $190,000 less than the value of the inventory a full year earlier. That was hardly a significant change that merited upgrading the loan from Substandard given the nearly $500,000 collateral deficit and weak cash flows of the borrower.

514. Because SEK concluded that the J&S loan should have remained at Substandard, SEK's audit workpapers added an additional FAS 114 reserve to the Bank's ALLL calculation for J&S in the amount of $483,577. SEK did not increase the total ALLL amount of $11.067 million calculated by the Bank, but rather moved the necessary $483,577 reserve from the "unallocated" portion of the

reserve to the "allocated" portion of the ALLL reserve, thereby reducing the unallocated portion in the Bank's calculation from $1.262M to $630k.

515. In its 2009 10-K, however, the Bank simply ignored the opinion of its auditor. Rather than include the necessary FAS 114 reserve for J&S, Orrstown disregarded SEK's opinion and presented the ALLL in the 10-K as the Bank had initially calculated it, without any specific reserve for J&S. Specifically, the 2009 10-K showed a total reserve of $11.067 million with $1.262 million being "unallocated," meaning no specific reserve was included for J&S. In addition, because the Bank failed to calculate a required reserve of at least $800,000 for Marvin Windows, the entire unallocated portion of the reserve reported in the 10-K was more than consumed by just two loan relations, which the bank knew were Substandard but excluded them from its ALLL calculations for the purpose of making the Bank's portfolio appear safer than it really was.

516. Moreover, since an FAS 114 reserve had been calculated, the J&S loans also should have been identified as impaired, which would have increased the bank's disclosure of impaired loans by nearly 13%

517. The Exchange Act Defendants deliberately (1) excluded Mourtil, (2) excluded Marvin Windows, and (3) removed J&S from the ALLL calculation in order to present a misleading picture of the trajectory of Bank's loan portfolio to investors.

518. Moreover, SEK unquestionably knew that Orrstown had improperly rated the J&S loan, failed to calculate an FAS 114 reserve, and failed to identify it as impaired. Upon information and belief the Bank also disclosed its treatment of the Marvin Windows loan to SEK. In light of this and the many other failures of internal controls of which SEK had knowledge discussed herein SEK could not truthfully issue a clean audit opinion, yet did so in order to aid Orrstown in its fraud on the investing public.

B. The Exchange Act Defendants' Scheme to Materially Understate Loan Loss Reserves and to Understate and Conceal the Magnitude of the Company's Impaired Loans and TDRs from the Class

519. Just five weeks after the March 2010 Offering closed, on May 7, 2010,Orrstown filed its quarterly report 1Q2010 which included a $21 million increase in Risk Assets (i.e., non-performing loans) but only a $1.4 million increase in loan loss reserves from the prior quarter ending December 31, 2009. Form 8-K Press Release on 1Q2010 Operating Results, filed 4/22/2010.

520. Recognizing that the $21 million increase in Risk Assets was only the tip of the iceberg, the Orrstown Exchange Act Defendants moved quickly to formulate and implement a scheme to defraud investors about the health and financial condition of Orrstown and to conceal and materially understate Company's Risk Assets. As found by the SEC, Orrstown repeatedly understated its impaired loans in 2010.

521. As stated in the SEC consent Order, which was proposed by Orrstown to the SEC, in its 10-Q for the second quarter of 2010, Orrstown disclosed approximately $21.7 million in impaired loans, but failed to disclose an additional $46.6 million in impaired loans. Moreover, what was particularly egregious was that of the $46.6 million in undisclosed impaired loans, Orrstown had actually calculated an FAS 114 impairment for $5.6 million of them but simply omitted them from its disclosures. In other words, there is no question Orrstown actually knew these loans were impaired -- since it calculated impairments on them -- but it deliberately or recklessly omitted them from its disclosures in order to conceal the losses inherent in its portfolio. These loans alone would have increased the disclosure of impaired loans by 125%. If all loans identified by the SEC as impaired had been disclosed, the total would have increased by 215%

522. Likewise in its 10-Q for the second quarter of 2010 Orrstown disclosed approximately $22.6 million in impaired loans, but failed to disclose an additional $69.5 million in impaired loans. Of those undisclosed loans, Orrstown had actually determined that $18.5 million were impaired but deliberately or recklessly excluded them from its disclosures in order to present a misleading picture of the Bank's portfolio. If Orrstown had included all the loans it actually identified as impaired, the total disclosed impaired loans would have increased by

182%. If all loans identified as impaired in the SEC Order had been included, the total would have increased 308%.

523. In its 2010 Form 10-K, filed March 11, 2011, Orrstown again understated impaired loans. As found by the SEC, Orrstown disclosed $14.1 million in impaired loans, but failed to disclose an additional $51 million in impaired loans that should have been disclosed. This misstatement was also repeated in footnotes to financial statements in Orrstown's 10-Qs for the second and third quarters of 2011, as well as the 10-K for 2011.

524. As found by the SEC, in its 10-Q for the first quarter of 2011 filed May 10, 2011, Orrstown disclosed $14.1 million in impaired loans but failed to disclose an additional $51 million in impaired loans.

525. Moreover, throughout 2010, Orrstown's ALLL calculations once again utilized stale appraisals, which did not comply with the Bank's Loan Policy, and did not comply with GAAP because Orrstown incorporated inappropriate inputs into its collateral valuation methods, which resulted in a failure to accurately calculate ALLL and identify impaired loans. There is no question this was deliberate or at least reckless, since the Bank's loan policy required updated appraisals and given the Bank's knowledge that real estate values had plummeted due to the financial crisis.

526. In evaluating Substandard loans for impairment and calculating reserves on them for the first quarter of 2010, approximately 53% of the loans evaluated had real estate appraisals more than two years old and 20% had appraisals over five years old. Once again, these outdated appraisals were completely unreliable. If Orrstown had utilized updated appraisals as required it would have had to calculate a materially higher ALLL.

527. Similarly, in the second quarter of 2010, approximately 40% of the loans evaluated for impairment were supported by real estate appraisals more than two years old, and 14% were supported by appraisals over five years old.

528. In the third quarter of 2010 approximately 29% of the loans evaluated for impairment were supported by real estate appraisals more than two years old, and 10% were supported by appraisals over five years old.

529. As a result of all of the above, Orrstown's disclosures of impaired loans and its ALLL were materially false and misleading. The Exchange Act defendants acted deliberately, or at least recklessly, given that these false and misleading statements were a direct result of the Bank's failure to comply with its own loan policies, GAAP, and a deliberate course of conduct with respect to "pretending and extending" loans in order to avoid taking required reserves and/or losses, which would have materially impacted the Bank's financial reports, including net income and capital.

530. The Orrstown Exchange Act defendants also knew or were reckless in not knowing that Orrstown had understated its investments in impaired loans in its SEC filings, but did nothing to correct those disclosures in order to present a misleadingly rosy financial picture. In fact, in October 2010 Barton specifically informed Everly and Embly that failing to disclose loans with impairment losses as impaired was inconsistent with accounting guidance, but no one took corrective action.

531. Throughout the Class Period, the Company's financial reporting was therefore materially false and/or misleading when made or omitted to state material facts necessary to make the statements made not misleading.

532. At the precise time that the Orrstown Exchange Act Defendants were making these statements in late 2010 and throughout 2011, the Bank – as confirmed by CW#1, CW#2, and CW#3 – was restructuring many of its larger troubled loan relationships as part of its effort to obfuscate the true level of Risk Assets and needed provisions for loan loss reserves. As illustrated by the Bank's lending relationship with the Azadis, in January 2011 the Bank restructured and secured guarantees on $5.8 million of loans to them (*see supra* Part VII.D.2). Further, at around the same time in 2011 CW#4 also confirmed that the Bank's management suggested that CW#4 restructure its 2007 and 2008 loans after CW#4 informed the Bank that CW#4 was financially struggling. In late 2010, CW#4

entered into a series of "Change in Terms Agreements" on $1.6 million of prior loans, all of which had been originally brokered by Terry Reiber in 2007, 2008 and 2009.

533. As set forth above, by the 2008-2010 time period many of the bank's largest borrowers had sought modifications of their loans due to cash flow problems and as a result of the real estate crash, the bank knew that the outdated appraisals on their collateral no longer represented the true value of the assets. Shaool, Azadi, and Mongold, to name just a few examples, had all sought modifications due to lack of cash flow, and their cash flow problems were discussed at meetings of Orrstown's Loan Committee, Executive Committee and/or Board of Directors. As attendees at these meetings, Quinn, Everly and Embly knew or should have known that the loans were impaired or, at a minimum, that these loans needed to be evaluated for impairment. Quinn, Everly and Embly received copies of the internal loan presentation materials that set forth the borrowers' financial difficulties, but Quinn, Everly and Embly did not raise any concerns about whether the loans should have been disclosed as impaired, or identified for impairment analysis.

534. In truth, the Orrstown Exchange Act Defendants knew in late 2010 that the Regulators were poised to "formally" launch their Joint Examination into the Company's banking practices and internal controls.

535. Moreover, in its 10-Q for the second quarter of 2011 Orrstown disclosed that approximately $34 million in restructured loans qualified as TDRs. In performing an impairment analysis of those loans, rather than use the expected future cash flows and each loan's effective interest rate as required by GAAP, Orrstown used each loan's contractual cash flows discounted by a "market rate" to arrive at the net realizable value. Barton informed Quinn, Everly, and Embly that this approach was "not technically within the accounting rules," but none of them took any action to conform the model to GAAP.

536. After all of the false and misleading statements as to the existence and effectiveness of the Bank's internal controls were stripped away and the truth was revealed, Orrstown's stock had been artificially inflated by as much as 70% throughout the Class Period, thereby damaging Plaintiff and the Exchange Act Class.

C. The False and Misleading Statements and SOX Certifications in the Form 10-Qs filed throughout the Class Period

537. Throughout the Class Period, the Company expressly assured investors in each Form 10-Q filed with the SEC that Defendants Quinn and Embly, as the Company's CEO and CFO respectively, had "carried out an evaluation . . .of the effectiveness of [Orrstown's] disclosure controls and procedures" and "[b]ased

upon that evaluation . . . concluded [that Orrstown's] disclosure controls and procedures [were] effective as of the end of the period covered by this report."[14]

538. In addition, for the first, second and third quarters of 2010 and the first quarter of 2011, the Company made the following statements with respect to the effectiveness of the Company's internal controls and that there had been no changes to the Company's internal controls throughout this period:

> **Item 4. Controls and Procedures**
>
> **(a) Evaluation of disclosure controls and procedures:**
>
> The Corporation's Chief Executive Officer and Chief Financial Officer have evaluated the effectiveness of the Corporation's disclosure controls and procedures (as such term is defined in Rules 13a-15(e) under the Securities Exchange Act of 1934, as amended) as of [March 31, 2010, June 30, 2010 and September 30, 2010]. Based on such evaluation, such officers have concluded that, as of [March 31, 2010, June 30, 2010 and September 30, 2010], the Corporation's disclosure controls and procedures are effective in alerting them on a timely basis to material information relating to the Corporation (including its consolidated subsidiary) required to be included in the Corporation's periodic filings under the Exchange Act.

[14] Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by an issuer in the reports that it files or submits under the Exchange Act is accumulated and communicated to the issuer's management, including its principal executive and principal financial officers or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosures. SEC Rule 13a-15, 17 C.F.R. § 240.13a-15; SEC Rule 15d-15(e), 17 C.F.R. § 240.15d-15(e).

> **(b) Changes in internal controls:**
>
> The Corporation regularly assesses the adequacy of its internal control over financial reporting and enhances its controls in response to internal control assessments and internal and external audit and regulatory recommendations. There have not been any significant changes in the Corporation's internal control over financial reporting or in other factors that have materially affected, or are reasonably likely to materially affect, such controls during the quarter ended [March 31, 2010, June 30, 2010 and September 30, 2010].

See Orrstown's Form 10-Qs for the quarterly periods ended March 31, 2010, June 30, 2010 and September 30, 2010, filed on 05/07/2010, 08/05/2010 and 11/05/2010 respectively; Orrstown's Form 10-Q for the quarterly period ended March 31, 2011.

539. After the Company retained an independent consulting firm to assist with its internal controls the Company slightly modified its controls and procedures report in its quarterly 10-Qs for the Second and Third Quarters of 2011. In the Second Quarter 2011 Form 10-Q, the Company stated:

> **Item 4. Controls and Procedures**
>
> **(a) Evaluation of disclosure controls and procedures:**
>
> The Company's Chief Executive Officer and Chief Financial Officer have evaluated the effectiveness of the Company's disclosure controls and procedures (as such term is defined in Rules 13a-15(e) under the Securities Exchange Act of 1934, as amended) as of June 30, 2011. Based on such evaluation, such officers have concluded that, as of June 30, 2011, the Company's disclosure controls and procedures are effective in alerting them on a timely basis to material information relating to the Company (including its consolidated

> subsidiary) required to be included in the Company's periodic filings under the Exchange Act.
>
> **(b) Changes in internal controls:**
>
> The Company regularly assesses the adequacy of its internal control over financial reporting and enhances its controls in response to internal control assessments and internal and external audit and regulatory recommendations. During the second quarter of 2011, the Company supplemented its internal loan review function in rating credits within the commercial portfolios by engaging an independent third party loan review company to participate in the review process. Management's decision to supplement its internal loan review was consistent with its desire to review every loan within these portfolios in excess of $500,000 and to obtain at least 75% coverage of the portfolio as measured in dollars. This level of review was necessitated based upon management's conclusion that a current review of credits was required in light of the continuing softness in overall economic conditions and deterioration of underlying collateral based upon recent appraisals of the collateral securing the loans. All relationships reviewed by either internal or contracted resources were reviewed with the Company's Credit Administration Committee, who reaffirmed the rating after a review of the loans cash flows, detailed collateral analysis and the development of action plans.
>
> With the exception of the engagement by the Company of the independent loan review firm noted above, there have not been any other significant changes in the Company's internal control over financial reporting or in other factors that have materially affected, or are reasonably likely to materially affect, such controls during the quarter ended June 30, 2011. Effective July 1, 2011, the Company outsourced its loan review function to a third party loan review firm to complete independent loan reviews and validate management's loan ratings.

See Orrstown's Form 10-Q for the quarterly period ended June 30, 2011, filed on 8/9/2011. Then, in the Third Quarter 2011 Form 10-Q, the Company stated:

Item 4. Controls and Procedures

(a) Evaluation of disclosure controls and procedures:

The Company's Chief Executive Officer and Chief Financial Officer have evaluated the effectiveness of the Company's disclosure controls and procedures (as such term is defined in Rules 13a-15(e) under the Securities Exchange Act of 1934, as amended) as of September 30, 2011. Based on such evaluation, such officers have concluded that, as of September 30, 2011, the Company's disclosure controls and procedures are effective in alerting them on a timely basis to material information relating to the Company (including its consolidated subsidiary) required to be included in the Company's periodic filings under the Exchange Act.

(b) Changes in internal controls:

The Company regularly assesses the adequacy of its internal control over financial reporting and enhances its controls in response to internal control assessments and internal and external audit and regulatory recommendations. As noted in the previous quarter, effective July 1, 2011, the Company outsourced its loan review function to a third party loan review firm to complete independent loan reviews and validate management's loan ratings. This level of review was necessitated based upon management's conclusion that a current review of credits was required in light of the continuing softness in overall economic conditions and deterioration of underlying collateral based upon recent appraisals of the collateral securing the loans. All relationships reviewed by the outside loan review firm were reviewed with the Company's Credit Administration Committee, who reaffirmed the rating after a review of the loans cash flows, detailed collateral analysis and the development of action plans.

With the exception of the engagement by the Company of the independent loan review firm noted above, there have not been any other significant changes in the Company's internal control over financial reporting or in other factors that have materially affected, or are reasonably likely to materially affect, such controls during the quarter ended September 30, 2011.

See Orrstown's Form 10-Q for the quarterly period ended September 30, 2011, filed on 11/9/2011.

540. The Company's Form 10-K for the fiscal year ended December 31, 2010, filed on 03/11/2011, recited substantially similar statements as those quarterly filings made in 2010:

> **ITEM 9A—CONTROLS AND PROCEDURES**
>
> The Company's Chief Executive Officer and Chief Financial Officer have evaluated the effectiveness of the Company's disclosure controls and procedures (as such term is defined in Rules 13a-14(c) under the Securities Exchange Act of 1934, as amended (the "Exchange Act")) as of December 31, 2010. Based on such evaluation, such officers have concluded that the Company's disclosure controls and procedures are effective as of December 31, 2010 in recording, processing, summarizing and reporting information required to be disclosed, within the time periods specified in the SEC's rules and forms. Management's Report on internal control over financial reporting for December 31, 2010 is included in Item 8 of this 10-K report and is incorporated by reference into this Item 9A. The audit report of the registered public accounting firm on internal control over financial reporting is included in Item 8 of this 10-K report and is incorporated by reference into this Item 9A. There have not been any changes in the Company's internal control over financial reporting during the quarter ended December 31, 2010 that materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

541. Separately, Quinn and Everly signed sworn SOX Certifications appended to each quarterly report on Form 10-Q representing that:

> 1. I have reviewed this quarterly report on Form 10-Q of Orrstown Financial Services, Inc.

2. Based on my knowledge, the quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report.

3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report.

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act rules 13a – 15(f) and 15d – 15(f)) for the registrant and we have:

(a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;

(b) designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

(c) evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this quarterly report our conclusions about the effectiveness of the disclosure

> controls and procedures, as of the end of the period covered by this quarterly report based on such evaluation; and
>
> (d) disclosed in this quarterly report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting.
>
> 5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent function):
>
> (a) all significant deficiencies and material weaknesses in the design or operation of the internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
>
> (b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

1Q2010 Form 10-Q, filed (emphasis added).

542. Each of foregoing statements and SOX Certifications was materially false or misleading when made or omitted to state material facts necessary to make the statements made not misleading because:

a. Throughout 2010, there was no effective underwriting process as the then-existing Loan Policy was honored in the breach and the Loan Committee regularly disregarded the credit analysts' recommendations to

extend credit, a practice which necessitated the outsourcing of these functions in mid-2011 to an independent consultant;

b. Throughout 2008 and 2010 Orrstown had failed to identify and disclose impaired loans;

c. From 2008 through 2010, Orrstown failed to properly calculate ALLL, in violation of accounting rules and guidance;

d. Orrstown failed to correctly identify TDRs;

e. There was no process or Commercial Real Estate ("CRE") Plan in place to reduce or detect undue credit concentrations;

f. Rather than recognize loans as impaired and/or calculate sufficient ALLL, the Bank routinely modified and extended loans in order to forestall the calculation of required reserves and charge-offs;

g. The suggestion beginning with the Second Quarter 2011 Form 10-Q, filed August 9, 2011, that an "independent third party loan review company" had been retained because of "continuing softness in overall economic conditions and deterioration of underlying collateral based upon recent appraisals" was materially false and misleading. Defendants were seeking to use the economic conditions to mask (i) the fact that the Bank's internal controls had failed and allowed the loans to be originated in the first place; (ii) the Bank's systemic internal control failures had allowed assets

with deteriorated credit quality not to be properly and timely classified; and (iii) the Regulators' presence at the Bank conducting a Joint Examination and their involvement in the retention of the third party loan review specialist.

h. Orrstown's practices were also in violation of banking regulations and guidelines as determined by the Federal Reserve and Reported in the Consent Order. Exhibit B at ¶ 14.

543. In sum the truth, which was known by the Exchange Act Defendants but concealed from the investing public during the Class Period, was as follows:

a. As early as September 2009 when the Bank created the position of Chief Credit Officer, the Exchange Act Defendants knew the Bank's underwriting standards and loan approval procedures violated the Loan Policy and the Bank had extended loans in 2008 through 2010 that were inherently risky with a high degree of default;

b. As early as December 2009, the Exchange Act Defendants knew from the information gathered but ignored by the structurally biased Internal Review that,

i. the Loan Committee routinely approved loans that did not meet the credit requirements of the Loan Policy;

ii. the loan officers often usurped the credit analyst's role such that there was a lack of independence in the underwriting and loan sales functions;

iii. there was a glut of risky commercial loans, concentrated especially in the Hagerstown, Maryland market, that either needed to be reclassified as Substandard or Doubtful or were on the verge of becoming Substandard or Doubtful; and

iv. the Bank needed to significantly increase its loan loss reserves to adequately address the impaired loans;

c. As early as December 2009, the Bank knew that its Enterprise Risk Management Committee had not put in place effective internal controls that would ensure timely and accurate identification of impaired loans and accurate allocations of loan loss reserves;

d. As early as January 2010, the Orrstown Exchange Act Defendants were aware that the Company would need to record unprecedented increases in Substandard, Doubtful and Impaired assets and increases in loan loss reserves which indicated material failures in the Bank's underwriting processes and internal controls and jeopardized the strength of the Company's balance sheet;

e. The Orrstown Exchange Act Defendants knew as early as 2008 and 2010 that Orrstown had failed to accurately disclose the Bank's investment in impaired loans;

f. The Orrstown Exchange Act Defendants knew that Orrstown had improperly calculated ALLL;

g. The Orrstown Exchange Act Defendants were aware as early late 2010 that the Department of Banking and Federal Reserve had concerns that the Bank and Company were engaging in unsound and unsafe practices yet failed to materially alter the Bank's lending practices and financial reporting or to make adequate disclosures about the matters that triggered the interest and concern of the Regulators;

h. The Orrstown Exchange Act Defendants were aware as early as March 31, 2011 that the Department of Banking and the Federal Reserve had formally launched their Joint Investigation into the Company's banking practices, including scrutiny of management's competency;

i. The Orrstown Exchange Act Defendants knew as early as March 31, 2011 that its internal controls over underwriting, risk management and financial reporting were ineffective because they had retained an independent consulting firm to take over these functions and devise new processes; and

j. The Orrstown Exchange Act Defendants knew that their attributing increased loan scrutiny and loan portfolio deterioration to economic conditions was false and misleading because they failed to acknowledge that these problems were largely due to a systemic failure in internal controls.

D. The False and Misleading Financial Reporting

544. The Orrstown Exchange Act Defendants' knowingly or recklessly made false and misleading statements and omissions identified above in the Company's quarterly financial reports (Form 10Q) and annual reports (Form 10-K) that were filed with the SEC and made publicly available to the investing public. Specifically, the Company's unaudited 1Q2010 10Q, 2Q2010 10Q, 3Q2010 10Q, 4Q 2010, 1Q 2011, 2Q 2011, 3Q 2011, 4Q2011, 1Q2012 and audited 2009, 2010 and 2011 Form 10-Ks were false and misleading when made and failed to disclose material facts concerning Orrstown and the Bank's financial condition, underwriting standards, loan portfolio quality, and internal controls over financial reporting.

545. With respect to the Orrstown Exchange Act Defendants' financial reporting, Defendants Quinn and Everly signed every Class Period Form10-Q quarterly financial report. In signing these filings, Quinn and Everly certified each time that

> Based on my knowledge, the quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report.

See, e.g., Form 10Q 1Q2010, filed 5/7/2010, at Quinn Certification and Everly Certification. Further, as the certifying officers, Quinn and Everly also certified:

> Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report.

Id.

546. Quinn and Everly along with the other individual Orrstown Exchange Act Defendants Zullinger, Shoemaker, Snoke and Coy signed every Class Period Form 10-K Annual Report. Quinn as Chief Executive Officer and Everly as Chief Financial Officer, certified:

> the annual report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this annual report.

Quinn and Everly also certified:

> Based on my knowledge, the financial statements, and other financial information included in this annual report, fairly present, in all material respects, the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this annual report.

See, e.g., Form 10-K 2010 Annual Report, filed 3/11/2010, at Quinn and Everly Certifications.

547. In signing the Form 10-Qs and Form 10-Ks, the Orrstown Exchange Act Defendants verified that the management-prepared financial statements were prepared in accordance with GAAP without material weaknesses, and that the Company was maintaining effective internal controls.

548. Following the November Loan Review, in early 2010 management was in the position that it could not ignore the new credit data gathered by the November Loan Review for the Bank's larger commercial lending relationships and the communications from large borrowers, such as the Azadis, Shaool, and Mongold, and the Yorktown of financial difficulties. The Orrstown Exchange Act Defendants did not want to sabotage the planned March 2010 Offering by issuing financial statements that revealed a weakened loan portfolio with sharply escalating, impaired loans, TDRs, asset with deteriorated credit quality and provisions for loan loss reserves.

549. Indeed, "Bank policy related to the allowance for loan losses is considered to be a ***critical accounting policy*** because the allowance for loan losses represents a ***particularly sensitive accounting estimate***. The amount of the allowance is based on management's evaluation of the collectability of the loan portfolio. . . ." From 10-Q 1Q2010, filed 5/7/2010, at 19 (emphasis added). Thus

the Orrstown Exchange Act Defendants, who were aggressively circumventing sound lending policies through abusive application of their exception discretion to approve risky loans and ignoring adverse credit data on their commercial borrowers, *see supra* Part VII.B.2, VII.C, X.B, through their use of the IRRS system were also those responsible for determining this highly critical and sensitive accounting estimate for loan losses.

550. This scheme caught up with the Orrstown Exchange Act Defendants when the Regulators' comprehensive investigation forced the Orrstown Exchange Act Defendants to admit in the 2011 Annual Report that the Company's internal controls, which incorporated the IRRS used in 2010 and 2011, were fundamentally flawed. The Company stated:

> ***As of December 31, 2011, the Company did not maintain effective internal control over the process to prepare and report information related to loan ratings and its impact on the allowance for loan losses.*** This control deficiency results in a reasonable possibility that a material misstatement to the annual or interim Consolidated Financial Statements will not be prevented or detected. Accordingly, management has determined that this condition constitutes a material weakness. ***Because of this material weakness, we have concluded that the Company did not maintain effective internal control over financial reporting as of December 31, 2011 based on the criteria in the Internal Control – Integrated Framework.***

Form 10-K 2011 Annual Report, filed 3/15/2012, at 74. (emphasis added)

551. As discussed above, the material weaknesses first revealed in 2011 had existed since at least 2008. The Bank's loan loss reserves and disclosed impaired loans were materially understated during the ***entire*** Class Period and the Bank had failed to apply the proper accounting methodology to calculate loan loss reserves, causing the Company's financial statements to be materially misstated and non-compliant with GAAP.

552. As a result of the Orrstown Exchange Act Defendants' false statements, Orrstown's common stock traded at artificially inflated levels during the Class Period. When the truth about Orrstown's practices was revealed to investors the Company's share price dramatically declined thereby damaging the Class.

E. Auditor Defendant SEK's Audit Opinions were Materially False and Misleading

553. Under § 10(b) of the Exchange Act and Rule 10b-5 promulgated thereunder, an auditor may be primarily liable for securities fraud when it provides an audit report containing an unqualified or "clean" audit opinion certifying financial statements that were false and misleading at the time the audit report was issued. If the auditor fails to take reasonable steps to correct or withdraw a previously issued "clean" audit report after the auditor subsequently learns, or is reckless in not learning, that its previously issued audit reports erroneously

certified financial statements that were in fact materially false and misleading, the auditor may also be primarily liable for securities fraud.

554. During the Class Period, SEK issued unqualified or "clean" audit reports for the years ending December 31, 2009 and 2010 that incorrectly certified Orrstown and the Bank's Class Period financial statements as being free of material misstatements, and opined that the Company's internal controls were effective and without any material weaknesses. For the year ending December 31, 2011, SEK also incorrectly issued a clean audit report of the Company's financial statements but did issue an adverse opinion as to the Company's internal financial controls. This adverse opinion of course contradicts the clean report on the 2011 financial statements that are a product of the Company's internal financial controls.

1. SEK's Materially False and Misleading 2009 Audit Opinion in the 2009 Annual Report

555. SEK's audit for 2009 was included in the Company's Annual Report Form 10-K filing. In the 2009 10-K, SEK expressed the following unqualified opinion:

> [T]he financial statements referred to above present fairly, in all material respects, the financial position of Orrstown Financial Services, Inc. and its wholly-owned subsidiary as of December 31, 2009 and 2008, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2009 in conformity with accounting principles generally accepted in the United States of America. Also, in our opinion, Orrstown Financial Services, Inc. and its wholly-owned subsidiary maintained, in all material respects, effective

> internal control over financial reporting as of December 31, 2009, based on criteria established in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

Form 10-K 2009 Annual Report, filed 3/15/2010, at 47.

556. SEK affirmatively stated that it had conducted its audit in accordance with PCAOB's standards. *See id.* SEK, therefore, applied PCAOB standard AU Section 342 in evaluating the reasonableness of the Company's loan loss reserves which required that SEK "review and test the process used by management to develop the estimate," develop its own "independent expectation of the estimate" to cross-check management's estimate, and "review subsequent events" that would have impacted the credit relationships for which loan loss reserves were being allocated. AU Section 342, Auditing Accounting Estimates; *see supra* ¶ 411. Further, AU Section 342, as well as FASB Statement No. 5 (*see supra* ¶ 412) and AS No. 5 (*see supra* ¶ 410), required SEK to delve deep into the recent and historic credit data for each of the Bank's loan relationships and integrate all relevant information coming from the Bank and Regulators to thoroughly test management's estimates.

557. An auditor has a responsibility to plan and perform an audit in such a manner as to determine whether the financial statements are free from material misstatement, whether caused by error or fraud. AU Section 316 ("AU 316"), *Consideration of Fraud in Financial Statement Audit*. AU 316 provides specific

standards and guidelines auditors must follow in order to fulfill their responsibility in accordance with PCAOB. An audit should be planned and performed with an attitude of "professional skepticism":

> Professional skepticism is an attitude that includes a questioning mind and a critical assessment of audit evidence. The auditor should conduct the engagement with a mindset that recognizes the possibility that a material misstatement due to fraud could be present, regardless of any past experience with the entity and regardless of the auditor's belief about management's honesty and integrity. Furthermore, professional skepticism requires an ongoing questioning of whether the information and evidence obtained suggests that a material misstatement due to fraud has occurred. In exercising professional skepticism in gathering and evaluating evidence, the auditor should not be satisfied with less-than-persuasive evidence because of a belief that management is honest.

AU 316.13, *The Importance of Exercising Professional Skepticism*.

558. As stated above, SEK knew from its audits that Orrstown and the Bank had violated GAAP and the Bank's own Loan Policy in calculating ALLL and identifying impaired loans, and that the financial statements contained material understatements with respect to the classification of impaired loans and allocation of loan loss reserves. SEK also knew that the bank had improperly risk rated loans and failed to calculate reserves on loans which should have been included in the impairment analysis and ALLL calculation.

559. In addition to the November Loan Review SEK would have been privy to the Credit Analyst Group's recommendations on loan applications and

aware that the Loan Committee's approval of loans that conflicted with the Credit Analyst Group's recommendations did not satisfy the credit requirements of the Loan Policy, such as the Debt Service Ratio, but rather were approved based upon an inadequate "exception."

560. SEK's unqualified audit report for the year 2009 was also materially false and misleading because SEK failed to apply the standards of the PCAOB. Under the PCAOB standards, a reasonable auditor would have exercised professional skepticism and discovered that the financial statements contained material understatements of Risk Assets, and that there was a material weakness in the Company's internal controls over the financial reporting of Risk Assets and loan loss reserve allocations such that the financial statements were not prepared in accordance with GAAP. SEK's financial interest in continuing to serve as Orrstown and the Bank's auditor, while at the same time continuing to serve as accountant for many of the bank's largest borrowers, eclipsed SEK's professional responsibility under the PCAOB and caused SEK to issue the materially false and misleading audit report for 2009.

2. SEK's Materially False and Misleading 2010 Audit Opinion in the 2010 Annual Report

561. SEK's audit for 2010 was included in the Company's Annual Report Form 10-K filing. In the 2010 10-K, SEK expressed the following unqualified opinion:

> [T]he financial statements referred to above present fairly, in all material respects, the financial position of Orrstown Financial Services, Inc. and its wholly-owned subsidiary as of December 31, 2010 and 2009, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2010 in conformity with accounting principles generally accepted in the United States of America. Also, in our opinion, Orrstown Financial Services, Inc. and its wholly-owned subsidiary maintained, in all material respects, effective internal control over financial reporting as of December 31, 2010, based on criteria established in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

Form 10-K 2010 Annual Report, filed 3/11/2011, at 67.

562. SEK affirmatively stated that it had conducted its audit in accordance with PCAOB's standards. *See id.* SEK therefore applied PCAOB standard AU Section 342 in evaluating the reasonableness of the Company's loan loss reserves, which required that SEK "review and test the process used by management to develop the estimate," develop its own "independent expectation of the estimate" to cross-check management's estimate, and "review subsequent events" that would have impacted the credit relationships for which loan loss reserves were being allocated. AU Section 342, Auditing Accounting Estimates; *see supra* ¶ 411. Further, AU Section 342, as well as FASB Statement No. 5 (*see supra* ¶ 412) and AS No. 5 (*see supra* ¶ 410), required SEK to delve deep into the recent and historic credit data for each of the Bank's loan relationships and integrate all relevant

information coming from the Bank and Regulators to thoroughly test managements estimates.

563. An auditor has a responsibility to plan and perform an audit in such a manner as to determine whether the financial statements are free from material misstatement, whether caused by error or fraud. AU Section 316 ("AU 316"), *Consideration of Fraud in Financial Statement Audit*. AU 316 provides specific standards and guidelines auditors must follow in order fulfill their responsibility in accordance with PCAOB. AU 316.13 requires that the audit be planned and performed with an attitude of "professional skepticism."

564. As stated above, SEK knew from its audits that Orrstown and the Bank had violated GAAP and the bank's own Loan Policy in calculating ALLL and identifying impaired loans, and that the financial statements contained material understatements with respect to the classification of impaired loans and allocation of loan loss reserves. SEK also knew that the bank had improperly risk rated loans, and failed to calculate reserves on loans which should have been included in the impairment analysis and ALLL calculation.

565. SEK's unqualified audit report for 2010 was also materially false and misleading because SEK failed to apply the standards of the PCAOB. Under the PCAOB standards a reasonable auditor would have exercised professional skepticism and discovered that the financial statements contained material

understatements of Risk Assets, and that there was a material weakness in the Company's internal controls over the financial reporting of Risk Assets and loan loss reserve allocations such that the financial statements were not prepared in accordance with GAAP. SEK's loyalty to its client and financial interest in continuing to serve as Orrstown and the Bank's auditor eclipsed SEK's professional responsibility under the PCAOB and caused SEK to issue the materially false and misleading audit report for 2010.

3. SEK's Additional Knowledge of Loan Rating Deficiencies By Q2 2011

566. By the second quarter 2011, the following were known or recklessly disregarded by the Individual Defendants and SEK:

a. The SEG First Quarter Report regarding the downgrading of a significant number of loans that had been improperly rated by OTB's internal staff, with respect to which SEG had concluded: "…internal capabilities for loan ratings were not adequate…"

b. OTB had failed to identify and classify loans as TDRs, and the federal bank examiners had insisted on TDR classifications that increased TDRs from $1M to $34M between the first and second quarters 2011.

c. SEG's Second Quarter Report dated 7/15/11 recommended additional downgrading of a significant number of loans that had been improperly rated by OTB's internal staff.

d. SEG's "gap" report dated 7/25/11, revealed over 50 gaps or deficiencies in OTB's business process.

567. The confluence of these factors mandated an immediate 8-K disclosure by Defendants of a material weakness in internal controls. Instead, Defendants along with SEK effectively conspired to "manage" the reality of internal control failures by calling the situation a "significant deficiency, a condition that did not mandate an immediate disclosure." A material weakness means "that there is a reasonable possibility that a material misstatement of the company's annual or interim financial statements will not be prevented or detected on a timely basis." AU Section 325(3). (emphasis added)

568. A material weakness would not only have required an immediate 8-K disclosure, it would likely have triggered a restatement of financial results for prior reporting periods.

569. SEK's audit partner acknowledged that, in his opinion, the factors set forth in para. 566 above constituted a material weakness in internal controls for financial reporting. Moreover, SEK understood that OTB could not treat the regulators as part of the Bank's internal controls; OTB needed its own internal controls to risk rate loans and assess and calculate the reserves necessary to account for possible loan losses.

570. The loans that were reclassified as TDRs in the 2Q 2011 would have been so classified prior to the guidance issued by the Financial Accounting Standards Board in ASU 2011-02 in April 2011. The FASB guidance did not apply to loan restructuring and modifications that predated 2011 (indeed, OTB's 2Q 2011 TDRs related to restructurings and loan modifications dating back to 2009-2010).[15] ASU 2011-02 was effective June 15, 2011 and was to be applied prospectively, and specifically stated that retrospective application would be made "to restructurings occurring on or after the beginning of the annual period of adoption." Sec. BC 16.

571. Moreover, TDRs had been specially noted by the examiners as early as the 2009 Report on Examination and during the Federal Reserve's "targeted" examination (i.e., special, not regularly scheduled) performed as of September 30, 2010. Despite this admonition about the need to identify and properly classify loans as TDRs, OTB's management did not undertake to even assess its loan restructurings and modifications for TDR status until Third Quarter 2011, after the examiners compelled reclassification of loans as TDRs. Indeed, Michael A. Moore, who became OTB's SVP/Chief Credit Officer in August 2011, stated that when he took that position there were no TDR processes at the Bank.

[15] The 2Q 2011 10-Q falsely represented that the TDRs resulted from loan modifications made in the "last several months" when, in fact, the modifications dated back to 2009-2010.

572. Defendants recognized that TDRs constituted a negative commentary on the Bank's financial portrayal, with one bank official remarking to a bank examiner that shareholders did not look favorably on TDRs.

573. SEK's audit failures with respect to TDRs were multi-fold:

a. SEK failed to adapt its audit procedures to assess OTB's internal controls with respect to identifying and properly classifying loans as TDRs, and providing ALLL reserves for such loans.

b. SEK failed to include in its loan reviews for fiscal year 2009, 2010 and 2011, loans that had been restructured and modified, thus consciously or recklessly avoiding the review of loans that were likely TDR candidates.

c. SEK did not receive or request in its audit procedures a list of loans that had been the subject of loan modifications or restructuring.

d. SEK did not review loan files to develop its own list of loans that had been modified or restructured.

e. In light of a.-d., SEK could not conduct any sampling or testing of (i) OTB's internal controls with respect to identifying and classifying TDRs; or (ii) how the then current economic environment was impacting the Bank's business operations, including loan review functions, risk-rating loan

competency, ALLL reserve and provision calculations and adequacy, and financial reporting integrity.

f. SEK's motivation in not doing a.-d. was driven by its knowledge that some of its largest accounting service clients were OTB borrowers with the highest loan balances. SEK further knew, based on the performance of accounting services for these borrows, including preparation of tax returns and financial compilations, that these large borrowers' loans had been the subject of systemic loan modifications and restructurings beginning in 2007 and 2008.

g. It should be noted that SEK's lack of testing the internal processes with regard to TDRs and the lack of TDR classification from Orrstown can only be willful and not an oversight of a technical accounting policy. In 2009 and 2010 the analysis of TDRs, together with the analysis of non-performing loans and the loan loss reserves, was one of the topics most heavily scrutinized reviewed by investors, security analysts and regulators. For example, the word TDR appeared 36 times in JP Morgan's 2010 10-K.

4. SEK's Materially False and Misleading 2011 Audit Opinion in the 2011 Annual Report

574. SEK's audit for 2011 was included in the Company's Annual Report Form 10-K filing. In the 2011 10-K, SEK expressed the following unqualified opinion:

> [T]he financial statements referred to above present fairly, in all material respects, the financial position of Orrstown Financial Services, Inc. and its wholly-owned subsidiary as of December 31, 2011 and 2010, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2011 in conformity with accounting principles generally accepted in the United States of America.

Form 10-K 2011 Annual Report, filed 3/15/2011, at 77. But then, SEK expressed the following adverse opinion as to the Company's internal controls:

> A material weakness is a control deficiency, or combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the Company's annual or interim financial statements will not be prevented or detected on a timely basis. The following material weakness has been identified and included in management's assessment. ***The Company did not have a timely and effective process to prepare and report information related to loan ratings and the allowance of loan losses allocations*. . . . *In our opinion, because of the effects of the material weakness described above on the achievement of the objectives of the control criteria, Orrstown Financial Services, Inc. and its wholly-owned subsidiary has not maintained effective internal control over financial reporting as of December 31, 2011*** . . . .

Id. at 75-76 (emphasis added); *see also id*. at 77 (same).

575. SEK affirmatively stated that it had conducted its audit in accordance with PCAOB's standards. *See id.* SEK therefore applied PCAOB standard AU Section 342 in evaluating the reasonableness of the Company's loan loss reserves, which required that SEK "review and test the process used by management to develop the estimate," develop its own "independent expectation of the estimate"

to cross-check management's estimate, and "review subsequent events" that would have impacted the credit relationships for which loan loss reserves were being allocated. AU Section 342, Auditing Accounting Estimates; *see supra* ¶ 411. Further, AU Section 342, as well as FASB Statement No. 5 (*see supra* ¶ 412) and AS No. 5 (*see supra* ¶ 410), required SEK to delve deep into the recent and historic credit data for each of the Bank's loan relationships and integrate all relevant information coming from the Bank and Regulators to thoroughly test managements estimates.

576. An auditor has a responsibility to plan and perform an audit in such a manner as to determine whether the financial statements are free from material misstatement, whether caused by error or fraud. AU Section 316 ("AU 316"), *Consideration of Fraud in Financial Statement Audit*. AU 316 provides specific standards and guidelines auditors must follow in order fulfill their responsibility in accordance with PCAOB. AU 316.13, *supra* ¶ 557, requires that the audit be planned and performed with an attitude of "professional skepticism."

577. As found by the SEC, in its 10-K for 2011 Orrstown failed to disclose approximately $51 million in impaired loans, an understatement of approximately 346%. By performing its 2011 audit in accordance with PCAOB auditing standards referenced above, which SEK affirmatively stated it had done in the 2011 audit report, it is implausible that SEK did not have actual knowledge that

Orrstown and the Bank's financial statements contained understatements of impaired loans, ALLL, and Substandard or Doubtful loans, especially in light of the work done by the Special Asset Group, and the Regulators' investigation about which SEK was aware. Moreover, SEK's own audit revealed a material weakness in the financial reporting controls related to the Company's process for preparing and reporting loan ratings and loan losses allocations, which undercuts the veracity of the Company's financial statements.[16]

578. SEK's unqualified audit report on the 2011 financial statements was materially false and misleading because SEK failed to apply the standards of the PCAOB. Under the PCAOB standards, a reasonable auditor would have exercised professional skepticism and discovered that the financial statements had not been prepared in accordance with GAAP since they contained material understatements of Risk Assets and loan loss reserves due, at a minimum, to the material weakness in the Company's internal controls over the financial reporting of Substandard or Doubtful loans and loan loss reserve allocations that SEK discovered in its audit. SEK's loyalty to its client and financial interest in continuing to serve as Orrstown and the Bank's auditor eclipsed SEK's professional responsibility under the

[16] The Company's Form 10-Q for 3Q2012 which reported a $19.8 million valuation allowance further evidences SEK's failure to test management's estimates and apply the rigorous professional skepticism required by the PCAOB in auditing Orrstown's 2011 financial statements.

PCAOB, and caused SEK to issue the materially false and misleading audit report for 2011.

F. The Truth Comes Out

579. A series of post-Offering disclosures concerning the Bank's escalating provisions for loan losses and increases in Risk Assets (*i.e.*, non-accrual, restructured, foreclosed, and 90-day past due loans), *see supra* Part VIII.A, revealed Orrstown's true financial condition and the material weaknesses in Orrstown's internal controls over underwriting, risk management and financial reporting at the time of the March 2010 Offering. These matters were material and, the March 2010 Offering Documents accordingly contained untrue statements and omitted material facts in violation of the Securities Act.

580. After the market closed on Thursday, July 14, 2011, Orrstown announced:

> The Company has preliminarily estimated that it will record an additional provision for loan losses at June 30, 2011 in the amount of approximately $21,000,000 as a result of the Bank's review of its outstanding loans (including approximately $ 5,621,029 added to the loan loss reserve for the Yorktown loan discussed above). This anticipated additional reserve increase reflects the Bank's recognition of continuing softness in economic conditions and comes as a result of internal risk rating downgrades to existing credits, plus additional specific reserve set-asides attributable to various commercial loan relationships.

Form 8-K Material Impairments, filed 7/14/2011; *see also supra* ¶¶ 199-213. In the same SEC filing, the Company gave positive reassurances to investors in an attempt to downplay the Yorktown loss, stating:

> The Bank intends to aggressively pursue a recovery of the amounts owed to it in the Bankruptcy Court proceedings as well as through other avenues of recovery that may be available to it including, without limitation, the guarantees provided by the Yorktown principals and other potential claims against third parties.

Form 8-K Material Impairments, filed 7/14/2011. In response to such revelations, Orrstown's stock price dropped by 23% to close on Monday, July 18, 2011 at $20.06.

581. On Thursday, July 28, 2011, the Company filed its Form 8-K providing Second Quarter 2011 operating results. The results revealed that for the first time in the Company's history it was reporting a quarterly loss. The Company also admitted that the Bank's underwriting and review departments had been expanded to include additional personnel, and most notably, that the Company had to ***"outsource certain credit review responsibilities in order to mitigate the Company's risk of loss, and to reduce its level of nonaccrual and classified loan."*** (emphasis added). This news was more fully reported with the filing of Orrstown's Form 10-Q on August 9, 2011. On August 9, 2011, Orrstown's stock closed at $17.87 per share, a 34% loss since its Offering Price of $27 per share.

582. The Company, however, perpetuated the façade of a "safe and sound" bank with sufficient capital by declaring a quarterly cash dividend of $0.23.

583. After the market closed on October 26, 2011, the Company reported that the Federal Reserve refused to approve the Company's payment of a cash quarterly dividend. The Federal Reserve took this step to prevent the Company from engaging in an "unsafe and unsound banking practice" which would further deplete the Company's capital base. In addition, the 8-K reported that the Company had $9.4 million of charge-offs in that quarter alone and that there were ***"decreases in asset quality ratios, including elevated levels of nonaccrual loans, restructured loans and delinquencies."*** Form 8-K 3Q2011 Operating Results, filed 10/26/2011, at 2 (emphasis added). On October 27, 2011, the Company filed an 8-K with a letter from Defendant Quinn to Orrstown's shareholders in which he told shareholders that despite the second quarter loss, federal regulator's intervention, and no dividend declaration, ***"Orrstown Bank is safe and sound."*** Form 8-K Letter, filed 10/27/2011 (emphasis added). The market reacted swiftly to these two filings, and the share price dropped by approximately 30% to close at $9.20 a share. This news, though shocking, only partially revealed the true state of affairs at the Bank. On January 26, 2012, the Company issued a press release with Fourth Quarter 2011 operating results, which included a quarterly net income loss and one-time non-cash goodwill impairment charge off of $19.4 million, as well as

the continued suspension of the payment of a dividend. Form 8-K Press Release on 4Q2011 Operational Results, filed 1/26/2012. Defendant Quinn, however, tempered the news, stating that the Company had effective internal controls to address the "asset quality issues" such that the market reaction was sharp, but not devastating. *Id*. It was not until March 30, 2012, that the Company revealed that 2011 had been a "challenge" and that the Company was "not able to continue historical performances" due to material weaknesses in its internal controls, which as a result of the Regulators' Enforcement Actions reported on March 23, 2012, the Company was making much needed "structural changes." Schedule 14A Additional Definitive Proxy Materials, filed 3/30/2012, at 1. By April 5, 2012, this news was digested by investors and the stock sunk to $8.20.

584. After markets closed on April 26, 2012, the Company issued a press release covering earnings results for the first quarter of 2012. The Company reported a net loss of $8.2 million, larger than analysts expected. This net loss was in contrast to net income of $3.8 million reported in the first quarter of 2011. In addition, the Company noted that its provision for loan losses totaled $19.2 million for the quarter ended March 31, 2012 as compared to a loan loss provision of $3.2 million for the same quarter in 2011. On the following trading day, April 27, 2012, the Company's stock dropped from $8.42 to $7.94, a decrease of 5.7%.

585. Plaintiff and the members of the Class have suffered significant losses and damages. Plaintiff and the Class acquired Orrstown securities issued in the March 2010 Offering pursuant to and/or traceable to the Offering Documents that contained untrue statements of material facts and material omissions concerning the effectiveness of Orrstown's internal controls, and sustained damages as a result of those acquisitions measured by the amount paid for the security (which was priced at $27 in the Offering) less the value of Orrstown stock at the time the suit was brought, the price of the security if sold in the market before suit, ***or*** the price at which the security is disposed of after suit (if greater than the value when suit was brought). Three years after Regulators issued their Enforcement Actions, Orrstown's stock hovered around $15 per share.

Orrstown currently trades around $19 per share, and has never reached its Offering price of $27, even while the broader NASDAQ market, on which Orrstown stock trades, has nearly tripled in that time.

XI. ADDITIONAL EXCHANGE ACT ALLEGATIONS

586. The preceding allegations are herein incorporated by reference and are in addition to the following allegations concerning Loss Causation, Scienter, Safe Harbor and Efficient Market, which are not mutually exclusive.

A. Loss Causation

587. During the Class Period, as detailed therein, the Exchange Act Defendants made false and misleading statements and engaged in a course of conduct to deceive that artificially inflated the prices of Orrstown common stock, and operated as a fraud or deceit on the Exchange Act Class by misrepresenting, throughout the Class Period, the quality of the Company's lending practices, loan portfolio and financial condition. Later, when the Exchange Act Defendants' prior misrepresentations and fraudulent conduct related to the quality of the Company's lending practices, loan portfolio and financial condition were revealed to the market, the price of Orrstown's common stock fell precipitously as a result of such revelations.

588. As a result of their purchases of Orrstown common stock during the Class Period, Plaintiff and the members of the Exchange Act Class suffered economic loss, *i.e.*, damages, under the federal securities laws.

B. Scienter

589. During the Class Period, the Exchange Act Defendants had both the motive and opportunity to commit fraud.

590. They had actual knowledge of the misleading nature of the statements they made, or acted with reckless disregard for the true information known to them at the time, as alleged *supra*. In so doing, the Exchange Act Defendants committed acts, and practiced and participated in a course of business that operated as a fraud or deceit on purchasers of Orrstown common stock during the Class Period.

591. Further, the Exchange Act Defendants benefitted from perpetuating the fraud of selling a "safe and sound" financial institution. The Company paid SEK fees for its professional auditing services which SEK risked losing if it challenged management about its accounting irregularities. Likewise, SEK risked losing lucrative contracts with many of the Bank's largest borrowers, as well as Orrstown, if it disclosed the true financial conditions of those borrowers, which would have required the Bank to identify the loans as impaired, calculate ALLL reserves, and identify modifications to their loans as TDRs.

592. The Orrstown Exchange Act Defendants also financially benefited by obfuscating the deteriorating financial condition of the Company. As illustrated by the compensation chart below, the Orrstown Exchange Act Defendants were able to receive handsome income and benefits in 2009 and 2010 when they were issuing the materially false and misleading financial statements alleged herein:

Name and Principal Position	**Year**	**Salary ($)**	**Bonus ($)**	**Stock Awards ($)(1)**	**Option Awards ($)(1)**	**Non-Equity Incentive Plan Compensation ($)**	**Change in Pension Value and Nonqualified Deferred Compensation Earnings ($)(2)**	**All Other Compensati on ($)(3)**	**Total ($)**
Thomas R. Quinn, Jr.	2011	414,027	0	-	0	-	135,051	16,347	565,425
President & Chief	2010	399,051	196,160	-	34,860	-	194,122	89,775	913,968
Executive Officer	2009	302,885	75,160	-	0	-	14,490	27,299	419,834
Bradley S. Everly	2011	206,013	0	-	0	-	49,272	7,126	262,411
Executive Vice	2010	180,204	70,267	-	27,888	-	49,266	33,262	360,887
President & Chief	2009	158,346	33,660	-	11,336	-	32,055	29,158	264,555
Financial Officer									
Jeffrey W. Embly	2011	209,906	0	-	0	-	11,824	6,718	228,448
Senior Executive Vice	2010	202,969	83,726	-	27,888	-	11,824	36,942	363,349
President & Chief	2009	188,077	40,226	-	13,224	-	11,824	34,157	287,508
Operating Officer									

Source: Form DEF 14A, filed 3/30/2012, at 25 (footnotes omitted).

593. Because the Orrstown Exchange Act Defendants were able to dupe investors throughout 2010 and inflate and misstate the Company's financial condition, they continued to collect their 2011annual salary. But once the fraud was publicly exposed, and the Regulators had imposed their supervision, Defendants' Quinn, Everly and Embly were no longer able to take their end of year

massive bonuses, resulting in a drastic decrease in compensation for the year 2011. *See* Form DEF 14A, filed 3/30/12, at 25.

594. Following the Regulators' intervention and the March 23, 2012 requirement that the Bank "adopt and implement a plan, acceptable to the [Regulators], to strengthen oversight of management and operations" *supra* Part VII.C, and engage an independent consultant to evaluate the competency and effectiveness of management with a report to be submitted to the Regulators within 120 days of the execution of the Enforcement Actions taken on March 23, 2012, Defendants Embly and Everly "resigned" as employees and executives of Orrstown. This, as well as the information from CWs and other facts alleged *supra,* evidences such Defendants' knowledge of and role in the wrongdoing throughout the Class Period.

595. The Orrstown Exchange Act Defendants Zullinger, Shoemaker, Snoke and Coy, as directors of the Company who also sat on at various times the Loan Committee, Enterprise Risk Management Committee and possibly the Credit Administration Committee, also benefitted from misleading and deceiving the investing public about the true financial condition of Orrstown, through receipt of the following compensation.

2011 DIRECTOR COMPENSATION TABLE

Name	Fees Earned or Paid in Cash ($)	Stock Awards ($)	Option Awards ($)(1)	Non-Equity Incentive Plan Compensation ($)	Change in Pension Value and Nonqualified Deferred Compensation Earnings ($)(2),(3)	All Other Compensation ($)	Total ($)
Jeffrey W. Coy	65,500	7,982	-	-	11,850	-	85,332
Kenneth R. Shoemaker	33,100	7,982	-	-	11,510		52,592(4)
Glenn W. Snoke	48,900	7,982	-	-	13,260	-	70,142
Joel R. Zullinger	78,700	7,982	-	-	22,602	-	109,284

Source: Form DEF 14A, filed 3/30/2012, at 14 (footnotes omitted).

C. No Safe Harbor

596. Orrstown's verbal "Safe Harbor" warnings accompanying its oral forward-looking statements ("FLS") issued during the Class Period were ineffective to shield those statements from liability.

597. The Exchange Act Defendants are also liable for any false or misleading FLS pleaded because, at the time each FLS was made, the speaker knew the FLS was false or misleading and the FLS was authorized and/or approved by an executive officer of Orrstown who knew that the FLS was false. None of the historic or present-tense statements made by the Exchange Act Defendants were assumptions underlying or relating to any plan, projection, or statement of future economic performance, as they were not stated to be such assumptions underlying or relating to any projection or statement of future economic performance when made, nor were any of the projections by the

Exchange Act Defendant expressly related to, or stated to be dependent, on those historic or present tense statements when made.

D. Efficient Market

598. At all relevant times, the market for Orrstown stock was an efficient market for the following reasons, among others:

a. Orrstown securities met the requirements for listing, were listed, and actively traded on the NASDAQ, a high efficient market;

b. Orrstown counts Boenning & Scattergood, Inc., Stifel, Nicolaus & Company, Inc., and Defendant Janney as market makers for Orrstown securities on the NASDAQ;

c. As a regulated issuer, Orrstown filed periodic public reports with the SEC and the NASDAQ;

d. Upon the filing of periodic public reports with the SEC of unexpected corporate events or news, Orrstown's stock price tends to react as alleged herein;

e. Orrstown securities were followed by securities analysts employed by major brokerage firms who wrote reports which were distributed to the sales force and certain customers of their respective brokerage firms. Each of these reports was publicly available and entered the public marketplace; and

f. Orrstown regularly issued press releases which were carried by national newswires. Each of these releases was publicly available and entered the public marketplace.

599. As a result, the market for Orrstown securities promptly digested current information with respect to the Company from all publicly-available sources and reflected such information in Orrstown's stock price. Under these circumstances, all purchasers of Orrstown securities during the Class Period suffered similar injury after the true facts were revealed.

600. Orrstown's own filings indicate its recognition that once Orrstown's common stock began trading on the NASDAQ in April 2009, there was an efficient market for Orrstown securities which did not exist prior when Orrstown traded on the OTC Bulletin Board. Form 10-K 2009 Annual Report, filed on 3/15/2010, at 19.

XII. EXCHANGE ACT CLAIMS FOR RELIEF

COUNT V
(For Violations of § 10(b) of the Exchange Act and Rule 10b-5 Promulgated Thereunder Against the Orrstown Exchange Act Defendants)

601. Plaintiff brings this claim on behalf of itself and the members of the Exchange Act Class against the Orrstown Exchange Act Defendants – Orrstown, the Bank, Quinn, Everly, Embly, Zullinger, Shoemaker, Snoke and Coy.

602. During the Class Period, Orrstown Exchange Act Defendants disseminated or approved the false statements specified herein, which they knew to be or recklessly disregarded as to whether they were misleading, in that they contained misrepresentations and failed to disclose material facts necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading.

603. During the Class Period, the Orrstown Exchange Act Defendants collectively and individually carried out a plan, scheme and course of conduct which was intended to and, throughout the Class Period, did: (a) deceive the investing public, including Plaintiff and the other members of the Exchange Act Class; (b) artificially inflate and maintain the market price of Orrstown common stock; and (c) cause Plaintiff and other members of the Class to purchase Orrstown stock at artificially inflated prices. In furtherance of this unlawful scheme, plan

and course of conduct, the Orrstown Exchange Act Defendants each participated in the actions set forth herein.

604. Plaintiff and the Class have suffered damages in that, in reliance on the integrity of the market, they paid artificially inflated prices for Orrstown common stock. Plaintiff and the Class would not have purchased Orrstown common stock at the prices they paid, or at all, if they had been aware that the market prices had been artificially and falsely inflated by Defendants' misleading statements.

605. As a direct and proximate result of the Orrstown Exchange Act Defendants' wrongful conduct, Plaintiff and the other members of the Exchange Act Class suffered damages in connection with their purchases of Orrstown common stock during the Class Period.

COUNT VI

(For Violations of § 10(b) of the Exchange Act and Rule 10b-5 Promulgated Thereunder Against the Auditor Defendant SEK)

606. Plaintiff brings this claim on behalf of itself and the members of the Exchange Act Class against the Auditor Defendant SEK.

607. As "independent auditors" of the Company SEK had a duty to examine Orrstown and the Bank's financial statements in accordance with the PCAOB to determine, among other things, whether the management prepared

financials were presented in accordance with GAAP. Further, in connection therewith SEK had a duty to disclose to management any defects in the system of internal controls.

608. At all relevant times SEK made, prepared, disseminated and/or approved statements contained in reports and other documents the Company filed with the SEC which were, at the time in light of the circumstances under which they were made, false and misleading with respect to material facts. SEK falsely represented that it had audited Orrstown and the Bank's financials in accordance with PCAOB, when in fact its audits had not complied with PCAOB. SEK falsely certified Orrstown and the Bank's financial statements for years 2009, 2010 and 2011 as having been in accordance with GAAP without any material weaknesses, when it knew or recklessly failed to know that these reports contained statements that were materially false and misleading.

609. As Orrstown was a public company, SEK knew and understood that its reports concerning the Company's financial statements would be distributed to the investing public, and that the investors would rely and had a right to rely on such reports. SEK knew and understood that its audit opinions would be included and constituted material parts of the Company's annual reports on Form 10-K filed with the SEC and with the Company's Registration Statement filed with the SEC in connection with the March 2010 Offering.

610. In auditing the Company's financial statements SEK disregarded, in violation of PCAOB, glaring irregularities in the Company's books and records and system of internal controls. SEK falsely represented to investors that it had audited the Company's financials in accordance with PCAOB, and that the Company's financial statements were presented in accordance with GAAP without material weaknesses when it issued unqualified audit opinions in connection with the Company's financial statements during the Class Period.

611. SEK's actions in disregarding these glaring irregularities, holding out to the public and the SEC that it had conducted the audits in accordance with PCAOB, and certifying the Company's financial statements as prepared in accordance with GAAP without material weaknesses were intentional or, at a minimum, reckless.

612. By virtue of its position as independent auditor of Orrstown and the Bank, SEK had access to key employees of the Company and continual access to and knowledge of the Company's confidential corporate, financial, operating, and business information at all relevant times. SEK knew or recklessly disregarded the Company's true financial and operating condition, and intentionally or recklessly failed to take steps which, as the independent auditor, it could and should have taken to fully and fairly disclose the true facts to the public.

613. Throughout the Class Period, SEK knew or was reckless in not knowing that the Company’s internal controls for classifying impaired loans and allocation loan loss reviews was faulty. Nevertheless, SEK continued to certify financial statements whose accuracy was dependent, in material part, on these accounting practices.

614. In sum, SEK either knew or recklessly disregarded the facts which indicated that Orrstown and the Bank’s financial statements were materially false and misleading, and issued unqualified opinions on 2009, 2010 and 2011 financial statements when such financial statements materially understated the Company's Risk Assets, loan loss reserves and net income.

615. SEK's scienter is further evidenced by the magnitude by which the Company's Risk Assets (e.g. loans with deteriorated credit quality) and loan loss reserves were misstated during the Class Period. Absent intentional or reckless conduct SEK would have detected these misstatements during the course of its audits and either taken corrective action or declined to issue unqualified audit opinions.

616. These materially false and misleading statements proximately caused Plaintiff and the Class to purchase Orrstown's common stock at artificially inflated prices throughout the Class Period, and thereby proximately caused Plaintiff and the Class to suffer damages.

617. The fraudulent activity alleged in this Count constituted a manipulative or deceptive device in violation of Section 10(b) of the Exchange Act, and a device, scheme, or artifice to defraud, prohibited by Rule 10b-5.

COUNT VII
(For Violation of § 20(a) of the Exchange Act Against Orrstown Exchange Act Defendants Quinn, Everly and Embly)

618. Plaintiff brings this claim on behalf of itself and the members of the Exchange Act Class against the Orrstown Exchange Act Defendants Quinn, Everly and Embly.

619. The Defendants Quinn, Everly and Embly acted as controlling persons of Orrstown within the meaning of Section 20(a) of the Exchange Act. By virtue of their power to control public statements about Orrstown, Defendants Quinn, Everly and Embly had the power and authority to control Orrstown and its employees.

620. During the Class Period, Defendants Quinn, Everly and Embly knew or were reckless in not knowing that the Company's financial statements contained untrue statements of material fact and/or omitted material facts required to be stated therein to make them not misleading.

621. At the time that Plaintiff and members of the Class purchased Orrstown's common stock they did not know of any of the false and/or misleading statements and omissions, and relied upon the representations made by the Company and Defendants Quinn, Everly and Embly.

622. As a direct and proximate result of the wrongful conduct of Defendants Quinn, Everly and Embly, Plaintiff and the Class suffered damages by purchasing Orrstown stock at artificially inflated prices.

623. By virtue of their positions as control persons, Defendants Quinn, Everly and Embly are liable pursuant to Section 20(a) of the Exchange Act.

624. By reason of such conduct, Quinn, Everly and Embly are liable pursuant to Section 20(a) of the Exchange Act.

XIII. PRAYER FOR RELIEF

A. Declaring this action to be a proper class action pursuant to Rule 23 of the Federal Rules of Civil Procedure;

B. Certifying class of investors to pursue claims under the Securities Act and Exchange Act;

C. Awarding Plaintiff and members of the Classes damages and interest;

D. Awarding Plaintiff's reasonable costs, including attorneys' fees; and

E. Awarding such equitable/injunctive or other relief as the Court may deem just and proper.

XIV. JURY TRIAL DEMANDED

Plaintiff hereby demands a trial by jury.

Dated: April 11, 2019

Respectfully submitted,

CHIMICLES SCHWARTZ KRINER & DONALDSON-SMITH LLP

/s/ Nicholas E. Chimicles
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EXHIBIT A

EX-10.1 2 ex10-1.htm EXHIBIT 10.1 - AGREEMENT

UNITED STATES OF AMERICA
BEFORE THE
BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D.C.

Written Agreement by and among ORRSTOWN FINANCIAL SERVICES, INC. Shippensburg, Pennsylvania ORRSTOWN BANK Shippensburg, Pennsylvania and FEDERAL RESERVE BANK OF PHILADELPHIA Philadelphia, Pennsylvania	Docket No. 12-021-WA/RB-HC 12-021-WA/RB-SMB

WHEREAS, in recognition of their common goal to maintain the financial soundness of Orrstown Financial Services, Inc, Shippensburg, Pennsylvania ("Orrstown"), a registered bank holding company, and its subsidiary bank, Orrstown Bank, Shippensburg, Pennsylvania (the "Bank"), a state-chartered bank that is a member of the Federal Reserve System, Orrstown, the Bank, and the Federal Reserve Bank of Philadelphia (the "Reserve Bank") have mutually agreed to enter into this Written Agreement (the "Agreement"); and

WHEREAS, on March 22, 2012, Orrstown's and the Bank's boards of directors, at duly constituted meetings, adopted resolutions authorizing and directing Thomas Quinn to consent to this Agreement on behalf of Orrstown and the Bank, and consenting to compliance with each and every applicable provision of this Agreement by Orrstown, the Bank, and their institution-affiliated parties, as defined in sections 3(u) and 8(b)(3)

of the Federal Deposit Insurance Act, as amended (the "FDI Act") (12 U.S.C. §§ 1813(u) and 1818(b)(3)).

NOW, THEREFORE, Orrstown, the Bank, and the Reserve Bank agree as follows:

Source of Strength

1. The board of directors of Orrstown shall take appropriate steps to fully utilize Orrstown's financial and managerial resources, pursuant to section 38A of the FDI Act (12 U.S.C. § 1831*o*-1) and section 225.4(a) of Regulation Y of the Board of Governors of the Federal Reserve System (the "Board of Governors") (12 C.F.R. § 225.4(a)), to serve as a source of strength to the Bank, including, but not limited to, taking steps to ensure that the Bank complies with this Agreement and any other supervisory action taken by the Bank's federal or state regulators.

Board Oversight

2. Within 60 days of this Agreement, the board of directors of the Bank shall submit to the Reserve Bank a written plan to strengthen board oversight of the management and operations of the Bank. The plan shall, at a minimum, address, consider, and include:

(a) The actions that the board of directors will take to improve the Bank's condition and maintain effective control over, and supervision of, the Bank's major operations and activities, including but not limited to, credit risk management, lending and credit administration, asset quality, liquidity, audit, capital, and earnings;

(b) the responsibility of the board of directors to monitor management's adherence to approved policies and procedures, and applicable laws and regulations and to monitor exceptions to approved policies and procedures;

(c) steps to improve the information and reports that will be regularly reviewed by the board of directors and its committees in their oversight of the operations and management of the Bank, including information on the Bank's credit risk management, lending and credit administration, adversely classified assets, interest only loans, allowance for loan and lease losses ("ALLL"), capital, liquidity, audit, and earnings; and

(d) the maintenance of adequate and complete minutes of all board and committee meetings.

Management Review

3. (a) Within 30 days of this Agreement, the board of directors of the Bank shall retain an independent consultant acceptable to the Reserve Bank to conduct a review of all management and staffing needs of the Bank and the qualifications and performance of all senior Bank management (the "Management Review"), and to prepare a written report of findings and recommendations (the "Report"). The primary purpose of the Management Review shall be to aid in the development of a suitable management structure that is adequately staffed by qualified and trained personnel.

(b) Within 10 days of the Reserve Bank's approval of the Bank's independent consultant selection, the Bank shall submit an engagement letter to the Reserve Bank for approval. The engagement letter shall require the independent consultant to submit the Report within 90 days of regulatory approval of the engagement letter and to provide a copy of the Report to the Reserve Bank at the same time that it is provided to the Bank's board of directors. The Review shall, at a minimum, address, consider, and include:

(i) the identification of the type and number of senior officers needed to manage and supervise properly the affairs of the Bank

(ii) an evaluation of each senior officer to determine whether the individual possesses the ability, experience, and other qualifications to competently perform present and anticipated duties, including their ability to: adhere to applicable laws and regulations and the Bank's established policies and procedures; restore and maintain the Bank to a safe and sound condition; and comply with the requirements of this Agreement;

(iii) an evaluation of reporting lines within the management structure;

(iv) a management succession plan for key senior officers; and

(v) the identification of present and future management and staffing needs for each area of the Bank, particularly in the areas of credit risk management, lending and credit administration, loan review, and problem asset resolution.

4. Within 30 days of receipt of the Report, the Bank's board of directors shall submit a written management plan to the Reserve Bank that fully addresses the findings and recommendations in the Report and describes the specific actions that the board of directors proposes to take in order to strengthen the Bank's management, including, but not limited to plans to hire or appoint additional or replacement personnel

Credit Risk Management

5. Within 90 days of this Agreement, the Bank shall submit to the Reserve Bank an acceptable written plan to strengthen credit risk management practices. The plan shall, at a minimum, address, consider, and include:

(a) Procedures to identify, limit and manage concentrations of credit that are consistent with the Interagency Guidance on Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices, dated December 12, 2006 (SR 07-1);

(b) procedures for the timely and accurate identification of problem loans;

(c) enhancements to the internal loan grading system to ensure timely and accurate risk ratings;

(d) enhanced stress testing of loan and portfolio segments; and

(e) improvements to the Bank's management information systems to ensure that the board of directors and senior management obtain timely and accurate information regarding the condition of the Bank's loan portfolio.

Lending and Credit Administration

6. Within 60 days of this Agreement, the Bank shall submit to the Reserve Bank an acceptable written lending and credit administration program that shall, at a minimum, address, consider, and include:

(a) Loan underwriting and credit administration procedures that include and provide for, at a minimum, documented analysis of: (i) the borrower's repayment sources, global cash flow, and overall debt service ability; and (ii) the value of any collateral;

(b) procedures to ensure that appraisals conform to accepted appraisal standards, as defined in the Uniform Standards of Professional Appraisal Practice, and comply with the requirements of Subpart G of Regulation Y of the Board of Governors (12 C.F.R. Part 225, Subpart G) made applicable to state member banks by section 208.50 of Regulation H of the Board of Governors (12 C.F.R. § 208.50), and the Interagency Appraisal and Evaluation Guidelines, dated October 27, 1994 (SR 94-55);

(c) standards for interest-only loans;

(d) the appropriate use of interest reserves;

(e) policies and procedures to minimize and monitor underwriting and document exceptions;

(f) enhancements to the loan workout process to ensure that workout plans for problem loans are consistent with the Interagency Guidance on Prudent Commercial Real Estate Loan Workouts, dated October 30, 2009 (SR 09-7);

(g) standards for renewing, extending or modifying existing loans;

(h) standards for the timely movement of loans to non-accrual status;

(i) compensation standards for loan origination officers that include an assessment of loan performance; and

(j) the appropriate accounting treatment of costs incurred in connection with the maintenance and sale of collateral.

Asset Improvement

7. The Bank shall not, directly or indirectly, extend, renew, or restructure any credit to or for the benefit of any borrower, including any related interest of the borrower, whose loans or other extensions of credit are criticized in the report of the joint examination conducted by the Reserve Bank and the Pennsylvania Department of Banking that commenced on May 16, 2011 (the "Report of Examination") or in any subsequent report of examination, without the prior approval of a majority of the full board of directors or a designated committee thereof. The board of directors or its committee shall document in writing the reasons for the extension of credit, renewal, or restructuring, specifically certifying that: (i) the Bank's risk management policies and practices for loan workout activity are acceptable; (ii) the extension of credit is necessary to improve and protect the Bank's interest in the ultimate collection of the credit already granted and maximize its potential for collection; (iii) the extension of credit reflects prudent underwriting based on reasonable repayment terms and is adequately secured; and all necessary loan documentation has been properly and accurately prepared and filed; (iv) the Bank

has performed a comprehensive credit analysis indicating that the borrower has the willingness and ability to repay the debt as supported by an adequate workout plan, as necessary; and (v) the board of directors or its designated committee reasonably believes that the extension of credit will not impair the Bank's interest in obtaining repayment of the already outstanding credit and that the extension of credit or renewal will be repaid according to its terms. The written certification shall be made a part of the minutes of the meetings of the board of directors or its committee, as appropriate, and a copy of the signed certification, together with the credit analysis and related information that was used in the determination, shall be retained by the Bank in the borrower's credit file for subsequent supervisory review.

8. (a) Within 60 days of this Agreement, the Bank shall submit to the Reserve Bank an acceptable written plan designed to improve the Bank's position through repayment, amortization, liquidation, additional collateral, or other means on each loan, relationship, or other asset in excess of $750,000, including other real estate owned ("OREO"), that (i) is past due as to principal or interest more than 90 days as of the date of this Agreement; (ii) is on the Bank's problem loan list; or (iii) was adversely classified in the Report of Examination.

(b) Within 30 days of the date that any additional loan, relationship, or other asset in excess of $750,000, including OREO, becomes past due as to principal or interest for more than 90 days, is on the Bank's problem loan list, or is adversely classified in any subsequent report of examination of the Bank, the Bank shall submit to the Reserve Bank an acceptable written plan to improve the Bank's position on such loan or asset.

(c) Within 45 days after the end of each calendar quarter thereafter, the Bank shall submit a written progress report to the Reserve Bank to update each asset improvement plan, which shall include, at a minimum, the carrying value of the loan or other asset and

changes in the nature and value of supporting collateral, along with a copy of the Bank's current problem loan list, a list of all loan renewals and extensions without full collection of interest in the last quarter, and past due/non-accrual report.

Allowance for Loan and Lease Losses

9. (a) The Bank shall, within 30 days from the receipt of any federal or state report of examination, charge off all assets classified "loss" unless otherwise approved in writing by the Reserve Bank.

(b) Within 60 days of this Agreement, the Bank shall review and revise its ALLL methodology consistent with relevant supervisory guidance, including the Interagency Policy Statements on the Allowance for Loan and Lease Losses, dated July 2, 2001 (SR 01-17 (Sup)) and December 13, 2006 (SR 06-17), and the findings and recommendations regarding the ALLL set forth in the Report of Examination, and submit a description of the revised methodology to the Reserve Bank. The revised ALLL methodology shall be designed to maintain an adequate ALLL and shall address, consider, and include, at a minimum, the reliability of the Bank's loan grading system, the volume of criticized loans, concentrations of credit, the current level of past due and nonperforming loans, past loan loss experience, evaluation of probable losses in the Bank's loan portfolio, including adversely classified loans, and the impact of market conditions on loan and collateral valuations and collectibility.

(c) Within 60 days of this Agreement, the Bank shall submit to the Reserve Bank an acceptable written program for the maintenance of an adequate ALLL. The program shall include policies and procedures to ensure adherence to the revised ALLL methodology and provide for periodic reviews and updates to the ALLL methodology, as appropriate. The program shall also provide for a review of the ALLL by the board of directors on at least a

quarterly calendar basis. Any deficiency found in the ALLL shall be remedied in the quarter it is discovered, prior to the filing of the Consolidated Reports of Condition and Income, by additional provisions. The board of directors shall maintain written documentation of its review, including the factors considered and conclusions reached by the Bank in determining the adequacy of the ALLL. During the term of this Agreement, the Bank shall submit to the Reserve Bank, within 30 days after the end of each calendar quarter, a written report regarding the board of directors' quarterly review of the ALLL and a description of any changes to the methodology used in determining the amount of ALLL for that quarter.

Capital Plan

10. Within 90 days of this Agreement, Orrstown shall submit to the Reserve Bank an acceptable written plan to maintain sufficient capital at Orrstown on a consolidated basis, and Orrstown and the Bank shall submit an acceptable joint written plan to maintain sufficient capital at the Bank as a separate legal entity on a stand-alone basis. The plans shall, at a minimum, address, consider, and include:

(a) Orrstown's current and future capital requirements, including compliance with the Capital Adequacy Guidelines for Bank Holding Companies: Risk-Based Measure and Tier 1 Leverage Measure, Appendices A and D of Regulation Y of the Board of Governors (12 C.F.R. Part 225, App. A and D);

(b) the Bank's current and future capital requirements, including compliance with the Capital Adequacy Guidelines for State Member Banks: Risk-Based Measure and Tier 1 Leverage Measure, Appendices A and B of Regulation H of the Board of Governors (12 C.F.R. Part 208, App. A and B);

(c) the adequacy of the Bank's capital, taking into account the volume of classified assets, concentrations of credit, the adequacy of the ALLL, current and projected asset growth, projected retained earnings, and anticipated and contingency funding needs;

(d) the source and timing of additional funds to fulfill Orrstown's and the Bank's future capital requirements; and

(e) the requirements of section 225.4(a) of Regulation Y of the Board of Governors that Orrstown serve as a source of strength to the Bank.

11. Orrstown and the Bank shall notify the Reserve Bank, in writing, no more than 30 days after the end of any calendar quarter in which any of Orrstown's consolidated capital ratios or the Bank's capital ratios (total risk-based, Tier 1 risk-based, or leverage) fall below the approved capital plan's minimum ratios. No more than 60 days after the end of any such calendar quarter, Orrstown and the Bank shall submit an acceptable written plan that details the steps Orrstown or the Bank, as appropriate, will take to increase Orrstown's or the Bank's capital ratios to or above the approved capital plan's minimums.

Internal Audit

12. Within 60 days of this Agreement, the Bank shall submit to the Reserve Bank an acceptable enhanced written internal audit program that shall, at a minimum, provide for:

(a) Improved oversight of all aspects of the audit program by the board of directors' audit committee;

(b) timely resolution of audit findings and follow-up reviews to ensure completion of corrective measures; and

(c) comprehensive tracking and reporting of the status and resolution of audit and examination findings to the audit committee.

Strategic Plan and Budget

13. (a) Within 90 days of this Agreement, the Bank shall submit to the Reserve Bank a strategic plan to improve the Bank's earnings and a budget for 2012. The written plan and budget shall include, but not be limited to:

(i) Identification of the major areas where, and means by which, the board of directors will seek to improve the Bank's operating performance;

(ii) a realistic and comprehensive budget for the remainder of calenda year 2012, including income statement and balance sheet projections; and

(iii) a description of the operating assumptions that form the basis for, and adequately support, major projected income, expense, and balance sheet components.

(b) A strategic plan and budget for each calendar year subsequent to 2012 shall be submitted to the Reserve Bank at least 30 days prior to the beginning of that calendar year.

Liquidity and Funds Management

14. Within 60 days of this Agreement, the Bank shall submit to the Reserve Bank an acceptable revised written contingency funding plan that, at a minimum, identifies available sources of liquidity and includes adverse scenario planning.

Interest Rate Risk Management

15. Within 60 days of this Agreement, the Bank shall submit to the Reserve Bank an acceptable written plan to improve interest rate risk management practices that are appropriate for the size and complexity of the Bank. The plan shall, at a minimum, include procedures and controls to ensure that the inputs and assumptions used to model and control

the vulnerability of the Bank's net interest income due to changes in interest rates are accurate and reflect the Bank's current balance sheet structure and market conditions.

Dividends and Payments

16. (a) Orrstown and the Bank shall not declare or pay any dividends without the prior written approval of the Reserve Bank and the Director of the Division of Banking Supervision and Regulation of the Board of Governors.

(b) Orrstown shall not take any other form of payment representing a reduction in capital from the Bank without the prior written approval of the Reserve Bank.

(c) All requests for prior approval shall be received at least 30 days prior to the proposed dividend declaration date. All requests shall contain, at a minimum, current and projected information, as appropriate, on the parent's capital, earnings, and cash flow; the Bank's capital, asset quality, earnings and ALLL needs; and identification of the sources of funds for the proposed payment or distribution. For requests to declare or pay dividends, Orrstown and the Bank, as appropriate, must also demonstrate that the requested declaration or payment of dividends is consistent with the Board of Governors' Policy Statement on the Payment of Cash Dividends by State Member Banks and Bank Holding Companies, dated November 14, 1985 (Federal Reserve Regulatory Service, 4-877 at page 4-323).

Debt and Stock Redemption

17. (a) Orrstown shall not, directly or indirectly, incur, increase, or guarantee any debt without the prior written approval of the Reserve Bank. All requests for prior written approval shall contain, but not be limited to, a statement regarding the purpose of the debt, the terms of the debt, and the planned source(s) for debt repayment, and an analysis of the cash flow resources available to meet such debt repayment.

(b) Orrstown shall not, directly or indirectly, purchase or redeem any shares of its stock without the prior written approval of the Reserve Bank.

Compliance with Laws and Regulations

18. (a) In appointing any new director or senior executive officer, or changing the responsibilities of any senior executive officer so that the officer would assume a different senior executive officer position, the Bank shall comply with the notice provisions of section 32 of the FDI Act (12 U.S.C. § 1831i) and Subpart H of Regulation Y of the Board of Governors (12 C.F.R. §§ 225.71 *et seq.*).

(b) The Bank shall comply with the restrictions on indemnification and severance payments of section 18(k) of the FDI Act (12 U.S.C. § 1828(k)) and Part 359 of the Federal Deposit Insurance Corporation's regulations (12 C.F.R. Part 359).

Compliance with the Agreement

19. Within 30 days after the end of each calendar quarter following the date of this Agreement, the boards of directors of Orrstown and the Bank shall jointly submit to the Reserve Bank written progress reports detailing the form and manner of all actions taken to secure compliance with this Agreement and the results thereof.

Approval and Implementation of Plans, Programs, and Engagement Letter

20. (a) The Bank, and as applicable, Orrstown, shall submit written plans, programs, and engagement letter that are acceptable to the Reserve Bank within the applicable time periods set forth in paragraphs 3(b), 5, 6, 8(a), 9(c), 10, 12, 14, and 15 of this Agreement.

(b) Within 30 days of approval by the Reserve Bank, the Bank, and as applicable Orrstown, shall adopt the approved plans, programs, and engagement letter. Upon

adoption, the Bank, and as applicable Orrstown, shall promptly implement the approved plans and programs and thereafter fully comply with them.

(c) During the term of this Agreement, the approved plans, programs, and engagement letter shall not be amended or rescinded without the prior written approval of the Reserve Bank.

Communications

21. All communications regarding this Agreement shall be sent to:

(a) Mr. Christopher C. Henderson
Assistant Vice President
Federal Reserve Bank of Philadelphia
Ten Independence Mall
Philadelphia, Pennsylvania 19106

(b) Mr. Thomas R. Quinn, Jr.
President and Chief Executive Officer
Orrstown Financial Services, Inc. and Orrstown Bank
77 East King Street
Shippensburg, Pennsylvania 17244

Miscellaneous

22. Notwithstanding any provision of this Agreement, the Reserve Bank may, in its sole discretion, grant written extensions of time to Orrstown and the Bank to comply with any provision of this Agreement.

23. The provisions of this Agreement shall be binding upon Orrstown and the Bank and their institution-affiliated parties, in their capacities as such, and their successors and assigns.

24. Each provision of this Agreement shall remain effective and enforceable until stayed, modified, terminated, or suspended in writing by the Reserve Bank.

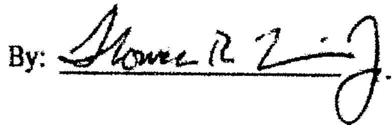
25. The provisions of this Agreement shall not bar, estop, or otherwise prevent the Board of Governors, the Reserve Bank, or any other federal or state agency from taking any

other action affecting Orrstown and the Bank or any of their current or former institution-affiliated parties and their successors and assigns.

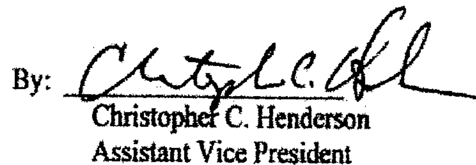
26. Pursuant to section 50 of the FDI Act (12 U.S.C. § 1831aa), this Agreement is enforceable by the Board of Governors under section 8 of the FDI Act (12 U.S.C. § 1818).

IN WITNESS WHEREOF, the parties have caused this Agreement to be executed as of the 22 day of March, 2012.

ORRSTOWN FINANCIAL SERVICES, INC.

By: 

FEDERAL RESERVE BANK OF PHILADELPHIA

By: 
Christopher C. Henderson
Assistant Vice President

ORRSTOWN BANK

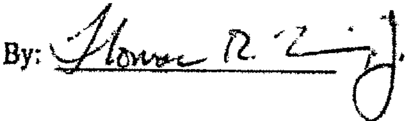
By: 

EXHIBIT B

EX-10.2 3 ex10-2.htm EXHIBIT 10.2 - CONSENT ORDER

COMMONWEALTH OF PENNSYLVANIA
DEPARTMENT OF BANKING

Commonwealth of Pennsylvania, Department of Banking, Bureau of Commercial Institutions	
v.	**Docket No.: 12 __________ (ENF-ORD)**
Orrstown Bank	

CONSENT ORDER

WHEREAS, Orrstown Bank, Shippensburg, Pennsylvania (the "Bank"), is a Pennsylvania state-chartered bank and subject to regulation by the Commonwealth of Pennsylvania Department of Banking (the "Department") and the Federal Reserve Bank of Philadelphia (the "Federal Reserve");

WHEREAS, the Bureau of Commercial Institutions (the "Bureau") is primarily responsible within the Department for the regulation and supervision of the Bank;

WHEREAS, the Bank was the subject of a Joint Report of Examination by the Bureau and the Federal Reserve as of March 31, 2011 (the "Report of Examination");

WHEREAS, the Report of Examination gave the Bureau the reason to believe that the Bank had engaged in unsafe or unsound banking practices or violations of law or policy; and,

WHEREAS, the Bank, without admitting or denying wrongdoing as more fully set forth in the Stipulation of Consent and Entry of Order executed by the Bank, agrees to the issuance of this Consent Order (the "Order") by the Bureau.

IT IS HEREBY ORDERED, pursuant to Section 501.A of the Department of Banking Code, 71 P.S. § 733-501.A, that the Bank, its directors, officers, employees, agents, and other

proposed replacement personnel, and must be received at least 30 days prior to the individual(s) assuming the "senior executive officer" position(s).

2. Board and Management.

(a) Within 30 days from the effective date of this Order, the Bank shall retain an independent consultant who is acceptable to the Bureau and who will develop a written analysis and assessment of the Bank's management needs ("Management Report") for the purpose of providing aid in the development of a suitable management structure that is adequately staffed by qualified and trained personnel.

(b) Prior to retaining the independent consultant, the Bank shall provide the Bureau with a copy of the proposed engagement letter or contract with the third party for non-objection or comment before it is executed. The contract or engagement letter shall include, at a minimum:

(i) a description of the work to be performed under the contract or engagement letter, the fees for each significant element of the engagement, and the aggregate fee;

(ii) the responsibilities of the firm or individual;

(iii) identification of the professional standards covering the work to be performed;

(iv) identification of the specific procedures to be used when carrying out the work to be performed;

(v) the qualifications of the employee(s) who are to perform the work;

(vi) the time frame for completion of the work;

(vii) any restrictions on the use of the reported findings;

(viii) a provision for unrestricted examiner access to work papers; and

(ix) a certification that the firm or individual is not affiliated in any manner with the Bank.

(c) The Management Report shall be developed within 120 days from the effective date of this Order and shall include, at a minimum:

(i) identification of both the type and number of officer positions needed to properly manage and supervise the affairs of the Bank;

(ii) identification and establishment of such Bank committees as are needed to provide guidance and oversight to active management;

(iii) an evaluation of each existing director and senior officer to determine whether these individuals possess the ability, experience, and other qualifications required to perform present and anticipated duties, including adherence to the Bank's established policies and practices, and restoration and maintenance of the Bank in a safe and sound condition;

(iii) evaluation of all Bank officers' compensation, including salaries, director fees, and other benefits;

(v) a current organization chart that identifies all existing and proposed staff and officer positions, delineates related lines of authority and accountability, and establishes a written plan for addressing any identified needs;

(vi) a management succession plan; and,

"institution-affiliated parties," as that term is defined in Section 3(u) of the FDIA, 12 U.S.C. § 1813(u), and its successors and assigns, shall take the following affirmative action:

1. Board Participation.

(a) The Board shall strengthen Board oversight of the management and operations of the Bank, with full responsibility for the approval of sound policies and objectives and for the supervision of all of the Bank's activities, consistent with the role and expertise commonly expected for directors of banks of comparable size.

(b) This participation shall include meetings to be held no less frequently than monthly at which, at a minimum, the following areas shall be reviewed and approved: reports of income and expenses; new, overdue, renewal, insider, charged off, and recovered loans; investment activity; liquidity levels and funds management; adoption or modification of operating policies; individual committee reports; audit reports; internal control reviews including management's responses; reconciliation of general ledger accounts; oversight and supervision over third-party service providers; oversight of the Bank's compliance program; oversight of the Bank's BSA program, including management's responses to recommendations from all external or internal audits or reviews, which shall be included as part of the Progress Reports required by the Order; and compliance with this Order. Board minutes shall document these reviews and approvals, including the names of any dissenting directors.

(c) The Bank shall notify the Bureau in writing of any additions, resignations, or terminations of any members of its Board or any of its "senior executive officers" (as that term is defined in 12 C.F.R. 225.71) within 10 days of the event. Any notification required by this subparagraph shall include a description of the background(s) and experience of any

(vii) a plan to recruit and hire any additional or replacement personnel with the requisite ability, experience, and other qualifications to fill those officer or staff member positions identified in the Management Report.

(d) Within 60 days from receipt of the Management Report, the Bank shall formulate a written plan ("Management Plan") that incorporates the findings of the Management Report, a plan of action in response to each recommendation contained in the Management Report, and a time frame for completing each action. At a minimum, the Management Plan shall:

(i) contain a recitation of the recommendations included in the Management Report, a plan of action to respond to each recommendation, and a time frame for completing each action;

(ii) include provisions to implement necessary training and development for all employees;

(iii) establish procedures to periodically review and update the Management Plan, as well as periodically review and assess the performance of each officer and staff member; and

(iv) contain a current management succession plan.

(e) The Management Plan shall be submitted to the Bureau for non-objection or comment. Within 30 days from receipt of non-objection or any comments from the Bureau, and after incorporation of all comments, the Board shall approve the Management Plan, which approval shall be recorded in the minutes of the Board meeting. Thereafter, the Bank shall implement and fully comply with the Management Plan.

3. Classified Asset Reduction.

(a) Within 60 days from the effective date of this Order, the Bank shall formulate and submit for review as described in subparagraph (c), a written plan ("Classified Asset Plan") to reduce the Bank's risk position in each loan relationship or other real estate owned property in excess of $750,000 which is classified "Substandard" or "Doubtful" in the Report of Examination. For purposes of this provision, "reduce" means to collect, charge off, or improve the quality of an asset so as to warrant its removal from adverse classification.

(b) The Classified Asset Plan shall include, at a minimum, the following:

(i) an action plan to review, analyze and document the current financial condition of each classified borrower with loans classified "Substandard," "Doubtful" or "Loss," including source of repayment, repayment ability, and alternative repayment sources, as well as the value and accessibility of any pledged or assigned collateral, and any possible actions to improve the Bank's collateral position;

(ii) a schedule showing, on a quarterly basis, the expected consolidated balance of all adversely classified assets, and the ratio of the consolidated balance to the Bank's projected Tier 1 Capital plus the allowance for loan and lease losses ("ALLL");

(iii) specific action plans intended to reduce the Bank's risk exposure in each classified asset;

(iv) delineation of areas of responsibility for loan officers; and

(v) provision for the submission of monthly written progress reports to the Board for review and notation in minutes of the Board meetings.

(c) The Classified Asset Plan shall be submitted to the Bureau for non-objection or comment. Within 30 days from receipt of non-objection or any comments from the Bureau, and after incorporation of all comments, the Board shall adopt the Classified Asset Plan, which adoption shall be recorded in the minutes of the Board meeting. Thereafter, the Bank shall implement and fully comply with the Classified Asset Plan.

(d) The Bank shall not extend, directly or indirectly, any additional credit to, or for the benefit of, any borrower who is already obligated in any manner to the Bank on any extensions of credit (including any portion thereof) that have been charged off the books of the Bank or classified "Loss" in the current or any future report of examination, so long as such credit remains uncollected, unless it receives the prior written consent of the Bureau.

(e) The Bank shall not extend, directly or indirectly, any additional credit to, or for the benefit of, any borrower whose loan or other credit has been classified "Substandard" or "Doubtful" or is listed for "Special Mention" in the current or any future report of examination, and is uncollected, unless the Board documents , in writing, the reasons why the extension is in the best interest of the Bank. Prior to extending additional credit pursuant to this subparagraph, whether in the form of a renewal, extension, or further advance of funds, such additional credit shall be approved by the Board, or a designated committee thereof, which shall determine that:

(i) the failure of the Bank to extend such credit would be detrimental to the best interests of the Bank, with a written explanation of why the failure to extend such credit would be detrimental;

(ii) the extension of such credit would improve the Bank's position, with a written explanatory statement of how and why the Bank's position would improve; and,

(iii) an appropriate workout plan has been developed and will be implemented in conjunction with the additional credit to be extended.

(f) The Board's or designated committee's determinations and approval shall be recorded in the meeting minutes of the Board or designated committee, and copies shall be submitted to the Bureau at such times as the Bank submits the Progress Reports required by this Order or sooner upon the written request of the Bureau.

4. Allowance for Loan and Lease Losses.

(a) The Bank shall eliminate from its books, by charge-off or collection, all assets or portions of assets classified "Loss" by the Bureau in the current Report of Examination that have not been previously collected or charged off. Elimination or reduction of such assets with the proceeds of other Bank extensions of credit shall not be considered "collection" for purposes of this paragraph. Thereafter, within 30 days after the receipt of any report of examination or target examination report from the Bureau, the Bank shall eliminate from its books, by charge-off or collection, all assets or portions of assets classified "Loss" in any report of examination or target examination report issued while this Order remains in effect, to the extent that such loans have not previously been collected or charged off.

(b) Within 60 days from the effective date of this Order, the Bank shall develop or enhance and submit to the Bureau for review, as described in subparagraph (d), a comprehensive policy and methodology for determining the ALLL ("ALLL Policy") that incorporates the comments set forth in the Report of Examination. The ALLL Policy shall provide for a review of the ALLL at least once each calendar quarter. Said review should be completed within 30 days following the end of each calendar quarter, so the results of the review conducted by the Board may be properly reported in the quarterly Consolidated Reports of Condition and Income ("Call Report"). Such reviews shall, at a minimum, be made in accordance with:

(i) Financial Accounting Standards Board ("FASB") Statements Numbers 5 and 114, as codified by FASB under its Accounting Standards Codification effective after September 15, 2009 (established by FASB Statement Number 168)("FASB 5 and 114");

(ii) the Federal Financial Institutions Examination Council's ("FFIEC") Instructions for the Consolidated Reports of Condition and Income;

(iii) the *Interagency Statement of Policy on the Allowance for Loan and Lease Losses* (SR 01-17 (SUP), issued July 2, 2001 and SR 06-17, issued December 13, 2006);

(iv) other applicable regulatory guidance that addresses the appropriateness of the Bank's ALLL; and

(v) any analysis of the Bank's ALLL provided by the Bureau.

(c) Such reviews shall include, at a minimum:

(i) the Bank's loan loss experience;

(ii) an estimate of the potential loss exposure in the portfolio; and

(iii) trends of delinquent and non-accrual loans and prevailing and prospective economic conditions.

(d) The minutes of the Board meetings at which such reviews are undertaken shall include complete details of the reviews and the resulting recommended adjustment in the ALLL. The Board shall document in the minutes the basis for any determination not to require provisions for loan losses in accordance with subparagraphs (a) and (b).

(e) The ALLL Policy shall be submitted to the Bureau for non-objection or comment. Within 30 days from receipt of non-objection or any comments from the Bureau, and after incorporation of all comments, the Board shall adopt the ALLL Policy, which adoption shall be recorded in the minutes of the Board meeting. Thereafter, the Bank shall implement and fully comply with the ALLL Policy.

(f) A deficiency in the ALLL shall be remedied in the calendar quarter in which it is discovered by a change to current operating earnings prior to any Tier 1 Capital determinations required by this Order; and prior to the Bank's submission of its Call Report. The Bank shall thereafter maintain an appropriate ALLL.

(g) The analysis supporting the determination of the adequacy of the ALLL shall be submitted to the Bureau within 30 days after the end of each calendar quarter.

5. Lending and Credit Administration. Within 90 days of the effective date of this Order, the Bank shall submit to the Bureau an acceptable written plan to strengthen credit risk management practices. The plan shall, at a minimum, address, consider, and include:

(a) Procedures to identify, limit and manage concentrations of credit that are consistent with the *Interagency Guidance on Concentrations in Commercial Real Estate Lending, Sound Risk Management Policies*, (SR-07-1, issued December 12, 2006);

(b) Procedures for the timely and accurate identification of problem loans;

(c) Enhancements to the internal loan grading system to ensure timely and accurate risk ratings;

(d) Enhanced stress testing of loan and portfolio segments; and,

(e) Improvements to the Bank's management information systems to ensure that the board of directors and senior management obtain timely and accurate information regarding the condition of the Bank's loan portfolio.

6. Correction of Loan Documentation Exceptions.

(a) Within 60 days from the effective date of this Order, the Bank shall adopt policies and procedures to minimize and monitor loan documentation exceptions as well as to identify and correct outstanding exceptions noted in the Report of Examination.

(b) Progress reports detailing each outstanding exception and the Bank's plan for corrective action shall be submitted to the Board for review during each regularly scheduled meeting. The review shall be noted in the minutes of the meeting of the Board.

7. Concentration of Credit–Commercial Real Estate.

(a) Within 90 days from the effective date of this Order, the Bank shall develop and submit to the Bureau for review, as described in subparagraph (c), a written plan to

identify, limit and manage the Bank's commercial real estate ("CRE") loan concentration of credit to an amount which is commensurate with the Bank's business strategy, management expertise, size, and location ("CRE Concentration Plan").

(b) The CRE Concentration Plan shall include, at a minimum:

(i) provisions requiring compliance with the *Interagency Guidance on Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices* (SR 07-1, issued December 12, 2006);

(i) provisions for controlling and monitoring of CRE, including plans to address the rationale for CRE levels as they relate to growth and capital targets, and segmentation and testing of the CRE portfolio to detect and limit concentrations with similar risk characteristics; and,

(iii) provisions for the submission of monthly written progress reports to the Board for review and notation in minutes of the Board meetings.

(c) The CRE Concentration Plan shall be submitted to the Bureau for non-objection or comment. Within 30 days from receipt of non-objection or any comments from the Bureau, and after incorporation of all comments, the Board shall adopt the CRE Concentration Plan, which adoption shall be recorded in the minutes of the Board meeting. Thereafter, the Bank shall implement and fully comply with the CRE Concentration Plan.

8. Capital.

(a) Within 90 days from the effective date of this Order, the Board shall develop a written capital plan ("Capital Plan"), subject to review and approval of the Bureau as described in subparagraph (c). At a minimum, the Capital Plan shall include specific benchmark Leverage Ratios, Tier 1 Risk-Based Capital Ratios, and Total Risk-Based Capital Ratios to be met at each calendar quarter end until the required capital levels are achieved. The Bank shall comply with the *Capital Adequacy Guidelines for State Member Banks: Risk Based Measures and Tier 1 Leverage Measure*, Appendices A and B of Regulation H of the Board of Governors (12 C.F.R. Part 208, App. A and B).

(b) In the event any required capital ratio falls below the minimum required by the approved Capital Plan, the Bank shall within 60 days after the end of any calendar quarter notify the Bureau and submit an acceptable plan that details the steps the Bank will take to increase the Bank's capital ratios to or above the approved capital plan's minimums.

(c) The Capital Plan shall be submitted to the Bureau or non-objection or comment. Within 30 days from receipt of non-objection or any comments from the Bureau, and after incorporation of all comments, the Board shall adopt the Capital Plan, which adoption shall be recorded in the minutes of the Board meeting. Thereafter, the Bank shall implement and fully comply with the Capital Plan.

(d) The Board shall review the Bank's adherence to the Capital Plan, at a minimum, on a monthly basis. Copies of the reviews and updates shall be submitted to the Bureau as part of the Progress Reports required by this Order, and any material changes to the Capital Plan shall be submitted to the Bureau no later than 10 days after completion.

9. Profit and Budget Plan.

(a) Within 90 days from the effective date of this Order, and within the first 30 days of each calendar year thereafter, the Bank shall develop and submit to the Bureau for review to the Bureau as described in subparagraph (c), a written profit and budget plan ("Profit Plan") consisting of goals and strategies, consistent with sound banking practices, and taking into account the Bank's other written plans, policies, or other actions as required by this Order.

(b) The Profit Plan shall include, at a minimum:

(i) a description of the operating assumptions that form the basis for, and adequately support, material projected revenue and expense components;

(ii) specific goals to maintain appropriate provisions to the ALLL;

(iii) realistic and comprehensive budgets for all categories of income and expense;

(iv) an executive compensation plan, addressing any and all salaries, bonuses and other benefits of every kind or nature whatsoever, both current and deferred, whether paid directly or indirectly, which plan incorporates qualitative as well as profitability performance standards for the Bank's senior executive officers;

(v) a budget review process to monitor the revenue and expenses of the Bank whereby actual performance is compared against budgetary projections not less than quarterly; and

(vi) recording the results of the budget review and any actions taken by the Bank as a result of the budget review in the Board minutes; and,

(vii) individual(s) responsible for implementing each of the goals and strategies of the Profit Plan.

(c) The Profit Plan shall be submitted to the Bureau for non-objection or comment. Within 30 days from receipt of non-objection or any comments from the Bureau, and after incorporation of all comments, the Board shall adopt the Profit Plan, which adoption shall be recorded in the minutes of the Board meeting. Thereafter, the Bank shall implement and fully comply with the Profit Plan.

(d) Within 30 days following the end of each calendar quarter following completion of the Profit Plan required by this paragraph, the Board shall evaluate the Bank's actual performance in relation to the Profit Plan, record the results of the evaluation, and note any actions taken by the Bank in the minutes of the Board's meeting at which such evaluation is undertaken.

10. Strategic Plan.

(a) Within 90 days of this Order, the Bank shall formulate a revised comprehensive written business/strategic plan ("Strategic Plan"), based on the Bank's financial information as of December 31, 2011, covering an operating period of at least three years. The Strategic Plan shall contain an assessment of the Bank's current financial condition and market area along with a description of the operating assumptions that form the basis for major projected income and expense components of the assessment.

(b) The Strategic Plan shall include short-term goals and operating plans to comply with the terms of this Order and correct all regulatory criticisms in the Report of Examination, intermediate goals and project plans, and long-range goals and project plans. Additionally, the Strategic Plan shall, at a minimum, include:

(i) strategies for pricing policies and asset/liability management;

(ii) anticipated average maturity and average yield on loans and securities, average maturity and average cost of deposits, the level of earning assets as a percentage of total assets, and the ratio of net interest income to average earning assets;

(iii) dollar volume of total loans, total investment securities, and total deposits;

(iv) plans for sustaining adequate liquidity, including back-up lines of credit to meet any unanticipated deposit withdrawals;

(v) financial goals including pro forma statements for asset growth, capital adequacy and earnings; and,

(vi) formulation of a mission statement and the development of a strategy to carry out that mission.

(c) The Board shall submit the Strategic Plan to the Bureau for review and comment. Within 30 days from receipt of any comment from the Bureau, and after due consideration of any recommended changes, the Board shall approve the Strategic Plan, which approval shall be recorded in the minutes of the Board meeting in which it is approved.

(d) The Bank shall implement and fully comply with the Strategic Plan after completion of the requirements of subparagraph (c) of this paragraph.

(e) Within 30 days from the end of each calendar quarter following the effective date of this Order, the Board shall evaluate the Bank's performance in relation to the Strategic Plan and record the results of the evaluation, and any actions taken by the Bank in the minutes of the Board meeting during which such evaluation is undertaken. In the event the Board determines that the Strategic Plan should be revised in any manner, the Strategic Plan shall be revised and submitted to the Bureau for review and comment within 30 days after such revisions have been approved by the Board.

(f) Within 30 days of receipt of any comments from the Bureau, and after consideration of all such comments, the Bank shall approve the revised Strategic Plan, which approval shall be recorded in the minutes of the Board meeting in which it is approved.

(g) The Board shall implement and fully comply with the revised Strategic Plan after completion of the requirements of subparagraph (f) of this paragraph.

11. Liquidity and Funds Management.

(a) Within 60 days from the effective date of this Order, the Bank shall revise its liquidity and funds management policy to strengthen the Bank's funds management procedures and maintain adequate provisions to meet the Bank's liquidity needs ("Liquidity and Funds Management Policy").

(b) The Liquidity and Funds Management Policy shall be submitted to the Bureau for non-objection or comment. Within 30 days from receipt of non-objection or any comments from the Bureau, and after incorporation of all comments, the Board shall adopt the Liquidity and Funds Management Policy, which adoption shall be recorded in the minutes of the Board meeting. Thereafter, the Bank shall implement and fully comply with the Liquidity and Funds Management Policy.

(c) The Bank shall review annually its Liquidity and Funds Management Policy for adequacy and, based upon such review, shall make necessary revisions to the policy.

12. Interest Rate Risk.

(a) Within 60 days from the effective date of this Order, the Bank shall develop and submit for review, as described in subparagraph (c), an interest rate risk policy and procedures ("IRR Policy") that shall include, at a minimum:

(i) measures designed to control the nature and amount of interest rate risk the Bank takes, including those that specify risk limits and define lines of responsibility and authority for managing risk;

(ii) a system for identifying and measuring interest rate risk;

(iii) a system for monitoring and reporting risk exposures; and

(iv) a system of internal controls, review, and audit to ensure the integrity of the overall risk management process.

(b) The IRR Policy shall address the exceptions noted in the current Report of Examination, comply with the FFIEC's *Advisory on Interest Rate Risk Management* (SR 10-1, issued January 11, 2010), the FFIEC's *Supervisory Policy Statement on Investment Securities and End-User Derivative Activities*, and the *Joint Agency Policy Statement on Interest Rate Risk* (SR 96-13, issued May 23, 1996).

(c) The IRR Policy shall be submitted to the Bureau for non-objection or comment. Within 30 days from receipt of non-objection or any comments from the Bureau, and after incorporation of all comments, the Board shall adopt the IRR Policy, which adoption shall be recorded in the minutes of the Board meeting. Thereafter, the Bank shall implement and fully comply with the IRR Policy.

13. Dividends. The Bank shall not declare or pay any cash dividends without the prior written approval of the Bureau. Requests for approval shall be received at least 30 days prior to the proposed date for the declaration of dividends and shall contain, but not be limited to, information on consolidated earnings for the most recent annual period and the last quarter.

14. Corrective Action. The Bank shall take all steps necessary, consistent with other provisions of this Order and sound banking practices, to eliminate, correct and prevent unsafe or unsound banking practices, violations of law or regulation, and all contraventions of regulatory policies or guidelines cited in the Report of Examination.

15. Fidelity Bond.

(a) Immediately upon renewal of the Bank's current bond required by 7 P.S. § 1410 (the "Bond"), the Bank shall provide a full and complete copy to the Bureau. The Bank shall provide a copy of the required Bond to the Bureau each time the Bond is renewed while this Order is in effect.

(b) The Bank shall immediately notify the Bureau of any notifications or information from the Bank's Bond insurance carrier, its agents and/or representatives that the Bond is not going to be renewed or will be terminated.

16. Oversight Committee. The Board shall establish a subcommittee of the Board ("Oversight Committee") charged with the responsibility of ensuring that the Bank complies with all of the provisions of this Order. The Oversight Committee shall submit a written report monthly to the full Board and a copy of the report and any discussion related to the report or the Order shall be included in the minutes of the Board meeting. Nothing contained herein shall diminish the responsibility of the entire Board to ensure compliance with the provisions of this Order.

17. Progress Reports. Within 30 days from the end of each calendar quarter following the effective date of this Order, the Bank shall furnish to the Bureau written Progress Reports detailing the form, manner, and results of any actions taken to secure compliance with this Order. All Progress Reports and other written responses to this Order shall be reviewed by the Board, and made a part of the Board minutes.

18. Section 403 Reports to the Bureau. All reports required to be submitted to the Bureau under this Order are special reports being required under Section 403 of the Department of Banking Code, 71 P.S. § 733-403, and shall be submitted to the Bureau in accordance with Section 403.B of the Department of Banking Code, 71 P.S. § 733-403.B.

19. Confidentiality. This Order and all reports and communications relating to this Order shall be confidential and shall not be released or divulged to any person or entity not officially connected to the Bank as a director, officer, attorney or employee without the express written permission of the Bureau. Notwithstanding the foregoing, the Bank may disclose the existence and contents of this Order under the provisions of 71 P.S. § 733-404.A, relating to disclosures required by federal and state securities laws.

20. Other Actions.

(a) If at any time the Department shall deem it appropriate in fulfilling the responsibilities placed upon the Department under applicable law to undertake any further action affecting the Bank, nothing in this Order shall in any way inhibit, estop, bar or otherwise prevent the Department from doing so.

(b) Nothing herein shall preclude any proceedings brought by the Department to enforce the terms of this Order, and that nothing herein constitutes, nor shall the Bank contend that it constitutes, a waiver of any right, power or authority of any other representatives of the

United States, departments or agencies thereof, Department of Justice, or any other representatives of the Commonwealth of Pennsylvania or any other departments or agencies thereof, including any prosecutorial agency, to bring other actions deemed appropriate.

21. Communications. All communications regarding this Order shall be sent to:

Robert C. Lopez, Director
Bureau of Commercial Institutions
Commonwealth of Pennsylvania
Department of Banking
17 North Second St., Suite 1300
Harrisburg, Pennsylvania 17101

22. Binding Nature. The provisions of this Order including the recital paragraphs shall be binding upon the Bank and all of their institution-affiliated parties, in their capacities as such, and their successors and assigns.

23. Effective Date. The effective date of this Order shall be the date upon which this Order has been executed by the Bureau. Each provision of this Order shall remain effective and enforceable, jointly and severally, until stayed, modified, terminated or suspended by the Bureau.

24. Titles. The titles used to identify the paragraphs of this document are for the convenience of reference only and do not control the interpretation of this document.

SO ORDERED

Date

Robert C. Lopez, Director
Bureau of Commercial Institutions
Commonwealth of Pennsylvania
Department of Banking
17 North Second Street, Suite 1300
Harrisburg, PA 17101

EXHIBIT C

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933
Release No. 10222 / September 27, 2016

SECURITIES EXCHANGE ACT OF 1934
Release No. 78947 / September 27, 2016

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 3807 / September 27, 2016

ADMINISTRATIVE PROCEEDING
File No. 3-17583

In the Matter of

ORRSTOWN FINANCIAL SERVICES, INC.,
THOMAS R. QUINN,
BRADLEY S. EVERLY, CPA,
JEFFREY W. EMBLY and
DOUGLAS P. BARTON, CPA,

Respondents.

ORDER INSTITUTING ADMINISTRATIVE AND CEASE-AND-DESIST PROCEEDINGS PURSUANT TO SECTION 8A OF THE SECURITIES ACT OF 1933, SECTIONS 4C AND 21C OF THE SECURITIES EXCHANGE ACT OF 1934 AND RULE 102(e) OF THE COMMISSION'S RULES OF PRACTICE, MAKING FINDINGS AND IMPOSING REMEDIAL SANCTIONS AND CEASE-AND-DESIST ORDERS

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 8A of the Securities Act of 1933 ("Securities Act") and Section 21C of the Securities Exchange Act of 1934 ("Exchange Act"), against Orrstown Financial Services, Inc. ("Orrstown"), Thomas R. Quinn ("Quinn"), Bradley S. Everly, CPA ("Everly"), Jeffrey W. Embly ("Embly") and Douglas P. Barton, CPA ("Barton") (collectively, "Respondents"), and that public administrative proceedings be, and hereby are, instituted against Everly pursuant to Section 4C of the Exchange Act and Rule 102(e)(1)(iii) of the Commission's Rules of Practice.

II.

In anticipation of the institution of these proceedings, Respondents have submitted Offers of Settlement (the "Offers") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over them and the subject matter of these proceedings, which are admitted, and except as provided herein in Section V, Respondents consent to the entry of this Order Instituting Administrative and Cease-and-Desist Proceedings Pursuant to Section 8A of the Securities Act of 1933, Sections 4C and 21C of the Securities Exchange Act of 1934 and Rule 102(e) of the Commission's Rules of Practice, Making Findings and Imposing Remedial Sanctions and Cease-and-Desist Orders ("Order"), as set forth below.

III.

On the basis of this Order and Respondents' Offers, the Commission finds[1] that:

SUMMARY

1. Orrstown Financial Services, Inc., is a publicly traded bank holding company whose principal business activity consists of owning and supervising its wholly owned subsidiary, Orrstown Bank (collectively, "Orrstown" or the "Bank"). Orrstown provides banking and bank related services, which include, among other things, commercial lending. As of December 31, 2010, approximately 75% of the Bank's $964 million loan portfolio consisted of commercial loans.

2. In 2010, as Orrstown's primary lending markets were experiencing a significant decline in real estate values, Orrstown incorrectly accounted for its commercial loans by not disclosing as much as approximately $69.5 million in loans as "impaired" in accordance with U.S. generally accepted accounting principles ("GAAP").

3. GAAP states that a loan is "impaired" when, based on current information and events, it is probable that a creditor will be unable to collect all amounts due according to the contractual terms of the loan agreement. For purposes of its periodic reporting requirements, a company is required by GAAP to evaluate whether or not a loan is impaired and disclose the total amount of impaired loans. Once a loan is determined to be impaired, GAAP requires a company to estimate the uncollectible portion of the loan and record that amount as impairment loss in its financial statements.

4. Here, Orrstown did not comply with GAAP's impaired loan disclosure requirements due to certain Respondents' negligence and Orrstown's lack of sufficient internal accounting controls. This failure resulted in material misstatements in Orrstown's impaired loan

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[1] The findings herein are made pursuant to Respondents' Offers and are not binding on any other person or entity in this or any other proceeding.

disclosures in its quarterly filings for the periods ended June 30, 2010 through September 30, 2011, and its annual filings for the years ended December 31, 2010 and 2011 (the "Relevant Period").

5. Additionally, Orrstown (i) did not calculate loan losses in accordance with GAAP in connection with the filing of its Form 10-Q for the period ended June 30, 2011, (ii) incorrectly implemented a newly issued GAAP accounting pronouncement in connection with the filing of its Form 10-Q for the period ended June 30, 2011 in a manner that was not consistent with the new standard, and (iii) incorrectly applied GAAP when calculating fair value for certain collateral in connection with its impairment analyses for its Form 10-Q for the periods ended June 30, 2010 and September 30, 2010.

6. As a result of the conduct described herein, Orrstown violated Sections 17(a)(2) and 17(a)(3) of the Securities Act, the reporting provisions of Section 13(a) of the Exchange Act and Rules 12b-20, 13a-1, and 13a-13 thereunder, the books and records provisions of Section 13(b)(2)(A) of the Exchange Act, and the internal accounting control provisions of Section 13(b)(2)(B) of the Exchange Act.

7. As a result of the conduct described herein, Respondents Thomas R. Quinn, Jr., Orrstown's Chief Executive Officer, Bradley S. Everly, Orrstown's former Chief Financial Officer, and Jeffrey W. Embly, Orrstown's former Chief Credit Officer, violated Securities Act Sections 17(a)(2) and 17(a)(3) and Exchange Act Rule 13b2-1, and caused Respondent Orrstown to violate Exchange Act Sections 13(a), 13(b)(2)(A) and (B), and Rules 12b-20, 13a-1, and 13a-13 thereunder. Respondents Quinn and Everly also violated Exchange Act Rule 13a-14. Respondent Douglas P. Barton, Orrstown's Chief Accounting Officer, violated Exchange Act Rule 13b2-1 and caused Orrstown to violate Exchange Act Sections 13(a), 13(b)(2)(A) and (B), and Rules 12b-20 and 13a-13 thereunder.

RESPONDENTS

8. **Orrstown Financial Services, Inc.** is a Pennsylvania corporation headquartered in Shippensburg, Pennsylvania. Orrstown Financial Services, Inc. is the holding company of Orrstown Bank, a Pennsylvania chartered bank with $1.3 billion in total assets as of June 30, 2016. Orrstown's common stock is registered with the Commission pursuant to Section 12(g) of the Exchange Act and quoted under the symbol "ORRF" on the NASDAQ Stock Market.

9. **Thomas R. Quinn, Jr.**, age 57, is a resident of Carlisle, Pennsylvania. Since May 2009, he has served as President and Chief Executive Officer ("CEO") of Orrstown Financial Services, Inc., and Orrstown Bank.

10. **Bradley S. Everly**, age 65, is a resident of Chambersburg, Pennsylvania. He was Executive Vice President and Chief Financial Officer ("CFO") of the Bank from 1997 until his resignation on May 14, 2012. Everly is a Certified Public Accountant ("CPA"), licensed in Maryland. His license is currently inactive and he is retired.

11. **Jeffrey W. Embly**, age 46, is a resident of Chambersburg, Pennsylvania. He was the Bank's Executive Vice President and Chief Credit/Risk Officer from September 2009 through May 2011. From May 2011 through August 2012, Embly served as Orrstown's Senior Executive Vice President and Chief Operating Officer, and from August 2012 through October 2012 he served as Orrstown's Executive Vice President of Operations and Technology. Embly resigned from Orrstown in October 2012. He no longer works in the banking industry.

12. **Douglas P. Barton**, age 51, is a resident of Brownstown, Pennsylvania. Since joining the Bank on September 27, 2010, he has served as its Senior Vice President and Chief Accounting Officer ("CAO"). He is a CPA licensed in Pennsylvania.

OTHER RELEVANT PERSONS

13. **Lending Relationship A** consisted of a husband and wife, their adult sons, and the husband's brother. All were customers of the Bank individually and through various entities they controlled. Lending Relationship A were real estate investors and developers primarily in the Hagerstown, Maryland market. They are no longer customers of the Bank.

14. **Lending Relationship B** consisted of a father and son who were customers of the Bank individually and through various entities they controlled. They were real estate investors and developers primarily in the Hagerstown, Maryland market. They are no longer customers of the Bank.

15. **Lending Relationship C** consisted of an individual customer of the Bank and various entities he controlled. Lending Relationship C engaged in real estate investment and development primarily in the Hagerstown, Maryland market. They are no longer customers of the Bank.

ACCOUNTING STANDARDS

16. The relevant accounting standards governing Orrstown's identification, assessment and measurement of impaired loans are set forth in Accounting Standards Codification ("ASC") Subtopic 310-10-35, *Receivables – Subsequent Measurement*. The relevant accounting standards providing guidance on disclosure of loans that are individually deemed to be impaired are set forth in ASC 310-10-50 *Receivables – Disclosure*.

17. ASC 310-10-50-15 requires that an entity disclose, as of the date of each statement of financial position presented, its recorded investment in impaired loans.

18. ASC 310-10-35-14 requires that a creditor apply its normal loan review procedures in identifying loans to be evaluated for collectability and includes certain criteria that are useful in identifying loans for evaluation.

19. ASC 310-10-35-16 requires a creditor to identify a loan as impaired if, based on current information and events, it is probable that a creditor will be unable to collect all amounts due according to the contractual terms of the loan agreement.

20. ASC 310-10-35-22 requires a creditor to measure an impaired loan's impairment based on the present value of expected future cash flows discounted at the loan's effective interest rate, except that as a practical expedient, a creditor may measure impairment based on a loan's observable market price, or the fair value of the collateral if the loan is a collateral-dependent loan.

21. Accounting Standards Update ("ASU") No. 2011-02, *A Creditor's Determination of Whether a Restructuring is a Troubled Debt Restructuring* ("ASU 2011-02"), codified as ASC 310-40, *Troubled Debt Restructurings by Creditors*, clarified existing troubled debt restructuring ("TDR") guidance by providing guidelines for determining when a restructuring constitutes a concession and when a debtor is experiencing financial difficulties. A restructuring of a debt constitutes a TDR if the creditor for economic or legal reasons related to the debtor's financial difficulties grants a concession to the debtor that it would not otherwise consider. ASU 2011-02 was issued in April 2011 and was effective for the first interim or annual reporting period beginning on or after June 15, 2011 and should have been applied retroactively to the beginning of the annual period of adoption (i.e., restructurings occurring on or after the beginning of the fiscal year of adoption).

FACTS

Orrstown's Loan Review Process

22. During the Relevant Period, Orrstown's loan review process was governed by its loan policy. The loan review was performed by a Loan Review Officer who was supervised by Embly and Orrstown's Credit Administration Committee. The Credit Administration Committee consisted of non-employee directors, though Quinn, Everly and Embly regularly attended meetings as non-voting members.

23. Orrstown's loan policy required the Loan Review Officer to conduct a risk review of forty-five percent to sixty percent of the Bank's total outstanding loan portfolio annually. Based on this review of relevant loan files, the Loan Review Officer assigned a risk rating to each relationship in accordance with a predetermined risk rating system that ranged from "1 – Excellent" to "8 – Loss." Loans rated "6 – Substandard," "7 – Doubtful," and "8 – Loss" were considered "classified" loans and represented the subset of the loan portfolio where risk of uncollectability was greatest. As a matter of practice all commercial relationships with a committed loan balance over $750,000 were risk rated each year.

24. During the Relevant Period, the loan policy further required that, on a quarterly basis, the Loan Review Officer review Orrstown's allowance for loan and lease losses ("ALLL") to ensure that the Bank was adequately reserved for projected loan and lease losses. In connection with this review, the Loan Review Officer evaluated only "Substandard" loans to determine if they were impaired and whether a provision for loan loss was required to be recorded in the financial statements.

25. As discussed in greater detail below, Orrstown did not timely incorporate material adverse information regarding certain borrowers' financial difficulties into the risk rating

component of its loan review process and instead relied largely on stale data. As a result, loans were incorrectly risk rated. Moreover, the processes and controls in place to ensure the accuracy of risk ratings set by the Loan Review Officer were ineffective to prevent or correct the incorrect risk ratings.

Loans to Several of Orrstown's Largest Lending Relationships
Were Not Disclosed as Impaired

26. In 2010, three of the Bank's largest customers, Lending Relationships A, B and C, approached Orrstown requesting to modify the terms of their loans, each claiming they had insufficient cash flow to repay their existing loans with Orrstown. These borrowers' cash flow problems were discussed at meetings of Orrstown's Loan Committee, Executive Committee and/or Board of Directors. As attendees at these meetings, Quinn, Everly and Embly knew or should have known that the loans to Lending Relationships A, B and C were impaired or, at a minimum, that these loans needed to be evaluated for impairment. Quinn, Everly and Embly received copies of the internal loan presentation materials that set forth the borrowers' financial difficulties, but Quinn, Everly and Embly did not raise any concerns about whether the loans should have been disclosed as impaired in accordance with ASC 310-10-50-12, or identified for impairment analysis in accordance with ASC 310-10-35-14 and ASC 310-10-35-16. In 2012 and 2013, Orrstown sold the Lending Relationships A, B and C loans at a substantial discount to their carrying values.

A. Lending Relationship A

27. As of December 31, 2010, outstanding loans to Lending Relationship A totaled approximately $28.8 million. By July 13, 2010, Quinn, Everly and Embly knew or should have known through loan presentation materials distributed at various committee meetings they attended that the patriarch of Lending Relationship A was "struggling with cash flow" due to the weakening real estate market. In or about the same time, Quinn, Everly and Embly were told that the adult children, also borrowers, were "experiencing significant cash flow issues" and had threatened to surrender their properties to the Bank. Earlier in May 2010, the patriarch's brother, himself a borrower, informed the Bank that he was "short" on money to continue construction of his real estate projects. By December 9, 2010, Quinn, Everly and Embly were told that the patriarch's brother was still suffering the effects of the weakening economy, which hindered his development plans. As a result of these financial difficulties, in 2010 Orrstown modified the terms of approximately $21.5 million in loans to Lending Relationship A but did not evaluate, identify, or disclose the loans as impaired, as required by GAAP.

B. Lending Relationship B

28. As of December 31, 2010, outstanding loans to Lending Relationship B totaled $12.2 million. As early as June 8, 2010, Lending Relationship B requested loan modifications because their commercial properties were "producing a negative cash flow after debt service." By June 28, 2010, Lending Relationship B had mentioned to the Bank on multiple occasions the possibility of filing for bankruptcy. And by December 17, 2010, Quinn, Everly and Embly knew or should have known that Lending Relationship B's largest financed project was potentially

"jeopardized" and that the borrowers were suffering the effects of the weakening economy and experiencing "significantly strained cash flow[s]." Despite this information, on December 23, 2010, Orrstown approved modifications to the terms of Lending Relationship B loans but did not evaluate, identify, or disclose them as impaired as required by GAAP.

C. Lending Relationship C

29. As of December 31, 2010, outstanding loans to Lending Relationship C totaled $7.7 million. By September 8, 2010, Quinn, Everly and Embly knew or should have known that the Bank had met with the principal for Lending Relationship C and one of his business partners to discuss the declining economy's impact on their commercial real estate portfolio. Quinn, Everly and Embly knew or should have known that Lending Relationship C and the partner were having "serious cash flow deficiencies." As a result, Orrstown agreed to modify many of these loans in September and October 2010 but did not evaluate, identify, or disclose them as impaired as required by GAAP.

<u>Orrstown Did Not Disclose Other Commercial Loans as Impaired at the Time it Recognized Impairment Losses</u>

30. In addition to Lending Relationships A, B and C, Orrstown incorrectly did not disclose the value of other impaired loans in its quarterly filings on Form 10-Q for the periods ended June 30, 2010 and September 30, 2010. During Q2 and Q3 2010, in connection with its quarterly review and assessment of the adequacy of its ALLL, Orrstown's Loan Review Officer performed an analysis to measure the amount of impairment loss, if any, required under ASC 310-10-35, on individual loans rated "Substandard." Under GAAP, loans with an impairment loss must be disclosed as impaired.

31. As part of this Q2 and Q3 2010 review of Orrstown's ALLL, the Loan Review Officer followed the Bank's loan policy by comparing the value at which the Bank carried each classified loan on its books and records, to the estimated net realizable value of the collateral securing each loan. Consistent with the Bank's loan policy, in instances where the loan's carrying value exceeded the estimate of the collateral's net realizable value, an impairment loss was recorded in the amount of the difference. However, certain loans where impairment losses were calculated were incorrectly not included in the Loan Review Officer's ALLL schedule of impaired loans.

32. As a result, the Q2 and Q3 2010 Forms 10-Q disclosures incorrectly omitted impaired loans in the amounts of approximately $5.6 million as of June 30, 2010 and approximately $18.5 million as of September 30, 2010.

33. The Loan Review Officer's calculation of impairment losses was memorialized and distributed to the Credit Administration Committee, which reviewed it but did not ensure that loans with impairment losses were designated as impaired in Orrstown's books and records (the ALLL schedule). These inaccurate books and records were then used to prepare Orrstown's impaired loan disclosures included in its Q2 and Q3 2010 Forms 10-Q. Because Orrstown did

not include the value of these impairments in its impaired loan disclosures, the disclosures were materially misstated.

34. Everly and Embly were directly notified that the Loan Review Officer did not appropriately record as impaired in Orrstown's books and records loans that had been assigned impairment losses. Specifically, in October 2010, Barton reviewed the Loan Review Officer's ALLL schedule, which included the impairment loss analysis discussed above, and informed Everly and Embly that failing to disclose loans with impairment losses as impaired was inconsistent with the accounting guidance. No one took corrective action. As a result, Orrstown's Q3 2010 Form 10-Q was filed without accurately disclosing Orrstown's recorded investment in impaired loans in accordance with GAAP.

Orrstown Did Not Accurately Disclose Impaired Loans Which Caused it to Make Materially Misstated Filings

35. Orrstown did not accurately record certain loans as impaired, resulting in materially misstated periodic filings filed with the Commission. The following Orrstown filings were materially misstated in the manner described below:

a. Orrstown filed its Q2 2010 Form 10-Q with the Commission on August 5, 2010. In its filing, Orrstown disclosed in its Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A") impaired loans of approximately $21.7 million. Orrstown did not disclose approximately $46.6 million of additional impaired loans, an understatement of approximately 215%.

b. Orrstown filed its Q3 2010 Form 10-Q with the Commission on November 5, 2010. In its filing, Orrstown disclosed in its MD&A impaired loans of approximately $22.6 million. Orrstown did not disclose approximately $69.5 million of additional impaired loans, an understatement of approximately 308%.

c. Orrstown filed its 2010 Form 10-K with the Commission on March 11, 2011. In its filing, Orrstown disclosed impaired loans in the footnotes to its financial statements of approximately $14.7 million. Orrstown did not disclose approximately $51.0 million of additional impaired loans, an understatement of approximately 346%.

d. Orrstown filed its Q1 2011 Form 10-Q with the Commission on May 10, 2011. In its filing, Orrstown disclosed impaired loans in the footnotes to its financial statements of approximately $14.1 million. Orrstown did not disclose approximately $51.0 million of additional impaired loans, an understatement of approximately 362%.

36. The misstatement in Orrstown's 2010 Form 10-K described above was repeated in the footnotes to the financial statements included in Orrstown's Q2 2011 Form 10-Q, Q3 2011 Form 10-Q and 2011 Form 10-K.

Orrstown Did Not Make and Keep Adequate Books and Records
by Failing to Comply with GAAP Provisions Relating to TDRs
and Loan Losses

A. Incorrect Application of the Provisions of ASU 2011-02

37. In connection with the preparation of its Q2 2011 Form 10-Q, Orrstown elected to early adopt the provisions of ASU 2011-02. This new accounting guidance was to be applied retroactively to identify and report restructurings that occurred on or after January 1, 2011 that qualified as TDRs.

38. As a result of its implementation of ASU 2011-02, Orrstown disclosed in its Q2 2011 Form 10-Q that approximately $34 million of restructured loans qualified as TDRs. However, at least $22 million of these loans were restructured in 2010 and were thus outside of ASU 2011-02's retroactive scope.

39. Barton was responsible for Orrstown's implementation of ASU 2011-02 and knew or should have known that retroactive application of this pronouncement to restructurings that occurred prior to January 1, 2011 was not in accordance with GAAP.

40. Additionally, Quinn, Everly and Embly knew or should have known that Orrstown was not permitted to retroactively apply ASU 2011-02 to restructurings before January 1, 2011. Nonetheless, Quinn, Everly, and Embly participated in and agreed to the decision to apply ASU 2011-02 to loans that were restructured in 2010, inconsistent with GAAP.

B. Loan Losses Were Not Calculated in Accordance with GAAP

41. In connection with Orrstown's recognition of approximately $34 million of TDRs in Q2 2011, Barton performed an impairment analysis to determine if impairment losses needed to be recorded for any of these TDRs – which, under GAAP are deemed impaired loans.

42. For a majority of the $34 million in loans, Barton utilized a discounted cash flow model ("DCF Model") to calculate impairment losses. But rather than using the expected future cash flows and each loan's effective interest rate in his DCF Model, as required by GAAP, Barton used each loan's contractual cash flows which he then discounted at a "market rate" to arrive at the net realizable value of the loans. This approach did not comply with ASC 310-10-35-22.

43. On or around September 2, 2011, Barton informed Quinn, Everly and Embly that this methodology was "not technically within the accounting rules" but none of them took any action to alter the DCF Model to conform to GAAP.

C. Orrstown Utilized Stale Real Estate Appraisals in Calculating Fair Value Measurements for Collateral Securing Certain Commercial Loans

44. As described above, during Q2 and Q3 2010, when the Bank performed an impairment analysis on certain classified loans, its analysis did not comply with its loan policy because it utilized stale real estate appraisals. Moreover, the Bank's analysis did not comply with GAAP because it incorporated inappropriate inputs into its collateral valuation models.

45. During Q2 and Q3 2010, Orrstown relied upon stale appraisals aged in excess of two years when calculating impairment losses on certain of its commercial loans. Orrstown's reliance upon stale real estate appraisals ran counter to its own loan policy, which required that all real estate loans be supported by current appraisals that were no more than two years old in a stable real estate environment and no more than "a few months" old in a "rapidly escalating or deteriorating market." Despite these requirements, and the declining real estate and broader economic market throughout 2010, Orrstown did not obtain current real estate appraisals or reliable real estate appraisal updates on many of its loans, including those issued to Lending Relationships A, B and C.

46. For example, during Q2 and Q3 2010, Orrstown evaluated approximately $42.3 million and $49.2 million of "Substandard" rated loans for impairment loss, respectively. For Q2 2010, approximately 40% of those loans were supported by real estate appraisals older than two years and 14% of those loans were supported by real estate appraisals older than five years. For Q3 2010, approximately 29% of those loans were supported by real estate appraisals older than two years and 10% were supported by real estate appraisals older than five years.

47. Additionally, in Q2 and Q3 2010, Orrstown utilized the fair value of collateral to measure impairment loss on certain commercial loans individually evaluated for impairment. GAAP defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date and provides a framework for measuring fair value in ASC 820. According to ASC 820, fair value measurements are to be based on, among other things, inputs that a market participant would incorporate into its valuation model as of the applicable measurement date.

48. During Q2 and Q3 2010, however, contrary to GAAP, Orrstown estimated the current value of its real estate collateral by relying on stale real estate appraisals and discounted the appraised values by a universal discount rate regardless of the age of the appraisal. The discount was based primarily on a regulatory study conducted in 2004 which had no bearing on the current real estate market as of 2010 and was irrelevant to the collateral valuation model as of Q2 and Q3 2010.

49. As members of the Loan Committee, Quinn, Everly and Embly were ultimately responsible for ensuring that each loan was supported by updated information and Embly, in particular, was ultimately responsible for regulatory compliance regarding appraisals. Moreover, Quinn, Everly and Embly knew or should have known that the Bank's use of stale appraisals in connection with the measurement of impairment loss, and its use of a universal discount rate, did not comply with GAAP and Orrstown's own loan policy.

Orrstown Did Not Devise and Maintain a Sufficient System of Internal Accounting Controls

50. During the Relevant Period, Orrstown did not maintain a system of internal accounting controls sufficient to provide reasonable assurances that transactions were recorded as necessary to permit preparation of financial statements in accordance with GAAP. Orrstown’s lack of internal accounting controls resulted in: (1) incorrect loan risk ratings; (2) incorrect disclosures of impaired loans; (3) incorrect calculations and disclosures of loan losses; (4) incorrect application of newly issued accounting pronouncements; and (5) the lack of action to remedy accounting problems after being alerted to them.

51. Quinn, Everly and Embly were ultimately responsible for the timely identification, evaluation and reporting of impaired loans.

52. As President and CEO, Quinn was responsible for the administration of Orrstown’s loan policy. He was a member of the Loan Committee, Executive Committee and Board of Directors. As principal executive officer of Orrstown, Quinn was responsible for certifying in its periodic filings that Orrstown had adequate internal controls to provide reasonable assurance regarding the reliability of financial reporting and preparation of financial statements in accordance with GAAP.

53. As CFO, Everly was responsible for ensuring that Orrstown’s financial reporting was materially accurate, complete and prepared in accordance with GAAP. He was a member of the Loan Committee and Executive Committee and regularly attended meetings of the Board of Directors. As principal financial officer of Orrstown, Everly was responsible for certifying in its periodic filings that Orrstown had adequate internal controls to provide reasonable assurance regarding the reliability of financial reporting and preparation of financial statements in accordance with GAAP.

54. As CCO, Embly was responsible for credit underwriting, loan work out and loan administration, including supervision of the loan review process and ensuring that material adverse information concerning borrowers was timely incorporated into the loan ratings. He was a member of the Loan Committee and Executive Committee and regularly attended meetings of the Board of Directors.

55. Quinn, Everly and Embly were members of committees that reviewed borrowers’ requests for loan modifications and, in the course of those meetings, received information regarding the borrowers’ financial difficulties.

56. Barton was responsible for overseeing the finance department in coordinating financial reporting and preparing monthly financial reports to senior management and the Board of Directors. He was also responsible for implementing new accounting pronouncements and ensuring that Orrstown’s accounting policies were consistent with GAAP. Barton drafted the disclosure pertaining to the early adoption of ASU 2011-02 in the Q2 2011 Form 10-Q and performed the calculation of loan loss reserves for the loans that were classified as TDRs in Q2 2011.

Orrstown Issued Securities During the Relevant Time Period

57. Orrstown offered securities in 2010 pursuant to a Form S-8 that it originally filed on April 11, 2000 and again offered securities in 2011 pursuant to a Form S-8 that it filed on June 3, 2011. The Form S-8 filed on April 11, 2000 incorporated by reference all subsequent periodic filings under the Exchange Act for securities sold under this registration statement. Thus, it incorporated by reference Orrstown's Q2 and Q3 2010 Forms 10-Q, which materially under-reported the Bank's impaired loans. The Form S-8 filed on June 3, 2011 incorporated by reference Orrstown's 2010 Form 10-K and its Q1 2011 Form 10-Q and all subsequent periodic filings under the Exchange Act for securities sold under this registration statement. Thus, it incorporated by reference Orrstown's Q2 and Q3 2011 Forms 10-Q and its 2011 Form 10-K, which also materially under-reported the Bank's impaired loans.

VIOLATIONS

58. Securities Act Section 17(a)(2) prohibits any person from obtaining money or property in the offer or sale of securities by means of any untrue statement of a material fact or any omission to state a material fact necessary to make the statements made, in light of the circumstances under which they were made, not misleading.

59. Securities Act Section 17(a)(3) prohibits any person from engaging in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser in the offer or sale of securities.

60. Exchange Act Section 13(a) and Rules 13a-1, and 13a-13 thereunder require that every issuer of a security registered pursuant to Exchange Act Section 12 file with the Commission, among other things, such annual and quarterly reports as the Commission may require.

61. Exchange Act Rule 12b-20 requires that, in addition to the information expressly required to be included in a statement or report filed with the Commission, there shall be added such further material information, if any, as may be necessary to make the required statements, in light of the circumstances under which they are made, not misleading.

62. Exchange Act Rule 13a-14 requires an issuer's principal executive and principal financial officer to certify each periodic report containing financial statements filed by an issuer pursuant to Section 13(a) of the Exchange Act.

63. Exchange Act Section 13(b)(2)(A) requires reporting companies to make and keep books, records and accounts which, in reasonable detail, accurately and fairly reflect transactions and dispositions of their assets.

64. Exchange Act Section 13(b)(2)(B) requires all reporting companies to devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that transactions are recorded as necessary to permit preparation of financial statements in conformity with GAAP and to maintain accountability for assets.

65. Rule 13b2-1 under the Exchange Act prohibits any person from, directly or indirectly, falsifying or causing to be falsified, any book, record, or account subject to Exchange Act Section 13(b)(2)(A).

66. As a result of the conduct described above, Orrstown violated Securities Act Sections 17(a)(2) and 17(a)(3) and Exchange Act Sections 13(a), 13(b)(2)(A) and 13(b)(2)(B), and Rules 12b-20, 13a-1 and 13a-13 thereunder.

67. As a result of the conduct described above, Quinn violated Securities Act Sections 17(a)(2) and 17(a)(3), and Exchange Act Rules 13a-14 and 13b2-1, and caused Orrstown to violate Exchange Act Sections 13(a), 13(b)(2)(A) and 13(b)(2)(B), and Rules 12b-20, 13a-1 and 13a-13 thereunder.

68. As a result of the conduct described above, Everly willfully[2] violated Securities Act Sections 17(a)(2) and 17(a)(3), and Exchange Act Rules 13a-14 and 13b2-1, and caused Orrstown to violate Exchange Act Sections 13(a), 13(b)(2)(A) and 13(b)(2)(B), and Rules 12b-20, 13a-1 and 13a-13 thereunder.

69. As a result of the conduct described above, Embly violated Securities Act Sections 17(a)(2) and 17(a)(3), Exchange Act Rule 13b2-1, and caused Orrstown to violate Exchange Act Sections 13(a), 13(b)(2)(A) and 13(b)(2)(B), and Rules 12b-20, 13a-1 and 13a-13 thereunder.

70. As a result of the conduct described above, Barton violated Exchange Act Rule 13b2-1 and caused Orrstown to violate Exchange Act Sections 13(a), 13(b)(2)(A) and 13(b)(2)(B), and Rules 12b-20 and 13a-13.

71. As a result of the conduct described above, Everly also willfully violated the federal securities laws or rules and regulations thereunder pursuant to Section 4C of the Exchange Act and Rule 102(e)(1)(iii) of the Commission's Rules of Practice.

ORRSTOWN'S REMEDIAL EFFORTS

72. In determining to accept Orrstown's Offer, the Commission considered remedial acts promptly undertaken by Orrstown and cooperation afforded the Commission staff.

IV.

In view of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanctions agreed to in Respondents' Offers. Accordingly, pursuant to Section 8A

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[2] A willful violation of the securities laws means merely "'that the person charged with the duty knows what he is doing.'" *Wonsover v. SEC*, 205 F.3d 408, 414 (D.C. Cir. 2000) (quoting *Hughes v. SEC*, 174 F.2d 969, 977 (D.C. Cir. 1949)). There is no requirement that the actor "'also be aware that he is violating one of the Rules or Acts.'" *Id.* (quoting *Gearhart & Otis, Inc. v. SEC*, 348 F.2d 798, 803 (D.C. Cir. 1965)).

of the Securities Act and Sections 4C and 21C of the Exchange Act and Rule 102(e) of the Commission's Rules of Practice, it is hereby ORDERED that:

A. Respondents Orrstown, Quinn, Everly and Embly cease and desist from committing or causing any violations and any future violations of Sections 17(a)(2) and (3) of the Securities Act.

B. Respondents Orrstown, Quinn, Everly and Embly cease and desist from committing or causing any violations and any future violations of Sections 13(a), 13(b)(2)(A) and (B) of the Exchange Act, and Rules 12b-20, 13a-1 and 13a-13 thereunder; Respondents Quinn, Everly and Embly further cease and desist from committing or causing any violations and any future violations of Exchange Act Rule 13b2-1; Respondents Quinn and Everly further cease and desist from committing or causing any violations and any future violations of Exchange Act Rule 13a-14.

C. Respondent Barton cease and desist from committing or causing any violations and any future violations of Sections 13(a), 13(b)(2)(A) and 13(b)(2)(B) of the Exchange Act, and Rules 12b-20, 13a-13 and 13b2-1 thereunder.

D. Respondent Orrstown shall, within ten (10) days of the entry of this Order, pay a civil money penalty in the amount of $1,000,000, to the Securities and Exchange Commission for transfer to the general fund of the United States Treasury, subject to Exchange Act Section 21F(g)(3). If payment of this civil penalty is not timely made, additional interest shall accrue pursuant to 31 U.S.C. §3717.

E. Respondent Quinn shall pay a civil penalty of $100,000 to the Securities and Exchange Commission. Payment shall be made in the following installments: one installment of $25,000 due within 10 days of the entry of this Order, and then three installments of $25,000 each plus post-judgment interest due within 90, 180, and 270 days of the date of the entry of this Order. If any payment is not made by the date the payment is required by this Order, the entire outstanding balance of civil penalties, plus any additional interest accrued pursuant to 31 U.S.C. §3717, shall be due and payable immediately, without further application.

F. Respondent Everly shall, within ten (10) days of the entry of this Order, pay a civil money penalty in the amount of $100,000, to the Securities and Exchange Commission for transfer to the general fund of the United States Treasury, subject to Exchange Act Section 21F(g)(3). If payment of this civil penalty is not timely made, additional interest shall accrue pursuant to 31 U.S.C. §3717.

G. Respondent Embly shall pay a civil penalty of $100,000 to the Securities and Exchange Commission. Payment shall be made in the following installments: one installment of $25,000 due within 10 days of the entry of this Order, and then three installments of $25,000 each plus post-judgment interest due within 90, 180, and 270 days of the date of the entry of this Order. If any payment is not made by the date the payment is required by this Order, the entire outstanding balance of civil penalties, plus any additional interest accrued pursuant to 31 U.S.C. §3717, shall be due and payable immediately, without further application.

H. Respondent Barton shall, within ten (10) days of the entry of this Order, pay a civil money penalty in the amount of $25,000, to the Securities and Exchange Commission for transfer to the general fund of the United States Treasury, subject to Exchange Act Section 21F(g)(3). If payment of this civil penalty is not timely made, additional interest shall accrue pursuant to 31 U.S.C. §3717.

Payment must be made in one of the following ways:

i. Respondent may transmit payment electronically to the Commission, which will provide detailed ACH transfer/Fedwire instructions upon request;

ii. Respondent may make direct payment from a bank account via Pay.gov through the SEC website at http://www.sec.gov/about/offices/ofm.htm; or

iii. Respondent may pay by certified check, bank cashier's check, or United States postal money order, made payable to the Securities and Exchange Commission and hand-delivered or mailed to:

Enterprise Services Center
Accounts Receivable Branch
HQ Bldg., Room 181, AMZ-341
6500 South MacArthur Boulevard
Oklahoma City, OK 73169

Payments by check or money order must be accompanied by a cover letter identifying Respondent as a Respondent in these proceedings, and the file number of these proceedings. A copy of the cover letter and check or money order, or documentation of whatever other form of payment is used, must be simultaneously sent to G. Jeffrey Boujoukos, Associate Director, Division of Enforcement, Securities and Exchange Commission, 1617 JFK Boulevard, Suite 520, Philadelphia, Pennsylvania 19103.

I. Respondent Everly is denied the privilege of appearing and practicing before the Commission as an accountant.

J. After three (3) years from the date of this Order, Respondent Everly may request that the Commission consider his reinstatement by submitting an application (Attention: Office of the Chief Accountant) to resume appearing or practicing before the Commission as:

i. A preparer or reviewer, or a person responsible for the preparation or review, of any public company's financial statements that are filed with the Commission.

1. Such an application must satisfy the Commission that Respondent's work in his practice before the Commission will be reviewed either by the independent audit committee of the public company for which he works or in some other acceptable manner,

as long as he practices before the Commission in this capacity; and/or

ii. An independent accountant. Such an application must satisfy the Commission that:

1. Respondent, or the public accounting firm with which he is associated, is registered with the Public Company Accounting Oversight Board ("Board") in accordance with the Sarbanes-Oxley Act of 2002, and such registration continues to be effective;

2. Respondent, or the registered public accounting firm with which he is associated, has been inspected by the Board and that inspection did not identify any criticisms of or potential defects in the respondent's or the firm's quality control system that would indicate that the respondent will not receive appropriate supervision;

3. Respondent has resolved all disciplinary issues with the Board, and has complied with all terms and conditions of any sanctions imposed by the Board (other than reinstatement by the Commission); and

4. Respondent acknowledges his responsibility, as long as Respondent appears or practices before the Commission as an independent accountant, to comply with all requirements of the Commission and the Board, including, but not limited to, all requirements relating to registration, inspections, concurring partner reviews and quality control standards.

K. The Commission will consider an application by Respondent Everly to resume appearing or practicing before the Commission provided that his state CPA license is current and he has resolved all other disciplinary issues with the applicable state boards of accountancy. However, if state licensure is dependent on reinstatement by the Commission, the Commission will consider an application on its other merits. The Commission's review may include consideration of, in addition to the matters referenced above, any other matters relating to the applying Respondent's character, integrity, professional conduct, or qualifications to appear or practice before the Commission.

L. Amounts ordered to be paid as civil money penalties pursuant to this Order shall be treated as penalties paid to the government for all purposes, including all tax purposes. To preserve the deterrent effect of the civil penalty, Respondents agree that in any Related Investor Action, they shall not argue that they are entitled to, nor shall they benefit by, offset or reduction of any award of compensatory damages by the amount of any part of Respondents' payment of a civil penalty in this action ("Penalty Offset"). If the court in any Related Investor Action grants such a Penalty Offset, Respondents agree that they shall, within 30 days after entry of a final

order granting the Penalty Offset, notify the Commission's counsel in this action and pay the amount of the Penalty Offset to the Securities and Exchange Commission. Such a payment shall not be deemed an additional civil penalty and shall not be deemed to change the amount of the civil penalty imposed in this proceeding. For purposes of this paragraph, a "Related Investor Action" means a private damages action brought against any Respondent by or on behalf of one or more investors based on substantially the same facts as alleged in the Order instituted by the Commission in this proceeding.

V.

It is further Ordered that, solely for purposes of exceptions to discharge set forth in Section 523 of the Bankruptcy Code, 11 U.S.C. §523, the findings in this Order are true and admitted by Respondents Orrstown, Quinn, Everly, Embly and Barton and further, any debt for civil penalty or other amounts due by each of the aforementioned Respondents under this Order or any other judgment, order, consent order, decree or settlement agreement entered in connection with this proceeding, is a debt for the violation by said Respondents of the federal securities laws or any regulation or order issued under such laws, as set forth in Section 523(a)(19) of the Bankruptcy Code, 11 U.S.C. §523(a)(19).

By the Commission.

Brent J. Fields
Secretary