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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 **AMENDED CLASS ACTION COMPLAINT** **ECF** 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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AMENDED COMPLAINT

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). Plaintiff bases its information and belief upon the investigation conducted by Plaintiff's counsel, which included: a review of the U.S. Securities and Exchange Commission ("SEC") filings by Orrstown Financial Services, Inc. ("Orrstown" or the "Company"), as well as regulatory filings and reports, 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 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 Orrstown Bank (the "Bank" or collectively "Orrstown" or the "Company"); and, interviews of individuals who possess relevant information regarding the Company, the Bank and Defendants (defined herein) including, but not limited to, Confidential Witnesses ("CWs"). Based upon the results of Plaintiff's investigation, it is anticipated that substantial evidentiary support for the allegations set forth below will be further developed after a reasonable opportunity

for discovery especially as to the evidence that is within the exclusive control of the Defendants.

I. SUMMARY OF THE ALLEGATIONS

1. In early 2010, Defendants raised almost $40 million from investors through the public offering of approximately 1.4 million shares of Orrstown common stock at $27.00 per share. The investors were told in public filings, among other things, that they were investing in a company:

a. with a "Disciplined Credit Culture";

b. with "Conservative Loan Approval" processes;

c. with a "Deep and experienced management team with strong community ties and operational ability";

d. that "emphasi[zed] credit quality. . .";

e. that took a "Proactive and Thorough Approach to Credit";

f. that had already taken steps to "further strengthen the [loan] approval process and provide independence between sales and credit" and had undertook an expanded review of its commercial loan portfolio;

g. that had adequate loan loss reserves of $4.9 million for the Bank's "Risk Assets";[1]

h. that loan loss reserves were also "ample given the current composition of the loan portfolio"; and,

i. that would use the netted investors' $37.5 million of capital for "General corporate purposes including organic growth and strategic acquisitions."

2. Those statements about the Company, however, stood in stark contrast to the actual state of affairs at that time, as confirmed by Confidential Witnesses and sources, including former employees of the Company and its commercial borrowers, discussed herein. For example:

a. The Bank's credit analysts' recommendations that loans ***not*** be approved, because of concerns about the borrowers' creditworthiness, were routinely and arbitrarily rejected by the Bank's Loan Committee. Commercial loans that did not meet the Company's Loan Policy's Debt Service Ratios were, nonetheless, approved based on purported

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[1] The Company defines "Risk Assets" as including nonperforming loans, nonaccrual loans, substandard loans, loans past 90 days and still accruing, special mention loans and all other classified loans. As alleged herein, this definition is purposefully narrow to avoid capturing the performing loans within the commercial portfolio that are inherently risky and show indicia of future impairment, *i.e.*, troubled loans.

"exceptions" such as: a loan officer's explanation that "It is what it is," and a Bank executive's proclamation that the borrower's dad would not let his kid's loans go bad.

b. The Bank's loan portfolio consisted of undisclosed risky, impaired loans, in particular, commercial loans concentrated in the Hagerstown, Maryland market. By the time of the 2010 Offering, the Hagerstown loans were internally deemed "poor" and, many of the loans, which were for commercial development projects including an amusement park and family entertainment center, were over-budget, behind schedule and under-collateralized. Then, after the Offering, in order to keep certain of the Hagerstown borrowers from defaulting (an event that would have to be reflected on the Company's financials), the Bank had aggressively restructured loans and even gave the borrowers new loans, essentially throwing good money after bad, to keep the borrowers from formally defaulting.

c. The Loan Committee approved commercial loans to well-known businessmen operating in the Bank's back-yard of Chambersburg, PA, despite their loan applications failing to satisfy the credit requirements of the Loan Policy. For example, loans were extended to such borrowers just because Orrstown's then-Chief Credit Officer had told

the Loan Committee that "Bob" (the Chief Credit Officer's next door neighbor) "needs this."

d. The Bank's Loan Review Officer, designated to monitor the credit risks of each of the Bank's loans and then make recommendations for provisions for these Risk Assets, had no formal training or experience that qualified him to perform these crucial functions.

e. The Company did not follow its reported methodology for allocating loan loss reserves by, among other things, ignoring current adverse credit data and manipulating its own standard for classifying Risk Assets.[2]

3. Accordingly, contrary to the Offering materials' portrayal of the Company: there was lack of independence in the Company's underwriting and loan sales functions; the Bank's implementation of its underwriting and credit administration policies, procedures and controls were not stringent or conservative; the Bank failed to maintain internal controls and programs that would identify and account for potential credit risks and provisions for loan losses; and, the Bank

[2] The Company defines loan loss reserves and a methodology for calculating them in the Offering materials, *see infra* ¶ 104. As alleged herein, in violation of GAAP, the Company failed to follow this methodology in allocating loan loss reserves and then later created a new, highly unreasonable methodology, *i.e.*, the ***eight point internal risk rating system***, to obfuscate the true levels of risk assets and required loan loss reserves, *see infra* ¶ 5.

management's level of experience and oversight was wanting and insufficient. Instead of bolstering the Bank's financial condition and growth opportunities, the $37.5 million of capital raised in the Offering was used to mask and offset the anticipated losses due to increases in the Bank's Risk Assets, so that the Bank would retain its Tier 1 capital ratios required by federal banking regulatory guidelines in order to maintain its designation as a "well-capitalized" bank, keeping the façade alive.

4. The investors suffered substantial monetary damage by the purchase of Orrstown stock in the Offering at $27 per share. The value of Orrstown stock was substantially less. In fact, at the time of the filing of this Action, Orrstown's stock price had dropped over 80%, closing at $7.84 on May 25, 2012.

5. Moreover, public investors purchasing Orrstown stock in the public market at the time of and after the Offering were misled by Defendants' materially misleading statements and Defendants failure to disclose material information about the true financial and operational condition of Orrstown. Among other things, Defendants misrepresented the quality of the Bank's management, its underwriting procedures, and internal controls, and continued to tell investors that the Bank was "safe and sound." The Company's auditor, Defendant Smith Elliott Kearns & Company, LLC ("Smith Elliott") issued "clean" auditor statements in the Company's 2009 Annual Report filed on March 15, 2010, the Company's 2010

Annual Report filed on March 11, 2011, and a partially "clean" auditor statement in the Company's 2011 Annual Report filed on March 15, 2012. Defendants also put a scheme in place – the ***eight point internal risk rating system*** – to forestall classification of its bad loans as Risk Assets and making the necessary provisions for loan loss reserves in order to prevent the investing public from accurately assessing the financial condition of the Bank. With such material misstatements, after the Offering, Orrstown's stock reached a closing price high of $28.61 per share on April 6, 2011.

6. On July 14, 2011, Defendants released a "preliminary[] estimate[]" of an additional provision for loan losses at June 30, 2011 in the amount of approximately $21 million, "as a result of ***internal risk rating downgrades to existing credits, plus additional specific reserve set-asides attributable to various commercial loan relationships.***" Orrstown also, for the first time, fully charged off an $8.5 million loan of one of its borrowers which had filed for Bankruptcy in 2010 and for which Orrstown had been classified as, since that time, an unsecured nonpriority creditor. In response to such revelations, Orrstown's stock price dropped by 23% to close on Monday, July 18, 2011 at $20.06.

7. Determined, however, to keep the stock price inflated and investors in the dark, on July 28, 2011 the Company declared a third quarter cash dividend of $0.23 per share, an *increase* of 4.6% over the third quarter of 2010. This dividend

was declared and paid despite the better judgment of the federal and state banking regulators who had told the Bank that paying a dividend at that time was not advisable. Also, Orrstown's President and Chief Executive Officer Thomas R. Quinn, Jr., in the same press release announcing the dividend, assured investors that, ***"We have decisively addressed current and future credit quality issues and expect to return our focus to growing the company over the balance of the year."*** Quinn's statement could not have been farther from the truth.

8. Less than three months later, ***after the market closed*** on October 26, 2011, the Company reported that the Federal Reserve Bank refused to approve the Company's payment of a cash quarterly dividend. The Federal Reserve Bank 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). The market was stunned; Orrstown share price tanked and closed on October 27, 2011 at $9.29 a share on extraordinarily heavy trading volume.

9. On January 26, 2012, Orrstown reported losses for 4Q2011 of $23 million, making it the only major publicly traded midstate-based bank to lose

money in 2011.[3] Orrstown also announced that it was taking a complete write off of goodwill in the amount of $19.4 million but assured investors that the credit administration processes were "greatly enhanced" and the Bank was "stronger" than it had been. These conditions and assurances did not square with the reality of what was happening at Orrstown behind closed doors and belie Defendants' attempts to blame its troubles on market conditions or a soft economy.

10. After two years of misleading the public investors, it was only on the eve of an announcement about enforcement actions taken against Orrstown by federal and state banking regulators that the Defendants, including the Company's auditor Smith Elliott Kearns & Company, were forced to reveal the truth about the Bank's condition.

11. On March 15, 2012, the Company disclosed for the first time in its 2011 Annual Report on Form 10-K, that 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 of loan losses."*** Also included in the 2011 Annual Report was the "Report of Independent Registered Public Accounting

[3] Tim Stuhldreber ,"Orrstown battles loan losses," *Central Penn Business Journal*, April 20, 2012 at http://www.centralpennbusiness.com/article/20120420/FRONTPAGE/120419774/0/.

Firm" by Defendant Smith Elliott in which, for the first time, Smith Elliott revealed that Orrstown's internal controls were flawed. The Company's financial and operational material weaknesses, of course, as revealed by the CWs and these belated disclosures, render the Company's financial reporting for each of the prior reporting periods in 2011, 2010 and 2009 false and misleading. Indeed, the Company violated GAAP when it failed to properly determine and report loan loss reserves and that GAAP violation should have been readily evident to Defendant Smith Elliott when conducting its audits.

12. On March 23, 2012, Orrstown, the Bank and their shared Board of Directors revealed that they had entered into an Agreement with the Federal Reserve Bank of Philadelphia ("Reserve Bank") and a Consent Order with the Commonwealth of Pennsylvania, Department of Banking, Bureau of Commercial Institutions (the "Department of Banking"). Under the Agreement and Consent Order, Orrstown had to adopt and implement the following plans and programs:

a. "to strengthen oversight of management and operations";

b. "to reduce the Bank's interest in criticized or classified assets";

c. "to strengthen the Bank's credit risk management practices";

d. "for the maintenance of an adequate allowance for loan and lease losses";

e. "to maintain sufficient capital on a consolidated basis for the Company and on a stand-alone basis for the Bank";

f. "revise the Bank's loan underwriting and credit administration policies";

g. to not declare or pay any dividend without prior approval from the Reserve Bank; and

h. to incur or increase debt or to redeem any outstanding shares without prior Reserve Bank approval.

13. A concurrent statement released by Quinn – that "[t]hese 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…" – further confirms the CWs' statements and the fact that Orrstown's problems were material, systemic, pervasive and long-standing, but also evidences Orrstown's stubborn and damaging intent to conceal from investors the Bank's dire condition. Finally, with the mailing of additional proxy materials to shareholders on Friday, March 30, 2012, Orrstown owned up it to its failures by stating, ***"the Company faced significant challenges in 2011"*** and has been operating under the ***"guidance"*** of the regulators to make significant ***"structural changes."*** Schedule 14A 2012 Definitive Additional Proxy Materials, filed 3/30/2012, at 1 (emphasis added). Within days of this mailing, Orrstown shareholders began digesting the

information and dumping their stock so that by April 5, 2012, the stock was down 5.7% from the date of the announcement to close at $8.20.

14. For Orrstown executives, the concealment of, and delay in such revelations becoming public, which overstated the financial condition and success of the Bank and Orrstown, permitted them in 2010 to double their prior-year bonuses, increase their salaries for 2011, and, for many, to keep their jobs.

15. Within months of the announcement about the agreements with the banking regulators, however, the executives – the so-called "Deep and experienced management team with strong community ties and operational ability" – were "resigning":

a. The Executive Vice President, Chief Executive Officer and Chief Financial Officer of Orrstown and the Bank, Defendant Bradley S. Everly, left on May 14, 2012.

b. The Senior Vice President and Director of the Special Assets Group of the Bank, Terry W. Miller, left on June 29, 2012.

c. The Senior Vice President and Chief Credit Officer of the Bank, Michael A. Moore, left on July 13, 2012.

d. The Executive Vice President and Chief Operating Officer of Orrstown and the Bank, Defendant Jeffrey W. Embly, left on September 18, 2012.

16. Plaintiff brings this class action pursuant to Rules 23(a) and (b)(3) of the Federal Rules of Civil Procedure, on behalf of two Classes, against Defendants Orrstown, the Bank, certain of Orrstown's officers and directors, Smith Elliott Kearns & Company, LLC, Sandler O'Neill & Partners L.P. and Janney Montgomery Scott LLC. The claims asserted herein stem from Defendants' issuance of materially untrue and/or misleading statements and omissions in violation of the federal securities laws.

17. 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 (the "March 2010 Offering" or "Offering"). The Securities Act Class seeks remedies under Sections 11, 12(a) and 15 of the Securities Act of 1933 (the "Securities Act"), 15 U.S.C. §§ 77k, 77l(a)(2) and 77o, against Orrstown, certain of its officers and/or directors, the Bank, auditor Smith Elliott Kearns & Company, LLC, and underwriters Sandler O'Neill & Partners, L.P. and Janney Montgomery Scott LLC (collectively the "Securities Act Defendants") for the materially false and

misleading statements contained in and the material facts omitted from the Registration Statement.

18. 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 5, 2012, inclusive (the "Class Period"), seeking remedies under Sections 10(b) and 20(a) of the Securities Exchange Act of 1934 (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 Smith Elliott Kearns & Company, LLC (collectively the "Exchange Act Defendants").

II. JURISDICTION AND VENUE

19. 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 United States Securities and Exchange Commission ("SEC").

20. 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].

21. 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].

22. 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.

23. 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 misleading and untrue statements of material facts, occurred in this District.

24. 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.

III. PARTIES

A. Lead Plaintiff

25. 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 underwriter, and also purchased Orrstown common stock on the open market during the Class Period. SEPTA was harmed as the result of Defendants' wrongdoing as alleged in this complaint.

B. Securities Act Defendants

1. The Orrstown Securities Act Defendants

26. 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. The Bank'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 September 30, 2012, Orrstown had total assets of $1.26 billion, loan portfolio totaling $811 million, total shareholders' equity of $87.3 million, and total deposits of approximately $1.12 billion.

27. 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-one branches, concentrated in Cumberland, Franklin and Perry Counties as well as one branch 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 75% of the Bank's loan portfolio is concentrated in commercial loans with the remaining portion segmented as follows: 13% residential mortgages; 12% home equity loans and lines; and 1% consumer loans.

28. 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.

29. 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.

30. 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 which was formed in 2009.

31. Defendant **Jeffrey W. Coy** ("Coy") is, and during the Class Period was, the Vice Chairman of the Boards of Directors of the Company and the Bank. He has been a Director since 1984, 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.

32. 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 which was formed in 2009. 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.

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

34. 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.

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

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

37. 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.

38. Defendant **John S. Ward** ("Ward") is, and during the Class Period was, a Director of the Company and Bank. He has been a Director since 1999, and at the time of the March 2010 Offering was a member of the Audit committee.

39. Defendants Quinn, Zullinger, Shoemaker and Coy were members of the Board of Directors' Enterprise Risk Management Committee which was formed in 2009 to provide additional oversight over seven risk areas: credit, operations, transaction, liquidity, market/interest rate, legal/compliance, strategies and reputation.

40. 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.

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

42. 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 Officer of the Bank. Embly recently 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.

43. 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 and loan underwriting processes and the deteriorating loan portfolio. Because of

their positions, the Individual Securities Act Defendants and Defendant Embly were responsible to critically review the Offering Documents to ensure accuracy and adequate disclosure.

44. Each of the Individual Securities Act Defendants signed the materially untrue and misleading Registration Statement. They are 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 representations contained therein.

2. The Underwriter Defendants

45. 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 paid

approximately $2.2 million in fees on the shares sold, indirectly 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

46. The $2.2 million in combined fees was 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.

47. Given the extraordinary conditions affecting financial services companies preceding and during the time of the Offering, 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 financial controls.

48. 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

49. Defendant **Smith Elliott Kearns & Company, LLC.** ("Smith Elliott" 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, Smith Elliott has 150 employees. Since 1963, Smith Elliott has been providing professional accounting services to independent community financial institutions and currently represents approximately 25 such community financial institutions. Smith Elliott 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]

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

50. Smith Elliott 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 since as late as 2006. As part of its audits, Smith Elliott also audited Orrstown and the Bank's internal controls over financial reporting.

51. During the Class Period, Smith Elliott 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 but, in 2011, Smith rendered an adverse opinion on the Company's internal financial controls. The Registration Statement incorporated by reference the financial statements audited by Smith Elliott and Smith Elliott's unqualified audit reports for calendar years 2008 and 2009. Smith Elliott 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 generally accepted accounting principles ("GAAP"). The Registration Statement also, upon authority of Smith Elliott, designated Smith Elliott as an expert in auditing and accounting.

52. Smith Elliott is a registered accounting and auditing firm with the Public Company Accounting Oversight Board ("PCAOB"). As required by the Sarbanes-Oxley Act of 2002, Smith Elliott 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 2008, 2009, 2010 and 2011, Smith Elliott purportedly applied the standards of the PCAOB and the Internal Control – Integrated framework issued by the Committee of Sponsoring Organizations of the Treadway Commission. Plaintiff's claims asserted against Smith Elliott as alleged herein, focus on Smith Elliott's unqualified audit reports for calendar years 2009, 2010 and partially unqualified audit report for 2011.

53. Orrstown, the Bank, the Individual Securities Act Defendants, the Underwriter Defendants, and Auditor Defendant Smith Elliott are sometimes collectively referred to herein as the "Securities Act Defendants" with respect to Plaintiff's Securities Act claims.

C. Exchange Act Defendants

54. 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 Smith Elliott are also collectively "**Exchange Act Defendants**."

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

55. 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, 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 Smith Elliott have access to confidential, non-public information concerning the Bank's internal operations and financial condition. 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 loan underwriting and credit approval processes, the deteriorating loan portfolio, and the Regulators' censure. 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.

IV. OTHER RELEVANT PERSONS

56. **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 Chambersburg, Pennsylvania. CW#1 was a Credit Analyst in the Credit Department and later became a Loan Underwriting Officer. CW#1 has personal knowledge of the Bank's internal controls, credit review and underwriting process that were in effect before and during the Class Period. CW#1 also has personal knowledge of the Bank's practice of restructuring loans to forestall classifying them as Risk Assets.

57. **Confidential Witness #2** ("CW#2") is a former Bank employee who worked from April 2010 to May 2011 at the Bank's Operations Center in Chambersburg, Pennsylvania. 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. CW#2 reported directly to the Chief Credit Officer who at the time of CW#2's employment was Defendant Jeffrey W. Embly. CW#2 has personal knowledge of

the Bank's internal controls, credit review and underwriting process, and loan approval process during most of the Class Period.

58. **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 applications' credit-worthiness while at Newport Bank. In 2009, CW#3 was promoted to Senior Credit Manager. CW#3 supervised three credit analysts, and CW#3 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. CW#3 has personal knowledge of the Bank's internal controls, credit review and underwriting process, and loan approval process during the Class Period.

59. **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. 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.

60. **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. CW#5 has personal knowledge of the Bank's management of lending relationships in Hagerstown, and of the banking regulators' oversight of the Bank's current affairs.

61. **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. 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.

62. **Ash Azadi** and his father **Morris Azadi** are professional commercial pilots. 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. On February 3, 2012, in the United States District Court of Maryland, Orrstown Bank filed a Complaint for Confession of Judgment and Breach of Contract 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 as to the lending relationship that existed between Orrstown Bank and Ash Azadi, Morris Azadi and the Azadis' various business entities.[6] Further, on August 3, 2012, Ash Azadi was interviewed by Plaintiff's counsel.

V. RULE 23 CLASS ALLEGATIONS

63. 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.

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[6] 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. This motion is pending. *See infra* n. 9 (discussing asset sale).

64. 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 and/or during the Class Period and who were damaged thereby.

65. 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.

66. 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.

67. 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 5, 2012 (the last day of the Class Period), the Company had approximately 8,064,206 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.

68. 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.

69. 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.

70. 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 Orrstown's internal

controls, credit review and underwriting standards, loan portfolio quality, and financial condition;

c. whether the Exchange Act Defendants participated in and pursued the common course of 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 Orrstown's internal controls, credit review and underwriting standards, loan portfolio quality, and financial condition;

g. whether the market price of Orrstown's common stock during the Class Period was inflated due to the material misrepresentations and failures to correct the material misrepresentations 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.

71. A class action is superior to all other available methods for the fair and efficient adjudication of this controversy since joinder of all members 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.

VI. BACKGROUND AND FACTS

A. Orrstown's Lending Practices

1. Aggressive Expansion into the Hagerstown, Maryland Commercial Lending Market

72. As a 90-year old community bank with 19 offices in South Central Pennsylvania, Orrstown had saturated the commercial lending markets in its region such that by 2005 management looked to Hagerstown, in Washington County, Maryland, as a market with opportunities and little competition.

73. To develop the Hagerstown market, Orrstown hired Terry L. Reiber, who was a member of the Washington County Planning Commission for the Department of Planning & Zoning since as early as January 2005. As one of seven board members of the Planning Commission, Reiber was able to cultivate relationships with developers who not only sought permits for their projects in

Hagerstown and throughout Washington County, but also who would need financing for these projects. As Orrstown's Senior Vice President of Business Development, Reiber was, therefore, strategically placed to funnel lending opportunities to the Bank and then was able to use his position on the Planning Commission to support the borrowers' projects. *See infra* Part VI.B.2. On September 1, 2005, Orrstown announced the hiring of Reiber in the Hagerstown-Washington County Chamber of Commerce publication. The Bank's ad stated:

> YOUR DEDICATED BUSINESS PARTNER
>
> Orrstown Bank has added Terry L. Reiber to our team of business banking professionals. As an experienced banker and resident of the area, Terry knows the importance of building relationships while providing true hometown service to his customers. And, as your dedicated partner, he will work hard to help your business grow even more successful. Call Terry today. You'll be glad you did![7]

Indeed, according CW#1, CW#2 and CW#3, Reiber rarely disappointed his customers as his customers' loan applications were generally approved by the Bank's Loan Committee irrespective of their credit-worthiness.

74. By March of 2006, Orrstown opened a branch at 201 South Cleveland Avenue in Hagerstown. This location was viewed as a "temporary solution until the bank could build a full service facility to serve the Hagerstown area." *See*

[7] http://www.hagerstown.org/newsletter/pdf/connect_2005_09.pdf

Orrstown 7/9/2010 Press Release, distributed by PRNewswire-First Call.[8] Orrstown later expanded its physical presence in Hagerstown by building and opening a flagship office at 1020 Profession Court to "meet the needs of this growing market." *Id.*

75. From the time that the Bank opened its doors on 201 South Cleveland Avenue, Reiber was aggressively developing lending relationships in Hagerstown. One such relationship that he developed was with the Bank's landlord on South Cleveland Avenue. The commercial building was owned by Morris Azadi, his son Ash Azadi and their related entities (collectively the "Azadis"). According to the Azadis, they were met with "open arms" by Reiber and the Bank, and Reiber "wooed" them into "refinance[ing] all of their real estate holdings with Orrstown." Azadi First Amended Answer to Complaint for Confession of Judgment and Breach of Contract and Counterclaim, Civil Action No. 1:12-cv-00345 ("Azadi Counterclaim") at 36-37. *See infra* Part III (discussing the Azadi lending relationship).

76. The lending relationships that Reiber developed in Hagerstown, however, became the Achilles Heel of the Bank, according to CW#1, CW#2 and CW#3. These Confidential Witnesses confirmed that Terry Reiber cultivated the

[8] http://www.prnewswire.com/news-releases/orrstown-bank-announces-consolidation-of-hagerstown-md-branches-98103549.html

relationships, influenced the credit review and approval process on the loan applications that were processed in 2005 through 2009, *see infra*, and 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 April 2009 to replace Reiber who had purportedly "retired" and shifted to a "consultant," had made known within the Bank that the vast majority of Hagerstown commercial loans Reiber "had left him" were of very poor quality. The Bank's lending relationships with its commercial borrowers the Azadis and Shaool Family, discussed *infra* Part III, are paradigmatic of the Bank's risky commercial lending practices in Hagerstown.

77. As confirmed by CW#1, CW#2 and CW#3, the aggressive, non-conservative lending undertaken by Reiber and the Bank to the specific lenders 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 and the Bank in a compromised operational and financial state by the time of the March 2010 Offering. Within the past two years since the Offering, the Bank has classified over $113.7 million as Risk Assets. *See* Form 10Q 1Q2012, filed 5/9/2012, at 44. In July 2012, Defendant Quinn admitted that there are still 20 troubled loans in Hagerstown and has since brokered two significant sales

including most of these troubled loans which collectively had a carrying balance of approximately $74.2 million.[9]

2. The Bank's Deficient Credit Review and Loan Approval Process

78. As described in the Offering Documents, the "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 the Orrstown Securities Act Defendants and the Orrstown Exchange Act 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;

[9] 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 will 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 VI.B.1) to investor group ACM.

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.

79. 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.

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

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

82. 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.

83. Moreover, the credit analysts were often working with incomplete loan packets while handling a volume of loans excessive for a staff of three. 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. CW#3 stated that, especially in 2009, 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.

84. 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 credit-worthy. CW#1 specifically recalls Hagerstown loan officer Terry Reiber either modifying "packets" prepared by the credit analysts or independently preparing the "packets."

85. 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 by securing updated financial data, *e.g.*, financial statements, on all lending relationship that would indicate the financial condition of each borrower and guarantor.

86. The Bank's Loan Policy required the Loan Committee to review loans and extend credit based upon the guidelines established by the Loan Policy, report

to the Board of Directors on loans that exceeded the Loan Committee's lending authority, and manage all loan approval related business.

87. The Loan Policy required the Loan Committee to carefully manage risks taken by the Bank when extending credit. The Loan Policy specifically condemned taking excessive risks in approving loans. According to CW#1 and CW#3, the Loan Committee routinely violated this policy statement by approving loans that failed to satisfy the credit standards of the Loan Policy.

88. 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.

89. In 2008, 2009 and up and until April 2010, CW#3 participated in the Loan Committee meetings to answer questions and voice the Credit Analyst Group's approval recommendation that was stated in the "packets." According to CW#3, Defendant Embly was the most influential member of the Loan Committee.

90. Under Embly, 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 VI.B.1-3. In these cases, the Loan Committee would approve the loans based upon an often frivolous "exception."

91. CW#3 recalls that the Loan Policy allowed for "exceptions" in approving credit 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 just one of the listed exceptions should be met before a credit extension is approved.

92. One of the Loan Policy's basic underwriting criteria for commercial loans is that the borrower's income must satisfy the debt service on a loan. 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 loans were regularly approved even

though the applicant failed to satisfy the 1.20 Debt Service Ratio. CW#3 specifically recalls the Debt Service Ratio being 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, more 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, 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 throughout 2007 and into 2011.

93. The Hagerstown commercial loans generated by Reiber 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 other than Reiber's vacuous response of, "It is what it is." In one telling Loan Committee meeting after 2007 but prior to April 2010, 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 III.B.2. Despite the Credit Analyst Group's recommendation to "not approve loan," the Loan Committee found that the uttered and unverified proposition by Defendant Embly, "Dustin's loans won't go bad – his dad won't let them," would be an exception to the criteria set forth in the Bank's Loan Policy.

94. Aside from inadequate Debt Service Ratios, Reiber's Hagerstown commercial loans 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. This occurred even at times when the Loan Committee did not have current appraisals for the collateral that were reviewed by the Bank's Staff Appraiser, according to CW#3.

95. CW#3 recalls the Loan Committee approving commercial loans from loan applicants who were well-known businessmen in Chambersburg, 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 two Chambersburg real estate developers Bob Hickey and Tom Mongold ("Chambersburg Developers"). *See infra* Part VI.B.3 (discussing the Chambersburg Developers). From CW#3's observations, the Loan Committee over extended the Bank and violated the Loan Policy just because, in Embly's words, "Bob needs this."

96. 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. Although this independence was needed, as verified by CW#1, it was not accomplished by the appointment of Embly to Chief Credit Officer. As the Chief Credit Officer, Embly became the Chair of the Loan Committee and controlled the scope of review and conversation on each loan that came before the Loan Committee. 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 credit worthy and later became Risk Assets. *See infra* Part VI.A.3.

97. In June 2011, Embly relinquished his position as Chief Credit Officer to take the position of Chief Operating Officer ("COO"). The Bank then hired Michael Moore to serve as Senior Vice President, Chief Credit Officer. Embly resigned as COO on September 18, 2012, in the wake of the banking regulators' intervention.

98. Another aspect of the Bank's loan process is the role the Bank's Credit Administration Committee has 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, insuring loans are adequately and effectively stress tested to trigger accurate classifications of loans

as Risk Assets, and designating adequate provisions for loan losses. The Credit Administration Committee, however, 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* Parts VI.A.3 and IX.C.

3. The Bank's November 2009 Internal Review

99. On the heels of creating the position of Chief Credit Officer in September 2009, the Bank initiated an Internal Review which the Company described 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 Internal Review was first announced in the Offering Documents and then in the 2009 Annual Report which were filed within weeks of each other.

100. In conducting its review to purportedly attempt to identify potential weaknesses and deterioration in the portfolio, the Internal Review mirrored the Bank's Loan Review Officer's responsibilities of calculating allocation of loan loss reserves for the loans rated as impaired, 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.

101. The Internal Review, however, was a ruse. It was never structured nor intended to fully unveil the weaknesses and deterioration in the Bank's portfolio and the Bank's imprudent and deliberate high risk lending. Moreover, Orrstown never intended to fully act on the adverse credit data to be gathered through the Internal Review so as to not jeopardize the upcoming March 2010 Offering. Orrstown's actions and statements concerning this Internal Review were intended to portray to investors a false sense of assurance about the Bank's internal controls and quality of the loan portfolio, and provide a vehicle to recognize some asset risks while delaying recognition of the vast majority of deteriorating loans.

102. The Internal Review was done by those who were at least in part responsible for the material weaknesses and deficiencies with the Company's loan portfolio as the team included one or more of the loan officers who brokered the very lending relationships under review. The Internal Review team consisted of "3 employees and 2 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 or threatened to become a Risk Asset. ***This structural bias enabled the Bank to limit the exposure uncovered by the Internal Review*** because the team was neither capable or motivated to delve into the adverse credit data for each commercial loan

and make determinations that would directly implicate themselves as pushing through risky loans or their supervisors, *i.e.*, Bank management, as failing to implement internal controls to avoid risky lending practices.

103. The Internal Review did not review all loans but only 60% of the overall commercial portfolio. The Internal Review purportedly 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." Form 10-K 2009 Annual Report, filed 3/15/2010, at 33. With this criterion, loans were rated to identify whether they were performing or had indicia of impairment.

104. The Company defines loan loss reserves as,

> [A] reserve established through a provision for loan losses charged to expense, that represents management's best estimate of probable incurred losses within the existing portfolio of loans. The level of the allowance reflects management's evaluation of, among other factors, the status of specific impaired loans, trends in historical loss experience, delinquency trends, credit concentrations and economic conditions within our market area. . . . Changes in economic conditions affecting borrowers, new information regarding existing loans, identification of additional problem loans and other factors, both within and outside of our control, may require us to increase our allowance for loan losses.

Form 10-K 2009 Annual Report, filed 3/15/2010 at 12. An increase in Risk Assets, impaired loans or observance of performing loans with new adverse credit

data should result in the Company's taking provisions to increase the loan loss reserves. This defined approach or methodology to assessing the necessary provisions for loan losses is consistent with Financial Accounting Standards Statement No. 5, *see infra* ¶ 180. Loan loss provisions affect the Company's income statement in that an increase in loan loss reserves is charged against gross income, and therefore decreases the Company's net income reported on the Company's financial statements.

105. The Internal Review resulted in the Company increasing the allowance for loan loss reserves by only $3.6 million for the three-month period ending December 31, 2009, which 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 follow the above methodology, *see supra* ¶ 104, by failing to accurately reflect the true level of impaired loans and the overall weakness and high risk in the Bank's commercial portfolio at that time because, among other things discussed herein, by mid-2009, Brian Selders had put the Bank on notice of wide-spread weaknesses in a majority of the Hagerstown commercial loans originally brokered by Terry Reiber and the Loan Committee, comprised of many of the Bank's senior officers and directors, were well aware of their frequent practice of advancing loans by exception to less than credit worthy borrowers.

B. Significant Commercial Lending Relationships Evidencing the Bank's Lack of Effective Internal Controls

106. Prior to the March 2010 Offering and throughout the Class Period, the Bank maintained it had "conservative" lending practices but these statements in the Offering Documents and public filings with the SEC are belied by these examples of the Bank's significant risky commercial lending relationships.

1. The Azadi Lending Relationship

107. In 2002, the Azadis became involved in real estate development by acquiring the historic Governor Hamilton Hotel which they planned to renovate and transform into a retail, office and residential condominium complex (the "Hamilton Project").

108. The Azadis first met Terry Reiber, Orrstown's Sr. Vice President of Business Development, *see supra* Part VI.A.1., in 2006 when the Azadis purchased South Cleveland Plaza commercial building in Hagerstown. This was soon after Orrstown had taken out a lease for commercial space in South Cleveland Plaza for the Bank's first branch in Hagerstown. Reiber "welcomed the Bank's new landlord [the Azadis] at the Cleveland Avenue Property and advocated that Ares and the Azadis refinance all of their real estate holdings with Orrstown." Azadi Counterclaim at 37.

109. By July of 2007, Reiber had secured three promissory notes from the Azadis for lines of credit in the amounts of $2.75 million, $200,000 and $250,000. *See* Orrstown Bank First Amended Complaint for Confession of Judgment and Breach of Contract, Civil Action No. 1:12-cv-00345 ("Orrstown Bank Complaint") at ¶ 10. By June 2008, the Bank had extended an additional $7.76 million to the Azadis through five loans that were made within the span of four months. *Id.*

110. In 2009, the Azadis acquired a property in Hagerstown which they planned to develop into a family entertainment and recreation center, with a bowling alley, an arcade, bar and restaurant (the "Bowling Center").

111. According to Ash Azadi, the Azadis first began to have financial difficulties in 2008. The situation worsened when in January 2010, Orrstown broke its lease at the Azadis' South Cleveland Avenue building which left a "gaping hole" in the Azadis' income stream. Azadi Counterclaim at 37.

112. In January 2010, the Azadis informed the Bank they "foresaw financial issues looming due to losses of commercial tenants [of which Orrstown was one] and an inability to find financing for the recreation center on the Bowling Alley Property." *Id.* at 37-38. These same concerns were reiterated six months later in an email from Ash Azadi to Defendant Embly on June 13, 2010. *Id.* at 38. Ash Azadi asked Embly for "either financing for the Bowling Center or relief on the interest rates on the entire portfolio of loans in order to obtain much needed

relief." *Id.* at 38. According to the Azadis, Embly authorized the additional credit. *Id.*

113. CW#3 recalls that additional credit was authorized even though the "cash flow didn't work." Moreover, CW#3 recalls that the Bank was not "monitoring" the construction draws on the Azadis' line of credit and there were significant cost overruns. Per the Bank's Loan Policy to avoid undue risk to the Bank, this monitoring should have been done by the loan officers and then again at the next level by the Loan Review Officer in his stress testing of the loan.

114. Within the first two weeks of January 2011, the Bank loaned the Azadis an additional $5,947,000 through a series of loan restructures or modifications with personal guarantees to enable the Azadis to complete the construction on the Bowling Center and Hamilton Project. Orrstown Bank Complaint, ¶ 10.

115. By July 2011, the Azadis were again in need of additional financing to finish their projects. According to the Azadis, Bank lending officers and Defendant Embly gave them "continuous assurances" that the Bank would continue to honor the Azadis' line of credit draws for their incomplete projects. Azadi Counterclaim at 38-39.

116. Once the Regulator's formally began investigating the Bank and were scrutinizing the lending process, Defendant Embly could no longer keep those

promises. On August 26, 2011, the Bank issued default notices to the Azadis. *Id.* at 40. The Azadis were unable to pay off their loans so, on February 3, 2012, the Bank filed suit against the Azadis for breach of contract and confession of judgment alleging that the Azadis owed the Bank approximately $16,300,000. *See* Orrstown Bank Complaint.

2. The Shaool Family Lending Relationship

117. In Hagerstown, Reiber managed other lending relationships that, like the Azadis, resulted in the making of a series of large risky development loans within a short span of time for various commercial projects. One of these lending relationships was with the Shaool Family. Through his position on the Washington County Planning Commission, Reiber frequently interacted with members of the Shaool Family, especially when they attended Planning Commission public hearings to present the merits of their various development projects and seek approvals. Reiber was, therefore, voting on whether to approve various aspects of the Shaool Family development projects in Washington County while brokering extensions of credit through the Bank. In one Planning Commission meeting on July 12, 2010, Reiber emphatically supported Sasson Shaool's request for a public hearing on the rezoning of property he wished to develop, and stated that the "County was doing an ***'injustice to private business'*** by making it difficult to

rezone the property and getting a public hearing scheduled."[10] Reiber thereafter made a motion for the public hearing which was passed. Reiber's efforts in Washington County Planning Commission meetings and in the Bank's Loan Committee meetings furthered the efforts of the Shaool Family's real estate development endeavors.

118. The Shaool Family and their entities borrowed millions from the Bank from 2005 through 2008 for their residential development projects such as Cortland Manor residential condominiums. Like the Azadis, the Shaool Family ultimately had their loans modified or restructured in 2011. The following chart illustrates the level of credit that the Bank extended to the Shaool Family, of over $24 million:

The Shaool Family	Loan Date	Loan Amount
Franklin Washington LLC	3/23/2005	$ 1,000,000.
Pangborn Heights Development	8/01/2007	4,275,000.
Shaool Walnut Point Development	8/16/2007	4,000,000.
Empire Development	8/22/2007	600,000.
Empire Development	9/28/2007	480,000.
Empire Development	6/20/2008	1,100,000.
Shaool Hagerstown Commons	12/10/2008	600,000.
Mansoor and Janet Emral Shaool	10/6/2009	637,000.
Shaool Walnut Point Development	10/6/2011	6,792,446.

[10] Washington County Planning Commission Regular Meeting, July 12, 2010, http://www.washco-md.net/washco_2/pdf_files/planning_minutes/2010/100712.pdf#search="shaool" (emphasis added).

The Shaool Family	Loan Date	Loan Amount
Pangborn Heights Development	10/6/2011	3,990,118.
Dustin Shaool	10/6/2011	1,110,000.
Empire Development	10/6/2011	955,597.

119. The Shaool Family carried great weight with Defendant Embly and Reiber. As discussed, *supra* ¶ 93, CW#3 recalls from a Loan Committee meeting Embly pushed for approval of loans to the Shaool Family even though there were credit concerns.

3. The Chambersburg Developers' Lending Relationship

120. Bob Hickey and Tom Mongold are real estate agents and developers in the Chambersburg area. *See supra* ¶ 95. At all times material to the issues raised in the complaint, Hickey was Defendant Embly's next-door neighbor. Hickey also sat on the Bank's Chambersburg-Greencastle Advisory Council. *See* Schedule 14A Additional Definitive Proxy Materials, filed 3/30/2012, at 10. Collectively Hickey and Mongold are referred to as the Chambersburg Developers. They are partners in several related entities which include but are not limited to Divinity Investments, RJH Investments LLC, DELM Developers, and Quad Developers LLC. 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

despite adverse credit information about the Chambersburg Developers and the failure to meet the standards set out in the Company's Loan Policy. Indeed, throughout the entire period that the Chambersburg Developers were borrowing from Orrstown, they had also borrowed millions of dollars from the two other local banks, Susquehanna Bank and Farmers and Merchants Trust Company. In evaluating the Chambersburg Developers' credit worthiness, these other outstanding debts should have been considered by the Loan Committee.

121. Since at least as early as 2006, the Chambersburg Developers have been acquiring land and developing residential neighborhoods and shopping centers in Chambersburg. The first recorded loan from Orrstown to one of the Chambersburg Developers' entities is on October 26, 2006 in the amount of $1.5 million.

122. In 2008, the Bank made loans totaling $8.1 million to the Chambersburg Developers' entities.

123. In 2009, the Bank made loans totaling over $3.3 million to the Chambersburg Developers' entities.

124. In 2010 alone, Orrstown made loans totaling over $9.7 million to the Chambersburg Developers' related entities. By late 2010, the Bank's Loan Committee approved in total over $21 million in loans to the Chambersburg Developers' related entities.

125. All banks are restricted by law from extending loans above certain amounts to any one entity or groups of related entities because over-concentration of loans significantly increases risk of wide-spread and insidious default across a wide swath of a loan portfolio. In 2010, the Company reported that its loan lending limit was $19,000,000. Form 10-K 2010 Annual Report, filed 3/11/11, at 42.

126. According to CW#3, the Bank realized sometime in late 2010 or early 2011, that they may have gone over the Bank's legal lending limit with respect to the Chambersburg Developers. CW#3 recalls that Defendant Embly and Everly were especially concerned and began exploring whether they needed to do "work arounds" to restructure the loans so that the loans could be reissued without either the Chambersburg Developers identified as guarantors of the loans or to conceal the relationship between the Chambersburg Developers and each of these entities.

4. The Yorktown Funding, Inc. Lending Relationship

127. Yorktown Funding, Inc. ("Yorktown"), headquartered in Cumberland, County, Pennsylvania, provides interim construction financing, secured by mortgages, for residential manufactured, modular and site-built homes. Form 8-K Current Report filed 3/22/2010.

128. In 2002, the Bank first extended a $4,000,000 line of credit to Yorktown. *Id.* The purpose of the credit extension was to enable Yorktown to finance construction loans that it makes to its customers. *Id.*

129. By 2009, the Bank made several amendments to the Yorktown loan documents such that the credit extensions escalated to $9.5 million. Given the size of the Yorktown credit extensions, they were reviewed by the Loan Committee and the Board's Credit Administration Committee (defined, *see supra* ¶ 98). The Company's lending relationship with Yorktown, similar to the undisclosed Azadi lending relationship (*see supra* Part VI.B.1 & 4), evidence the fundamental disregard for the Company's Loan Policy and the failures of the Company's underwriting and management-led loan review process that existed prior to and during the March 2010 Offering. The credit extensions made to Yorktown were of a size that triggered review by the Chief Credit Officer, the Loan Committee, and the Credit Administration Committee, at times when Defendants Quinn, Embly, Everly, Snoke, and Shoemaker participated in the loan review. Despite this level of management involvement and purported oversight, the Securities Act Defendants permitted and escalated credit extensions to Yorktown, a financier for residential real estate developers, during a time when other commercial banks had stopped extending precisely those types of loans. The Company's lending to Yorktown belies statements made in the Offering Documents as to the Company's

stringent credit oversight and conservative lending practices. *See infra* Part VII.A-B.

130. Both CW#1 and CW#3 believed that the Yorktown loans were excessively risky and should not have been made because the $9.5 million was only secured by "pledges of the construction loans and the mortgages securing the construction loans extended by Yorktown" and "unconditional, continuing guarantees given by the two principals of Yorktown." Form 8-K Current Report filed 3/22/2010.

131. On February 9, 2010, Yorktown filed a petition for relief under Chapter 11 of the Bankruptcy Code in the United States Middle District Court of Pennsylvania. The case is docketed at *In re: Yorktown Funding, Inc.,* No. 1:10-bk-01042 MDPA Bankruptcy. An amended petition was filed on March 9, 2010. *Id.* at Dkt. #20. Given the lending relationship that existed between Yorktown and Orrstown, a reasonable inference can be drawn that the Bank was made aware of Yorktown's initial bankruptcy petition on or around the time it was filed.

132. Orrstown did not notify the investing public of the Yorktown bankruptcy until March 22, 2010 after Yorktown had filed its Schedule F (Id. at Dkt. #24), identifying Orrstown as an "unsecured nonpriority claim" in the amount of $8,386,793.98. See Form 8-K Current Report filed 3/22/2010. In total, Yorktown reported liabilities of $40,821,671.69 and assets of $31,622,827.46. *Id.*

133. In reporting on the Yorktown bankruptcy, Orrstown sought to reassure investors that it would "aggressively pursue recovery" but conceded the weak position of the Bank with respect to other creditors:

> ***If, as alleged by Yorktown, the security interests granted by Yorktown to secure the Yorktown Loan are ultimately determined to be unperfected, the Bank would participate in the Yorktown bankruptcy as an unsecured creditor*** and would receive a pro rata share of the distribution to unsecured creditors after payment of priority claims, administrative claims and claims of senior classes of creditors. . . . The amounts that will be available for payment of claims cannot, at this time, be determined with any reasonable certainty.

Id. (emphasis added). Further, the Bank had to reclassify Yorktown loans as nonperforming,

> The first meeting of creditors was held on March 19, 2010 pursuant to Section 341 of the Bankruptcy Code. . . . ***Yet, because Yorktown has alleged that the Bank is the holder of an unsecured nonpriority claim for pre-petition indebtedness, Yorktown has not paid, and will not pay, regular debt service payments on the Yorktown Loan during the pendency of the Chapter 11 case.*** Therefore, although the Bank and its counsel have not completed their analysis of the Yorktown Loan documentation and the extent to which the Bank may be able to challenge its classification as a holder of an unsecured nonpriority claim, after consultation with its counsel following the first meeting of creditors, the Bank determined that, ***unless circumstances change, the Bank will place the Yorktown Loan on nonaccrual status and report the loan as nonperforming at March 31, 2010***.

Id. (emphasis added).

134. Soon after Orrstown made these disclosures, the Bank began working with a consortium of other banks to provide bankruptcy financing to Yorktown and the non-debtor entity Yorktown Funding II, Inc. (“Yorktown II”). On April 19, 2010, Defendant Embly sent Yorktown a “Bank Term Commitment Letter” providing for $16,968,403 to Yorktown to “enable [it] to formulate, and seek confirmation of, a plan of reorganization” and also a revolving line of credit in the amount of $16 million to Yorktown II. *In re: Yorktown Funding, Inc.,* No. 1:10-bk-01042 MDPA Bankruptcy at Dkt. # 473-3. Orrstown did not contemporaneously report to investors the Yorktown bankruptcy funding but rather waited until May 11, 2011 to notify investors that Orrstown had taken an active role in the bankruptcy reorganization plan and “arranged for exit financing.” Form 8-K Current Report, filed 5/11/2011.

135. One year after the Bank’s unsecured position on over $8 million in the Yorktown bankruptcy was disclosed and just weeks after announcing it would serve as “lead bank” in exit financing for Yorktown (see *id.*), the Bank announced “Material Impairments”:

> [O]n July 12, 2011 the Bank notified Yorktown and the newly formed entity that ***the Bank would not be able to extend its commitments which expired on June 30, 2011***. . . . The Bank previously allocated $2,977,187 of its loan loss reserve to the Yorktown loan. ***As a result of the Bank’s termination of its involvement with the Plan of Reorganization exit financing for Yorktown, the***

> ***Bank determined on July 12, 2011 that it was appropriate to charge off as of June 30, 2011 $8,598,216*** (which includes the previously allocated loan loss amount of $2,977,187).

Form 8-K Material Impairments, filed 7/14/2011 (emphasis added). The Company also disclosed,

> ***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.***

Id. (emphasis added). On this news, Orrstown's stock price dropped by 23% causing damage to Plaintiff and Class Members. *See infra* Part VII.D.

C. The March 2010 Offering

136. 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. The March

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

137. In the Registration Statement, Orrstown touted its historic success as the result of a "conservative business model." The Offering Documents provided favorable financial data for the years 2007 through 2009 which the Bank leveraged to support its representation to investors that the Bank had a "strong balance sheet." After reporting record earnings in 2009, the Registration Statement portrayed the Company as "well-positioned" to move forward and, with the proceeds of the Offering, to build up its cash reserves so as to seek out new growth opportunities.

138. 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 supra* Part VI.A.3, 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*, the Internal Review resulted

in management increasing over the prior year provisions for loan losses. 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.

139. 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. 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 evidenced 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.

140. Subsequent to the concurrent announcements about the additional provisions for loan losses (*supra* ¶ 138) and the Yorktown situation (*supra* Part VI.B.4), 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 public statement about the quality of the Bank's management, commercial loan portfolio, lending practices and internal controls. *See infra* Part VII.

141. The March 2010 Offering was well received. 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.

D. The Federal and State Banking Regulators' Intervention and Enforcement Actions

142. Without public disclosure, the Regulators officially kicked-off their investigation on March 31, 2011. The Regulators refer to their investigation as the Joint Report of Examination by the Bureau and the Federal Reserve Bank (the "Joint Examination").

143. However, that "official" kick-off was preceded months earlier by the Regulators' stepped up scrutiny of Orrstown, as evidenced by the following: CW#2 recalls that outside of the ordinary examinations done by the Regulators, the Federal Reserve Bank was on-site at the Bank's Operations Center around November-December of 2010. Moreover, without explanation, after the first two

quarters of 2010, the following statement no longer appears in Orrstown's Form 10-Qs:

> ***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).

144. It was not until March 23, 2012, that the investing public was informed of the existence of the Joint Examination and its scope. As revealed in the Company's Form 8-K filing, the Joint Examination began a year prior in March 2011 and scrutinized every aspect of the Company's management, internal controls, underwriting and lending practices by examining, *inter alia*, (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, at Agreement 2-8.

145. Soon after the "official" start of the Joint Examination in March 2011, the Bank was prompted by the Regulators' scrutiny of the Bank's internal controls to outsource 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 was tasked with "identify[ing] gaps in the underwriting process, credit administration and problem loan identification and monitoring." 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. In disclosing the retention of this independent consulting firm to the investing public, the Bank positioned this move as a responsible effort to ensure good risk management: "Management's decision to supplement its internal 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." Form 10-Q 2Q2011, filed on 8/9/2011, at 56-57. The Company, at that time, did not disclose the existence of the Joint Examination nor did the Company reveal the true state of the deteriorating commercial loan portfolio or the Bank's inability to adequately assess loan risks.

146. In July 2011, the Bank declared a quarterly cash dividend at $0.23. According to CW#3, the Regulators had expressed their strong disapproval to Bank management about the Company declaring a dividend for 2Q2011.

147. However, on October 26, 2011, after the market closed, the Company filed with the SEC a Form 8-K revealing that the Federal Reserve rejected the Company's request to declare a quarterly dividend for 3Q2011 and the market reacted sharply to this bad news. Form 8-K 3Q2011 Operating Results, filed 10/26/2011, at 2 (emphasis added); *see also infra* Parts VII.D and IX.F.

148. In March 2012, the Company issued a series of disclosures that gradually informed the investing public of the Bank's true operating and financial condition thus breaking a silence and correcting misrepresentations that had persisted throughout the Class Period. First, 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*. According to CW#6, despite the Company's pledge, Defendant Quinn met very infrequently with SAG at the Bank's Operations Center and often disagreed with SAG's recommendations on the necessity to downgrade particular loans. Then, one week later after these dramatic disclosures, the investing public was told about the Regulators' Joint Investigation of and resulting enforcement actions against the Bank

149. On March 23, 2012, the investing public was told the extent of the Regulators' involvement. The Department of Banking and Federal Reserve Bank had issued enforcement actions against Orrstown and the Bank in the form of a "Consent Order" and "Written Agreement," respectively. 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).

150. The Regulators, per their March 23, 2012 agreements with Orrstown and the Bank, required the Bank to conduct an in-depth, critical evaluation of its management. Specifically, the Federal Reserve Bank required that by mid-June 2012, the Bank 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')." Form 8-K Federal Reserve Bank Agreement, filed 3/23/2012, at 3. 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 independent consultant issued his/her Report. Through its Consent Order, The Department of Banking also required the Bank to take affirmative steps to review and improve its 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 Department of Banking required that a "Management Report" be issued within 120 days of the execution of the Consent Order and, like the Federal Reserve Bank's Management Review, the Department of Banking required the independent consultant 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).

151. Within months of the Regulators' mandate for management reviews, there were several officer and senior level departures and, as confirmed by CW#5, the Regulators were scrutinizing the Bank's lending activity. The Regulators' required management reviews resulted in the following departures as reported in the Company's SEC filings:

> "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 July 13, 2012, ***Michael A. Moore*** resigned as Senior Vice President and Chief Credit Officer of the Bank." *Id* (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).

Each of these individuals was employed by the Bank during the Class Period. Defendant Everly signed the Registration Statement. Everly and Embly, as Securities Act Defendants, participated in the preparation of the false and misleading Offering Documents for the March 2010 Offering.

152. As Orrstown and the Bank were announcing these 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).

153. Contrary to the Regulators' mandate to evaluate the efficacy of the directors (*see supra* ¶¶ 144, 149-150), Orrstown and the Bank's internal scrutiny of management did not reach the board-level. With the exception of Defendant Shoemaker who announced he would not stand for re-election, there have been no other departures of the non-officer Individual Defendant directors despite the fact that each one of these Individual Defendants, Zullinger, Coy, Ceddia, Keller, Pugh, Rosenberry, Snoke, and Ward had direct involvement with the Loan Committee, Enterprise Risk Management Committee, Credit Administration Committee and/or Audit Committee throughout the time period relevant to the matters alleged herein.

154. The Individual Defendants, who sit on the Orrstown Board, seek to insulate themselves from scrutiny and having any accountability for the Bank's distress which has prompted the Regulators' ongoing oversight. This is most evident in the Board's recent actions in opposition to PL Capital.

155. PL Capital is a group of affiliated investment firms that specializes in the banking industry and focuses its long-term investments in publicly traded banks and thrifts. In October 2012, PL Capital became a 6.9% shareholder in the Company. When PL Capital filed its Form Schedule 13D with the SEC, it put Orrstown on notice that it intended "to monitor the performance of the Company and the actions of the Company's management and board, and where needed, to assert stockholder rights." PL Capital Form Schedule 13D, filed 10/22/2012.

156. Within just four weeks of the filing of PL Capital's Schedule 13D, on November 21, 2012, Orrstown filed a Form 8-K to announce that the Board had amended the bylaws to provide for new director eligibility requirements. Orrstown Bylaw Announcement Form 8-K, filed 11/21/2012. These bylaw amendments (a) require that a director reside within 50 miles of Orrstown's headquarters in Shippensburg, Pennsylvania; (b) prohibit a director from serving on the board of another banking institution; and (c) require that a director be less than 75 years of age. *Id.* The Board conveniently exempted current directors, *i.e.*, the Individual Defendants, from these bylaws. Moreover, the Board amended the bylaws without seeking shareholder approval which is statutorily required under Pennsylvania banking law.

157. The actions of the Board, which consists entirely of Individual Defendants except for one director, can only be viewed as an artifice to entrench themselves and foreclose PL Capital from putting forth one or both of its two principals as nominees for directorship. With these bylaw amendments, PL Capital's principals are not qualified to serve as directors because they live outside of the 50-mile residency requirement and sit on the board of other financial institutions.

158. PL Capital demanded that the Board rescind these bylaw amendments but when the Board refused, on January 8, 2013, PL Capital filed a derivative

lawsuit in the Middle District Court of Pennsylvania claiming that the Board had breached its fiduciary duties for the "wrongful adoption and discriminatory application of amendments to certain director qualification by-laws." Verified Complaint, (Dkt. #1), *PL Capital, et al. v. Zullinger, et al.*, Case No. 1:13-cv-00047-JEJ (M.D.PA.). Further, to enjoin the board from enacting and applying these bylaw amendments, PL Capital contemporaneously filed a Motion for Preliminary Injunction to ensure that PL Capital's nominee would be included in the 2013 proxy materials that are to be mailed to Orrstown shareholders by March 29, 2013. *See* Plaintiffs' Motion for Preliminary Injunction and Expedited Discovery, (Dkt. #3), *PL Capital, et al. v. Zullinger, et al.*, Case No. 1:13-cv-00047-CCC (M.D.PA.). In support of their motion, PL Capital stated:

> The Board deprived [PL Capital] and the other shareholders of this core right when it abruptly enacted new bylaws that dramatically reduced the pool of candidates eligible to sit on the Board and entrench the current members' positions on the Board. The Entrenchment Bylaws violate Pennsylvania law by stripping Plaintiffs of their fundamental shareholder right to nominate and vote for a directorial candidate of their choosing, and harm the Company by depriving it of qualified, competent professionals who could benefit Orrstown by serving on the Board.

Brief In Support of Plaintiffs' Motion for Preliminary Injunction and Expedited Discovery, (Dkt. #4), *PL Capital, et al. v. Zullinger, et al.*, Case No. 1:13-cv-00047-CCC (M.D.PA.). In its motion papers, PL Capital set forth compelling legal

authority to support its position that the bylaw amendments were impermissible and violated the Board's fiduciary duties. The court acted quickly on PL Capital's motion, set an expedited discovery, and scheduled for February 25, 2013, the Preliminary Injunction hearing and trial on the merits of the Derivative Complaint.

159. The Board apparently realized that it had gone too far in protecting its own interests at the sake of the shareholders and Company that just three weeks after PL Capital filed its lawsuit, Orrstown entered into a settlement with PL Capital that, among other things, provided that the Board would rescind the director eligibility requirements it unilaterally enacted and would not through 2015 add any director eligibility requirements to the bylaws that would prevent PL Capital from nominating a director candidate plus pay PL Capital $125,000 in legal fees related to the litigation. Orrstown Settlement Announcement, Form 8-K, filed 2/4/2013. Furthermore, this settlement with PL Capital came on the heels of the Company announcing that the Board had finally amended the bylaws in recognition of the shareholder-approved proposal from the May 2012 annual shareholder meeting for simple majority voting requirements to replace existing super-majority shareholder voting requirements. Orrstown Amendments to Articles of Incorporation or Bylaws, Form 8-K, filed 1/24/2013.

160. The PL Capital litigation highlights the Board's fundamental inability to effectively govern Orrstown and the Bank with the necessary prudent corporate

governance and to ensure effective leadership is implementing internal controls that are in the best interests of the Company and the shareholders.

161. Orrstown and the Bank continue to operate under the agreements with the Regulators. As of late December 2012, Defendant Quinn admitted that there is a "constant dialogue" with the Regulators and that "it's not easy" but the Bank has "frequent conversations" with them.[11] Indeed, the Regulators' intense scrutiny and oversight of Orrstown is evident by Quinn's statement concerning the pressure on the Board to "fix[] the company": "Our board has met over 175 times this year, including committee meetings. I've gotten directors out of bed, and put them to bed." [12] As of January 25, 2013, the Regulators' enforcement action against the Bank remains in effect such that Quinn and the directors are still under the Regulators' microscope.

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

162. The Securities Act claims contained in this portion of the Complaint specifically exclude any allegations of knowledge or scienter, and any allegation

[11] 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).
[12] *Id*.

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.

163. Plaintiff's Securities Act allegations stem from materially untrue and misleading statements contained in Orrstown's Offering Documents concerning (a) the quality of management and its oversight; (b) the quality of the Bank's underwriting standards and loan review process; (c) the quality of the Bank's loan portfolio including the percentage of Risk Assets; (d) the required levels of loan loss reserves; and (e) the intended purpose for the proceeds raised in the Offering.

164. Where any materially untrue and misleading statement is deemed to be a statement of opinion not verifiable by objective facts, the 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).

A. The Offering Documents' Materially Untrue and Misleading Statements and Omissions Regarding the Credit, Underwriting and Loan Review Procedures

165. In painting the picture of a well-run, disciplined Company on the move, the Offering Documents made a series of statements about the quality of the Bank's underwriting standards, credit review policies and internal controls:

a. "We view ***sound credit practices and stringent underwriting standards*** as an integral component of our continued success. ***In September 2009, we created the position of Chief Credit Officer to enhance our processes and controls, as well as clearly delineate independence between sales and credit."*** Form 424B Prospectus Supplement, filed 3/24/10, at 2 (emphasis added).

b. "Our ability to successfully grow will also depend on the continued availability of loan opportunities that meet ***our stringent underwriting standards***." Form 424B Prospectus Supplement, filed 3/24/10, at 13 (emphasis added).

c. "The Bank follows ***conservative lending practices and continues to carry a high quality loan portfolio*** with no unusual or undue concentrations of credit." Form 10-K 2009 Annual Report, file 3/15/2010, at 30 (emphasis added).

d. "Orrstown Bank employs a Loan Review Officer, who is independent from the loan origination function and reports directly to the Credit Administration Committee. ***The Loan Review Officer continually monitors and evaluates loan customers utilizing risk-rating criteria established in the Loan Policy in order to spot deteriorating trends and detect conditions which might indicate potential problem loans***.

The Loan Review Officer reports the results of the loan reviews at least quarterly to the Credit Administration Committee for approval and provides the basis for evaluating the adequacy of the allowance for loan losses." Form 10-K 2009 Annual Report, filed 3/15/2010, at 30 (emphasis added).

166. The Offering Documents boasted about the Company's low percentage of Risk Assets while highlighting its conservative approach to allocating sufficient loan loss reserves:

a. "While certain borrowers have come under stress due to the economic conditions affecting our markets, we believe that this ***disciplined approach to lending results in peer-leading asset quality metrics even in a difficult environment.*** As of December 31, 2009, our nonperforming assets to total assets ratio was 0.44%. Additionally, ***we have proactively moved to address any problem credits and ensure that we are adequately reserved for any potential losses."*** Form 424B Prospectus Supplement, filed 3/24/2010, at 2 (emphasis added).

b. "In recognition of sustained loan growth and a continuation of its ***historically prudent approach***, the Company added $3,600,000 to its loan loss reserve in the fourth quarter." Form 8-K 4Q 2009 Operating Results, filed 1/28/2010, at 1 (emphasis added).

c. "Commenting on the Bank's loan portfolio Mr. Quinn stated, "Our ratio of nonperforming loans to end of period loans of 1.18% and net charge offs to average loans of 0.11% ***are well below peers and demonstrate our continued focus on credit quality risk mitigation***." Form 8-K 4Q 2009 Operating Results, filed 1/28/2010, at 1 (emphasis added).

167. The 2010 Annual Report, which was filed nine days before the March 2010 Offering and incorporated by reference in the Offering Documents, continued in this same vein:

a. "The ***quality of the Corporation's asset structure continues to be strong. A substantial amount of time is devoted by management to overseeing*** the investment of funds in loans and securities and the formulation of policies directed toward the profitability and ***minimization of risk associated*** with such investments." Form 10-K 2009 Annual Report, filed 3/15/2010, at 29 (emphasis added).

b. ***"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.***

Management is prepared to make reserve adjustments that may become necessary as economic conditions continue to change." Form 10-K 2009 Annual Report, filed 3/15/2010, at 35 (emphasis added).

168. Defendants Quinn, Embly and Everly reiterated the statements made above, *supra* ¶¶ 165-167, concerning the Bank's underwriting standards, credit review policies and internal controls when they conducted the "Road Show" for the March 2010 Offering. The "Road Show" was essentially management's opportunity to market the March 2010 Offering directly to investment managers and other financial advisors as well as to the investing public. On March 16, 2010, Orrstown filed with the SEC the "Road Show PowerPoint Presentation" that was used by the Underwriter Defendants and management, including Quinn, Embly and Everly, to sell Orrstown stock to the Class. The Road Show PowerPoint Presentation makes the following statements:

a. ***"Conservative lending practices have resulted in strong asset quality metrics*** in a difficult credit environment. . ." Form 8-K "Road Show" PowerPoint Presentation, filed 3/16/10, at 4 (emphasis added).

b. ***"Global credit oversight*** by the Bank's Credit Administration Committee, which is comprised of ***four independent directors***." Form 8-K "Road Show" PowerPoint Presentation, filed 3/16/10, at 19 (emphasis added).

c. Orrstown's ***"[e]mphasis on credit quality, return to shareholders, solid financial performance, and deliver[y] [of] peer-group leading results"*** is a ***"highlight"*** for the investing public to consider. Form 8-K "Road Show" PowerPoint Presentation, filed 3/16/2010, at 28 (emphasis added).

169. In truth, however, all of the foregoing statements, *supra* ¶¶ 165-168, were materially untrue or misleading when made or omitted to state material facts necessary to make the statements made not misleading because, *inter alia,*

a. The Bank's loan portfolio was not high quality and was materially impaired by the Individual Orrstown Defendants' failure to follow policies and internal controls. Orrstown had not employed "conservative," "disciplined" or "stringent" lending and underwriting procedures. The Loan Committee repeatedly violated the Loan Policy by making unsupported exceptions to the Loan Policy to extend credit to borrowers whose loans failed to satisfy the Loan Policy's Debt Service Ratio and other credit requirements;

b. The provisions for loan losses was not "ample" given the composition of the commercial loan portfolio, particularly because of the risky loans and credit extended to Hagerstown borrowers, Yorktown, and the Chambersburg Developers;

c. Orrstown had not taken a "historically prudent approach to lending" and by mid-2009, after Brian Selders was hired as Vice President, Business Development Officer to replace Terry Reiber, and prior to the filing of the Offering Documents, Selders put management on notice that the Hagerstown commercial loans that Reiber had originated and the Loan Committee approved were of very poor quality and impaired;

d. Orrstown was not providing the necessary "oversight" to manage "credit risks" such when in January of 2010, the Azadis, a large commercial borrower, notified the Bank of financial distress there was no disclosure that this lending relationship with an aggregate exposure *at that time* of over $10 million had the potential to become a Risk Asset;

e. Orrstown did not put an "emphasis on credit quality" or "minimize risk" because the management led Loan Committee routinely approved loans that the Credit Analyst Group recommended against; and

f. The Board's Credit Administration Committee did not provide "global credit oversight" because it allowed the independence of the Company's credit review and loan approval process in place before

and during the March 2010 Offering to be compromised by the influence of the loan officers who sought to push loans through for their customers.

170. After the March 2010 Offering closed, management continued to issue false statements about the Company's stringent credit procedures and misled investors about the reasons for the increase in provisions for loan losses, stating such increase was in line with the Bank's "conservative business model" when, in reality, the increase was caused by deficient internal controls and undisciplined lending practices. Such statements include those by Defendant Quinn:

a. "I am pleased to announce that Orrstown Financial Services, Inc. has closed the ***first quarter of 2010 with exceptional results***. . . . We remain mindful of the economic challenges facing our customers and ***continued to add to our loan loss provision, which is in line with our conservative business model."*** First Quarter Report, "The Road Ahead: Paving the Way to Greater Success," dated 3/31/2010, at 1 (emphasis added).

b. "***The momentum created with record earnings in 2009 and a strong first quarter 2010 have continued through the midpoint of the year. Indicators of the financial strength of our Company this quarter include: increasing our dividend; improving earnings 13% vs. the***

same quarter last year; and significantly reducing nonperforming assets since the first quarter of 2010. . . . Our financial performance, local and national recognition are a testament to the hard work and support of our Board of Directors, Executive Management Team, and nearly 300 dedicated team members. ***Our solid core earnings position us well for the second half of 2010."*** Form 8-K 2Q2010 Operating Results, filed on 7/22/2010, at 1 (emphasis added).

c. "***Despite a tough banking environment, we have been able to produce consistent operating results, bolster our reserves and capital, and continue our efforts in addressing asset quality.*** This forward momentum will continue to serve us well during the remainder of 2010 and into 2011." Form 8-K 3Q2010 Operating Results, filed on 10/28/2010, at 1 (emphasis added).

d. "Our performance in 2010 resulted in the best earnings (net income up 24%) ever in the 91-year history of the organization. Of course ***2010 was a challenging year for all community banks, but we nevertheless produced strong results*** which will be substantially above local peer levels once the year-end results are compiled. Additionally, ***we bolstered our reserves, added meaningfully to capital and were intensively focused on asset quality, which we***

believed remains quite solid." Form 8-K 4Q2010 Operating Results, filed on 1/27/2011, at 1 (emphasis added).

e. "***We are pleased to have increased our dividend and still retain capital from earnings, while continuing to conservatively add to reserve coverage of problem assets.*** Total nonperforming assets continue to decline and were down 6.5% at March 31 from end of year levels. ***We believe our capital position is quite robust and should provide us with a significant platform to enhance our strong organic growth."*** Form 8-K 1Q2011 Operating Results, filed on 4/28/2011, at 1 (emphasis added)

171. The foregoing statements were false and misleading, for the reasons set forth *supra* Part VI, in that the Bank held a high risk portfolio where a large dollar value of the loans had been approved via an exemption to prudent lending practices and the Bank's Loan Policy. These statements, therefore, concealed true loan conditions and thus overstated earnings, financial condition and the adequacy of the Bank's capital position and loan loss reserves; overstated the financial stability and future growth prospects for the Bank; inaccurately characterized the asset quality and the efforts to maintain asset quality; and inaccurately stated that the Bank had superior performance to its peers. Further, the Company's declaration of a dividend increase while it extended increasing credit to troubled

customers jeopardized the capital position of the Bank and provided the false impression to the investing public of a stable, secure and growing bank.

B. The Offering Documents' Materially Untrue and Misleading Statements and Omissions Regarding the Effectiveness of Management

172. The Offering Documents "highlighted" the quality of management as a compelling "rationale" for investors to purchase Orrstown stock:

a. ***"Deep and experienced management team*** with ***strong*** community ties, ***operational ability and proven track record*** of acquisition integration." Form 8-K "Road Show" PowerPoint Presentation, filed 3/16/10, at 4, 7 (emphasis added).

b. "We view the current market environment as being full of opportunity for those institutions with a ***strong balance sheet and management.****"* Form 424B Prospectus Supplement, filed 3/24/10, at S-2 (emphasis added).

c. In their Road Show marketing presentation, Defendants Quinn, Everly and Embly also stated that management fostered a ***"disciplined credit culture. . . ."*** Form 8-K "Road Show" PowerPoint Presentation, filed 3/16/10, at 19 (emphasis added), and exercised significant oversight:

d. The Offering Documents emphasized the significant role of senior management: ***"Members of senior management are involved heavily*** in customer interaction and business development and ***play an integral role*** in promoting Orrstown's brand and capabilities." Form 424B Prospectus Supplement, filed 3/24/10, at S-2 (emphasis added).

173. In truth, however, the foregoing statements, were materially untrue or misleading when made or omitted to state material facts necessary to make the statements made not misleading because management had not fostered a disciplined credit culture and had undermined Orrstown's brand and capabilities. As confirmed by CW#1, CW#2 and CW#3, senior management did not implement internal controls and processes that would have (a) prevented the Bank from extending risky commercial loans throughout 2009 and 2010, resulting in a 7% growth in their commercial loan portfolio and further concentrating the Company's overall loan portfolio in commercial loans and (b) required ***effective*** periodic stress testing of all existing commercial loans to ensure that the Company's financial reporting accurately reflected the amount of Risk Assets, loan loss provisions and loan loss reserves which would have indicated to investors the poor quality of the Bank's loan portfolio and potential for significant net-charge-offs.

174. Moreover, the problems at Orrstown were not temporary or immaterial. The problems with management were systemic: (a) management had

been intimately involved in a lending relationship that resulted in a $8.5 million charge-off; (b) the Company required assistance of an independent third-party to provide credit review "to mitigate the Company's risk of loss"; (c) the Company ceased paying a quarterly cash dividend; (d) the Company admitted to a "material weakness" in its internal controls with respect to its risk classification of loans and provisions for loan losses; and (e) state and federal regulators were forced to intervene to prevent the Company from engaging in unsafe and unsound banking practices. *See infra* Part IX.

175. Furthermore, even more recent events evidence that the Company's statements as to the quality and effectiveness of management made at the time of the March 2010 Offering were false and misleading. The Regulators, per their March 23, 2012 agreements with Orrstown and the Bank, required the Bank to conduct an in-depth, critical evaluation of its management. *See supra* Part VI.D. Within months of the Regulators' mandate for management reviews, there were several officer and senior level departures, including Defendants Embly and Everly. Each of these individuals was employed by the Bank during the Class Period. The departures of senior managers Everly, Embly and the Moore – after the Regulators' enforcement actions – indicate that Orrstown and the Bank's management in place prior to and during the March 2010 Offering was not

"strong," "deep" and "experienced" as falsely and misleadingly stated in the Registration Statement (*see supra* ¶ 172).

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

176. Auditor Defendant Smith Elliott "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 Smith Elliot audited. *See* Form 424B5 Prospectus, filed 3/24/2012, at 25-26. It is Smith Elliott's statements in the 2009 Annual Report that are false, misleading and lack a reasonable basis.

177. In its Report of Independent Registered Accounting Firm dated March 15, 2010, Smith Elliott 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).

178. The Sarbanes-Oxley Act of 2002 authorized the Public Company Account Oversight Board ("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 continues 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.

179. In conducting its audit, Smith Elliott would have evaluated 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, Smith Elliott, 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.

180. Smith Elliott was also to follow Financial Accounting Standards Board ("FASB") Statement No. 5, which is the primary guidance on the accounting and reporting 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.

181. Smith Elliot failed to follow Rule 3100 issued by PCAOB, AS No. 5, AU Section 342, and FASB Statement No. 5 in connection with its audit. Smith Elliott failed to verify that Orrstown has 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. Ultimately, Smith Elliott disregarded red flags, failed to obtain sufficient evidence to support opinions and proceeded to issue a

clean audit report and affirming that Orrstown had maintained, in all material respects, effective internal controls. Also, Smith Elliot'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," *supra*, was false, misleading and lacked a reasonable basis.

182. Smith Elliott ignored and failed to account for: (a) the inadequate provisions for loan losses in calendar year 2009 by management which should have been but was not revealed by the Internal Review; (b) the number of loans made by the Bank and Loan Committee that were based on exceptions; (c) that loans failed to satisfy the Loan Policy's 1.20 Debt Service Ratio; (d) the heavy concentration of commercial loans, particularly development loans, made to affiliated borrowers in certain geographic areas; (e) adverse credit data about borrowers; and (f) undue influence and control over loan decisions by management.

183. Importantly, the Internal Review (discussed *supra* Part VI.A.3) was conducted at a time when Smith Elliott was auditing Orrstown and the Bank's financial statements for the year ending December 31, 2009. At that time, the Bank's Internal Review had purportedly made findings as to the credit quality of 60% of the Bank's commercial loan portfolio. In response to the Internal Review's

findings and any recommendations made by the Credit Administration Committee, the Bank increased its provisions for loan loss reserves by $3 million in 4th Quarter 2009. The findings of the Internal Review (which were inherently flawed and unreliable in that the full scope of the loan risks were not disclosed) and the Credit Administration Committee's recommendations on those findings that were reflected in the financial statements prepared by the Company, at least as of that time, put Smith Elliott on notice of internal problems at the Bank, and that management had improperly forestalled the allocation of additional provisions for loan loss reserves which would have had the concomitant effect of driving down the Company's net income.

184. Smith Elliot's material auditing failures are consistent with those of other auditing firms registered with the PCAOB. The PCAOB recently 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 years ending 2009 which, the PCAOB concluded, indicates that auditing firms are not following the methodologies and standards required of them. *Id.* at ii.

185. 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.

186. Under the circumstances of this Action, and based on the facts disclosed above, it is apparent that Smith Elliott's integrated audits of the 2009,

2010 and 2011 financial statements were materially deficient in the same manner as the serious deficiencies identified in ¶ 185 *supra*.

D. The Securities Act Class Is Damaged by the Offering Documents' False and Misleading Statements

187. A series of post-Offering disclosures concerning these subjects, *see supra* Part VII.A-B, revealed Orrstown's true financial condition at the time of the March 2010 Offering and demonstrated that such subject matters were material and, therefore, the Offering Documents contained untrue statements and omitted material facts in violation of the Securities Act.

188. 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* Part VI.B.4. This was the first time the Company alerted the public shareholders to

any weakness in its commercial loan portfolio. 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.

189. 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.”*** 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 share price, a 34% loss since its Offering Price of $27 per share.

190. The Company, however, perpetuated the façade of a "safe and sound" bank by declaring a quarterly cash dividend of $0.23 (discussed *supra* ¶¶ 7, 146).

191. After the market closed on October 26, 2011, the Company reported that the Federal Reserve Bank refused to approve the Company's payment of a cash quarterly dividend. The Federal Reserve Bank 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 its internal controls, which as a result of the Regulators' enforcement actions reported on March 23, 2012, the Company made much needed "structural changes." Schedule 14A Additional Definitive Proxy Materials, filed 3/30/2012, at 1. *See infra* Part IX. By April 5, 2012, this news was digested by investors and the stock sunk to $8.20.

192. 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, 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). As illustrated by the following stock price chart, Orrstown closed at $7.84 on the date the suit was filed, and has traded below $10 since October 27, 2011, the first disclosure revealing the Regulators' intervention, through the end of the Class Period.

VIII. SECURITIES ACT CLAIMS FOR RELIEF

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

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

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

195. 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.

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

197. 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.

198. 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.

199. 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)

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

201. 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.

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

203. 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.

204. 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.

205. 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.

206. 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.

207. 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 and material understatement of loan loss reserves were revealed and resulted in the stock price dropping as alleged herein.

208. 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.

209. 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.

210. 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)

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

212. 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.

213. 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.

214. 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.

215. 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 misstatements and omissions contained in the Registration Statement.

216. 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 untruths and omissions contained in the Registration Statement.

217. 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.

218. 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 rescissory damages.

219. 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.

220. 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.

221. 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)

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

223. 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.

224. The Company and Bank are liable under Section 11 of the Securities Act as set forth above in Count I.

225. 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.

226. 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.

227. 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.

228. 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.

IX. EXCHANGE ACT ALLEGATIONS: THE EXCHANGE ACT DEFENDANTS' FRAUDULENT CONDUCT AND COURSE OF BUSINESS

229. The Orrstown Exchange Act Defendants and Auditor Defendant are liable for: (1) making false material statements; or (2) failing to disclose adverse material facts know 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, credit review and underwriting standards, loan portfolio, adequacy of loan loss reserves, and financial condition; (2) artificially inflated the prices of Orrstown common stock; and (3) caused the Exchange Act Class to purchase Orrstown at inflated prices.

230. Throughout the Class Period, the Orrstown Exchange Act Defendants maintained and perpetuated the artifice of a healthy, robust Company that was

smartly growing by filing with the SEC false annual reports, quarterly reports, financial statements, press materials and marketing presentation materials throughout 2010 and mid-2012. Similarly, 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.

A. The Orrstown Exchange Act Defendants' Fraudulent Material Statements and Omissions in the 2009 Annual Report, Form 10-K

231. As early as September 2009, the Orrstown Exchange Act Defendants were confronting failures in the credit review and loan approval process. 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 initiated its Internal Review of 60% of the Bank's commercial loan portfolio. Through this Internal Review, *see supra* Part VI.A.3, the Orrstown Exchange Act Defendants were presented with 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 or sound investment.

232. On March 15, 2010, the Company filed its 2009 Annual Report. The Orrstown Exchange Act Defendants made statements touting the purported quality of the Bank's underwriting standards, credit review policies and internal controls:

a. "The Bank follows ***conservative lending practices and continues to carry a high quality loan portfolio*** with no unusual or undue concentrations of credit." Form 10-K 2009 Annual Report, filed 3/15/2010 at 30 (emphasis added).

b. "The ***quality of the Corporation's asset structure continues to be strong. A substantial amount of time is devoted by management to overseeing*** the investment of funds in loans and securities and the formulation of policies directed toward the profitability and ***minimization of risk associated*** with such investments." Form 10-K 2009 Annual Report, filed 3/15/2010, at 29 (emphasis added).

233. In the 2009 Annual Report, the Orrstown Exchange Act Defendants made statements focusing investors on the Company's purported low percentage of

Risk Assets while highlighting management's conservative approach to allocating sufficient loan loss reserves:

a. "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***." Form 10-K 2009 Annual Report, filed 3/15/2010, at 35 (emphasis added).

b. ***"Following the [Internal] 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. . . . The unallocated portion of the reserve ensures that any additional unforeseen losses that are not otherwise identifiable will be able to be absorbed. It is intended to provide for imprecise estimates in assessing projected losses, uncertainties in economic conditions and allocating pool reserves. ***Management deems the total of the allocated and unallocated portions of the allowance for loan losses to be adequate to absorb losses at this time***." Form 10-K 2009 Annual Report, filed 3/15/2010, at 33 (emphasis added).

234. 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 because Orrstown's credit review and loan approval process was wholly inadequate and failed to comply with Orrstown's Loan Policy. As confirmed by CW#1, CW#2 and CW#3, the credit review and underwriting practices were not "conservative," "sound" or "stringent." Rather, 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, the loan officers who had brokered the loans unduly influenced the loan approval process such that borrowers were often portrayed as being more credit-worthy than they actually were. This lack of independence between the sales and credit functions adversely affected the quality of loans extended.

235. The statements in the Form 10-K were also false and misleading because, as CW#1, CW#2 and CW#3 confirmed, large commercial loans were extended, such as in Hagerstown and to the Chambersburg Developers (*see supra* Part VI.B), 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 VI.B.1)

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. Defendants were just throwing good money after bad to mask the failed loans and to deceptively delay disclosure of Orrstown's losses and materially weakened financial position.

236. 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 made by the Credit Analyst Group as to whether the Loan Committee should approve the loan. Accordingly, the Orrstown Exchange Defendants knew throughout the Class Period that the Bank's internal controls were failing. The Loan Committee's penchant for disregarding the Credit Analyst Group's recommendations and instead making arbitrary exceptions to the Loan Policy for poor quality commercial loans rendered materially false and misleading the Orrstown Exchange Act Defendants' statements about Orrstown's "high quality loan portfolio,"

minimization of risk," "conservative lending practices" and "adequacy of loan losses."

237. 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 Internal Review (*see supra* Part VI.A.3). Moreover, the Internal Review operated under a very narrow view of "Risk Assets" and imprudently failed to account for, particularly in the context of the failures of Orrstown's loan approval process, substandard loans, which was never disclosed to investors. The result was that the loan loss reserves of ($4,267,000), a critical accounting estimate, was materially understated, failing to account for commercial loans that were troubled and needed reclassification based upon past and present credit information. It was therefore false and misleading when the Orrstown Exchange Act Defendants stated that they had "adequately" provided for and allocated loss reserves for the identified Risk Assets because, at that time, the Bank only stated that there were $4,267,000 of Risk Assets when in fact the Orrstown Exchange Act Defendants should have known from information gathered but ignored by the Internal Review team and recent communications from large commercial borrowers the Azadis and Yorktown that there was ***at least*** an

additional $19 million in Risk Assets that should have been identified and loan loss provisions allocated. The Orrstown Exchange Act Defendants, however, did not want to sabotage the March 2010 Offering by accounting for the $19 million in additional Risk Assets.

238. To assist in this delayed disclosure of Risk Assets, the Bank adopted a new eight point internal risk rating system which forestalled the proper classification of troubled loans and allocation of provisions for loan losses (*see infra* Part IX.C.). Form 10-K 2010 Annual Report, filed 3/11/2011, at 47-48 (discussing eight point risk rating system).

B. The Orrstown Exchange Act Defendants' False and Misleading Statements to the Class at the May 4, 2010 Shareholder Meeting and in the May 5, 2010 Form 8-K

239. On May 4, 2010, Orrstown held its annual shareholder meeting, during which a slide show presentation was given. The meeting transcript and slide presentation were filed with the SEC as exhibits to a May 5, 2010 Form 8-K issued by Orrstown. At the meeting, Defendant Joel Zullinger, Orrstown's Chairman of the Board of Directors, stated:

a. "As a poor economy would indicate, we have also had a higher level of loan losses than we have in the past, yet despite this, we have added to our loan loss reserve and still ended 2009 with an increase in

income over 2008 and our first quarter of 2010 shows a substantial increase in income over the same period in 2009."

b. "We have a strong and experienced management team that can capitalize on any opportunities we are presented with and also deal with the economic and regulatory environment we are facing."

240. Defendant Embly, Orrstown's then-Chief Credit Officer, discussed Orrstown's "Credit Quality Review," representing to investors that Orrstown takes a "Proactive & Thorough Approach to Credit" and has a "Disciplined Credit Culture." Form 8-K Annual Slide Presentation, field 5/5/2010.

241. The Orrstown Exchange Act Defendants, again, touted to the Class that Orrstown's loan performance was far superior to that of its peers, with Defendant Embly highlighting that only 0.44% of Orrstown's total assets were non-performing assets, which was 75% lower than its regional peers. *Id*.

242. Defendant Quinn also represented to investors that the Company's conservative practices would continue and characterized Orrstown's growth as "responsible":

a. "We will continue our trend of strong financial performance mixed with ***conservative lending practices***." Form 8-K Annual Slide Presentation, filed 5/5/2010, at 65 (emphasis added).

b. "We will continue to invest in our business with ***responsible growth*** as a byproduct." Form 8-K Annual Slide Presentation, filed 5/5/2010, at 65 (emphasis added).

243. These statements were materially false or misleading when made or omitted to state material facts necessary to make the statements made not misleading because: economic conditions were not the bane of the Company's troubles (tellingly, such claim is undermined by Orrstown's concurrent representations about it materially outperforming its regional peers and its perceived growth opportunities); the Company did not have a strong and experienced management team; Orrstown's approach to credit was not thorough or disciplined; and, its lending practices were not conservative. The truth was:

a. The Loan Committee habitually extended credit to borrowers who did not satisfy the Bank's credit requirements, especially the crucial Debt Service Ratio. The Bank's lending practices were also not conservative in that loan officers, such as Terry Reiber, unduly influenced the credit review and approval process to extend credit to risky borrowers which diminished the loan portfolio's credit quality.

b. Further, for the Bank's commercial loan portfolio which comprises 75% of the Bank's entire portfolio, $259,000 was the average value for commercial loans originated in 2010. *See* Form 10-K 2010

Annual Report, filed on 3/11/2011, at 4. This meant that, per the Company's loan level review process, these loans were extended without any oversight by the Chief Credit Officer, the Loan Committee, and the Board's Credit Administration Committee. *Id*. Rather, the Loan Review Officer was the only one to check on all of these loans. The Loan Review Officer, however, lacked the educational background and formal training to qualify the Loan Review Officer for this significant underwriting responsibility. This lack of oversight does not evidence a purported emphasis on "credit quality."

c. Moreover, as discussed above (*see supra* Parts VI.A.2 and IX.A.), Embly caused the Company to take unwarranted or excessive risks in approving commercial, including loans generated by Terry Reiber in the Hagerstown market and loans in which the applicant was part of the "Old Boys Club" of Chambersburg, by pushing the Loan Committee to approach such loans based upon an often frivolous "exception" that Defendant Embly offered.

C. The Exchange Act Defendants' Scheme to Materially Understate Loan Loss Reserves and to Understate and Conceal the Magnitude of the Company's Risk Assets from the Class With Their Eight Point System.

244. 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 but only a $1.4 million increase in loan loss reserves from the prior quarter ending December 31, 2009. Commenting on the Company's quarterly performance, Defendant Quinn told investors: "Our core fundamentals remain solid and we were pleased with our first quarter results given the challenging economic conditions." Form 8-K Press Release on 1Q2010 Operating Results, filed 4/22/2010.

245. Cunningly, the Orrstown Exchange Act Defendants reported this increase in the amount of Risk Assets just after the March 2010 Offering while the Company was still basking in the glow of the $40 million capital raise and having had hammered the market and investors with positive statements about Orrstown (*see supra* Part VII.A-B, discussing management's "Road Show"). Moreover, the Company also only recorded a $1.4 million increase in loan loss reserves and pointed to "challenging economic conditions" in order to mislead investors as to the real reason for the Company's increase in Risk Assets. The Orrstown Exchange Act Defendants' public statements about Risk Assets, loan loss reserves and the

"challenging economic conditions" in the 1Q2009 Form 10-Q were false and misled the investing because they concealed and understated the true magnitude of Orrstown's Risk Assets and loan losses which had nothing to do with "challenging economic conditions" but the systemic failure and manipulation of the Company's credit review and loan approval processes.

246. The Exchange Act Defendants would not, however, keep the additional $21 million of Risk Assets on Orrstown's books for long as doing so would unseat them from their purported position as a bank that was far superior to their regional peers in comparable financial and banking metrics, in particular with respect to the percentage of non-performing assets to its total assets -- in contrast to their statements to investors in the March 2010 Offering and at the May 5, 2010 Shareholder meeting. *See infra* ¶ 278 (Orrstown Troubled Asset Chart).

247. The Orrstown Exchange Act Defendants then formulated and implemented a scheme to defraud investors about the health and financial condition of Orrstown and to conceal and materially lower the Company's Risk Assets. The Bank adopted a new ***eight point internal risk rating system***, which gave the Bank the discretion to use several different rating levels until it would ultimately have to move a troubled loan into the nonperforming category. Consequently, the Bank no longer identified as "impaired" its "performing substandard loans." This change in policy, which was not mentioned until

Orrstown's 2010 Form 10-K filed in March 2011, was implemented to facilitate Defendants' concealment of, and their misleading investors about, the magnitude of impaired loans, in particular the Hagerstown-based and Azadi loans.

248. The Company's quarterly Form 10-Q filings for Second, Third and Fourth Quarters 2010, illustrate the significant decreases in Risk Assets and yet the slight increases in loan loss reserves *after* First Quarter 2010 when the Orrstown Exchange Act Defendants implemented the eight point risk rating system:

	1Q2010	**2Q 2010**	**3Q2010**	**4Q2010**
Total Risk Assets	$ 32,822,000	$ 23,015,000	$ 20,481,000	$ 18,437,000
Reserve for Loan Losses	12,020,000	14,582,000	15,386,000	16,020,000

D. The Orrstown Exchange Act Defendants' False and Misleading Statements to the Class from the Second Quarter 2010 Through First Quarter 2011

249. On July 22, 2010, the Company told investors that it had ***"significantly reduc[ed] nonperforming assets"*** and had a ***"solid core earnings position."*** Form 8-K Press Release of 2Q 2010 Operating Results, filed on 7/22/2010 (emphasis added).

250. On November 5, 2010, the Company told investors that the ***"Company continues to be diligent in its handling of nonperforming and other***

risk assets" and is working to ***"reduce the level of risk assets."*** Form10-Q for 3Q2010, filed 11/5/2010, at 25 (emphasis added).

251. Defendant Quinn continued to mislead investors about the true state of Orrstown's financial condition when in November 2010 he spoke at the "2010 East Coast Financial Services Conference" hosted by Underwriter Defendant Sandler O'Neill & Partners L.P. At the conference, Defendant Quinn stated: there are ***"compelling investment considerations"*** when investing in Orrstown because at Orrstown there is an ***"emphasis on credit quality, return to shareholders, solid financial performance, and delivering peer-group leading results."*** Form 8-K, Presentation, filed on 11/10/10, at 24 (emphasis added).

252. In reporting on the operation results of 4Q2010, Defendant Quinn stated: "[W]e bolstered our services, added meaningfully to capital and were ***intensively focused on asset quality,*** which we believe ***remains quite solid."*** Form 8-K Press Release, filed 1/27/2011 (emphasis added).

253. In February 2011 and March 2011, Defendant Quinn spoke at two different investment conferences for investment managers and other financial services providers were present. Again, Defendant Quinn "highlighted" Orrstown's ***"deep and experienced management team," "emphasis on credit quality"*** and "***emphasis on growing mortgages."*** Form 8K Presentation, filed 2/2/11, at 7, 24; Form 8-K, Presentation, filed 3/2/2011, at 7, 24 (emphasis added).

The Orrstown Exchange Act Defendants stated that, when compared against its peers, the Company was performing well: it had ***"excellent return ratios,"*** had ***"reduced"*** Risk Assets while ***"growing"*** both its assets and deposits. Form 8-K, Presentation Materials, filed on 3/1/2011, at 5, 10, 15-16, 23 (emphasis added). The Orrstown Exchange Act Defendants also stated that the Bank continued to place an ***"emphasis on credit quality, return to shareholders, solid financial performance, and delivering peer-group leading results."*** *Id*. at 24 (emphasis added).

254. On February 10, 2011, Defendant Quinn continues to tout the Company's success:

> Over the past several years our Company has seen remarkable results and experienced significant growth. We recently announced the highest earnings ever in the history of the organization and also reported that we surpassed the $1.5 billion asset mark for the year ending December 31, 2010.

Form 8-K Press Release, filed on 2/10/2011.

255. Orrstown's Form 10-K for the Year Ended 12/31/2010, filed with the SEC on March 11, 2011, included the following statements:

a. "***The quality of the Company's asset structure continues to be strong.*** A substantial amount of time is ***devoted by management to overseeing*** the investment of funds in loans and securities and the ***formulation of policies directed toward*** the profitability and

minimization of risk associated with such investments. Form 10-K 2010 Annual Report, filed 3/11/2011, at 40 (emphasis added).

b. "Company follows ***conservative lending practices*** and continues to carry a ***high quality loan portfolio with no unusual concentrations of credit***." Form 10-K 2010 Annual Report, filed 3/11/2011, at 42 (emphasis added).

c. "***Credit risk is mitigated through conservative underwriting standards***, ***on-going risk credit review, and monitoring*** asset quality measures." Form 10-K 2010 Annual Report, filed 3/11/2011, at 45 (emphasis added).

d. "The company continues to be ***diligent in its handling of nonperforming and other risk assets.*** . . ." Form 10-K 2010 Annual Report, filed 3/11/2011, at 46 (emphasis added).

e. "The Bank has a loan review policy and program which is ***designed to reduce and control risk in the lending function***." Form 10-K 2010 Annual Report, filed 3/11/2011, at 48 (emphasis added).

256. The foregoing statements were materially false and/or misleading when made or omitted to state material facts necessary to make the statements made not misleading because throughout 2010 the Bank's Loan Committee continued to extend risky large commercial loans to certain borrowers such as to

the various related real estate development entities of the Chambersburg Developers (discussed *supra* Part VI.B.3) even though, according to CW#3 the loans did not satisfy the Loan Policy's credit requirements. By late 2010, the Loan Committee lead by the Orrstown Exchange Act Defendants, approved in total over $21 million in loans to the Chambersburg Developers' related entities from 2008 through late 2010. According to CW#3, the Orrstown Exchange Act Defendants realized that they may have gone over the Bank's legal lending limit. The Orrstown Exchange Act Defendants' extensions of credit to the Chambersburg Developers did not constitute "conservative lending" and represented an "unusual concentration[] of credit" in one group of borrowers. Notably, it was the so-called "deep and experienced management team" that was directly responsible for these lending relationships all under the purported oversight of the Board's Credit Administration Committee.

257. These statements, *supra* ¶¶ 249-255, were also materially untrue or misleading when made or omitted to state material facts necessary to make the statements made not misleading because they failed to disclose that the eight point internal risk rating system enabled the Company to gradually move troubled loans across this rating system to forestall classifying them as Risk Assets to mask the declining credit quality of the Bank's commercial loan portfolio, many of which were approved by the Orrstown Exchange Act Defendants despite the fact that the

loans did not satisfy the credit requirements of the Loan Policy. Further, these statements are false and misleading because at the precise time that the Orrstown Exchange Act Defendants were making these statements, 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 the Azadis (*see supra* Part VI.B.1). Further, at around the same time, CW#4 also confirmed that the Bank 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.

258. The Company's report of "significant growth" in 2010 was accompanied by the increase over the year prior of Risk Assets. This increase was at its high-water mark in the 1Q2010 but declined in subsequent 2010 quarters when the Company applied the eight point internal risk rating system. This artificial decline in Risk Assets and understatement of loan loss reserves provided investors with financial data reassurance that the Company was competently managing the credit risks of its portfolio. In the 2010 Annual Report, the Orrstown

Exchange Act Defendants gave no indication that the levels of Risk Assets were due to the failure of the Company's internal controls and loan review process.

259. In truth, however, the Orrstown Exchange Act Defendants knew that at the precise time that they were touting the Company's financial health and credit practices, *supra* ¶¶ 249-255, the Bank's primary regulators – the Federal Reserve Bank and the Department of Banking – were poised to formally launch its Joint Investigation into the Company's banking practices. *See supra* Part VI.D. Throughout the Class Period the foregoing false statements, misrepresentations and hallow assurances caused Orrstown to trade at artificially inflated prices.

E. The Orrstown Exchange Act Defendants' False and Misleading Statements to the Class in the Second Quarter 2011

260. Unbeknownst to the Class, as early as July 2010, the Regulators had put the Company on notice that its management and banking practices raised material concerns. *See Supra* Part VI.D. The Regulators' Joint Examination officially commenced on March 31, 2011, with the Regulators scrutinizing every aspect of the Company's management and internal controls.

261. Despite knowledge of the Bank's lack of prudent internal controls that led to the Regulator's intense scrutiny of its banking practices and management, and the false reporting of the Company's Risk Assets and loan loss reserves, the Orrstown Exchange Act Defendants falsely portrayed the Bank throughout 2010,

2011 and into 2012 as a conservative lender, diligent in assessing loan quality and allocating loan loss reserves, thereby duping investors to purchase Orrstown stock at artificially inflated prices.

262. In the Company's Form 8-K announcing operation results for 2Q2011 (filed on 7/28/2011) followed by the Form 10-Q for 2Q2011, the Company declared a cash dividend and stated: ***"Generally speaking, the Company follows conservative lending practices and continues to carry a high quality loan portfolio with no unusual or undue concentrations of credit."*** Form 10-Q 2Q2011, filed on 8/9/11, at 41 (emphasis added). The Company also continued to maintain that it had ***"conservative underwriting standards[,]"*** (*id*. at 42 (emphasis added)), while declaring a $0.23 quarterly cash dividend, representing a 4.5% increase over the prior year period to signal to investors that the Bank was financially sound. *Id.* at 54; *see also* Form 8-K 2Q2011 Operation Results, filed on 7/28/2011.

263. These statements were materially untrue or misleading when made or omitted to state material facts necessary to make the statements made not misleading because they failed to disclose that the Bank's underwriting standards had failed the Bank as evidenced by the Regulators' Joint Investigation and its troubled lending relationships, like the Azadis' lending relationship.

264. Moreover, at this precise point of time in August 2011, the Azadis expressed their desperate financial condition to Defendant Embly such that default was imminent on approximately $16 million. *See supra* Part VI.B.1. Further, these statements (*supra* ¶ 262) are at complete odds with contemporaneous reports that (i) the Bank would charge-off $8.5 million related to the management-approved loans to Yorktown Funding, Inc.; (ii) the Bank's Risk Assets "increased to $54.5 million at June 30, 2011 from $18.4 and $23.0 million at December 31, 2010 and June 30, 2010" and (iii) the fact that in response to the Regulator's investigation, the Company retained an ***outside firm*** in July 2011 to provide ***independent loan reviews*** to fairly ascertain the quality and risk level of the Company's loan portfolio. Form 8-K 2Q2011 Operation Results, filed on 7/28/2011; *see also* Form 10-Q 2Q2011, filed on 8/9/11, at 44, 56-57.

265. Indeed, against the better judgment of the Regulators, Orrstown issued this quarterly dividend at a 4.6% increase over the third quarter from a year prior to continue to conceal from investors the true financial condition and operations of Orrstown. In fact, CW#3 recalls the backlash from the Regulators after Orrstown ignored the Regulators' concerns and declared the increased cash dividend. Orrstown, apparently, was willing to risk stirring the ire of the Regulators' to minimize the market reaction to the negative news revealed in the Form 8-K

2Q2011 Operating Results and following Form 10-Q for the same reporting period, *see supra* ¶ 264.

F. The Orrstown Exchange Act Defendants False and Misleading Statements to the Class From the Third Quarter 2011 Through the End of the Class Period that Slowly Reveal the Truth

266. After the market closed on October 26, 2011, investors were told of the Federal Reserve Bank's scrutiny of the Company and concerns that the company was engaging in unsafe and unsound banking practices.

267. With the filing of the Company's Form 8-K Press Release on 3Q2011 Operating Results, the Company announced that the Federal Reserve Bank would not authorize the Company's declaration of a cash dividend for the Third Quarter of 2011. In consideration of the Company's financial condition, the Federal Reserve Bank Board will only deny approval of a dividend if payment of such a dividend represents an unsafe or unsound practice. By refusing to authorize Orrstown's payment of a quarterly dividend, the Federal Reserve Bank Board concluded that it would be an unsafe or unsound practice for Orrstown to make such a declaration.

268. On October 27, 2011, the Orrstown Exchange Act Defendants tried to blunt the market reaction to this news and filed a letter with the SEC addressed to shareholders. Form 8-K Current Report, filed on 10/27/2011. In the Form 8-K,

Defendant Quinn stated that the Company remained ***"safe and sound."*** *Id.* (emphasis added).

269. This statement was materially untrue or misleading when made or omitted to state material facts necessary to make the statement made not misleading because the Bank was not "safe and sound." Aside from not being permitted to declare a dividend, as discussed *supra*, the Bank's internal controls had failed, the loan portfolio was not of high quality, and the Exchange Act Defendants had deceptively implemented the eight point internal risk rating system to conceal the true level of Risk Assets and needed loan loss reserves, and the Company was under investigation by the Regulators for failing to, *inter alia*, maintain effective controls, *see supra* Part VI.D.

270. The market reacted to the reported news of regulatory concerns with the Bank's practices, continued losses and the Company's inability to declare a cash dividend. On October 27, 2011, in only one day, Orrstown's stock fell 29.6% to $9.29. Plaintiffs and members of the Class were thereby damaged.

271. On January 26, 2012, the Company issued a press release and filed it with the SEC on Form 8-K, announcing its 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":

> ***Our Credit Administration department, processes, and procedures have been greatly enhanced*** since mid-2011 and the ***Special Asset Group is actively engaged in the identification and work out of problem credits*** in the manner most favorable to the Company. The ***re-engineering of our credit processes and procedures have made us a stronger bank*** that is well positioned for the future when conditions rebound.

Id. (emphasis added).

272. Defendant Quinn's statement, however, was materially untrue or misleading when made or omitted to state material facts necessary to make the statements made not misleading because Defendant Quinn knew that the Company had a material weakness with respect to its internal credit controls. The Exchange Act Defendants knew from the non-public Joint Investigation that the Regulators suspected the Bank was engaging in unsafe and unsound banking practices such that none of the changes the Bank made in 2011 were comprehensive enough to result in the Bank being "stronger" and "well positioned for the future." Indeed, the Bank continued to have the same management that had caused the Bank's downward trajectory. Moreover, the Exchange Act Defendants knew, as discussed *supra*, the Bank's commercial loan portfolio was not of high quality but rather consisted of a large number of troubled loans.

273. The market reacted to the reported news of continued losses and ongoing suspension of a quarterly dividend. On January 26, 2012, Orrstown stock closed at $7.94, representing a 14.5% drop from the closing price on October 27, 2011. Plaintiffs and members of the Class were thereby damaged.

274. Less than two months later, on March 12, 2012, the Company filed a Form 8-K to restate the earnings for FYE 12/31/2011 which stated in relevant part:

> The updated earnings release was prompted by events that arose subsequent to the original earnings release on January 26, 2012 that resulted in additional asset impairments. These additional impairments necessitated an increase of $13.7 million in the provision for loan losses for the quarter ended December 31, 2011 above the previously-announced level. This additional provision, net of deferred tax benefit of $4.7 million, lowered previously reported earnings by $9.0 million. As a result of the additional $9.0 million of provision for loan losses, net of deferred tax benefit, for the quarter ended December 31, 2011, the Company reported a net loss of $29.5 million, or $3.66 per diluted share, compared to net income of $4.4 million, or $0.55 per diluted share, for the quarter ended December 31, 2010. On a year to date basis, net loss for the year ended December 31, 2011 was $32.0 million, or $3.98 per diluted share, compared to net income of $16.6 million, or $2.17 per diluted share, for the year ended December 31, 2010.

Form 8-K Results of Operations and Financial Condition, filed 3/12/2012. This restatement further evidences that Defendant Quinn's statements made on January 25, 2012, *supra* ¶ 271, that the Company had effective internal controls to address

the "asset quality issues" were misleading and materially untrue or misleading when made or omitted to state material facts.

275. Following this disclosure, on March 15, 2012, the Company filed the 2011 Annual Report, Form 10-K with the SEC. In "Management's Report on Internal Control over Financial Reporting," management admitted that 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 of loan losses."*** Form 10-K 2011 Annual Report, filed 3/15/2012, at 125. Further, the Company admitted that this material weakness in its internal controls persisted throughout 2011 as the Company scrambled to remediate while under the then-nonpublic scrutiny of the Regulators' Joint Investigation:

> [T]he Company has taken vigorous steps to address its asset quality issues during 2011. These steps include the ***hiring a third party loan review firm to identify gaps in the underwriting process, credit administration and problem loan identification and monitoring.*** As a result of this gap analysis, the Credit Administration department, processes and procedures have been greatly enhanced to address gaps noted. In addition, ***the Special Assets Group (SAG), the Company's loan workout department, was formed in the third quarter of 2011 and as of December 31, 2011 has 12 employees actively engaged in the identification and work out of problem credits*** in the most favorable manner to the Company. However, ***as enhancements were being made to underwriting, credit administration and problem loan identification and monitoring, 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.***

Id. (emphasis added). The admission of material weaknesses undermined the accuracy of the Company's financial reporting for each of the prior reporting periods in 2011 *and* 2010 since the Company used the same eight point internal risk rating system in both years following the inadequate 2009 Internal Review. Also included in the 2011 Annual Report was the "Report of Independent Registered Public Accounting Firm" by Defendant Smith Elliott in which, for the first time, Smith Elliott recognized publicly that Orrstown's internal controls were flawed.

276. Despite the significant disclosures made in the 2011 Annual Report, the Company continued to blame its excessive level of Risk Assets solely on external factors:

> [T]he Company has experienced a ***steady increase in risk assets from 2007 – 2011, which coincides with the downturn in the state and local economies, and softness in the real estate market.*** The largest increase in risk elements was nonaccrual loans, which totaled $83,697,000 at December 31, 2011 compared to $13,896,000 at December 31, 2010, an increase of $69,801,000. All loan segments experienced increases in nonaccrual loans from year end December 31, 2010 to 2011, with ***commercial acquisition and development and non-owned occupied segments experiencing the greatest dollar and percentage increases***, reflective of

> softness in the real estate market and corresponding decline in collateral values.

Form 10-K 2011 Annual Report, filed 3/15/2012, at 48 (emphasis added).

277. This statement was materially untrue or misleading when made or omitted to state material facts necessary to make the statements made not misleading because the primary reason for the increased Risk Assets is because of Orrstown's failed internal loan review and approval process that originally extended commercial loans to borrowers who lacked the credit-worthiness required by the Bank's Loan Policy and, as stated by CW#3, the loan's just "didn't work" such that by 2009, 2010 and 2011, the loans had become Risk Assets.

278. The following "Troubled Asset Ratio"[13] chart illustrates the Exchange Act Defendants' level of troubled or impaired loans as benchmarked against the national median for financial institutions. In comparison to the national median, Orrstown's ratio spikes in March 2010 when the Company filed its 2009 10K disclosing an increase in loan loss reserves, but then quickly recovers by keeping pace with the national median when the Bank implements its eight point internal

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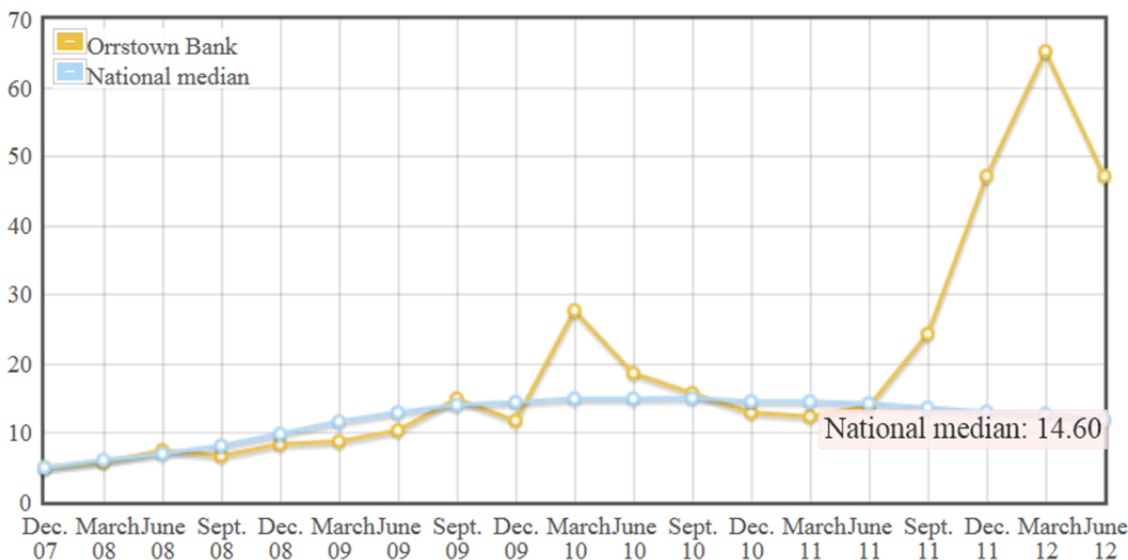
[13] A "troubled asset ratio" compares the sum of troubled assets with the sum of Tier 1 Capital plus Loan Loss Reserves. Higher values in this ratio generally indicate that a bank is under more stress caused by loans that are not paying as scheduled. American University BankTracker Report, http://banktracker.investigativereportingworkshop.org/banks/pennsylvania/shippensburg/orrstown-bank/ .

risk rating system to prolong classification of impaired loans and allocations for loan loss reserves. Then, the chart illustrates the Company's huge spike beginning in July 2011 into October through March 2012 which coincides with the time period when the Regulators, unbeknownst to the Class, were conducting their Joint Investigation and the Bank began disclosing significant increases in its impaired loans and provisions for loan losses. Thus, the Company's deception concealed throughout the Class Period the true level of Risk Assets or troubled loans and loan loss reserves so that it appeared the Company's troubled asset ratio was tracking with the national median and not disproportionate to its peers.



Source: American University BankTracker Report.

279. On March 23, 2012, the Company announced the agreements entered into with the Regulators. *See supra* Part IV. The force and effect of the Regulators' actions demonstrate and confirm that at the time of the March 2010 Offering and throughout the Class Period, the Orrstown Exchange Act Defendants were aware of the severity of the Regulators' concerns with respect to the Bank's banking practices and internal controls (*see supra* Part VI.D.), yet they continued to: (i) engage in unsound and unsafe practices; (ii) falsely represent Orrstown as a conservative lender focused on asset quality; (iii) materially overstate Orrstown's financial condition; and (iv) materially understate Orrstown's Risk Assets and loan loss reserves. The Exchange Act Defendants materially false and misleading representations and fraudulent conduct resulted in substantial monetary harm and damage to the shareholders who purchased Orrstown stock.

280. On or around Friday, March 30, 2012, Orrstown mailed to its shareholders and filed with the SEC additional proxy materials in which, Quinn, for the first time candidly admits that the Bank faced ***"significant challenges in 2011"*** and the Bank's systemic problems required the Company to ***"heed[] the advice and guidance of the governmental agencies that regulate" the Bank, and to "have begun the process of stress testing many aspects of the organization."*** Schedule 14A Additional Definitive Proxy Materials, filed 3/30/2012, at 1 (emphasis added). Such statements were in direct contrast to what Defendants

were telling the Class during the Class Period.[14] By April 5, 2012, Orrstown stock closed at $8.20.

281. After all of the false and misleading statements as to the quality of the Bank's assets and internal controls were stripped away and the truth was revealed, Orrstown's stock had been artificially inflated by as much as 80% throughout the Class Period, thereby damaging Plaintiff and the Exchange Act Class.

282. 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 were neither stringent nor conservative such that the Bank extended loans in 2007 through 2010 that were inherently risky with a high degree of default;

[14] Even with these admissions, the Exchange Act Defendants still sought to conceal the depth of the Bank's financial distress in the 2011 Annual Report, Form 10-K, in different respects including their handling of the Bank's net deferred tax assets. In the 2011 Annual Report, the Bank stated that there were $18.2 million in net deferred tax assets as of December 31, 2011. However, the Bank did not take a valuation allowance on these deferred tax assets because management "believe[d] that it is more likely than not these assets will be realized" which is a positive statement on the Bank's estimated future taxable income. *See* Form 10-Q 3Q2012, filed 11/8/2012, at 26-27. Just six months later, management revealed that its "belief" was wrong and the Bank would need to take a valuation allowance of $19.8 million. *Id.* at 12, 26-27, 40-41. This valuation allowance negatively impacted the Bank's Tier 1 and total risk based capital and was the primary reason for the Bank's quarterly decline in capital ratios. *Id.* at 63.

b. as early as December 2009, the Exchange Act Defendants knew from the information gather 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 Risk Assets or were on the verge of becoming Risk Assets; and

   iv. the Bank needed to significantly increase its loan loss reserves to adequately address the impaired loans;

c. as early as January 2010, the Orrstown Exchange Act Defendants were aware that the Company would need to record unprecedented increases in Risk Assets and increases in loan loss reserves which indicated failures in the Bank's underwriting processes and internal controls and jeopardized the strength of the Company's balance sheet;

d. the Orrstown Exchange Act Defendants knew as early as March 2010 that the Bank's eight point internal risk rating system would enable management to forestall classifying loans as Risk Assets and making the needed loan loss reserve allocations;

e. the Orrstown Exchange Act Defendants were aware as early as July 2010 that the Department of Banking and Federal Reserve Bank 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; and

f. the Orrstown Exchange Act Defendants were aware as early as March 31, 2011 that the Department of Banking and the Federal Reserve Bank had formally launched their Joint Investigation into the Company's banking practices which included scrutiny of management's competency.

283. Each of the Orrstown Exchange Act Defendants' statements that are identified above and were made throughout 2010, 2011 and into 2012 concerning Orrstown's financial condition, underwriting standards, loan portfolio quality, and internal controls were materially untrue and misleading. The Orrstown Exchange Act Defendants knew that the statements made were false, and/or acted with severe reckless disregard for the truth, because – as confirmed by CW#1, CW#2, CW#3

and the Regulators – the Orrstown Exchange Act Defendants knew that Orrstown was not and had not been "conservatively" extending loans using "stringent underwriting standards" with proper internal oversight and the balance sheet was not "strong" because of the dramatically increasing levels of and related costs for the Risk Assets and the needed increases of provisions for loan loss reserves. *See supra* Part VI.A-B; *see infra* Part X.B.

G. The False and Misleading Financial Reporting

284. Many of the Orrstown Exchange Act Defendants' knowingly or recklessly false and misleading statements and omissions identified above were made in the Company's quarterly financial reports (Form 10Q) and annual reports (Form 10-K) 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 10Ks 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.

285. With respect to the Orrstown Exchange Act Defendants financial reporting, Defendants Quinn and Everly signed every Class Period 10Q 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.

286. Quinn and Everly along with the other individual Orrstown Exchange Act Defendants Zullinger, Shoemaker, Snoke and Coy, signed every Class Period 10K 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.

287. In signing the Form 10Qs 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.

288. Following the Internal Review, in early 2010 management was in the position that it could not ignore the new credit data gathered by the Internal Review for the Bank's larger commercial lending relationships and the communications from large borrowers the Azadis and 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 Risk Assets and provisions for loan loss reserves. The Orrstown Exchange Act Defendants, therefore, reached a compromise position in that they reclassified ***some*** of the impaired loans and made ***some*** of the requisite allocations for loan loss reserves in 4Q2009 but forestalled accounting for the other impaired loans until ***after*** the March 2010 Offering closed.

Then, after the March 2010 Offering closed, the Exchange Act Defendants employed the eight point internal risk rating system to further forestall classifying loans as Risk Assets and making loan loss reserve allocations that would have negatively impacted the Company's net income. *See supra* Part IX.C.

289. 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 VI.A-B, through their use of the eight point risk rating system were also those responsible for determining this highly critical and sensitive accounting estimate for loan losses.

290. 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 eight point internal risk rating system used in 2010 and 2011, were 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.

291. This admission reveals that the Bank's loan loss reserves were materially understated during the Class Period, the Bank had failed to use the proper accounting methodology to calculate loan loss reserves, causing the Company's financial statements to be materially misstated and non-compliant with GAAP.

292. As a result of the Orrstown Exchange Act Defendants' false statements, Orrstown's common stock traded at artificially inflated levels during the Class Period. However, when the truth about Orrstown's practices was revealed to investors, the Company's share price dramatically declined thereby damaging the Class.

H. Auditor Defendant Smith Elliott's Audit Opinions were Materially False and Misleading

293. 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.

294. During the Class Period, Smith Elliott 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, Smith Elliott 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. Smith Elliott's Materially False and Misleading 2009 Audit Opinion in the 2009 Annual Report

295. Smith Elliott's audit for 2009 was included in the Company's Annual Report Form 10-K filing. In the 2009 10-K, Smith Elliott 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.

296. Smith Elliott affirmatively stated that it had conducted its audit in accordance with PCAOB's standards. *See id.* Smith Elliott, therefore, applied PCAOB standard AU Section 342 in evaluating the reasonableness of the

Company's loan loss reserves which required that Smith Elliott "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* ¶ 179. Further, AU Section 342, as well as FASB Statement No. 5 (*see supra* ¶ 180) and AS No. 5 (*see supra* ¶ 178), required Smith Elliott 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.

297. 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*.

298. By performing its audits in accordance with PCAOB auditing standards referenced above (*see supra* ¶¶ 296-297), which Smith Elliott affirmatively stated it had done in the 2009 audit report, it is implausible that Smith Elliott did not have actual knowledge that Orrstown and the Bank's financial statements contained material understatements with respect to the classification of impaired loans and allocation of loan loss reserves especially in light of the updated credit data gathered by the Internal Review of which Smith Elliott would have been apprised. In addition to the Internal Review, Smith Elliott would have been privy to the Credit Analyst Group's recommendations on loan applications, and 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."

299. Smith Elliott's unqualified audit report for the year 2009 was materially false and misleading because Smith Elliott 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. Smith Elliott's loyalty to its client and financial interest in continuing to serve as Orrstown and the Bank's auditor (of which it still is today) eclipsed Smith Elliott's professional responsibility under the PCAOB and caused Smith Elliott to issue the materially false and misleading audit report for 2009.

2. Smith Elliott's Materially False and Misleading 2010 Audit Opinion in the 2010 Annual Report

300. Smith Elliott's audit for 2010 was included in the Company's Annual Report Form 10-K filing. In the 2010 10-K, Smith Elliott 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.

301. Smith Elliott affirmatively stated that it had conducted its audit in accordance with PCAOB's standards. *See id.* Smith Elliott, therefore, applied PCAOB standard AU Section 342 in evaluating the reasonableness of the Company's loan loss reserves which required that Smith Elliott "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* ¶ 179. Further, AU Section 342, as well as FASB Statement No. 5 (*see supra* ¶ 180) and AS No. 5 (*see supra* ¶ 178), required Smith Elliott 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.

302. 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* ¶ 297, requires that the audit be planned and performed with an attitude of "professional skepticism."

303. By performing its 2010 audit in accordance with PCAOB auditing standards referenced above (*see supra* ¶¶ 301-302), which Smith Elliott affirmatively stated it had done in the 2010 audit report, it is implausible that Smith Elliott did not have actual knowledge that Orrstown and the Bank's financial statements contained material understatements of Risk Assets with respect to the classification of impaired loans and allocation of loan loss reserves especially in light of the updated credit data gathered by the Internal Review, the Bank's eight point internal risk rating system implemented in 2010 which purposefully delayed the Bank's classification of impaired loans, and the Regulators' investigation all of which Smith Elliott would have been apprised.

304. Smith Elliott's unqualified audit report for 2010 was materially false and misleading because Smith Elliott 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. Smith Elliott's loyalty to its client and financial interest in continuing to serve as Orrstown and the Bank's auditor eclipsed Smith Elliott's professional responsibility under the PCAOB and caused Smith Elliott to issue the materially false and misleading audit report for 2010.

3. Smith Elliott's Materially False and Misleading 2011 Audit Opinion in the 2011 Annual Report

305. Smith Elliott's audit for 2011 was included in the Company's Annual Report Form 10-K filing. In the 2011 10-K, Smith Elliott 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, Smith Elliot 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).

306. Smith Elliott affirmatively stated that it had conducted its audit in accordance with PCAOB's standards. *See id.* Smith Elliott, therefore, applied PCAOB standard AU Section 342 in evaluating the reasonableness of the Company's loan loss reserves which required that Smith Elliott "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* ¶ 179. Further, AU Section 342, as well as FASB Statement No. 5 (*see supra* ¶ 180) and AS No. 5 (*see supra* ¶ 178), required Smith

Elliott 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.

307. 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* ¶ 306, requires that the audit be planned and performed with an attitude of "professional skepticism."

308. By performing its 2011 audit in accordance with PCAOB auditing standards referenced above (*see supra* ¶¶ 306-307), which Smith Elliott affirmatively stated it had done in the 2011 audit report, it is implausible that Smith Elliott did not have actual knowledge that Orrstown and the Bank's financial statements contained understatements of Risk Assets with respect to the classification of impaired loans and allocation of loan loss reserves especially in light of the updated credit data gathered by the Internal Review, the Bank's eight point internal risk rating system implemented in 2010 which purposefully delayed the Bank's classification of impaired loans, the work done by the Special Asset Group, and the Regulators' investigation all of which Smith Elliott would have

been apprised. Moreover, Smith Elliott'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.[15]

309. Smith Elliott's unqualified audit report on the 2011 financial statements was materially false and misleading because Smith Elliott 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 as 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 Risk Assets and loan loss reserve allocations that Smith Elliott discovered in its audit. Smith Elliott's loyalty to its client and financial interest in continuing to serve as Orrstown and the Bank's auditor eclipsed Smith Elliott's professional responsibility under the PCAOB and caused Smith Elliott to issue the materially false and misleading audit report for 2011.

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[15] The Company's Form 10-Q for 3Q2012 which reported a $19.8 million valuation allowance further evidences Smith Elliott's failure to test management's estimates and apply the rigorous professional skepticism required by the PCAOB in auditing Orrstown's 2011 financial statements. *See supra* n. 14.

X. ADDITIONAL EXCHANGE ACT ALLEGATIONS

310. 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

311. 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.

312. As a result of the 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

313. During the Class Period, the Exchange Act Defendants had both the motive and opportunity to commit fraud.

314. 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 above. 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.

315. Further, the Exchange Act Defendants benefitted from perpetuating the fraud of selling a "safe and sound" financial institution. The Company paid Smith Elliott fees for its professional auditing services which Smith Elliott risked losing if it challenged management about its accounting irregularities. 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 Compensation ($)(3)	Total ($)
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).

316. Since the Orrstown Exchange Act Defendants were able to dupe investors throughout 2011 and inflate and misstate the Company's financial condition, they, throughout 2011, continued to collect their annual 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.

317. Following the Regulators' intervention and the requirement that the Bank "adopt and implement a plan, acceptable to the [Regulators], to strengthen oversight of management and operations[,]" *supra* Part VI.D., 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, alleged *supra,* evidences such Defendants' knowledge of and role in the wrongdoing throughout the Class Period.

318. 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

319. 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.

320. 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

321. 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.

322. 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.

323. 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.

XI. 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)

324. 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.

325. 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.

326. 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.

327. 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.

328. As a direct and proximate result of 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 Smith Elliott)

329. Plaintiff brings this claim on behalf of itself and the members of the Exchange Act Class against the Auditor Defendant Smith Elliott.

330. As "independent auditors" of the Company, Smith Elliott had a duty to examine Orrstown and the Bank's financial statements in accordance with PCAOB to determine, among other things, whether the management prepared financials were presented in accordance with GAAP. Further, in connection therewith, Smith Elliott had a duty to disclose to management any defects in the system of internal controls.

331. At all relevant times, Smith Elliott 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. Smith Elliott 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. Smith Elliott 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.

332. As Orrstown was a public company, Smith Elliott 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. Smith Elliott 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.

333. In auditing the Company's financial statements, Smith Elliott disregarded, in violation of PCAOB, glaring irregularities in the Company's books and records and system of internal controls. Smith Elliott 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.

334. Smith Elliott'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.

335. By virtue of its position as independent auditor of Orrstown and the Bank, Smith Elliott 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. Smith Elliott 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.

336. Throughout the Class Period, Smith Elliott 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, Smith Elliott continued to certify financial statements whose accuracy was dependent, in material part, on these accounting practices.

337. In sum, Smith Elliott 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.

338. Smith Elliott's scienter is further evidenced by the magnitude by which the Company's Risk Assets and loan loss reserves were misstated during the Class Period. Absent intention or reckless conduct, Smith Elliott would have detected these misstatements during the course of its audits and either taken corrective action or declined to issue unqualified audit opinions.

339. 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.

340. 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)

341. 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.

342. 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.

343. During the Class Period, Defendants Quinn, Everly and Embly knew or were reckless in not knowing that he 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.

344. 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.

345. 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.

346. By virtue of their positions as control persons, Defendants Quinn, Everly and Embly are liable pursuant to Section 20(a) of the Exchange Act.

347. By reason of such conduct, Quinn, Everly and Embly are liable pursuant to Section 20(a) of the Exchange Act.

XII. 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. Awarding Plaintiff and members of the Classes damages and interest;

C. Awarding Plaintiff's reasonable costs, including attorneys' fees; and

D. Awarding such equitable/injunctive or other relief as the Court may deem just and proper.

XIII. JURY TRIAL DEMANDED

Plaintiff hereby demands a trial by jury.

Dated: March 4, 2013

Respectfully submitted,

CHIMICLES & TIKELLIS LLP

/s/ Nicholas E. Chimicles
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CERTIFICATE OF SERVICE

I, Christina Donato Saler, a specially admitted member of the bar of this Court, hereby certify that true and correct copies of *Plaintiff's Amended Complaint* have been electronically filed and served on all Defendants' counsel, via the Court's ECF system, this 4th day of March, 2013, as follows:

David J. Creagan
David E. Edwards
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215-864-7032
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By: *__/s/ Christina Donato Saler__*

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CERTIFICATION

I, James B. Jordan, hereby certify as follows:

1. I am fully authorized to enter into and execute this Certification on behalf of Southeastern Pennsylvania Transportation Authority ("SEPTA"). I have authorized counsel to prepare a complaint against Orrstown Financial Services, Inc. ("Orrstown") alleging violations of the federal securities laws. I have reviewed the complaint and I authorize its filing.

2. I understand that SEPTA is a named plaintiff and a proposed class representative in this action against Orrstown.

3. SEPTA did not purchase securities of Orrstown at the direction of counsel or in order to participate in any private action under the federal securities laws;

4. SEPTA is willing to serve as a lead plaintiff in this matter and as a representative party on behalf of a class, including providing testimony at deposition and trial, if necessary;

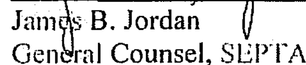
5. SEPTA's transactions in the securities of Orrstown are reflected in Exhibit A, attached hereto;

6. During the three years prior to this certification, SEPTA has sought to serve as a representative party on behalf of a class in the following securities class actions: *In re Wells Fargo Mortgage-Backed Certificates Litigation*, 09-cv-1376-SI (N.D. Cal.); *In re Level 3 Communs., Inc. Secs. Litig.*, 09-cv-00200-PAB-CBSConsolidated (D. Colo.); *Southeastern Pennsylvania Transportation Authority v. The Bank of New York Mellon Corporation*, 2:11-cv:01628 (E.D. Pa.), *transfer, In re Bank of NY Mellon Corp. Foreign Exchange Transaction Litigation*, MDL No. 2335; and *Gaer v. Educ. Mgmt. Corp.*, 2:10-cv-01061 (W.D. Pa.); *In re Wachovia Preferred Securities & Bond/Notes Litigation*, 09-cv-6351 (S.D.N.Y.) (closed); *Miller v. Wachovia*, 5:09-cv-00998 (N.D. Cal.) (closed).

7. During the three years prior to this certification, SEPTA has served as a representative party on behalf of a class in the following securities class actions: *In re Wells Fargo Mortgage-Backed Certificates Litigation*, 09-cv-1376-SI (N.D. Cal.); *Southeastern Pennsylvania Transportation Authority v. The Bank of New York Mellon Corporation*, 2:11-cv:01628 (E.D. Pa.), *transfer, In re Bank of NY Mellon Corp. Foreign Exchange Transaction Litigation*, MDL No. 2335; and *Gaer v. Educ. Mgmt. Corp.*, 2:10-cv-01061 (W.D. Pa.); *In re Wachovia Preferred Securities & Bond/Notes Litigation*, 09-cv-6351 (S.D.N.Y.) (closed); *Miller v. Wachovia*, 5:09-cv-00998 (N.D. Cal.) (closed).

8. Beyond its pro rata share of any recovery, SEPTA will not accept payment for serving as a representative party on behalf of the class, except the reimbursement of such reasonable costs and expenses (including lost wages) as ordered or approved by the Court.

I declare under penalty of perjury, under the laws of the United States, that the foregoing is true and correct this 24 day of May, 2012.



James B. Jordan
General Counsel, SEPTA

Exhibit A

SEPTA's Purchases of Orrstown Financial Services Common Stock

ACTIVITY	*Purchased / Sold*	*UNITS*	*ORIGINAL COST ($)*
3/24/2010	Purchased	4,160	112,320.00
3/24/2010	Purchased	357	9,540.47
3/31/2010	Purchased	1,240	31,781.20
4/8/2010	Purchased	401	10,335.22
4/12/2010	Purchased	2,606	65,972.45
4/14/2010	Purchased	150	3,833.43
5/10/2010	Purchased	53	1,252.18
5/20/2010	Purchased	432	10,408.74
5/21/2010	Purchased	799	19,732.91
5/25/2010	Purchased	481	11,746.36
5/28/2010	Purchased	241	5,764.32
7/6/2010	Purchased	832	18,241.52
7/13/2010	Purchased	1,140	25,740.86
8/10/2010	Purchased	530	12,576.74
3/11/2011	Purchased	527	13,522.56
4/12/2011	Purchased	500	13,143.00
5/9/2011	Purchased	125	3,141.41