

**UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT OF PENNSYLVANIA**

SECURITIES AND EXCHANGE COMMISSION,

Plaintiff,

v.

**JOSEPH M. BRAAS and
MICHAEL J. SCHLAGER,**

Defendants.

**Civil Action No.
11-cv-0087-PD**

COMPLAINT

Plaintiff Securities and Exchange Commission (the “Commission”) alleges as follows:

SUMMARY

1. This matter involves a financial fraud conducted by two senior officers at Equipment Finance, LLC (“EFI”), formerly a commercial lender to the soft pulp logging industry and wholly-owned subsidiary of Sterling Financial Corp. (“Sterling”). Sterling was a publicly traded bank holding company based in Lancaster, Pennsylvania.

2. From at least February 2002 until April 2007, defendants Joseph M. Braas, EFI’s Vice President and Chief Operating Officer, and Michael J. Schlager, EFI’s Executive Vice President, orchestrated a pervasive and wide-ranging scheme using fraudulent underwriting and reporting practices to hide mounting losses and defaults within EFI’s commercial loan portfolio from Sterling’s senior management and auditors.

3. Braas and Schlager were able to subvert virtually every aspect of EFI’s loan process and internal controls. They created fictitious loans for the purpose of making monthly

payments on delinquent loans, altered loan documents to hide delinquent and fictitious loans, granted excessive deferrals and resets of delinquent loans to make them appear current, reassigned loan payments to unrelated accounts to fund payments on delinquent loans, and used aliases for borrowers to circumvent EFI's maximum lending limitations. They also deceived Sterling's internal and independent auditors through fraudulent accounting entries, false collateral descriptions and appraisals, fabricated UCC filings, and by recruiting vendors to assist in the circumvention of loan confirmation procedures.

4. The defendants' conduct caused EFI to report false financial information to Sterling. Sterling filed its financial statements on a consolidated basis and, consequently, from 2002 through 2006, Sterling filed quarterly and annual reports with the Commission containing materially false and misleading financial statements.

5. In a series of announcements beginning on April 19, 2007, Sterling disclosed its discovery of the fraud and that it would materially impact the company's previously filed financial statements for fiscal periods as far back as 2002. As a result of the fraud, Sterling ultimately charged off \$281 million of EFI finance receivables, which represented a large majority of EFI's loan portfolio, and approximately 13 percent of Sterling's total loan portfolio during the period of the fraud.

6. As a result of the conduct described in this Complaint, defendants Braas and Schlager violated Section 17(a) of the Securities Act of 1933 ("Securities Act") [15 U.S.C. § 77q(a)]; Sections 10(b) and 13(b)(5) of the Securities Exchange Act of 1934 ("Exchange Act") [15 U.S.C. §§ 78j(b) and 78m(b)(5)], and Rules 10b-5 and 13b2-1 thereunder [17 C.F.R. §§ 240.10b-5 and 240.13b2-1]; and aided and abetted violations of Sections 13(a), 13(b)(2)(A) and 13(b)(2)(B) of the Exchange Act [15 U.S.C. §§ 78m(a), 78m(b)(2)(A) and 78m(b)(2)(B)], and

Rules 12b-20, 13a-1 and 13a-13 thereunder [17 C.F.R. §§ 240.12b-20, 240.13a-1 and 240.13a-13].

JURISDICTION AND VENUE

7. The Commission brings this action pursuant to Sections 20(b) and 20(d) of the Securities Act [15 U.S.C. § 77t(b) and 77t(d)] and Section 21(d) of the Exchange Act [15 U.S.C. § 78u(d)], to enjoin such acts, transactions, practices, and courses of business; obtain disgorgement; and for other appropriate relief.

8. This Court has jurisdiction over this action pursuant to Section 22(a) of the Securities Act [15 U.S.C. § 77v(a)], and Sections 21(d) and 27 of the Exchange Act [15 U.S.C. §§ 78u(d) and 78aa].

9. Venue is proper because certain of the acts, transactions, practices, and courses of business constituting the violations alleged herein occurred within the Eastern District of Pennsylvania. In addition, Braas and Schlager worked and resided in the Eastern District of Pennsylvania and Sterling had its headquarters within this district.

10. In connection with the conduct alleged in this Complaint, the defendants directly or indirectly made use of the means or instruments of transportation or communication in interstate commerce, or the means or instrumentalities of interstate commerce, or the mails, or the facilities of a national securities exchange.

DEFENDANTS

11. **Joseph M. Braas**, age 45, is a resident of Lititz, Pennsylvania. During all times relevant to the conduct alleged in this Complaint, Braas was the Vice President and Chief Operating Officer of EFI.

12. **Michael J. Schlager**, age 49, is a resident of Lancaster, Pennsylvania. During all times relevant to the conduct alleged in this Complaint, Schlager was the Executive Vice President of EFI.

RELATED ENTITIES

13. **Sterling Financial Corporation** was a financial holding company headquartered in Lancaster, Pennsylvania. Through its subsidiaries, Sterling provided banking and financial services, including community banking, lease financing, commercial finance, and trust and investment services in south-central Pennsylvania, Maryland and Delaware. At various times, Sterling's common stock traded on the NASDAQ National Market and on the NASDAQ Global Select Market. On April 4, 2008, Sterling was acquired by PNC Financial Services Group, Inc.

14. **Equipment Finance, LLC** was a wholly-owned subsidiary of the Bank of Lancaster County ("Bank of Lancaster"), itself a wholly-owned subsidiary of Sterling. EFI provided equipment financing for the soft pulp logging and land-clearing industries, serving primarily the paper industry in the southeastern United States. Sterling purchased EFI, then a private company, in February 2002. During the relevant time period, EFI had approximately 15 employees.

FACTS

Background

15. In February 2002, when it was acquired by Sterling, EFI held financing contracts with forestry and land clearing equipment dealers through which EFI financed loans.

16. Sterling instituted a management and reporting hierarchy to oversee the operations of EFI. Sterling replaced EFI's Board of Directors with a Board of Managers, which

included EFI's CEO as well as senior officers of Sterling. The Board met quarterly to review EFI's operations and performance.

17. Sterling retained EFI's management and employees and allowed EFI to maintain substantial autonomy over its operations. With the availability of funding provided by Sterling, EFI grew rapidly as an originator of high interest commercial loans for the logging industry.

18. During all times relevant to the conduct alleged in this Complaint, Braas was the principal officer in charge of EFI's daily operations and managed the overall loan portfolio. Schlager also had the authority to conduct all aspects of the business of EFI including supervising employees, approving loans, and managing credit collections. From February 2002 until the discovery of the fraud in April 2007, defendants Braas and Schlager effectively controlled all aspects of EFI's operations.

19. EFI appeared to be profitable and represented one of Sterling's fastest growing segments, each year contributing a greater share of Sterling's total annual earnings. In fiscal year 2002, EFI contributed \$4 million to Sterling's net income (representing 17 percent) and, by 2006, EFI contributed \$17 million to Sterling's net income (41 percent).

The Fraudulent Scheme

20. Defendants Braas and Schlager were the architects of the fraud at EFI. Together, they orchestrated every aspect of the fraudulent scheme, guided its implementation, and covered it up. As senior officers of EFI, they acted with full knowledge that their actions would result in the reporting of false information to, and by, Sterling.

21. Knowing that Sterling reported its financial statements on a consolidated basis, defendants knew, or were reckless in not knowing, that the reports that Sterling filed with the Commission would contain material misrepresentations and omissions of fact regarding its

earnings for the quarters and years 2002 through 2006. Moreover Braas and Schlager knew, or were reckless in not knowing, that Sterling's false and misleading annual and periodic reports were incorporated by reference in registration statements in effect during the period of the fraud.

A. The Scheme to Hide Delinquent Loans

1. Loan Deferrals and Account Resets

22. In or around February 2002, when Sterling acquired EFI, EFI began experiencing increased delinquencies among its borrowers. In order to conceal the deteriorating loan portfolio during this period and until the fraud's discovery in April 2007, Braas and Schlager exploited EFI's loan deferral and account reset process to ensure that delinquent customer accounts appeared to remain in current status.

23. EFI's policies permitted deferrals and account resets to be made on an individual basis, taking into account a customer's specific circumstances, at the discretion of Braas or Schlager. However, Braas and Schlager ignored EFI's policies and procedures and routinely approved loan deferrals and account resets regardless of a customer's circumstance.

24. The deferrals ensured that delinquent customer loan payments were deferred to the final payment of the loan. By moving the delinquent payment to the end of the loan through the deferral process, Braas and Schlager were able to classify customer delinquent loans as current receivables. Likewise, defendants also used account resets to conceal EFI's deteriorating portfolio. Similar to a deferral, a reset results in the refinancing of the original delinquent loan.

25. EFI policy also required that a deferral fee or a reset fee be added to the balance of the customer's account. Braas and Schlager authorized numerous deferrals without the customer's consent and did not assess fees to customer accounts. Braas and Schlager also altered

EFI's accounts receivable aging reports to conceal that EFI was not assessing fees to the deferred and reset accounts.

2. Fraudulent and Fictitious Loans

26. Braas and Schlager approved loans in the names of various customers without their knowledge and then used the proceeds from these loans to make monthly payments on behalf of delinquent customer accounts.

27. For example, many of EFI's fictitious loans involved an equipment dealer ("Dealer"), who sold logging and related heavy equipment financed by EFI.

28. In or about 2002, the Dealer improperly sold approximately \$300,000 of equipment that EFI had secured as collateral for various loans and used the proceeds to pay other unrelated debts. Braas and Schlager improperly reset the loans on the sold equipment as current in an effort to allow the Dealer time to repay the outstanding balance on the loans. When it became clear that the Dealer could not repay the \$300,000, defendants resorted to various fraudulent practices to hide the delinquencies on these loans.

29. These practices included approving loans ostensibly to fund equipment purchases of various customers of the Dealer. In reality, these loans were held in fictitious names and used by defendants to fund monthly loan payments on other delinquent EFI loans.

3. Fictitious Insurance and Use of Insurance Funds to Repay Loans

30. EFI policy required that all financed equipment contain insurance against loss or damage. EFI initiated insurance coverage with a temporary binder and then once a contract was finalized, insurance premiums were due on a yearly basis. Braas and Schlager prepared fake insurance binders for fictitious loans where no equipment existed, by utilizing forms from existing, legitimate insurance vendors.

31. Braas and Schlager also used EFI funds disbursed for insurance purposes to make payments on delinquent or fictitious loans. For example, Schlager provided the Dealer with a list indicating the value of the insurance coverage on the legitimate and fraudulent loans at EFI, and arranged for the Dealer to create false insurance invoices based on the purported value of the equipment. Defendants then disbursed EFI funds to the Dealer to ostensibly pay the insurance invoices. The Dealer then returned the majority of the funds to Braas and Schlager, who used the funds to make payments on the delinquent and fictitious loans.

4. Loans Without Down Payments

32. EFI's loan policy required that all loans have a down payment of at least 20 percent. On several occasions, Braas and Schlager falsified loans to reflect that a 20 percent down payment on the underlying equipment was made by the borrower, even though no down payment was made.

5. Fraudulent UCC Filings

33. To further conceal their scheme, defendants Braas and Schlager altered UCC filings associated with the fraudulent loans they approved for nonexistent equipment. They instructed EFI employees to print blank UCC forms that EFI used to perfect EFI's security interest in collateralized equipment it financed. They then wrote fictitious serial numbers for the purported financed equipment on the UCC form and placed it into a customer loan file. The false UCC documentation made it appear that a legitimate UCC form had been filed and the security interest perfected.

B. Braas and Schlager Misled EFI's Board of Managers and Sterling's Credit Department

34. As described in this Complaint, following its acquisition by Sterling in 2002, EFI maintained its own accounting system, internal controls and maintained the collections of its finance receivables.

35. Defendants Braas and Schlager routinely altered internal reports relating to the operations at EFI before presenting them at periodic meetings to EFI's Board of Managers, Sterling's credit department, and Sterling's internal and independent auditors. Braas was the primary officer at EFI responsible for presenting the results of operations and financial condition of EFI to the Board of Managers at their quarterly meetings. The reports, cumulatively referred to as the Quarterly Manager's Reports, were also provided to EFI's internal and independent auditors along with a copy of the minutes of the Board of Manager's meetings. Braas altered these reports to hide delinquent loans and provided false information regarding conditions in the timber industry, new loan business and the current status of collections, repossessions and sales of repossessed equipment.

36. Each month, EFI submitted a summary of its collection activity, aging of accounts receivables and estimated allowance for loan losses to Sterling's credit department. The allowance report contained a summary of the total receivables, current allowance for loan losses, the historical trend of loan losses and any specific reserves applicable to specific loans. Sterling's credit department incorporated these reports into Sterling's total allowance for loan losses. When Braas and Schlager developed these reports they knew that they contained inaccurate information and concealed the true quality of the loan portfolio and the number of delinquent accounts.

37. Each quarter, Braas and Schlager met with the Board of Managers and provided falsified quarterly results of operations and the financial condition of EFI. Braas presented fabricated quarterly operating results of EFI, including revenue and expenses for the quarter, new business and present conditions in the industry. Defendants also included a presentation on the departmental reports which, among other things, included a detailed fabricated summary by geographic region of purported new business and dealers generating revenue for the company.

38. Defendants also misled the Board of Managers by presenting a falsified quarterly Collection Analysis Report, which concealed the aged receivables and delinquent accounts, the poor credit conditions and the true impact that other external conditions, such as weather and the demand from the pulpwood mills, were having on customers who financed logging equipment through EFI.

C. Braas and Schlager Misled Sterling's Internal and Independent Auditors

39. Braas and Schlager routinely provided false and misleading information to both Sterling's internal and independent auditors to conceal the extent of delinquent and fraudulent loans at EFI. By altering EFI's accounting records, falsifying loan files and manipulating the audit confirmation process, Braas and Schlager were able to deceive the auditors and prevent the discovery of their fraudulent scheme.

1. Falsifying Accounts Receivable Aging Reports

40. Braas falsified the reports of EFI's aging of accounts receivable before providing them to Sterling's internal and independent auditors. Braas knew that the aging report, which was hundreds of pages long, was inaccurate because it failed to accurately identify all loans that were delinquent or otherwise fraudulent.

2. Braas and Schlager Circumvented Sterling's Internal Accounting Controls

41. EFI maintained detailed policies and procedures relating to the origination and monitoring of finance receivables. However, Braas and Schlager's control over the daily operations of EFI and the participation of lower-level EFI employees in the scheme enabled Braas and Schlager to circumvent both EFI's and Sterling's internal accounting controls. Sterling's business structure, which allowed its subsidiaries to operate autonomously and separate from its own internal accounting infrastructure, provided defendants with the opportunity to circumvent the internal controls.

42. Braas purposely circumvented EFI's accounting controls in order to conceal information about the fraudulent loans from Sterling's auditors. For example, Braas removed the fraudulent loan information from the loan system in advance of audits to prevent the internal and independent auditors from discovering the scheme. Once the audits were completed, he re-entered the fraudulent information into the system. In addition, Braas intentionally withheld certain EFI checks from the cash receipts reports that the auditors often requested to prevent them from discovering that some customer loans were being paid with EFI checks.

3. Falsifying Customer Loan Files

43. In advance of periodic internal and year-end audits, Braas directed employees to "clean-up" both legitimate and fictitious customer loan files to ensure that they contained the requisite documentation outlined in EFI's internal policies and procedures. Braas and Schlager added to the loan files fictitious work references, summary approvals, and credit reports. For example, defendants copied legitimate credit reports and then used White-Out to conceal the dates on the copied forms and then placed the altered documents into the loan files. In order to

circumvent EFI's requirement that loan files include coupon payment books, Braas instructed his staff to refrain from ordering coupon books for certain loans and to place a copy of the coupon book order form in the customer's file.

4. Circumventing the Auditor Confirmation Process

44. Braas and Schlager manipulated the audit confirmation process. For example, after Sterling's auditors selected customers to obtain loan balance confirmations, the defendants changed certain customer addresses to ensure the confirmations went undelivered or were sent to others involved in the scheme. In some cases, if customers called Braas disputing the balance of the loan, Braas would have the customer send the confirmation to him. He would then forge the customer's signature before forwarding the confirmation to the auditors.

5. Altering Check-by-Phone Payments

45. EFI had a collection system referred to as check-by-phone that permitted customers to make payments by phone. In early 2006, the auditors approached members of EFI's accounting department and requested documents evidencing six particular check-by-phone transactions. These transactions never existed, since the defendants had fraudulently entered them into EFI's accounting records. Braas directed his staff to make adjustments to the accounting records and create fraudulent check-by-phone transactions for the auditors. Schlager presented the fabricated check-by-phone transactions to the auditors and then altered the internal EFI accounting reports to match the dates of the requested transactions.

D. Materially False and Misleading Financial Statements

46. Braas and Schlager's fraudulent loan scheme had a material impact on Sterling's consolidated financial statements for the periods 2002 through 2006. During the period of the

fraud, EFI contributed approximately \$56 million (approximately 33 percent) to Sterling's consolidated net income of approximately \$167.5 million.

47. On May 24, 2007, after discovery of the fraud, Sterling announced that, under Generally Accepted Accounting Principles, Sterling would be required to record a material impairment of certain assets of EFI. As part of the February 2008, Form S-4 registration statement filed with the Commission in connection with the merger between Sterling and PNC, Sterling included audited financial statements for the year end 2006 and nine months ended September 30, 2007. As a result of the fraud, Sterling recorded a cumulative after-tax charge of approximately \$200 million. These assets primarily included EFI financing contracts and interest associated with those contracts.

E. Defendants Benefited from the Fraud

48. As a result of his fraudulent conduct, from 2002 through the first quarter of 2007, defendant Braas received ill-gotten gains of at least \$1,105,086, consisting of accumulated salary and bonuses received from EFI.

49. As a result of his fraudulent conduct, from 2002 through the first quarter of 2007, defendant Schlager received ill-gotten gains of at least \$822,104, consisting of accumulated salary and bonuses received from EFI.

FIRST CLAIM

**Violations of Section 17(a) of the Securities Act,
Section 10(b) of the Exchange Act and Rule 10b-5 thereunder**

50. Paragraphs 1 through 49 are realleged and incorporated herein by reference.

51. As a result of the conduct alleged herein, defendants Braas and Schlager, directly or indirectly, by use of the means or instruments of transportation and communication in interstate commerce, or the means and instrumentalities of interstate commerce, or of the mails,

or the facilities of a national securities exchange, in the offer or sale or in connection with the purchase or sale of Sterling securities, knowingly or recklessly: (a) employed devices, schemes or artifices to defraud; (b) obtained money or property by means of, and made, untrue statements of material fact or omitted to state material facts necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading; or (c) engaged in acts, transactions, practices, or courses of business which operated or would operate as a fraud or deceit upon offerees, purchasers and prospective purchasers of securities.

52. By reason of the foregoing conduct, defendants Braas and Schlager violated Section 17(a) of the Securities Act [15 U.S.C. § 77q(a)], Section 10(b) of the Exchange Act [15 U.S.C. § 78j(b)] and Rule 10b-5 thereunder [17 C.F.R. § 240.10b-5].

SECOND CLAIM

Violations of Section 13(b)(5) of the Exchange Act and Rule 13b2-1 thereunder

53. Paragraphs 1 through 52 are realleged and incorporated herein by reference.

54. As a result of the conduct alleged herein, defendants Braas and Schlager, directly or indirectly, knowingly circumvented or knowingly failed to implement a system of internal accounting controls or knowingly falsified books, records or accounts subject to Section 13(b)(2) of the Exchange Act [15 U.S.C. § 78m(b)(2)].

55. By reason of the foregoing conduct, defendants Braas and Schlager violated Section 13(b)(5) of the Exchange Act [15 U.S.C. § 78m(b)(5)], and Exchange Act Rule 13b2-1 thereunder [17 C.F.R. § 240.13b2-1].

THIRD CLAIM

Violations of Section 13(a) of the Exchange Act and Rules 12b-20, 13a-1 and 13a-13 thereunder

56. Paragraphs 1 through 55 are realleged and incorporated herein by reference.

57. Section 13(a) of the Exchange Act [15 U.S.C. § 78m(a)], and Exchange Act Rules 13a-1 and 13a-13 [17 C.F.R. §§ 240.13a-1 and 240.13a-13], require issuers of registered securities to file with the Commission factually accurate quarterly and annual reports. Exchange Act Rule 12b-20 [17 C.F.R. § 240.12b-20] further provides that, in addition to the information expressly required to be included in a statement or report, there shall be added such further material information, if any, as may be necessary to make the required statements, in the light of the circumstances under which they were made, not misleading.

58. From at least 2002 through 2006, Sterling filed with the Commission and disseminated to investors false and misleading quarterly and annual reports. In doing so, Sterling violated Section 13(a) of the Exchange Act and Exchange Act Rules 12b-20, 13a-1 and 13a-13.

59. By reason of the foregoing conduct, defendants Braas and Schlager aided and abetted violations of Section 13(a) of the Exchange Act and Exchange Act Rules 12b-20, 13a-1 and 13a-13.

FOURTH CLAIM

Violations of Sections 13(b)(2)(A) and 13(b)(2)(B) of the Exchange Act

60. Paragraphs 1 through 59 are realleged and incorporated herein by reference.

61. Section 13(b)(2)(A) of the Exchange Act [15 U.S.C. § 78m(b)(2)(A)] requires issuers to make and keep books, records, and accounts which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of its assets. Section 13(b)(2)(B) of the Exchange Act [15 U.S.C. § 78m(b)(2)(B)] requires issuers to devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that transactions are recorded as necessary to permit preparation of financial statements in conformity with GAAP and to maintain the accountability of assets.

62. By reason of the foregoing conduct, Sterling violated Sections 13(b)(2)(A) and 13(b)(2)(B) of the Exchange Act.

63. By reason of the foregoing conduct, defendants Braas and Schlager aided and abetted violations of Sections 13(b)(2)(A) and 13(b)(2)(B) of the Exchange Act.

WHEREFORE, the Commission respectfully requests that this Court:

I.

Issue an injunction permanently restraining and enjoining defendants Braas and Schlager from violating Section 17(a) of the Securities Act, Sections 10(b) and 13(b)(5) of the Exchange Act and Rules 10b-5 and 13b2-1 thereunder; and from aiding and abetting violations of Sections 13(a), 13(b)(2)(A) and 13(b)(2)(B) of the Exchange Act and Rules 12b-20, 13a-1 and 13a-13 thereunder.

II.

Order defendants Braas and Schlager to disgorge all ill-gotten gains derived from the activities set forth in this Complaint, together with prejudgment interest.

III.

Pursuant to Section 20(e) of the Securities Act and Section 21(d)(2) of the Exchange Act, prohibit defendants Braas and Schlager from acting as officers or directors of any issuer that has a class of securities registered pursuant to Section 12 of the Exchange Act or that is required to file reports pursuant to Section 15(d) of the Exchange Act.

IV.

Order such other and further relief as this Court may deem just and appropriate.

Respectfully submitted,

s/David S. Horowitz

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