UNITED STATES DISTRICT COURT
MIDDLE DISTRICT OF FLORIDA
ORLANDO DIVISION

IN RE:

SUNTERRA CORPORATION SECURITIES LITIGATION

Case No: 6:00-cv-79-Orl-28DAB

Consolidated Case Numbers:

6:00-cv-97-Orl-28B	6:00-cv-112-Orl-28B	6:00-cv-115-Orl-28B
6:00-cv-116-Orl-28B	6:00-cv-121-Orl-28B	6:00-cv-127-Orl-28B
6:00-cv-128-Orl-28B	6:00-cv-169-Orl-28B	6:00-cv-210-Orl-28B
6:00-cv-268-Orl-28B	6:00-cv-278-Orl-28B	6:00-cv-285-Orl-28B
6:00-cv-286-Orl-28B	6:00-cv-321-Orl-28B	

ORDER

This securities fraud case comes before the Court on multiple motions to dismiss and Plaintiffs' response in opposition.[1] Upon consideration of the Third Amended Complaint, the

[1]The motions before the Court are: Motion of Defendant Andrew Jody Gessow to Dismiss the Third Consolidated Amended Class Action Complaint (Doc. 267); Motion (Supplemental Memorandum in Support) to Dismiss of Defendant Richard A. Goodman (Doc. 271); Motion (Supplemental Memorandum in Support) to Dismiss of Defendant L. Steven Miller (Doc. 272); Motion (Supplemental Memorandum in Support) to Dismiss of Defendant Steven C. Kenninger (Doc. 273); Defendant Arthur Andersen LLP's Motion to Dismiss (Doc. 274); Defendant Ann Cohen's Motion to Dismiss Third Consolidated Amended Class Action Complaint (Doc. 276); Defendant Carol Sullivan's Motion to Dismiss Third Consolidated Amended Class Action Complaint (Doc. 278); and Defendants Charles Frey and Genevieve Giannoni's Supplemental Motion to Dismiss the Third Amended Consolidated Class Action Complaint (Doc. 280). Plaintiffs have filed Lead Plaintiffs' Combined Supplemental Memorandum in Opposition to the Supplemental Motions to Dismiss Filed By All Defendants (Doc. 291).

302

submissions of the parties, and oral argument,[2] the Court finds that Plaintiffs have sufficiently pled their claims against individual Defendants Miller, Goodman, Frey, Cohen, and Kenninger. Although Plaintiffs' claims against individual Defendant Gessow are also sufficiently pled, those claims are plainly time-barred and must be dismissed on that basis. Plaintiffs have failed to state a cause of action against individual Defendants Giannoni and Sullivan. Finally, the claim against Defendant Arthur Andersen has been sufficiently pled.

I. Background[3]

A. Overview & Parties

Plaintiffs bring this securities fraud action on behalf of persons who purchased the common stock of Sunterra Corporation ("Sunterra") from October 6, 1998 to January 19, 2000 ("the Class Period"). Sunterra shareholders filed fifteen separate cases shortly after the Class Period ended. The Court then entered orders consolidating the cases (Doc. 20) and appointing Lead Plaintiffs (Doc. 66). Sunterra and several of its officers and directors were named as Defendants. On May 31, 2000, Sunterra filed for bankruptcy under Chapter 11, and the proceedings against Sunterra were automatically stayed pursuant to 11 U.S.C. § 362(a) (Doc.

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[2]The court heard oral argument on the motions to dismiss Plaintiffs' Second Amended Consolidated Class Action Complaint on December 16, 2002. (Docs. 257 & 263). Those arguments for dismissing the Second Amended Complaint pertain to the Third Amended Complaint as well.

[3]The Background section of this Order has been compiled from the allegations in the Corrected Third Consolidated Amended Class Action Complaint. The Court, of course, makes no determination at this stage of the case as to the veracity of these allegations but, as noted in the text *infra*, the Court must accept the allegations as true for the purpose of ruling on the motions to dismiss.

70).

On November 13, 2000, the Lead Plaintiffs filed a Consolidated Amended Class Action Complaint ("the First Amended Complaint") against six Sunterra officers and directors as well as Arthur Andersen LLP. (Doc. 92). The Court found that Plaintiffs had not sufficiently pled their claims and dismissed the First Amended Complaint without prejudice. *In re* Sunterra Corp. Sec. Litig., 199 F. Supp. 2d 1308 (M.D. Fla. 2002) (Doc. 164). Granted leave to amend, Plaintiffs filed their Second Consolidated Amended Class Action Complaint on July 3, 2002 (Doc. 170). The Court dismissed that Second Amended Complaint in order to allow Plaintiffs to amend it to add allegations that had come to light and had been included in a related proceeding in a federal district court in Maryland. (Doc. 265).

Plaintiffs filed their Third Consolidated Amended Class Action Complaint on April 28, 2003 (Doc. 266) and have since filed a Corrected Third Consolidated Amended Class Action Complaint (Doc. 299)[4] ("Third Amended Complaint") which is presently pending before the Court. The following parties are named as Defendants in the Third Amended Complaint:

1. Arthur Andersen LLP ("Arthur Andersen" or "Andersen"), Sunterra's independent auditor during the Class Period;
2. Steven C. Kenninger ("Kenninger"), a Sunterra Director and Executive Committee member during the Class Period;
3. L. Steven Miller ("Miller"), Sunterra's President, Chief Executive Officer ("CEO"),

[4]The Corrected Third Consolidated Amended Class Action Complaint cures clerical errors in the numbering of paragraphs in the Third Consolidated Amended Class Action Complaint.

Director, and Executive Committee member during the Class Period;

4. Richard C. Goodman ("Goodman"), former Sunterra Executive Vice President and Chief Financial Officer ("CFO") during most of the Class Period;

5. Andrew Jody Gessow ("Gessow"), a Sunterra Director and Audit Committee member during the Class Period;

6. Charles C. Frey ("Frey"), who held several different positions at Sunterra, including Vice President of Accounting & Administration and Senior Vice President – Owner Services during the Class Period;

7. Genevieve Giannoni ("Giannoni"), Sunterra's Senior Vice President – Central Services during the Class Period;

8. Ann S. Cohen ("Cohen"), Sunterra's Senior Controller during the Class Period; and

9. Carol W. Sullivan ("Sullivan"), Sunterra's Senior Vice President – Mortgage Portfolio during the Class Period.

In light of Sunterra's bankruptcy filing, Sunterra has not been named as a Defendant in the Third Amended Complaint.

Plaintiffs' two-count Third Amended Complaint alleges that Defendants violated the Securities Exchange Act of 1934 ("the Exchange Act"). Count I alleges that all Defendants violated Section 10(b) of the Exchange Act and Rule 10b-5 promulgated thereunder by making false statements that caused Sunterra shareholders to purchase stock at fraudulently inflated prices during the Class Period. Count II alleges that the individual Defendants (but not Arthur Andersen) violated Section 20(a) of the Exchange Act by using their "controlling person"

authority to influence and control Sunterra's fraudulent conduct. Defendants move to dismiss Plaintiffs' claims, arguing that Plaintiffs have failed to plead securities fraud with the specificity required by Federal Rule of Civil Procedure 9(b) and the Private Securities Litigation Reform Act of 1995.

B. Sunterra's Business Practices & The Class Period

Sunterra is a vacation ownership company that markets and sells timeshare interests in resorts it operates worldwide. Until July 1998, Sunterra was known as Signature Resorts, Inc., a company incorporated in 1996 by, inter alia, Defendants Gessow and Kenninger. On August 18, 1996, Signature Resorts became publicly tradeable, with Defendants Kenninger, Gessow, Frey, Giannoni, Sullivan, and Cohen assuming officers' positions. By January 2000, Sunterra had ninety resort locations on three continents and managed eighteen condominiums in Hawaii.

Sunterra sold timeshares – vacation ownership interests that afforded the purchaser a furnished vacation residence, generally for a one-week period every year, in perpetuity. In most cases, the buyer made a 10% deposit towards the purchase price and Sunterra financed the remainder through a mortgage. The company carried the 90% balance due from the buyer as a mortgage receivable. Sunterra accounted for the 10% buyer deposits as revenue and the 90% mortgages receivable as assets. Because 90% of Sunterra's rentals were financed, its operating costs were significantly higher than its incoming revenue. Therefore, in order to obtain the capital it needed to expand, Sunterra secured loans from Bank of America, Finova Capital Corporation ("Finova"), and Heller Financial ("Heller"). Sunterra pledged its mortgages

receivable as security for the loans it obtained to finance its expansion.

Initially, third-party contractors serviced the mortgages receivable. In 1998, however, Sunterra centralized the mortgages receivable program by hiring Defendant Sullivan, a former outside consultant, to consolidate and control the mortgages receivable portfolio. Arthur Andersen provided the initial impetus for this action by issuing a report in January 1998 criticizing the portfolio's lack of standardized format among various resorts and variations between Sunterra's ledgers and the individual resorts' ledgers. (Doc. 299 ¶ 57). Notes prepared by a former Sunterra officer in May or June 1998 confirmed these concerns. (Doc. 299 ¶ 58). Consequently, on June 11, 1998, Sunterra created the "Senior Vice President – Mortgage Portfolio" position, which was filled by Sullivan. (Doc. 299 ¶ 59).

On October 6, 1998, the first day of the Class Period, Sunterra sold $32.8 million in mortgages receivable, purportedly to repay debt and increase assets. Throughout the Class Period, Sunterra issued press releases, mandatory Securities and Exchange Commission ("SEC") filings, and reports touting its record growth and performance. Sunterra's stock price rose from $6 at the beginning of the Class Period to a high of $16.06 in early 1999. On the last day of the Class Period, Sunterra's stock listed at $6.19 per share. The next day it fell to $2.37 per share.

Starting in late 1998, the beginning of the Class Period, Sunterra began pursuing an "exit strategy" – a plan for selling the company. Pursuant to this strategy, Sunterra began sale negotiations with Airtours Group, Plc ("Airtours"), another timeshare company. Airtours's due diligence investigation, conducted in late 1999, revealed numerous accounting discrepancies in Sunterra's records, causing Airtours to become concerned. In October 1999, Sunterra

allegedly began an "in-depth review" of its balance sheet because it perceived Airtours would still purchase Sunterra at a lower per-share price if Sunterra took some minor write-offs. (Doc. 299 ¶ 239). During this review Sunterra officials allegedly "cleaned up" the balance sheet so that Sunterra could finalize its sale to Airtours.

The Class Period concluded on January 19, 2000, the day before Sunterra issued a press release stating that it expected to record a non-cash charge of between $38 and $45 million as a result of the in-depth balance sheet review that had revealed, among other things, delinquent mortgages receivable. Airtours deemed the high write-off excessive and backed out of sale negotiations. Rather than telling the public that the balance sheet review had been undertaken because of newly discovered discrepancies, Sunterra's January 20, 2000 press release stated that the review was conducted due to "adverse factors in the fourth quarter." (Doc. 299 ¶¶ 239, 241). As a result of the press release, Sunterra's stock price plummeted to $2.37 per share, and Sunterra declared bankruptcy on May 31, 2000.

C. Plaintiffs' Allegations

Plaintiffs allege an organized structure of corruption and dishonesty involving Sunterra's mortgages receivable portfolio and timeshare inventory. All of the individual Defendants were allegedly aware of this corruption and either ignored it or took active steps to perpetuate it. In short, Plaintiffs maintain that "Sunterra's business model was a pervasive and continuing fraud predicated on mortgages receivable that were undocumented, non-existent or long-defaulted, and on timeshare inventory that was artificially inflated (by fraudulent capitalization of expenses and otherwise) and inadequate to sustain continued growth" (Doc. 299 ¶ 13). Additionally,

Plaintiffs assert that Defendants employed fraudulent accounting devices throughout the Class Period.

1. The Mortgages Receivable Portfolio

Plaintiffs identify seven separate fraudulent devices, schemes, and artifices by which Sunterra manipulated its mortgages receivable portfolio. Plaintiffs contend that Sunterra undertook these fraudulent acts to conceal the true nature of its mortgages receivable portfolio from the public. Sunterra allegedly mischaracterized its mortgages receivable portfolio as healthy when, in truth, the portfolio was overflowing with delinquent, defaulted, or non-existent mortgages receivable.

a. Millenium Management

Plaintiffs allege that Sunterra paid an independent promotional company, Millenium Management, Inc. ("Millenium"), to conceal the delinquent status of mortgages receivable in Sunterra's portfolio. Ostensibly, Millenium promoted, marketed, and sold timeshares on behalf of Sunterra. Plaintiffs assert, however, that Sunterra actually used Millenium to "clean up" Sunterra's mortgages receivable portfolio before and after Sunterra went public. According to Plaintiffs, Sunterra funneled money to Millenium and Millenium used that money to make payments on timeshare units whose owners had defaulted on their mortgages. These units were then used by Millenium for sales promotions. After Millenium used a portion of Sunterra's money to pay down the default, Sunterra classified these mortgages as "current" until they again lapsed into default status a few months later.

Additionally, Sunterra gave Millenium the funds to pay the deposits for timeshare customers who either could not afford or did not want to pay the customary 10% deposit.

Sunterra then counted the entire 10% deposit as revenue and the remaining 90% balance as an asset, even though the purchaser had not actually made a deposit. Sunterra allegedly used this ruse to report increased revenue and assets.

By 1999, Sunterra had advanced over $5 million to Millenium in connection with these mortgage and down payment schemes. Millenium refused to return the money, contending that it had returned most of it through the means previously detailed. As a result of this scheme Sunterra's write-offs announced at the conclusion of the Class Period included $2.8 million to "write-down a receivable from a marketing company" (Doc. 299 ¶ 66). Later in bankruptcy, the amount of this bad debt was revealed to be $2.2 million higher — $5 million in total.

b. Two Sets of Books

Plaintiffs also allege that Sunterra kept two sets of books: one for performing mortgages receivable, which was updated automatically, and one for delinquent or defaulted mortgages receivable, which was not. Even before Sunterra went public, it had millions of dollars worth of delinquent, rescinded, improperly entered, non-performing, and impermissibly modified mortgages. These mortgages were not reflected in Sunterra's primary books, which were kept in Las Vegas, Nevada, but instead were maintained in the second set of books kept in Orlando, Florida.

By early 1998, Sunterra began having difficulty securing the additional financing necessary to offset its relatively small incoming revenues. Finova, Sunterra's primary lender, expressed concern about the high default rate in Sunterra's mortgages receivable portfolio. (Doc. 299 ¶ 68). In response, Sunterra replaced delinquent mortgages receivable with new contracts in order to obtain additional financing from Finova. The delinquent accounts were

not foreclosed or written off, however, but instead were sent to Florida for "modifications."

In mid-1998, Sunterra set up and maintained a Nevada database of "good" receivables that could be pledged for financing or sale. If an account in that database became delinquent, the program noted it automatically. By contrast, Sunterra's Florida database was filled with "returned, undocumented, rescinded, modified or just plain defaulted mortgages receivable." (Doc. 299 ¶ 70). When accounts in the Florida database became delinquent, the program did not note it automatically.

c. Mortgage Modifications and Manipulations

Plaintiffs further allege that during the Class Period, the Defendants "concocted, engineered and manipulated various 'accounting' and 'transactional' devices to make Sunterra's mortgages receivable appear more 'current' than they actually were." (Doc. 299 ¶ 89). For example, Sunterra offered mortgage modifications to delinquent mortgagees and then listed the modified mortgages receivable as "current." Because Sunterra failed to record these modified mortgages receivable as modified, the values of these mortgages receivable were reflected at amounts far greater than their actual terms.

Sunterra also contacted defaulted and delinquent mortgagees and offered to change their timeshare interests into more flexible "Vacation Points." Once changed, Sunterra again reported these defective mortgages receivable as "cured." Sunterra did not, however, make the appropriate changes to reflect the decreased value of the mortgages receivable accounts. Furthermore, Sunterra did not actually set aside timeshares to allow the owners to take advantage of their supposedly "more flexible" Vacation Points.

As a result of its mortgage manipulations, Sunterra was unable to fulfill its contractual

obligation to Finova, its largest lender, to pay the delinquent mortgages of timeshare owners when Finova could not collect upon them. This "revert back" provision became a significant issue for Sunterra by late 1998, as large numbers of owners defaulted on their loans and Sunterra was unable to reimburse Finova. Heller, another primary lender, withdrew its participation and recorded a write-off. Unable to collect from Sunterra, Finova extended Sunterra a $50 million credit. Finova eventually filed for bankruptcy protection, allegedly in large part due to Sunterra's defaulted loans. (Doc. 299 ¶ 99).

d. The "Pending Department"

Sunterra's "Pending Department" was supposed to collect on delinquent mortgages receivable, foreclose on defaulted accounts, and return foreclosed accounts to Sunterra's inventory for sale. In actuality, because it was less expensive for Sunterra to resell a defaulted receivable than to foreclose upon it, the Pending Department presided over a scheme by which defaulted timeshares were simply resold to different purchasers without foreclosure. The Pending Department then issued reports showing delinquent mortgages receivable of up to 360 days past due as "performing." (Doc. 299 ¶ 102). Plaintiffs allege that the Pending Department "was simply the administrator of [a] '$45 million bad debt portfolio.'" (Doc. 299 ¶ 102).

e. False St. Maarten Mortgages Receivable

Plaintiffs further allege that Sunterra leased units in two resorts it acquired in St. Maarten but classified the $47 million in lease agreements as mortgages receivable like it did with its timeshare holdings. However, the St. Maarten properties were not timeshare holdings; they were rented to long-term lessees. Sunterra never established a timeshare homeowners association or created any of the infrastructure necessary to produce a valid timeshare

arrangement. Thus, the lessees refused to pay the timeshare expenses that Sunterra attempted to assess. When revealed, this deception led to a $47.3 million charge to retained earnings in 1999 and a decrease in retained earnings of $57 million in 2000. (Doc. 299 ¶ 105).

f. Selling Mortgages Receivable

Plaintiffs allege that in 1998 Sunterra began "monetizing" its mortgages receivable portfolio by selling portions of it. In 1998, Sunterra sold $420 million in mortgages receivable, but the sale merely served to fund $351 million in new mortgages receivable acquired in the same year and to facilitate repayment of the interest on existing debt. (Doc. 299 ¶ 114). This process highlighted the large number of delinquent accounts Sunterra held, yet Sunterra failed to disclose that the remaining mortgages receivable portfolio was deficient. Indeed, by attempting to sell its mortgages receivable, Sunterra subjected the accounts to third-party due diligence and review. In early 1999, S.G. Cowen, Sunterra's placement agent for securitizations, returned millions of defaulted mortgages receivable to Sunterra and warned that Sunterra's portfolio was not as strong as represented and that future securitizations would be more expensive. Sunterra did not disclose this transaction, which occurred during the Class Period.

In an effort to create more mortgages receivable that would be eligible for sale, Sunterra allegedly undertook a number of fraudulent schemes. First, Sunterra employees falsely documented changes in timeshare accounts, such as upgrades to better weeks or units, as new sales. Sunterra employees allegedly recorded 600 sales in 1998 and 1999 inaccurately or incorrectly. (Doc. 299 ¶ 113). Second, Sunterra sold the same mortgages receivable several times. Third, Sunterra knowingly refused to foreclose upon delinquent and defaulted

accounts. These cancelled or otherwise uncollectible mortgages receivable remained on the books and resulted in an overstatement of revenue. In late 1999, despite Sunterra's attempts to sell an additional $100 million in mortgages receivable, Sunterra was only able to find $71 million in "good" mortgages receivable that would qualify for sale. (Doc. 299 ¶ 118).

g. False Residuals

Finally, Plaintiffs allege that in selling the "good" mortgages receivable in 1998 and 1999, Sunterra recorded "profits" from the expected returns from the purchased mortgages. These "residual interests" depended upon the 4.6% default rate in the mortgages receivable portfolio represented to the public. This rate, however, was artificially low. Consequently, Sunterra had to write off $5.5 million in 1998, $5 million in 1999, and $14.6 million in 2000 because the residual interests were calculated falsely. (Doc. 299 ¶ 122). Further, $1.4 million in recorded residual interests for 1999 simply did not exist. (Doc. 299 ¶ 123).

2. The Timeshare Inventory

Plaintiffs highlight five separate fraudulent devices, schemes, and artifices by which Sunterra manipulated its timeshare inventory. Plaintiffs allege that Sunterra undertook these fraudulent acts "to inflate materially [Sunterra's] revenues and mortgages receivable during the Class Period." (Doc. 299 ¶ 124). Sunterra allegedly kept improper inventory records, sold inventory multiple times, improperly capitalized homeowners association ("HOA") fees and costs, improperly deferred marketing costs, and wrongly capitalized and depreciated computer and software costs.

a. Improper Record-Keeping

Plaintiffs allege that Sunterra intentionally failed to complete sales documents, maintain

working files, or finish essential paperwork. Sunterra employees "threw contract folders in boxes" after sales were made without completing final paperwork or reporting modifications to the initial contract. (Doc. 299 ¶ 128). The contracts were then recorded as "good" mortgages receivable even if they were not signed or had the wrong inventory entered. (Doc. 299 ¶ 131). In 1999, a search led to discovery of approximately one hundred boxes of sales documents in Nevada and Arizona. Additional boxes of incomplete or mislabeled sales documents were located in Washington state. Sunterra could not locate customers' documents, nor did it furnish some customers with payment coupon books to service their contracts.

b. Multiple Bookings

Sunterra's improper timeshare inventory record-keeping and fraudulent mortgages receivable portfolio allegedly led to multiple bookings of identical timeshare inventory. On the July Fourth holiday in 1999, police officers were called to break up disputes and threatened assaults when numerous Sunterra timeshare owners converged upon double- and triple-booked rooms in Orlando. Similar events occurred at a Sunterra resort in Miami. Sunterra blamed the multiple bookings on computer system errors.

c. Improperly Capitalized HOA Fees & Improperly Deferred Costs

Plaintiffs allege that Sunterra also improperly capitalized HOA maintenance fees, taxes, interest, and foreclosure costs instead of counting them as expenses. This inflated the value of Sunterra's inventory and allowed Sunterra to secure additional financing. After bankruptcy, Sunterra wrote off $29.3 million in improperly capitalized HOA fees. (Doc. 299 ¶ 150).

d. Deferred Marketing Costs

Plaintiffs further allege that Sunterra deferred marketing costs associated with timeshare

sales. The sales were recorded as revenue, but the costs accruing to those sales were not expensed. This resulted in a $2.9 million charge to retained earnings for 1999. (Doc. 299 ¶ 154).

e. Capitalized and Depreciated Computer and Software Costs

Finally, Plaintiffs allege that Sunterra capitalized and depreciated computer and software costs that were noncapitalizable. This resulted in a $2.4 million post-bankruptcy charge. (Doc. 299 ¶ 155).

3. Fraudulent Accounting Devices

Plaintiffs highlight seven separate fraudulent accounting devices that Sunterra allegedly employed during the Class Period to inflate the values of the mortgages receivable portfolio and timeshare inventory in Sunterra's financial statements. These improper practices included recording: 1) fictitious and unexecuted sales; 2) upgrades as new sales; 3) rescinded sales agreements as sales; 4) overvalued revenue; 5) multiple sales of the same inventory; 6) accrued interest on imaginary and uncollectible mortgages receivable; and 7) imaginary and uncollectible HOA fees. (Doc. 299 ¶ 157). Plaintiffs further allege that these fraudulent accounting practices were in violation of Generally Accepted Accounting Principles ("GAAP").

Moreover, Plaintiffs allege that Sunterra violated its GAAP obligations by failing to account for decreases in value to its properties or long-lived assets. Consequently, in January 2000 Sunterra took a $16.7 million write-down in the value of its properties. (Doc. 299 ¶ 170). This loss was improperly deferred until January 2000 and should have been accounted for from the beginning of the Class Period.

D. Alleged False and Misleading Statements Before and During the Class Period

Plaintiffs allege wide-sweeping, pervasive, and blatant fraudulent activity by Sunterra and the individual Defendants during the Class Period. Plaintiffs also painstakingly detail Sunterra's public filings and statements during that time. Plaintiffs argue that these statements demonstrate that, throughout the Class Period, Sunterra consistently made misrepresentations to the public regarding the company's financial well-being.

Before the Class Period, Sunterra filed its 1997 Form 10-K with the SEC on or about March 30, 1998. In that filing, Sunterra represented that:

> The Company's practice has been to continue to accrue interest on its loans to purchasers of Vacation Intervals until such loans are deemed to be uncollectible (which is generally 120 days after the date a scheduled payment is due), at which point it expenses the interest accrued on such loan, commences foreclosure proceedings and, upon obtaining title, returns the Vacation Interval or Vacation Points to the Company's inventory for resale.

(Doc. 299 ¶ 175). Sunterra also made these representations in its 1997 Annual Report and in its May 14, 1998 SEC Rule 424(b)(3) filing under the Securities Act of 1933. (Doc. 299 ¶ 176). In actuality, Sunterra gave delinquent customers 720 days to repay delinquent mortgages receivable and did not write off the uncollectible accounts. Instead, Sunterra listed them as collectible.

The Class Period began on October 6, 1998. On that date, Sunterra announced that it had sold a portion of its mortgages receivable portfolio. The Class Period ended on January 19, 2000, the day before Sunterra announced that it expected to record a non-cash charge of $38 to $45 million, after tax, related to various discrepancies on its balance sheet. During the Class Period, Sunterra made at least thirteen public representations about its corporate health

and profitability, some of which are described below. Plaintiffs contend that each of these statements was false.

1. Press Release: October 6, 1998

On October 6, 1998, Sunterra announced that it had sold $32.8 million of its mortgages receivable portfolio for $33.4 million. Sunterra's press release reported that it used the sale proceeds to repay $17.5 million in debt secured by the sold receivables and added $15.9 million to Sunterra's assets. (Doc. 299 ¶ 183). The release quoted Defendant Miller as touting the "high quality of [Sunterra's] customer base and the consistency and predictability of [Sunterra's] portfolio performance." (Doc. 299 ¶ 183). The release also listed low default, doubtful account, and foreclosure rates. (Doc. 299 ¶ 184).

Plaintiffs allege that Sunterra made at least six misrepresentations in this press release in that: 1) Sunterra's customer base was not "high quality" and its mortgages receivable portfolio was not consistent or predictable; 2) the delinquency rate of its mortgages receivable portfolio was artificially low; 3) the default rate of its mortgages receivable portfolio was artificially low; 4) the foreclosure rate of its mortgages receivable portfolio was artificially high; 5) the doubtful rate of its mortgages receivable portfolio was artificially low; and 6) its ability to monetize its mortgages receivable portfolio did not provide Sunterra with a reliable source of capital or financial flexibility. In addition, Sunterra's October 6 press release also maintained falsely that mortgages receivable accounts were deemed delinquent if scheduled payments were more than sixty days past due.

2. Press Release and SEC Form 10-Q: Third Quarter Results for 1998

On November 4, 1998, Sunterra issued a press release in which Miller claimed "record"

results for the third quarter of 1998. (Doc. 299 ¶ 185). On November 16, 1998, Sunterra filed a Form 10-Q with the SEC that contained similar representations. (Doc. 299 ¶¶ 187-88). Plaintiffs allege that these items were rife with material misrepresentations concerning Sunterra's financial performance. The press release and filing represented that Sunterra's mortgages receivable portfolio was healthy and that default, delinquency, and doubtful mortgages receivable rates remained unchanged or nearly unchanged. Moreover, Sunterra touted the flexibility of the mortgages receivable portfolio, contending that it provided numerous means by which to raise cash. Finally, the press release and filing stated that efficiency, operations, and income at Sunterra's resorts were increasing.

Plaintiffs maintain that the press release and filing were materially false and misleading because they: 1) overstated the rate of performing mortgages receivable; 2) overstated revenue; 3) understated the delinquent, default, and doubtful rates of the mortgages receivable portfolio; 4) misrepresented the liquidity of the mortgages receivable portfolio; and 5) understated Sunterra's bad debt. Plaintiffs further contend that Sunterra materially omitted information concerning its mismanagement of its mortgages receivable portfolio.

3. Press Release: Fourth Quarter and Year-End Results for 1998

On February 10, 1999, Sunterra issued its financial results for the quarter and year ended December 31, 1998. (Doc. 299 ¶ 191). Miller again commented on Sunterra's "record" performance. (Doc. 299 ¶ 192). Sunterra reported increased revenues and significant progress in converting its mortgages receivable portfolio into cash. Plaintiffs assert that Sunterra misrepresented and omitted the same information it had misrepresented in and omitted from the press release and filings for the third quarter of 1998.

4. SEC Form 10-K and Annual Report: 1998

On March 31, 1999, Sunterra filed its 1998 Form 10-K with the SEC. (Doc. 299 ¶ 195). This document, signed by Defendants Miller, Goodman, Gessow, and Kenninger, stated that the mortgages receivable portfolio provided a source of continued profit. Sunterra based this representation on an artificially low default rate. Sunterra reported stable delinquency and doubtful rates for its mortgages receivable portfolio and again asserted that mortgages were deemed delinquent if sixty days past due.

Plaintiffs allege that Sunterra's 1998 Form 10-K misrepresented and omitted similar information as Sunterra's earlier press releases and SEC filings. Plaintiffs contend that the Form 10-K overstated revenue and performing mortgages receivable but understated doubtful accounts and bad debt. Moreover, the Form 10-K mischaracterized the mortgages receivable portfolio as a source of continued liquidity, while Sunterra knew it was not. Finally, the Form 10-K omitted Sunterra's fraudulent business and accounting practices.

In early 1999, Sunterra published its Annual Report to Shareholders for 1998. (Doc. 299 ¶ 210). This Report included documents entitled "Fellow Shareholders" and "Letter from the Chief Executive Officer." In the "Fellow Shareholders" document, Defendants Gessow and Kenninger stated that 1998 was a "record year" for Sunterra in which it "managed costs and growth while exploiting economies of scale to achieve industry leading margins and record financial performance." (Doc. 299 ¶ 211). The "Letter," signed by Miller, represented that Sunterra's strategy of converting its mortgages receivable portfolio into cash was "successful." (Doc. 299 ¶ 213). Plaintiffs contend that the Annual Report made material misrepresentations and omissions concerning the actual strength of the mortgages receivable portfolio.

5. Press Release and SEC Form 10-Q: First Quarter Results for 1999

On May 5, 1999, Sunterra issued another press release in which Miller again claimed "record" results, this time for the first quarter of 1999. (Doc. 299 ¶¶ 215-17). On May 13, 1999, Sunterra filed a Form 10-Q with the SEC signed by Goodman that contained similar representations about the first quarter. (Doc. 299 ¶ 218). Sunterra again announced record results, including increased revenues. Sunterra represented that its default rate on mortgages receivable decreased and its doubtful rate remained stable. Plaintiffs argue that the first quarter press release and filing suffered from similar misrepresentations and omissions as Sunterra's other public releases during the Class Period.

6. Press Release and SEC Form 10-Q: Second Quarter Results for 1999

On August 4, 1999, Sunterra issued yet another press release claiming "record" results for the second quarter of 1999. (Doc. 299 ¶¶ 222-23). On August 16, 1999, Sunterra filed a Form 10-Q with the SEC signed by Goodman that contained similar representations. (Doc. 299 ¶ 224). Sunterra again represented that revenues had increased and that delinquent and doubtful mortgages receivable rates had increased only slightly. Plaintiffs argue that the press release and filing misrepresented increases in revenue and grossly understated the doubtful and delinquent rates of Sunterra's mortgages receivable portfolio. Furthermore, Plaintiffs again contend that Sunterra materially omitted the massive deficiencies of its mortgages receivable portfolio and its timeshare inventory.

7. Press Release and SEC Form 10-Q: Third Quarter Results for 1999

On November 3, 1999, Sunterra issued a press release in which Miller claimed "record" results and "top line growth" during the third quarter of 1999. (Doc. 299 ¶¶ 226-27). On

November 12, 1999, Sunterra filed a Form 10-Q with the SEC signed by Goodman that contained similar representations. (Doc. 299 ¶ 229). Again, Sunterra reported increases in revenue and mortgages receivable portfolio value. The company reported that the delinquency rate for the mortgages receivable portfolio decreased, while the doubtful rate slightly increased. Plaintiffs raise identical arguments regarding these documents as with Sunterra's previous press releases and SEC filings.

E. Events After the Class Period

On January 20, 2000, Sunterra issued a press release stating that "due to adverse factors in the fourth quarter of [1999]," expected shareholder earnings would decrease from $0.31 per diluted share to the range of $0.01 to $0.08 per diluted share. Moreover, Sunterra expected to record a non-cash charge of "between $38 million and $45 million, after tax." (Doc. 299 ¶¶ 241-42). The largest portion of this charge wrote off delinquent mortgages receivable. Consequently, Sunterra's stock price dropped from $6.19 per share on January 19, 2000 to $2.37 per share on January 20, 2000.

In its 1999 SEC Form 10-K, which was filed on March 31, 2000, Sunterra elaborated upon the charges to earnings that had been taken in the fourth quarter of 1999: 1) $44.3 million in mortgages receivable that were either 180 days or more past due or sixty days or more delinquent when the purchaser paid only the initial deposit; 2) $9.6 million in accrued interest on the same delinquent and defaulted mortgages receivable; 3) $0.8 million in loan costs; 4) $5.5 million to reflect the difference between actual versus projected value of retained interest in mortgages receivable; 5) $7.2 million in HOA receivables; 6) $16.7 million in resort property;

7) $1.3 million in terminated acquisition costs; and 8) $2.8 million for a receivable "from a marketing company." (Doc. 299 ¶ 243). These write-offs totaled $88.2 million.

A short time thereafter, on May 31, 2000, Sunterra declared bankruptcy under Chapter 11 of the Bankruptcy Code. In August 2000, Sunterra listed its assets at over $222 million, versus in excess of $675 million in liabilities. Jay Alix & Associates ("Jay Alix"), Sunterra's bankruptcy manager, revealed that Sunterra's general ledger and mortgages receivable portfolio had never been reconciled. Jay Alix also disclosed that Sunterra was unable to "identify each lender's collateral and encumbrance portfolio." (Doc. 299 ¶ 249).

II. Pleading Standards

A. Motion to Dismiss

In assessing a motion to dismiss, the Court must accept as true the allegations of the complaint and the reasonable inferences from those allegations. Jackson v. Okaloosa County, Fla., 21 F.3d 1531, 1534 (11th Cir. 1994). Generally, in analyzing a motion made under Federal Rule of Civil Procedure 12(b)(6) for failure to state a claim, the Court may consider only pleadings and attached exhibits. Grossman v. Nationsbank, N.A., 225 F.3d 1228, 1231 (11th Cir. 2000). Where a complaint alleges violations of securities laws, however, the Court may take judicial notice of "relevant public documents required to be filed with the SEC, and actually filed." Bryant v. Avado Brands, Inc., 187 F.3d 1271, 1278 (11th Cir. 1999).

B. The Exchange Act

Defendants stand accused of violating two provisions of the Exchange Act: Section 10(b), which prohibits manipulative and deceptive devices, and Section 20(a), which provides

for the liability of "controlling persons." 15 U.S.C. § 78j(b) (1997); 15 U.S.C. § 78t(a) (1997). Plaintiffs have not alleged that Arthur Andersen violated Section 20(a).

Section 10(b) of the Exchange Act imposes liability on any person who "use[s] or employ[s], in connection with the purchase or sale of any security . . ., any manipulative or deceptive device or contrivance in contravention of" SEC rules and regulations. 15 U.S.C. § 78j(b). SEC Rule 10b-5 proscribes: 1) employing a "device, scheme, or artifice to defraud"; 2) making any untrue statement or omission of material facts; and 3) engaging in any act or practice operating as a fraud or deceit upon a purchaser or seller of securities. 17 C.F.R. § 240.10b-5 (2003). In order to state a claim for securities fraud under Section 10(b) and Rule 10b-5, a plaintiff must allege that: 1) the defendant made a misstatement or omission; 2) of a material fact; 3) with scienter; 4) upon which the plaintiff relied; and 5) proximately caused the plaintiff's injuries. Bryant, 187 F.3d at 1281; *In re* Sunstar Sec. Healthcare Litig., 173 F. Supp. 2d 1315, 1318 (M.D. Fla. 2001).

Section 20(a) of the Exchange Act declares that every person who directly or indirectly controlled another person liable for Exchange Act violations is jointly and severally liable, unless the "controlling person" acted in good faith and did not induce the acts constituting the Exchange Act violations. 15 U.S.C. § 78t(a). A defendant is liable as a controlling person if he or she "had the power to control the general affairs of the entity primarily liable at the time the entity violated the securities laws[,] . . . had the requisite power to directly or indirectly control or influence the specific corporate policy which resulted in the primary liability[,] . . . [and] that the controlled entity violated the securities laws." Brown v. Mendel, 864 F. Supp. 1138, 1145 (M.D. Ala. 1994), aff'd sub nom. Brown v. Enstar Group, Inc., 84 F.3d 343 (11th

Cir. 1996).

C. Federal Rule of Civil Procedure 9(b)

In addition to satisfying the standards elucidated by the Exchange Act, a plaintiff's allegations must also satisfy Federal Rule of Civil Procedure 9(b). Rule 9(b) requires that the circumstances constituting fraud "be stated with particularity." This "standard assures fair notice to the defendants" of the claims against them and that the "defendants have adequate information to frame a response." *In re* Sunbeam Sec. Litig., 89 F. Supp. 2d 1326, 1336 (S.D. Fla. 1999). A plaintiff fulfills Rule 9(b)'s requirements by pleading: "1) the content of the precise statement or omission; 2) who made, or failed to make, the statement; 3) where the statement was, or should have been, made; 4) when the statement was, or should have been, made; and 5) what the defendants gained as a consequence." *In re* Sunstar, 173 F. Supp. 2d at 1318.

D. PSLRA

In 1995, Congress enacted the Private Securities Litigation Reform Act ("PSLRA") in an effort to clarify the standard a plaintiff must satisfy when pleading scienter, a required element under Section 10(b). See generally Nicole M. Briski, Comment, Pleading Scienter Under the Private Securities Litigation Reform Act of 1995: Did Congress Eliminate Recklessness, Motive, and Opportunity?, 32 Loy. U. Chi. L.J. 155 (Fall 2000) (examining circuit courts' pleading standards for Section 10(b) claims both before and after the PSLRA's enactment). The PSLRA requires that a plaintiff "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." 15 U.S.C. § 78u-4(b)(2).

In Bryant, the Eleventh Circuit held that under the PSLRA "a complaint alleging with particularity that a defendant acted with a severely reckless state of mind still suffices to state a claim for civil liability under § 10(b) and Rule 10b-5." 187 F.3d at 1283. The Eleventh Circuit previously explained:

> "Severe recklessness is limited to those highly unreasonable omissions or misrepresentations that involve not merely simple or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and that present a danger of misleading buyers or sellers which is either known to the defendant or is so obvious that the defendant must have been aware of it."

McDonald v. Alan Bush Brokerage Co., 863 F.2d 809, 814 (11th Cir. 1989) (quoting Broad v. Rockwell Int'l Corp., 642 F.2d 929, 961-62 (5th Cir. 1981) (en banc)), *quoted in* Bryant, 187 F.3d at 1282 n.18. The Bryant court held that under the above definition and the PSLRA, bare allegations that a defendant had the motive and opportunity to commit fraud, "without more, are not sufficient to demonstrate the requisite scienter in our Circuit." 187 F.3d at 1285-86.

III. Analysis

In order to survive Defendants' motions to dismiss, Plaintiffs "must plead facts, not solely based on motive and opportunity evidence, constituting strong circumstantial evidence of reckless or conscious misconduct." *In re* Sunbeam, 89 F. Supp. 2d at 1337. Defendants argue that Plaintiffs have not met this standard. The sufficiency of the allegations in the Third Amended Complaint as to each Defendant is addressed separately, although where appropriate the Defendants are discussed in pairs.

A. Miller and Goodman

On September 10, 1998, Miller became Sunterra's President and CEO, as well as a Director and a member of the Executive Committee of the Board of Directors. Goodman became Sunterra's Executive Vice President and CFO in October 1998. Plaintiffs allege that "within weeks" of their arrival at Sunterra in late 1998, Miller and Goodman knew about Sunterra's fraudulent actions but they did not initiate the balance sheet review until late 1999, when Sunterra was seeking to be bought by Airtours. Sunterra personnel, including "high-ranking employees in sales and marketing, and [information technology], as well as two controllers and one accountant" told Miller and Goodman that Sunterra's consolidated financials that were included in the SEC filings during the Class Period were not accurate. (Doc. 299 ¶ 15). By the beginning of 1999, two senior accountants told Miller and Goodman "that the mortgages receivable data bases were unreliable and deficient" and that Sunterra was using two sets of books. (Doc. 299 ¶¶ 74, 194). In their official capacities, Miller and Goodman received and had access to reports from S.G. Cowen, Airtours, and Finova indicating that the strength of the mortgages receivable portfolio was overstated.

According to Plaintiffs, Miller and Goodman knew about and approved a number of Sunterra's fraudulent devices, schemes, and artifices concerning its mortgages receivable portfolio, including the Millenium relationship, the two sets of books, the sale of mortgages receivable, and the false residuals. Miller and Goodman failed to disclose or write off the bogus settlement offer Sunterra reached with Millenium after Sunterra used the independent travel company to "clean up" Sunterra's mortgages receivable portfolio. (Doc. 299 ¶ 65).

In early 1999, when S.G. Cowen returned millions in defaulted mortgages receivable,

it advised Miller and Goodman that further mortgages receivable sales would be more expensive because Sunterra's portfolio was not as strong as Sunterra represented. (Doc. 299 ¶ 117). Miller and Goodman kept this information from Sunterra's shareholders. (Doc. 299 ¶ 22). Later that year, when Sunterra attempted to sell $100 million more in mortgages receivable, Defendant Sullivan warned Miller and Goodman that she could only find $71 million in mortgages receivable that would qualify. (Doc. 299 ¶ 118). Neither Miller nor Goodman reported this deficiency to the investing public. Finally, according to Sunterra accounting and business management employees, Miller and Goodman were instrumental in determining the false residual interests in mortgages receivable that Sunterra created and then inflated. (Doc. 299 ¶¶ 121-23).

In addition to their roles in covering up the status of the mortgages receivable portfolio, Miller and Goodman also were allegedly cognizant of Sunterra's problems with its timeshare inventory. Miller and Goodman wrote and received numerous memoranda and e-mails detailing internal control problems, systems breakdowns, improper recording of timeshare inventory, and absence of proper record retention, filing, and retrieval systems. (Doc. 299 ¶ 136). Miller and Goodman attended quarterly review and budget meetings in May, July, August, and October 1999 in which Sunterra's senior business, accounting, and financial managers discussed the problems with the mortgages receivable portfolio and the inventory accounting practices. (Doc. 299 ¶ 143). Nonetheless, Miller and Goodman approved "grossly overstated" inventory and receivables figures for financial publication. (Doc. 299 ¶ 144).

With regard to Defendant Goodman in particular, the Third Amended Complaint alleges that he sent a memorandum to the Board of Directors on January 7, 1999 stating that $85

million worth of Sunterra's mortgages receivable were ineligible as collateral because the mortgages had not been recorded, title policies had not been issued, and/or payments had not been received. Another $15 million worth of mortgages receivable were also ineligible as collateral because they were right-to-use or leasehold contracts. (Doc. 299 ¶ 76). Two weeks later, on January 20, 1999, Arthur Andersen warned Goodman in writing that potential misstatements existed in the mortgages receivable portfolio. (Doc. 299 ¶¶ 77, 299). On June 7, 1999, Arthur Andersen reiterated – again, in writing – this warning that Sunterra's accounting deficiencies could be creating misstatements. (Doc. 299 ¶ 303).

Defendant Cohen sent Goodman an e-mail on February 1, 1999 that outlined the discrepancies in Sunterra's delinquency and default calculations. Cohen's e-mail clearly stated that Sunterra's default rate "only includes receivables that are being processed through legal." (Doc. 299 ¶ 74). Despite these warnings from Andersen and Cohen, Goodman allowed Sunterra to use two sets of books until the balance sheet review in late 1999. (Doc. 299 ¶ 75).

On February 14, 1999, Goodman acknowledged in an internal report that the 1998 net mortgages receivable amount was overstated, but he blamed this inaccuracy on a "breakdown in interval reporting systems." (Doc. 299 ¶¶ 79, 87). Nevertheless, this "overstated" figure was the one submitted in the 1998 SEC Form 10-K. (Doc. 299 ¶ 79). Goodman also stated in a quarterly meeting held in May 1999 that the resorts' inventory records indicated that Sunterra would be unable to meet its publicly announced revenue projections due to a lack of inventory. (Doc. 299 ¶ 21). Goodman never informed the investing public of any of these shortcomings.

Goodman also allegedly knew about, and in some cases orchestrated, Sunterra's manipulations of timeshare inventory. Goodman was a central figure in Sunterra's improper

record keeping, multiple bookings, and capitalizations. A Sunterra Inventory Management Department employee stated that Goodman instructed personnel to resell defaulted inventory as opposed to foreclosing on the accounts first. (Doc. 299 ¶ 113). These cancelled or otherwise uncollectible mortgages receivable remained on the books and resulted in an overstatement of revenue.

Throughout the Class Period, Goodman caused Sunterra to report fictitious income in the form of interest on uncollectible and nonexistent mortgages receivable, as well as related HOA fees. (Doc. 299 ¶ 127). For example, a Sunterra portfolio manager stated that senior management, including Goodman, was aware that Sunterra reported $45 million in non-performing mortgages receivable as performing during the Class Period. (Doc. 299 ¶ 142). Moreover, Goodman did not respond to the problems with undocumented sales and multiple bookings. When a Vice President of sales and marketing attempted to call a meeting to address the undocumented and unserviced mortgages receivable, Goodman told him "to mind his own business." (Doc. 299 ¶ 133). At an August 1999 quarterly meeting during which the inventory problems and mortgages receivable portfolio errors were discussed, Goodman "chewed out" Cohen "because her inventory and receivable figures were grossly overstated." (Doc. 299 ¶¶ 143-44). Nonetheless, Goodman ultimately approved these figures for financial publication.

Goodman signed Sunterra's 1998 and 1999 SEC Forms 10-K. He also signed the 1999 first, second, and third quarter SEC Forms 10-Q. (Doc. 299 ¶¶ 218, 224, 229). Following the conclusion of the Class Period, Goodman stated, "While we regret having to take this non-cash charge, we believe that we have put these balance sheet issues behind us and placed the

Company in a stronger position going forward." (Doc. 299 ¶ 247). Goodman resigned in May 2000, the month Sunterra filed for bankruptcy.

Regarding Defendant Miller in particular, in the Third Amended Complaint Plaintiffs note that in the press release that began the Class Period on October 6, 1998, Miller stated, "Buyers of our securitized debt and receivables have been attracted to the high quality of our customer base and the consistency and predictability of our portfolio performance." (Doc. 299 ¶ 183). On November 4, 1998, Miller announced that Sunterra achieved "record" performance for the third quarter of 1998. He touted a "substantial increase in recurring management fee income from acquired resorts, continuing improvement in operations at acquired companies and increased sales efficiency at mature resorts." (Doc. 299 ¶ 185).

On February 10, 1999, Miller commented on 1998 fourth quarter and year-end results, heralding Sunterra's successful mortgages receivable sales. (Doc. 299 ¶¶ 191-92). Miller signed the 1998 SEC Form 10-K, which allegedly contained a number of misrepresentations and grossly overstated Sunterra's earnings and retained interests. (Doc. 299 ¶ 202). He also signed the "Letter from the Chief Executive Officer" contained in Sunterra's 1998 Annual Report, which touted Sunterra's ability to convert its mortgages receivable into cash. (Doc. 299 ¶ 213).

In Sunterra's 1999 first quarter press release, Miller remarked on Sunterra's record growth and quoted a low 6.8% default rate. (Doc. 299 ¶¶ 215-17). These results were included in the 1999 first quarter SEC Form 10-Q. (Doc. 299 ¶ 218). After the 1999 third quarter, Miller stated that "with the cost of sales and advertising/sales/marketing costs within target ranges, we were able to generate commensurate bottom line growth." (Doc. 299 ¶ 227).

Miller resigned on January 20, 2000, immediately after the Class Period's conclusion. (Doc. 299 ¶ 38).

Plaintiffs have alleged material misstatements and omissions by Miller and Goodman. The Third Amended Complaint also alleges with particularity facts supporting a strong inference of scienter against both Miller and Goodman. Unlike the First Amended Complaint, the Third Amended Complaint goes beyond the bare allegations that Miller and Goodman should have known about the fraud because of their executive positions. Rather, Plaintiffs now allege with specificity that both Miller and Goodman knew about the ongoing fraudulent activities at Sunterra from at least early 1999.

With regard to information provided by anonymous sources, as in the prior Order the Court adopts the analysis issued by the Holmes court, which held that aggrieved plaintiffs " ' "need not name their sources as long as [other] facts provide an adequate basis" ' " to support the reliability of the information. *In re* Sunterra, 199 F. Supp. 2d at 1325 (quoting Holmes v. Baker, 166 F. Supp. 2d 1362, 1380-81 (S.D. Fla. 2001) (quoting Novak v. Kasaks, 216 F.3d 300, 314 (2d Cir. 2000))). It is not Plaintiffs' obligation to name corporate whistle-blowers at this stage of the proceedings, so long as their allegations have some specificity and indicia of reliability. Unlike Plaintiffs' First Amended Complaint, which relied upon "only vague and general references to e-mail," id., the Third Amended Complaint provides names, job titles, relevant dates, and content. These names and job titles are not generalized as they were in the First Amended Complaint. Rather, Miller and Goodman are specifically named in connection with the e-mails and other correspondence, and in two instances the actual names of the whistle-blowers are given.

The Third Amended Complaint alleges that "within weeks" of Miller and Goodman's arrival, high-ranking Sunterra officials had informed Miller that Sunterra's consolidated financials were inaccurate and had informed Goodman of the mortgages receivable portfolio's problems. Moreover, "by the beginning of 1999," two senior accountants had told both Miller and Goodman about the unreliable and deficient mortgages receivable database. (Doc. 299 ¶ 194).

It is important to note that Plaintiffs allege that both Miller and Goodman knew that only $71 million of the desired $100 million of saleable mortgages receivable would qualify for sale. Miller and Goodman received information from both Sullivan and S.G. Cowen concerning this detail. Also, both Miller and Goodman received and sent e-mails detailing the many fraud problems at Sunterra during the Class Period. It is also significant that Miller and Goodman attended at least four meetings in which the double-bookings and errors in the mortgages receivable portfolio were discussed.

Plaintiffs further allege that Goodman wrote a memorandum to the Board of Directors on January 7, 1999 detailing $85 million worth of deficient mortgages receivable. Two weeks later, Goodman received written notice from Arthur Andersen of deficiencies in the mortgages receivable portfolio. Plaintiffs also allege that Goodman received an e-mail from Cohen on February 1, 1999 detailing the discrepancies in Sunterra's delinquency and default calculations for its mortgages receivable portfolio. On February 20, 1999, Goodman acknowledged in writing that the mortgages receivable amount was overstated. Finally, in mid-July, Goodman told a Sunterra Vice President to "mind his own business," warning him not to get involved in the mortgages receivable problems. These actions all occurred almost six months before

Sunterra undertook its in-depth balance sheet review and claimed that it was doing so because of adverse factors in the fourth quarter of 1999.

Unlike the First Amended Complaint, which essentially imputed knowledge to Miller and Goodman based on their corporate titles, the Third Amended Complaint clearly alleges that these Defendants personally had involvement in and knowledge of the fraudulent activity concerning the mortgages receivable portfolio and the timeshare inventory. The allegations include dates, names, and specific details providing strong indicia of reliability. These allegations support the inference that Miller and Goodman should not have waited until late 1999 to initiate the balance sheet review. Rather, if true, both Miller and Goodman should have been aware of the issues with the mortgages receivable portfolio and timeshare inventory by February 1999 at the latest. Instead of disclosing this information to shareholders, Miller and Goodman signed publicly-filed SEC forms legitimizing Sunterra's fraudulent figures and activities.

Plaintiffs have therefore pled with particularity facts supporting the requisite strong inference of severe recklessness on the part of Miller and Goodman. Additionally, Plaintiffs have sufficiently alleged that both Miller and Goodman were controlling persons of Sunterra, in that they had the power to control its general affairs and to control or influence the specific corporate policies at issue here. For these reasons, Miller and Goodman's motions to dismiss are denied.

B. Frey

Frey worked for Sunterra since its inception. He began his Sunterra career as the

Senior Vice President of Accounting and Administration and Company Treasurer, with "overall responsibility for accounting." (Doc. 299 ¶ 5). Prior to the Class Period, Frey signed or was listed as "Chief Accounting Officer" in at least eight "registration statements, exchange offers or periodic reports publicly filed" under SEC requirements, including the SEC Form S-1 registration statement for Sunterra's secondary offering of common stock and the SEC Form 10-K for 1996. (Doc. 299 ¶ 7). For the first few months of the Class Period, Frey was Sunterra's Vice President of Accounting and Administration. For the remainder of the period, Frey was Senior Vice President — Owner Services. The 1998 SEC Form 10-K listed his responsibilities as "manag[ing] all service functions related to owners, guests and visitors, including hospitality management and call center operations (reservation, travel and membership services), as well as construction for both newly acquired and existing resorts." (Doc. 113, Ex. 5 at 2). Frey did not sign SEC filings or issue press releases during the Class Period.

The Third Amended Complaint alleges that Frey was a member of "the core group [of individuals] who understood, had access to and day-to-day control of all critical financial information." (Doc. 299 ¶ 8). Frey and his assistant attended quarterly review and budget meetings in May, July, August, and October 1999. (Doc. 299 ¶ 143). Frey allegedly promised at one or more of these meetings to "come up with something to make the numbers" in order to effectuate Sunterra's sale to Airtours. (Doc. 299 ¶ 156). Frey then prepared and manipulated the allegedly false or misleading inventory and mortgages receivable financial information for Sunterra's SEC filings. (Doc. 299 ¶¶ 14, 15, 144). A senior business manager personally observed Frey communicate his manipulations of the consolidated financial

information included in Sunterra's SEC filings to Defendant Gessow "practically on a day-to-day basis." (Doc. 299 ¶ 15).

Frey spearheaded many of Sunterra's fraudulent devices, schemes, and artifices concerning its mortgages receivable portfolio, including Millenium, the two sets of books, the mortgage modifications and manipulations, the sale of mortgages receivable, and the false residuals. For example, Frey is alleged to have orchestrated Sunterra's use of Millenium to "clean up" the mortgages receivable portfolio. (Doc. 299 ¶¶ 62-65). He attempted to settle with Millenium in October 1999, during Sunterra's negotiations with Airtours, stating, "I cannot afford another write-off now." (Doc. 299 ¶ 238).

Additionally, Frey maintained the second set of books pertaining to the "bad" mortgages receivable in Florida, and he reviewed and adjusted financial statements reflecting the fraud. (Doc. 299 ¶ 73). In order to obtain funds from Finova, Frey continually replaced non-performing receivables with newly written contracts. (Doc. 299 ¶ 68). He did not write off these non-performing receivables but instead maintained them at Sunterra's Florida offices. (Doc. 299 ¶ 70). A senior business analyst in Sunterra's Nevada office informed Frey of a $40 million shortfall in escrow balances in 1999, but Frey insisted that she was wrong and took no action. (Doc. 299 ¶ 14).

Frey was "at the forefront" of the mortgage modifications and manipulations. (Doc. 299 ¶ 90). He instructed Sunterra employees to offer mortgage modifications to delinquent mortgagees, and the delinquent mortgages were then listed as "current"; however, the modifications were not properly recorded, nor were the receivables adjusted to show the modified terms. (Doc. 299 ¶ 90). Frey knew that the modified mortgages were being pledged

as collateral for loans at amounts greater than their actual terms. (Doc. 299 ¶ 91). Further, when the modified mortgages were "revived," the relevant database listed Frey as the salesman, leading a Sunterra Business Manager to believe Frey received undocumented compensation for these sales. (Doc. 299 ¶ 91). Frey also had Sunterra personnel persuade defaulted timeshare owners to convert their ownership interests into smaller Vacation Points. But, again, Sunterra did not properly record these changes to the mortgages receivable, nor did it set aside appropriate timeshare inventory to reflect these changes. (Doc. 299 ¶ 100).

Frey was also involved with the fraudulent monetization of Sunterra's mortgages receivable portfolio beginning in 1998. A Sunterra Inventory Management Department employee stated that Frey instructed personnel to resell defaulted inventory as opposed to first properly foreclosing on the accounts. (Doc. 299 ¶ 113). These cancelled or otherwise uncollectible mortgages receivable remained on the books and resulted in an overstatement of revenue. In early 1999, when S.G. Cowen returned millions in defaulted mortgages receivable, it advised Frey that further sales would be more expensive. (Doc. 299 ¶ 117). Later that year, when Sunterra attempted to sell $100 million more in mortgages receivable, Sullivan warned Frey she could only find $71 million in mortgages receivable that would qualify. (Doc. 299 ¶ 118). Frey did nothing to report this shortfall to the investing public. By contrast, throughout the Class Period, Frey caused Sunterra to report fictitious income in the form of interest on uncollectible and nonexistent mortgages receivable, as well as related HOA fees. (Doc. 299 ¶ 127). Finally, according to Sunterra accounting and business management employees, Frey was one of the officers who were instrumental in determining the false residual interests in mortgages receivable that Sunterra sold. (Doc. 299 ¶ 121).

According to Plaintiffs, Frey was also a central figure in Sunterra's manipulations of its timeshare inventory, especially the multiple bookings. When double- and triple-booked timeshares led to threatened assaults during the Fourth of July weekend in 1999, a Sunterra senior business manager reported the problem to Frey. Frey told him to "stay out of it." (Doc. 299 ¶ 133). When a Vice President of sales and marketing attempted to call a meeting to address the undocumented and unserviced mortgages receivable, Frey told him to "mind his own business." (Doc. 299 ¶ 133). Despite the Fourth of July problems, Frey continued to instruct Sunterra personnel not to record inventory correctly. (Doc. 299 ¶ 134).

Frey wrote and received numerous memoranda and e-mails detailing internal control problems; systems breakdowns; improper recording of revenue and timeshare inventory; and absence of proper document retention, filing, and retrieval systems. (Doc. 299 ¶ 136). For example, Frey wrote memoranda "acknowledging that the audit trail was weak and that certain accounting systems of [acquired companies] were in complete disarray." (Doc. 299 ¶ 137). Frey also acknowledged in writing that Sunterra needed to centralize databases and improve record keeping. (Doc. 299 ¶ 138). Ultimately, however, a Sunterra portfolio manager stated that Frey knew that during the Class Period Sunterra reported $45 million in non-performing mortgages receivable as performing. (Doc. 299 ¶ 142).

In the Third Amended Complaint, Plaintiffs allege with the requisite particularity that Frey made misleading statements or omissions. In dismissing the First Amended Complaint, the Court noted that Plaintiffs did not adequately allege that Frey signed the SEC filings, was in a position of control over the SEC filings' content, or was involved in Sunterra's day-to-day management. *In re* Sunterra, 199 F. Supp. 2d at 1328. Plaintiffs still have not alleged that

Frey signed the SEC filings; they have, however, adequately alleged that Frey controlled their content and was involved in the daily management of Sunterra. These allegations, through the group pleading doctrine, satisfy the PSLRA's requirements.

"[U]nder the group pleading doctrine, . . . statements in group published information are presumed to be the collective action of corporate officers involved in day-to-day management of the corporation." *In re* Sunbeam, 89 F. Supp. 2d at 1340. In applying the group pleading doctrine in the Order dismissing the First Amended Complaint, this Court noted that the Eleventh Circuit Court of Appeals had not yet addressed the issue of whether the doctrine survives the passage of the PSLRA. *In re* Sunterra, 199 F. Supp. 2d at 1327. In the absence of authority from the Eleventh Circuit that the group pleading doctrine does not survive the PSLRA, the doctrine will be applied.[5]

Frey allegedly prepared, manipulated, and drafted inaccurate and misleading inventory and mortgages receivable financial information for Sunterra's SEC filings, according to a senior Sunterra business manager. (Doc. 299 ¶¶ 14, 15, 144). He orchestrated the fraudulent Millenium relationship, maintained a second set of books in Sunterra's Florida offices, recorded delinquent and modified mortgages as "current," instructed Sunterra personnel not to record inventory correctly, and caused Sunterra to report fictitious income. Plaintiffs have adequately

[5]Frey and Giannoni cite the recent Eleventh Circuit decision of Theoharous v. Fong, 256 F.3d 1219 (11th Cir. 2001), in their discussion of the group pleading theory. In an unpublished decision, the Theoharous district court declined to apply the group pleading doctrine. The Eleventh Circuit did not address this aspect of the district court's decision in its published opinion. See id. Moreover, subsequent to the Theoharous decision, other district courts have noted that the Eleventh Circuit still has not addressed the viability of the group pleading doctrine. See, e.g., *In re* Sensormatic Elecs. Corp. Sec. Litig., No. 018346CIVHURLEY, 2002 WL 1352427, at *4 (S.D. Fla. June 10, 2002).

alleged that Frey had daily involvement in Sunterra's management.

Plaintiffs have also alleged particular facts giving rise to a strong inference of scienter against Frey. In his motion to dismiss the First Amended Complaint, Frey argued that Plaintiffs did not specify how he oversaw the mortgages receivable portfolio and that the statements accusing him were made by anonymous employees with no indicia of reliability. In considering the earlier motion to dismiss, the Court determined that while the allegations against Frey were stronger than those against the other named Defendants, they were not sufficient to withstand the motion to dismiss. Again, Frey argues the allegations are insufficient to sustain the Third Amended Complaint. This time, the Court disagrees.

While most of the allegations against Frey are still levied by anonymous Sunterra employees, this does not preclude a finding of scienter so long as there are indicia of reliability. See *In re* Sunterra, 199 F. Supp. 2d at 1325. In this instance, Plaintiffs allege over a dozen statements made by or to Frey acknowledging Sunterra's fraudulent mortgages receivable and inventory activity. Highlights include a memorandum Frey wrote admitting that Sunterra's accounting systems were "in complete disarray." (Doc. 299 ¶ 137). Furthermore, Frey wrote and received numerous memoranda and e-mails detailing this disarray. He told a Vice President of sales and marketing "to mind his own business" when that Sunterra executive attempted to resolve the multiple-bookings fraud. (Doc. 299 ¶ 133). Additionally, both Sullivan and S.G. Cowen told Frey about the shortfall in "good" mortgages receivable. Finally, a Sunterra senior business manager personally watched Frey communicate his manipulations of SEC-filed data "practically on a day-to-day basis." (Doc. 299 ¶ 15).

Plaintiffs have therefore pled facts alleging Frey's misstatements and omissions as well

as strong circumstantial evidence of a severely reckless state of mind. Although Frey never signed publicly issued financial statements, Plaintiffs have sufficiently alleged the "making a misstatement or omission" element of their Section 10(b) claim through the group pleading doctrine because they have alleged Frey's involvement in the day-to-day management of Sunterra. Plaintiffs also have adequately alleged that Frey was a controlling person of Sunterra in that he had the power to control its general affairs and to control or influence the specific corporate policies upon which Plaintiffs' allegations are based. For these reasons, Frey's motion to dismiss is denied.

C. Cohen

Cohen worked for Sunterra since its inception. She was the Sunterra Senior Controller during the Class Period, with "overall responsibility for assembling financial reports from resorts and regional controllers in preparation of consolidated financial statements." (Doc. 299 ¶¶ 5, 42). All of Sunterra's controllers reported directly to Cohen, and Cohen received reports on the mortgages receivable from Sullivan, Frey, and Giannoni and then assembled all the reports in order to prepare Sunterra's quarterly consolidated financial statements. (Doc. 299 ¶¶ 14, 42, 73). Cohen did not sign SEC filings or issue press releases during the Class Period. She was not named in the First Amended Complaint.

Plaintiffs allege that Cohen was also a member of the core group of individuals who "understood, had access to and day-to-day control of all critical financial information." (Doc. 299 ¶ 8). Cohen allegedly prepared, manipulated, and drafted fraudulent financial information for Sunterra's SEC filings and frequently spoke with Gessow and Kenninger about this process.

(Doc. 299 ¶ 15). Additionally, Cohen helped to create the proposed "fictitious settlement agreement" with Millenium to hide the fraudulent relationship. (Doc. 299 ¶¶ 64, 65). Moreover, she knew about the mortgage modifications that were not being recorded or taken into account. (Doc. 299 ¶ 91). According to former Sunterra accounting and business management employees, Cohen was one of the officers who were instrumental in determining the false residual interests in mortgages receivable that Sunterra sold. (Doc. 299 ¶ 121).

In 1999, Cohen twice acknowledged, in writing, that Sunterra's internal controls were flawed. (Doc. 299 ¶¶ 74, 301). In response to an Arthur Andersen memorandum pointing out internal control deficiencies, Cohen wrote a memorandum that was given to Goodman and Arthur Andersen stating that Sunterra salespersons were not processing cancellations, that accounting was not communicating with other departments, and that the amount of adequate mortgages receivable needed to be considered in connection with "aging reports and static pool analysis." (Doc. 299 ¶ 301). Then, on February 1, 1999, Cohen sent Goodman an e-mail outlining the problems in Sunterra's delinquency and default rate calculations and confirming that Sunterra's default rate "only includes receivables that are being processed through legal." (Doc. 299 ¶ 74). This resulted in an artificially low default rate.

In addition to having knowledge of Sunterra's faulty reporting and recording procedures, Cohen allegedly engaged in "several forms of manipulation" to ensure that Sunterra's mortgages receivable portfolio appeared to be healthier than it actually was. (Doc. 299 ¶ 52). Several former Sunterra employees have detailed Cohen's manipulations as part of the group that maintained the second set of books for the "bad" mortgages receivable that were defaulted, undocumented, delinquent, or improperly aged. (Doc. 299 ¶¶ 42, 70). For example,

when a Sunterra senior business analyst reported a $40 million shortfall in escrow balances in 1999, Cohen first told her she was wrong and then, when the analyst again could not find the $40 million, told her "it's there, just write it." (Doc. 299 ¶ 14). An employee who worked with the "bad" mortgages receivable portfolio stated that Cohen knew that Sunterra reported at least $45 million in non-performing receivables as current. (Doc. 299 ¶ 142). Moreover, another former employee stated that Cohen "massaged" Sunterra's final financial figures by deleting a portion of the delinquent accounts receivable from the list of aging receivables. (Doc. 299 ¶ 317).

Plaintiffs also allege that Cohen knew about the fraudulent activity pertaining to Sunterra's timeshare inventory. Throughout the Class Period, she caused Sunterra to report fictitious income in the form of interest on uncollectible and nonexistent mortgages receivable, as well as related HOA fees. (Doc. 299 ¶ 127). Cohen wrote and received numerous memoranda and e-mails detailing internal control problems; systems breakdowns; improper recording of revenue and timeshare inventory; and absence of proper record retention, filing, and retrieval systems. (Doc. 299 ¶ 136). Cohen attended meetings in May, July, August, and October 1999 in which the double bookings and errors in the mortgages receivable portfolio were discussed. (Doc. 299 ¶ 143). In the August meeting, Goodman "chewed out" Cohen "because her inventory and receivable figures were grossly overstated" after a regional controller identified the disparity between Cohen's consolidated reports and the individual resorts' reports. (Doc. 299 ¶ 144). Despite Goodman's complaint, Sunterra ultimately published these false financial figures, which were prepared in large part by Cohen, with the SEC. (Doc. 299 ¶ 144).

Plaintiffs have adequately alleged that Cohen controlled the content of Sunterra's SEC filings and was involved in day-to-day Sunterra management. These contentions, through the group pleading doctrine, fulfill the PSLRA's requirements for alleging false and misleading statements. See *In re* Sunterra, 199 F. Supp. 2d at 1327-28. Indeed, it was Cohen's job to compile various Sunterra financial reports for SEC publication.

Plaintiffs also have alleged facts giving rise to a strong inference of scienter against Cohen. The allegations against Cohen are sufficiently particularized and detailed to satisfy the PSLRA's requirements for pleading severe recklessness. These allegations include: 1) Cohen's e-mail to Goodman on February 1, 1999, which outlines auditing issues, including the default and delinquency calculations (Doc. 299 ¶ 74); 2) Cohen being "chewed out" by Goodman in an August 1999 quarterly review meeting after her "grossly overstated" inventory and mortgages receivable figures were pointed out by a regional controller (Doc. 299 ¶ 144); and 3) Cohen's memorandum to Goodman in early 1999, which acknowledged that Sunterra's internal controls were flawed. (Doc. 299 ¶ 301).

Although some of the paragraphs cite an anonymous source for the information, most of the sources are identified by their positions and the information provided is detailed enough to be deemed reliable. Plaintiffs have alleged other facts — including statements made in writing by Cohen herself — that provide the requisite particularity and give rise to a strong inference of severe recklessness. Plaintiffs have also sufficiently alleged that Cohen had the requisite power and control to survive the motion to dismiss the Section 20(a) controlling person claim against Cohen.

Finally, Cohen argues that Plaintiffs' failure to name her as a Defendant within the one-

year statute of limitations bars this action against her. Claims brought pursuant to Section 10(b) of the Exchange Act and SEC Rule 10b-5 "must be commenced within one year after the discovery of the facts constituting the violation." Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson, 501 U.S. 350, 364 (1991). This one-year statute of limitations is triggered by either actual or inquiry notice of a violation. Theoharous v. Fong, 256 F.3d 1219, 1228 (11th Cir. 2001). Cohen maintains that Plaintiffs had inquiry notice of potential fraud claims against her more than one year prior to July 3, 2002 – the date that Plaintiffs filed their Second Amended Complaint and for the first time named Cohen as a defendant in this case.

Cohen bears the burdens of production and persuasion on her statute-of-limitations defense. See Smith v. Duff and Phelps, Inc., 5 F.3d 488, 492 n.9 (11th Cir. 1993). In support of her contention that Plaintiffs had inquiry notice of the claims against her prior to July 3, 2001, Cohen points out that before that date Sunterra had submitted the press release ending the Class Period, the ensuing drop in Sunterra's stock price had occurred, and Sunterra had declared bankruptcy. Cohen notes that she prepared the bankruptcy schedules and argues if Plaintiffs knew that there were problems with the mortgages receivable portfolio and that Cohen was in charge of internal controls for that portfolio, then Plaintiffs should have named her in the First Amended Complaint which was filed in November 2000.

However, it is not appropriate to dismiss a complaint on statute-of-limitations grounds unless the running of the statute is apparent from the face of the complaint. See, e.g., Omar v. Lindsey, 334 F.3d 1246, 1251-52 (11th Cir. 2003).[6] Cohen's arguments rely on issues of

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[6]In an order adopted and attached as an appendix to the Eleventh Circuit's opinion, the Omar District Court stated, "In keeping with the standard of review [for motions to dismiss], the

fact that are not apparent from the face of the Third Amended Complaint or any other documents appropriately considered by the Court at this stage of the case. Unlike the situation involving Gessow, which will be discussed below, the facts are not clear as to when Plaintiffs should have become aware of Cohen's possible role in Sunterra's alleged misdeeds. It is not appropriate for the Court to resolve such factual issues at this stage of the proceeding, and accordingly Cohen's motion to dismiss the claims against her on this basis is also denied.

D. Kenninger and Gessow

Kenninger and Gessow were two of Sunterra's three founders. (Doc. 299 ¶ 4). At Sunterra's inception, Kenninger became its Chief Operating Officer and Gessow became its CFO. (Doc. 299 ¶ 5). During the Class Period, Kenninger and Gessow served as members of Sunterra's Board of Directors and their employment agreements required them to devote "substantially full time" to Sunterra. (Doc. 299 ¶¶ 36, 37). Both signed Sunterra's 1998 SEC Form 10-K. (Doc. 299 ¶ 195). Kenninger and Gessow, as co-Chairmen of the Board of Directors, signed the letter to "Fellow Shareholders" contained in Sunterra's 1998 Annual Report. The letter described 1998 as "another record year for Sunterra" and stated that during 1998 Sunterra had "managed costs and growth while exploiting economies of scale to achieve industry leading margins and record financial performance." (Doc. 299 ¶ 211).

Plaintiffs allege that Kenninger and Gessow were also members of the core group of

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Court concludes that the statute of limitations issue cannot be resolved at this stage of the litigation because such resolution would depend either on facts on yet in evidence or on construing factual ambiguities in the complaint in Defendants' favor, which would be inappropriate." Id. at 1252.

individuals who "understood, had access to and day-to-day control of all critical financial information." (Doc. 299 ¶ 8). According to his assistant, Kenninger had "practically day-to-day contact" with Gessow, Miller, and Goodman and "frequently directed Miller and Goodman to take actions to perpetuate the fraud." (Doc. 299 ¶ 37). Gessow also had "nearly day-to-day contact" with Miller, Goodman, Frey, Giannoni, Cohen, and Sullivan concerning Sunterra's business activities. (Doc. 299 ¶ 36). He often directed Miller and Goodman "to take steps" based on the information he learned from Frey, Giannoni, Cohen, and Sullivan. (Doc. 299 ¶ 36).

During 1998 and 1999, Kenninger and Gessow attended at least four quarterly review and budget meetings in person or via telephone in which Sunterra's senior business, accounting, and financial managers discussed in detail the problems with the mortgages receivable portfolio and the inventory accounting practices. (Doc. 299 ¶¶ 36, 37). In addition, an April 24, 1998 memorandum from Sunterra management to Arthur Andersen discussing Sunterra's internal control deficiencies was circulated to Gessow and Kenninger. (Doc. 299 ¶ 297). In late 1999, when Sunterra attempted to sell an additional $100 million in mortgages receivable, Sullivan warned Kenninger and Gessow that she could only find $71 million in mortgages receivable that would qualify. (Doc. 299 ¶ 118). Kenninger and Gessow did not report this shortfall to the investing public.

Kenninger and Gessow were aware of Sunterra's fraudulent devices, schemes, and artifices concerning its mortgages receivable portfolio. Kenninger and Gessow knew and approved of Frey and Giannoni's activities with Millenium and helped to create the "fictitious settlement agreement." (Doc. 299 ¶¶ 62, 64). Additionally, both were aware of the two sets

of books pertaining to the mortgages receivable portfolio, and they reviewed financial statements reflecting the fraud. (Doc. 299 ¶ 73). Finally, according to Sunterra accounting and business management employees, Kenninger and Gessow were "instrumental" in determining the false residual interests in mortgages receivable that Sunterra sold. (Doc. 299 ¶ 121).

Plaintiffs also allege that Kenninger and Gessow knew about the fraudulent activity pertaining to Sunterra's timeshare inventory. Kenninger and Gessow knew about the unrecorded mortgage modifications and the "Pending Department's" resale of defaulted mortgages without foreclosure (Doc. 299 ¶¶ 92, 100, 101). According to a Sunterra Inventory Management Department employee, Gessow instructed personnel to resell defaulted inventory instead of foreclosing on it. (Doc. 299 ¶ 113). These cancelled or otherwise uncollectible mortgages receivable remained on the books and resulted in an overstatement of revenue.

Ultimately, Kenninger and Gessow approved inventory and receivable figures for financial publication knowing these figures were "grossly overstated." (Doc. 299 ¶ 144). Throughout the Class Period, they caused Sunterra to report fictitious income in the form of interest on uncollectible and nonexistent mortgages receivable, as well as related HOA fees. (Doc. 299 ¶ 127).

The Third Amended Complaint adequately alleges actionable misstatements or omissions by Kenninger and Gessow. The Plaintiffs have alleged that both Kenninger and Gessow signed Sunterra's 1998 SEC Form 10-K and the "Fellow Shareholders" letter contained in Sunterra's 1998 Annual Report. These documents allegedly made material misstatements or omitted material facts.

As to the scienter requirement, this Court dismissed the claims against Kenninger in the

First Amended Complaint because the Plaintiffs attempted to rely on little more than Kenninger's status as a director, his Board committee membership, his stock sales, and his signature on Sunterra's 1998 Form 10-K to raise an inference of scienter. *In re* Sunterra, 199 F. Supp. 2d at 1330-31. In the Third Amended Complaint, the Plaintiffs have failed to cure some of the shortcomings of the First Amended Complaint; for example, Plaintiffs have repeated their allegations regarding Kenninger's stock sales during the Class Period and have again failed to allege that those sales were inconsistent with his trading history or were part of an unusual trading pattern. See id. at 1330. Unlike in the First Amended Complaint, however, Plaintiffs have now alleged particular facts against Kenninger that support a strong inference of severe recklessness. Although Gessow was not named as a Defendant in the First Amended Complaint, Plaintiffs' allegations against him in the Third Amended Complaint closely mirror those against Kenninger and likewise meet the PSLRA's requirements for pleading scienter.

The First Amended Complaint failed to allege that Kenninger had personal participation in Sunterra's accounting practices or even daily involvement in the Company. See id. By contrast, the Third Amended Complaint alleges both. Plaintiffs have alleged that Kenninger and Gessow had employment agreements that required them to devote "substantially full time" to Sunterra (Doc. 299 ¶¶ 36, 37) and that both were part of a core group that "understood, had access to and day-to-day control of all critical financial information." (Doc. 299 ¶ 8). Plaintiffs allege that Kenninger and Gessow had almost daily contact with other key Defendants and frequently directed Miller and Goodman's actions. (Doc. 299 ¶¶ 36, 37).

Further, Kenninger and Gessow are alleged to have actively participated in Sunterra's

fraudulent schemes: they helped to create the fictitious settlement agreement with Millenium (Doc. 299 ¶¶ 62, 64), reviewed financial statements reflecting the two-sets-of-books fraud (Doc. 299 ¶ 73), were instrumental in determining the false residual interests in mortgages receivable that Sunterra sold (Doc. 299 ¶ 121), and approved grossly overstated inventory and receivable figures for publication (Doc. 299 ¶ 144). Gessow also instructed Sunterra employees to resell defaulted inventory without foreclosure. (Doc. 299 ¶ 113).

The Third Amended Complaint has also cured the First Amended Complaint's failure to allege that Kenninger received any internal communications or Arthur Andersen reports detailing the accounting problems. See id. In addition to having almost daily contact with other key Defendants, Plaintiffs have alleged that Kenninger and Gessow attended at least four meetings in which the problems were discussed (Doc. 299 ¶¶ 36, 37), received an Arthur Andersen memorandum detailing internal control issues (Doc. 299 ¶ 297), and were informed of Sunterra's shortfall in sellable mortgages receivable by Sullivan (Doc. 299 ¶ 118).

In sum, the Third Amended Complaint does not merely allege Kenninger and Gessow's status as co-founders, co-Chairmen of the Board of Sunterra, and 1998 Form 10-K signatories. Nor does it rely on their committee membership or stock sales. The Third Amended Complaint adequately alleges that Kenninger and Gessow had daily involvement in Sunterra, had knowledge of Sunterra's fraudulent accounting practices, and actively participated in many of Sunterra's fraudulent devices. While some of the allegations are attributed to anonymous sources, these allegations contain the requisite indicia of reliability.

Plaintiffs have therefore pled facts constituting strong circumstantial evidence of Kenninger and Gessow's severely reckless scienter. Plaintiffs have also sufficiently pled

Section 20(a) controlling person claims against Kenninger and Gessow.

Although Plaintiffs have met their obligation of pleading with specificity, Gessow correctly contends that the claims against him must be dismissed because they are barred by the one-year statute of limitations. Gessow was named as a defendant in three of the initial fifteen complaints that were consolidated by the Court. Gessow was not, however, named in the First Amended Complaint, which was filed on November 13, 2000 and dismissed on March 12, 2002. In the Second Amended Complaint, filed on July 3, 2002, Gessow was again named as a defendant. After being granted leave to amend, Plaintiffs filed their Third Amended Complaint on April 25, 2003 against the same defendants. Thus, the issue is whether the Plaintiffs were on inquiry notice as to Gessow's participation in the fraud more than a year before filing the Second Amended Complaint on July 3, 2001.

In Theoharous v. Fong, the Eleventh Circuit explained that inquiry notice means "'knowledge of facts that would lead a reasonable person to begin investigating the possibility that his legal rights had been infringed.'" 256 F.3d 1219, 1228 (11th Cir. 2001) (quoting Kauthar SDN BHD v. Sternberg, 149 F.3d 659, 670 (7th Cir. 1998)). The Theoharous court held that the plaintiffs were put on inquiry notice of the possibility of fraud by a company's announcement that it was filing for bankruptcy. Id. Additionally, in Franze v. Equitable Assurance, 296 F.3d 1250, 1255 (11th Cir. 2002), the Eleventh Circuit emphasized that inquiry notice is analyzed using an objective standard, meaning that a plaintiff's actual ignorance is irrelevant. There, the court held that the statute of limitations was triggered when the defendant company gave the plaintiffs a prospectus and policy providing sufficient information to put a reasonable person on inquiry notice of the possibility of fraud. Id. If an objectively

reasonable person would have been put on inquiry notice to investigate the possible fraud claims against Gessow more than one year before the Plaintiffs named him as a defendant in the Second Amended Complaint, then the claims against Gessow are barred by the statute of limitations.

Plaintiffs argue that they were not on inquiry notice before July 3, 2001 because they could not reasonably have known that Gessow acted with the requisite scienter. However, in Theoharous, the Eleventh Circuit rejected this argument, stating that a Plaintiff is on notice before he has full knowledge of the nature and extent of the fraud: "[i]nquiry notice is triggered by evidence of the *possibility* of fraud, not full exposition of the scam itself." 256 F.3d at 1228 (quotation omitted). The fact that Gessow was named in several of the initial lawsuits filed in this Court in early 2000 is sufficient as a matter of law to have put Plaintiffs on inquiry notice of the possibility that Gessow was involved in the fraud. See, e.g., Gaudin v. KDI Corp., 576 F.2d 708, 712 (6th Cir. 1978) (finding that claims were time-barred where plaintiffs were put on inquiry notice by their awareness of five separate lawsuits brought against KDI for violations of the federal securities laws); Aizuss v. Commonwealth Equity Trust, 847 F. Supp. 1482, 1486-87 (E.D. Cal. 1993) (finding that claims were time-barred where plaintiffs did not file suit for more than a year after receiving actual or inquiry notice of allegations in a separate lawsuit).

Having effectively dismissed their claims against Gessow by not naming him in the First Amended Complaint, Plaintiffs may not revive those claims more than one year after they clearly had notice of Gessow's potential involvement in the fraud. Cf. Kolling v. Am. Power Conversion Corp., No. 02-2618, 2003 WL 22350886, at *4 (1st Cir. Oct. 16, 2003) (finding that plaintiff abandoned claim by omitting it from amended complaint); Dee-K Enters., Inc. v.

Heveafil SDN. BHD., 177 F.R.D. 351, 355-56 (E.D. Va. 1998) ("An amendment pursuant to Rule 15 that eliminates (or proposes to eliminate) all causes of action against a particular defendant is the same as a motion to dismiss . . . as to that defendant."); 6 Charles Alan Wright et al., Federal Practice and Procedure § 1476, at 556-57 (2d ed. 1990) ("Once an amended pleading is interposed, the original pleading no longer performs any function in the case."), *quoted in* Kolling, 2003 WL 22350886, at *4. The Second Amended Complaint, in which Gessow was re-named as a defendant, does not relate back to the date of the filing of the initial amended complaint (November 2000) or the original complaints in the individual suits (January and February 2000), because the omission of Gessow from the Second Amended Complaint obviously was not the result of mistake. See Fed. R. Civ. P. 15(c)(3) (providing in part that for an amended pleading to relate back to date of the original pleading where a party is changed, the new party must have had reason to know "that, but for a mistake concerning the identity of the proper party, the action would have been brought against the party"); *In re* Syntex Corp. Sec. Litig., 855 F. Supp. 1086, 1099 (N.D. Cal. 1994) (noting that "the relevant inquiry [under Rule 15(c)] focuses on when the plaintiff first had notice of the defendant's correct identity, not on when the plaintiff first had notice of the defendant's culpability"); cf. 9 Charles Alan Wright & Arthur R. Miller, Federal Practice and Procedure § 2367, at 323-24 (2d ed. 1995) ("The statute of limitations is not tolled by bringing an action that later is dismissed voluntarily.").

It is proper to grant a motion to dismiss if the running of the statute of limitations is apparent on the face of the complaint. See Theoharous, 256 F.3d at 1228 (affirming dismissal on statute-of-limitations grounds); Hunt v. Am. Bank & Trust Co., 783 F.2d 1011, 1013 (11th

Cir. 1986) (same). Additionally, the court "may consider materials in addition to the complaint if such materials are public records or are otherwise appropriate for the taking of judicial notice." New England Health Care Employees Pension Fund v. Ernst & Young, LLP, 336 F.3d 495, 501 (6th Cir. 2003). Here, it is clear from the Third Amended Complaint and the other complaints in the record in these consolidated actions that the Plaintiffs were on notice in early 2000 of their potential claims against Gessow. See id. (concluding that plaintiff's earlier-filed complaint against client of accounting firm clearly showed that plaintiff was on inquiry notice of accounting firm's fraud). In sum, the Court is convinced that the Plaintiffs can prove no set of facts demonstrating that they lacked inquiry notice of their claims against Gessow after February 2000. Hence, Plaintiffs' claims against Gessow are time-barred and are dismissed on this basis.

E. Giannoni

Giannoni also worked for Sunterra since its inception. (Doc. 299 ¶ 5). During her employment with Sunterra, she held several Senior Vice President positions – of Central Services, of Owner Services, and of Operations (Doc. 299 ¶ 41). Giannoni did not sign SEC filings or issue press releases during the Class Period.

Giannoni allegedly assisted Frey in many of Sunterra's fraudulent mortgages receivable practices. She helped Frey to maintain Sunterra's non-performing mortgages receivable at Sunterra's Florida offices. (Doc. 299 ¶ 70). Therefore, she knew about the two sets of books and that the reports she reviewed before circulation of the consolidated financial statements were flawed. (Doc. 299 ¶ 73).

Giannoni was also allegedly involved with the fraudulent monetization of Sunterra's mortgages receivable portfolio beginning in 1998. A Sunterra Inventory Management Department employee stated that Sunterra officers, including Giannoni, instructed personnel to resell defaulted inventory as opposed to foreclosing on the accounts first. (Doc. 299 ¶ 113). A senior business analyst in Sunterra's Nevada office informed Giannoni of a $40 million shortfall in escrow balances in 1999, but Giannoni merely told her that she was wrong. (Doc. 299 ¶ 14).

Giannoni also allegedly perpetuated Sunterra's fraudulent timeshare inventory activity. When a Vice President of sales and marketing attempted to call a meeting to address the undocumented and unserviced mortgages receivable, Giannoni told him to "mind his own business." (Doc. 299 ¶ 133). Despite the multiple-booking problems over the Fourth of July, Giannoni continued to instruct Sunterra personnel not to record inventory. (Doc. 299 ¶ 134).

In addition, Giannoni allegedly wrote and received numerous memoranda and e-mails detailing internal control problems; systems breakdowns; improper recording of revenue and timeshare inventory; and absence of proper record retention, filing, and retrieval systems. (Doc. 299 ¶ 136). Finally, Giannoni was "primarily responsible" for Sunterra's improper capitalization of its HOA fees, taxes, interest, and foreclosure costs. (Doc. 299 ¶ 148). This inflated Sunterra's inventory and allowed it to secure additional financing.

These allegations against Giannoni in the Third Amended Complaint suffer from the same shortcomings as those made against her in the First Amended Complaint. Plaintiffs cannot allege that Giannoni signed the SEC filings, and Plaintiffs have not adequately alleged that Giannoni controlled their content or was involved in day-to-day Sunterra management.

Thus, even under the group pleading doctrine, Plaintiffs have not sufficiently alleged that Giannoni made a misstatement or omission.

Plaintiffs summarily allege that Giannoni was a member of the core group of individuals who "understood, had access to and day-to-day control of all critical financial information" (Doc. 299 ¶ 8) and that she prepared, manipulated, and drafted fraudulent financial information for Sunterra's SEC filings (Doc. 299 ¶ 15), but they provide no particularized facts to support their contention. Although numerous paragraphs of the Third Amended Complaint name Frey and Giannoni together or Frey without Giannoni, Giannoni appears without an accompanying reference to Frey only once. That paragraph, which references Giannoni's responsibility for overseeing the HOA aspect of resort operations, does not allege that she directed the HOA fraud; it merely states that her position made her "primarily" responsible for HOA fees. (Doc. 299 ¶ 148). The paragraph does not provide any details concerning Giannoni's involvement in the fraud, but rather seems to imply that she must have been involved because she was in charge of those fees. The remaining allegations against Giannoni are equally generalized and do not establish that Giannoni had day-to-day involvement in Sunterra's management. To the contrary, they suggest that Giannoni merely followed Frey's orders.

Moreover, even if Plaintiffs had alleged an actionable material misstatement or omission by Giannoni, Plaintiffs fail to allege with particularity facts supporting a strong inference of scienter against Giannoni. As in the First Amended Complaint, Plaintiffs merely rely upon conclusory allegations of fraud and Giannoni's position to buttress their claim against her. Plaintiffs only allege three statements that anonymous sources attributed to Giannoni: an inventory management employee's statement that Giannoni instructed personnel to resell

defaulted Sunterra inventory before closing on the accounts, a vice president of sales and marketing's statement that Giannoni told him to stay away from the multiple-bookings problems, and a senior business analyst's statement that Giannoni told her she was wrong about a $40 million shortfall in escrow balances. Unlike the more than a dozen statements attributed to Goodman, Miller, and Frey by a variety of named and unnamed Sunterra officials, these three statements regarding Giannoni are not enough to support a strong inference that she acted with severe recklessness.

Plaintiffs have failed to plead facts alleging that Giannoni made a material misstatement or omission under the group pleading doctrine; Plaintiffs have not adequately alleged that Giannoni had control over the information contained in Sunterra's SEC filings or had day-to-day involvement in Sunterra's operation. Nor have Plaintiffs sufficiently alleged that she acted with severe recklessness. Additionally, Plaintiffs' Section 20(a) controlling person claim against Giannoni also fails because they have not alleged that she had the requisite power to control and/or influence Sunterra's general affairs and specific corporate policies. For these reasons, Giannoni's motion to dismiss is granted.

F. Sullivan

Responding to disorganization in its mortgages receivable portfolio, Sunterra appointed Sullivan to the newly created position of Senior Vice President – Mortgages Portfolio on June 11, 1998, four months before the Class Period began (Doc. 299 ¶ 59). This in-house position represented the first time Sunterra did not rely upon a third party to oversee its mortgages receivable portfolio. Sullivan was responsible for "directing the management of [Sunterra's]

mortgages receivable portfolio including administration, serving, collection and reporting." (Doc. 299 ¶ 59). During the Class Period, she was promoted to Senior Vice President and Treasurer and was given responsibility for overseeing Sunterra's relationship with Finova. (Doc. 299 ¶¶ 43, 69). Sullivan did not sign SEC filings or issue press releases during the Class Period, and she was not named in the First Amended Complaint.

Plaintiffs allege that Sullivan, like the other Defendants, was a member of the core group of individuals who "understood, had access to and day-to-day control of all critical financial information." (Doc. 299 ¶ 8). Sullivan allegedly prepared, manipulated, and drafted fraudulent financial information for Sunterra's SEC filings and frequently spoke with Gessow and Kenninger about this process. (Doc. 299 ¶ 15).

According to Plaintiffs, Sullivan's fraudulent behavior primarily concerned Sunterra's two sets of books. She provided financial figures and maintained computer data for the "good" mortgages receivable that were performing, documented, and properly aged and that could be pledged for financing or sale. (Doc. 299 ¶¶ 43, 69). Sullivan issued reports on the "good" mortgages receivable portfolio to Cohen, Frey, and Giannoni. (Doc. 299 ¶ 73). Sullivan was also responsible for attempting to "verify, reflect, modify or revive" the "bad" mortgages receivable that were not performing, not documented, or not properly aged. (Doc. 299 ¶ 43). Ultimately, Sullivan provided portfolio figures to various investors and Airtours "that she knew to be materially incomplete and misleading." (Doc. 299 ¶ 43).

Sullivan also allegedly knew about Millenium, the mortgage modifications and manipulations, and the Pending Department. Sullivan knew that the modified mortgages were not reflected as modified on Sunterra's books (Doc. 299 ¶ 91) and that the reports she got from

the "Pending Department" indicated that many mortgages were listed as "performing" when they actually were not. (Doc. 299 ¶ 102).

Sullivan was actively involved in the sale of mortgages receivable. In early 1999, when S.G. Cowen returned millions in defaulted mortgages receivable, it advised Sullivan that the default rate was much higher than stated by Sunterra and that any additional mortgage receivable securitizations would be more expensive. Sullivan did not disclose this information. (Doc. 299 ¶¶ 22, 117). Later that year, when Sunterra attempted to sell $100 million more in mortgages receivable, Sullivan warned Miller, Goodman, Gessow, Kenninger, and others that she could only find $71 million in mortgages receivable that would qualify. (Doc. 299 ¶ 118). Finally, in October 1999 Sullivan was ordered to "clean up" Sunterra's balance sheet for the prospective acquisition by Airtours. (Doc. 299 ¶ 238).

Sullivan wrote and received numerous memoranda and e-mails detailing internal control problems, systems breakdowns, improper recording of revenue and timeshare inventory, and absence of proper record retention, filing, and retrieval systems. (Doc. 299 ¶ 136). Sullivan attended meetings in May, July, August, and October 1999 in which the double-bookings and errors in the mortgages receivable portfolio were discussed. (Doc. 299 ¶ 143). Nevertheless, Sunterra issued false financial figures prepared, in part, by Sullivan. (Doc. 299 ¶ 144).

These allegations against Sullivan are insufficient because Plaintiffs have not adequately pled that Sullivan made any misstatements or omissions or that she acted with scienter. Plaintiffs do not allege that Sullivan signed Sunterra's SEC filings or otherwise made a misstatement. Therefore, Plaintiffs must rely upon the group pleading doctrine to set forth actionable misstatements or omissions against Sullivan, which means they must adequately

allege that Sullivan controlled the content of the SEC filings or had involvement in the daily management of Sunterra. Plaintiffs have not done so. Rather, their allegations portray Sullivan as managing the "good" mortgages receivable portfolio and "warning" senior Sunterra officials that the desired amount of sellable mortgages receivable was not present. (Doc. 299 ¶¶ 43, 118). These actions do not constitute a misstatement or omission under the Exchange Act, and Plaintiffs have failed to plead with particularity that Sullivan had control over any publicly released financial information or was involved in the daily management of Sunterra.

Even if a misstatement or omission by Sullivan had been sufficiently pled, Plaintiffs have failed to allege with particularity facts giving rise to a strong inference of scienter against Sullivan. While the Plaintiffs summarily allege that Sullivan knew or should have known of problems in the mortgages receivable portfolio, they have not pled specific facts giving rise to a strong inference of severe recklessness. Plaintiffs' allegations are largely anonymous and rely heavily upon Sullivan's job title to attempt to establish scienter. Of the paragraphs naming Sullivan, only five name a source for the allegations. (Doc. 299 ¶¶ 8, 22, 52, 117, 136). These sources are general, as in "former Sunterra employees" (Doc. 299 ¶¶ 8, 52), "buyers of this securitization" (Doc. 299 ¶ 22), or "S.G. Cowen" (Doc. 299 ¶ 117). Paragraph 136 references e-mails sent by "senior accounting and management personnel," but this, by itself, is not enough to lend the requisite indicia of reliability to the allegations against Sullivan. The paragraph providing the most detail about Sullivan's role contains no source information whatsoever. (Doc. 299 ¶ 43).

Plaintiffs have therefore failed to plead facts constituting misstatements or omissions by Sullivan, nor have they alleged strong circumstantial evidence that she acted with severe

recklessness. Additionally, because Plaintiffs have failed to allege that Sullivan had the requisite power to influence and control Sunterra's conduct, their Section 20(a) controlling person claim against Sullivan in Count II also fails. For these reasons, Sullivan's motion to dismiss is granted.

Like Gessow and Cohen, Sullivan also contends that the claims against her are barred by the statute of limitations and, therefore, must be dismissed. In light of the Court's conclusion that the claims against Sullivan have not been sufficiently pled, the Court need not reach this issue. However, because Sullivan's arguments on this point are essentially the same as those made by Defendant Cohen (and distinguishable from those raised by Gessow), the Court notes that it would not have dismissed the claims against Sullivan on statute-of-limitations grounds. As stated in the discussion of Cohen's motion to dismiss *supra*, the notice issues raised are too fact-intensive to be resolved on a motion to dismiss. See, e.g., Omar v. Lindsey, 334 F.3d 1246, 1251-52 (11th Cir. 2003).

G. Arthur Andersen

Arthur Andersen was Sunterra's independent auditor during the Class Period. Andersen audited and certified Sunterra's financial statements for 1998 and 1999. Arthur Andersen issued reports on Sunterra's consolidated financial statements on February 10, 1999 and March 10, 2000. Furthermore, Andersen consented to use of its opinion letters in Sunterra's 1998 and 1999 SEC Forms 10-K. (Doc. 299 ¶ 46). In March 2001, Sunterra terminated Arthur Andersen's services.

The Third Amended Complaint contains many significant allegations not present in

earlier versions. Many of these allegations detail reports and correspondence between Arthur Andersen and Sunterra. Based on the facts summarized below, Plaintiffs conclude that no reasonable auditor would have signed off on Sunterra's financial statements and that Arthur Andersen's audits were consequently so deficient as to amount to no audit at all. (Doc. 299 ¶ 305).

On January 28, 1998, Arthur Andersen delivered a Memorandum on Internal Control Structure to the Sunterra Board and management. (Doc. 299 ¶¶ 57, 295). In this memorandum, Arthur Andersen noted several "significant deficiencies" in Sunterra's mortgages receivable portfolio. For example, Andersen advised Sunterra that there were no standardized formats for mortgages receivable prepared by different resorts and that the mortgages receivable balances accumulated by Sunterra's mortgage servicers differed from those compiled by Sunterra.

On February 20, 1998, Arthur Andersen faxed a revised report to Sunterra management that repeated its earlier concerns and added others. Arthur Andersen noted a lack of uniformity in software usage by Sunterra resorts and a lack of an adequate time reporting system to account for costs. (Doc. 299 ¶ 296). In April 1998 Sunterra responded to Arthur Andersen, agreeing to make some of the suggested changes. Sunterra acknowledged that it: 1) needed to implement policies to insure consistency; 2) needed an internal audit department; 3) needed to develop and implement procedures to ensure financial consolidation reports were accurate; 4) should adjust the mortgages receivable ledger balance; and 5) should prepare an analysis for each resort to better determine the mortgages receivable reserve available at that resort. (Doc. 299 ¶ 297).

On January 20, 1999, Arthur Andersen submitted another Memorandum on Internal Control Structure to the Sunterra Board and management. In this memorandum, Arthur Andersen repeated its previous concerns, listed fifteen examples of inconsistent accounting policies and processes at Sunterra resorts, criticized the mortgages receivable consolidation process and lack of an internal audit department, and warned Sunterra that it needed a system of review to determine asset impairment. (Doc. 299 ¶ 298). On the same day, Andersen wrote to Goodman, warning that Sunterra's mortgages receivable analysis was still flawed. (Doc. 299 ¶¶ 77, 299). Arthur Andersen stated that Sunterra's analysis was weak, untimely, and could lead to misstatements in the mortgages receivable balance. According to an "undated, unsigned management response," Sunterra acknowledged many of these flaws and a continuing need for improvement. (Doc. 299 ¶ 300). Cohen later submitted a response to the memorandum, acknowledging that cancellations were not being processed correctly, expenses were not being reported timely, and the mortgages receivable analysis needed improvement. (Doc. 299 ¶ 301).

On May 11, 1999, Arthur Andersen sent Sunterra management an audit committee report for year-end 1998. This report again noted " 'inconsistent applications and interpretations of accounting policies and processes,' lack of proper financial statement consolidation process, and the lack of an internal audit department." (Doc. 299 ¶ 302). On June 7, 1999, Arthur Andersen submitted a follow-up memorandum to Goodman reiterating all of its prior criticisms. (Doc. 299 ¶ 303).

In August 1999, Arthur Andersen issued a more severe warning to the Sunterra Board in a Risk/Control Assessment Report. This report, in excess of fifty pages, detailed "specific

areas where Sunterra internal controls may not be operating effectively." (Doc. 299 ¶ 304). The report emphasized, inter alia: "a) a lack of quality and timeliness of financial information; b) an inadequate budgeting process; c) a need for 'competent accounting people'; d) poor staff follow-up; e) unexplained accounting entries for as much as one (1) million dollars; f) poor month-end closing procedures; and g) a need to develop and update accounting policies and procedures." (Doc. 299 ¶ 304).

Finally, on May 30, 2000 Arthur Andersen submitted an audit committee report for year-end 1999. This report reiterated many of Andersen's previous concerns, including that mortgages receivable reconciliations were untimely and inaccurate. In addition, the report stated that Sunterra's accounting applications were inconsistent. (Doc. 299 ¶ 321).

Plaintiffs argue that these allegations demonstrate that Arthur Andersen knew about the ongoing fraud at Sunterra and failed to act in accordance with Generally Accepted Auditing Standards ("GAAS"). Pursuant to GAAS, Arthur Andersen was obligated to: 1) express an adverse opinion on Sunterra's 1998 financial statements; 2) insist that Sunterra restate its 1998 financial statements; 3) decline certification of Sunterra's financial statements for year-end 1999; and 4) include "going concern" qualifications for both the 1998 and 1999 audit opinions.

Plaintiffs further allege that Arthur Andersen was not independent in its auditing responsibilities by virtue of the tax and consulting services it performed for Sunterra. (Doc. 299 ¶ 263). Arthur Andersen received "substantial fees" for these services, which created a conflict of interest. (Doc. 299 ¶ 286). Finally, Plaintiffs allege that Arthur Andersen's personnel were regularly present at Sunterra during the Class Period and had "continual access to, and knowledge of" Sunterra's confidential business information through contact with its employees

and review of its private documents. (Doc. 299 ¶ 263). A "high level" former Sunterra employee stated that Arthur Andersen "had to have known" of the "significant deficiencies" in Sunterra's accounting processes "at all relevant times" because of Andersen's ongoing presence and work at Sunterra. (Doc. 299 ¶ 323). Significantly, an Arthur Andersen representative was present at Sunterra's annual shareholder meetings and was available to answer questions. (Doc. 299 ¶ 312).

Plaintiffs have satisfied the particularity requirement under the PSLRA by adequately alleging material misstatements by Arthur Andersen. *In re* Sunterra, 199 F. Supp. 2d at 1332. With regard to the scienter requirement, the First Amended Complaint was deficient in several respects: 1) Andersen's audit of Sunterra's 1998 books only encompassed three months of the sixteen-month Class Period; 2) Plaintiffs did not allege facts tending to show that Arthur Andersen should have been aware of Sunterra's flawed internal accounting policies; and 3) Plaintiffs did not allege that Arthur Andersen had a motive to participate in the fraud. Id. at 1334-38. It was also noted that GAAP and GAAS violations, standing alone, were not enough to establish severe recklessness. Id. at 1333. In the Third Amended Complaint Plaintiffs have addressed the shortcomings of the First Amended Complaint and have alleged with particularity facts giving rise to a strong inference of severe recklessness against Andersen.

First, Plaintiffs have alleged relevant acts encompassing nearly the entire Class Period. In the First Amended Complaint, the only relevant acts Andersen allegedly performed "were the audit of Sunterra's 1998 annual financial statements and the expression of an opinion on those 1998 financial statements in early 1999." Id. at 1332. In the Third Amended Complaint, Plaintiffs have expanded these alleged relevant acts to include allegations that Andersen also

performed a 1999 audit and accompanying opinion statement.

Second, Plaintiffs have alleged six other written communications between Andersen and Sunterra in which Andersen communicated concerns about Sunterra's lack of internal controls and possible accounting shortcomings. These communications satisfy a second deficiency in the First Amended Complaint – the absence of an allegation that Andersen had been put on notice of Sunterra's fraudulent accounting practices. Plaintiffs have alleged not only that Andersen was informed of the faulty accounting policies and procedures but also that Andersen warned Sunterra that Sunterra was committing fraud.

Third, in the Third Amended Complaint Plaintiffs have alleged that Arthur Andersen had a motive to conceal Sunterra's fraud. Andersen allegedly performed "tax, consulting and other non-audit services" for Sunterra in addition to its audit responsibilities. (Doc. 299 ¶ 263). These services resulted in "substantial fees" for Andersen. (Doc. 299 ¶ 286). Due to an internal Arthur Andersen policy, Andersen auditing partners were expected to generate twice as much revenue from non-auditing services – such as consulting – as from auditing services. (Doc. 299 ¶ 281). Consequently, "Andersen's interest in generating tax and consulting fees from Sunterra caused a conflict of interest while performing Sunterra's audits and reviews." (Doc. 299 ¶ 287). These allegations establish a motive for Andersen's participation in the alleged fraud.

Finally, Plaintiffs have alleged that Arthur Andersen committed numerous GAAP and GAAS violations. In the First Amended Complaint, Plaintiffs asserted that the magnitude of the fraud, Andersen's GAAP and GAAS violations, and the "red flag" warnings of fraud that Anderson ignored created an inference of scienter. Finding that the alleged "red flags" were

simply more GAAP and GAAS violations, the Court noted that such violations can only lead to an inference of scienter if they are "supported by specific factual allegations" tending to show that Andersen's audit was "no audit at all." In re Sunterra, 199 F. Supp. 2d at 1337-38. (quotation marks omitted). While Plaintiffs fell short of this showing in the First Amended Complaint, they have successfully done so in their Third Amended Complaint.

Essentially, Plaintiffs have alleged that despite Andersen's knowledge of Sunterra's fraud, detailed through numerous written memoranda and reports, Andersen nonetheless refused to retract its favorable opinion of Sunterra's 1998 year-end financial reports. Furthermore, it did not call Sunterra shareholders' attention to the numerous and glaring deficiencies in Sunterra's mortgages receivable portfolio by insisting that Sunterra restate its 1998 financial statements, declining certification of Sunterra's financial statements for year-end 1999, or including "going concern" qualifications for both the 1998 and 1999 audit opinions. Instead, despite issues like "unexplained accounting entries for as much as one million (1) dollars," (Doc. 299 ¶ 304(e)), Andersen remained silent.

Arthur Andersen argues that its repeated warnings to Sunterra management concerning these issues should preclude its involvement in this lawsuit. However, throughout the Class Period Andersen did nothing to retract or modify its earlier public endorsements of Sunterra's well-being, despite every indication that Sunterra was doing absolutely nothing to remedy the pervasive deficiencies that Andersen had identified to Sunterra. Such inaction, in blatant defiance of numerous GAAP and GAAS standards, effectively rendered Arthur Andersen's audits meaningless.

Plaintiffs have therefore pled facts alleging Arthur Andersen's misstatements and

omissions, as well as strong circumstantial evidence supporting a strong inference of severe recklessness. For these reasons, Arthur Andersen's motion to dismiss is denied.

IV. Conclusion

Plaintiffs have adequately alleged a widespread scheme at Sunterra that defrauded shareholders of millions of dollars. Moreover, Plaintiffs have averred with requisite particularity that the majority of the Defendants have violated the securities laws. These Defendants' motions to dismiss will be denied. Plaintiffs failed, however, to sufficiently their claims against Defendants Giannoni and Sullivan, and the claims against Defendant Gessow – though pled with sufficient specificity – are untimely. These Defendants' motions will be granted, and the claims against them will be dismissed with prejudice.

Accordingly, it is **ORDERED** and **ADJUDGED** as follows:

1. The Motion of Defendant Andrew Jody Gessow to Dismiss the Third Consolidated Amended Class Action Complaint (Doc. 267) is **GRANTED** and the claims against Gessow are **DISMISSED** as barred by the statute of limitations.

2. The Motion (Supplemental Memorandum in Support) to Dismiss of Defendant Richard A. Goodman (Doc. 271) is **DENIED**.

3. The Motion (Supplemental Memorandum in Support) to Dismiss of Defendant Steven L. Miller (Doc. 272) is **DENIED**.

4. The Motion (Supplemental Memorandum) of Defendant Steven C. Kenninger (Doc. 273) is **DENIED**.

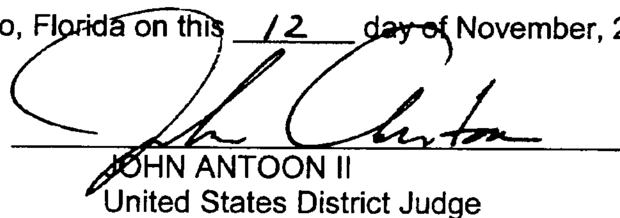
5. Defendant Arthur Andersen LLP's Motion to Dismiss (Doc. 274) is **DENIED**.

6. Defendant Ann Cohen's Motion to Dismiss Third Consolidated Amended Class Action Complaint (Doc. 276) is **DENIED**.

7. Defendant Carol Sullivan's Motion to Dismiss Third Consolidated Amended Class Action Complaint (Doc. 278) is **GRANTED** and the claims against Sullivan are **DISMISSED**.

8. Defendants Charles Frey and Genevieve Giannoni's Supplemental Motion to Dismiss the Third Amended Consolidated Class Action Complaint (Doc. 280) is **GRANTED in part** and **DENIED in part**. As to Defendant Frey, the motion is **DENIED**. As to Defendant Giannoni, the motion is **GRANTED** and the claims against Giannoni are **DISMISSED**.

DONE and **ORDERED** in Orlando, Florida on this 12 day of November, 2003.



JOHN ANTOON II
United States District Judge

Copies furnished to:
Counsel of Record