IN THE UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT OF VIRGINIA
Alexandria Division

IN RE THE MILLS CORPORATION SECURITIES LITIGATION This Document Relates To: 1:06-cv-00077 1:06-cv-00247 1:06-cv-00265 1:06-cv-00304 1:06-cv-01446 1:07-cv-00296	**Civil No. 1:06-cv-00077 (LO/TRJ).** **Judge Liam O'Grady** **Mag. Judge Thomas Rawles Jones, Jr.**

MEMORANDUM OF LAW IN SUPPORT OF DEFENDANT LAURENCE SIEGEL'S MOTION TO DISMISS

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INTRODUCTION

The Amended Complaint fails to cure any of the deficiencies of the prior complaint with respect to Defendant Laurence Siegel. Because the Plaintiffs premise their securities fraud claims against Mr. Siegel exclusively on allegations of accounting improprieties, it is not enough for them to allege that the Company's accounting was wrong, or even fraudulent. Nor is it enough for the Plaintiffs to allege that Mr. Siegel—who is not an accountant—was generally familiar with projects that turned out to have been accounted for incorrectly. Instead, the Plaintiffs have the burden of pleading particularized facts demonstrating that Mr. Siegel personally knew (or was severely reckless in disregarding) that the accounting for the Company's projects and transactions was materially false.

The Plaintiffs have not added any facts to the Amended Complaint that remedy their previous failure to make this showing, and accordingly, the Amended Complaint fails to raise the strong inference of scienter necessary to support their claims against Mr. Siegel.

Nor have the Plaintiffs supplemented their misplaced claim that Mr. Siegel's trading activities give rise to an inference that he intended to defraud Mills' investors. The Amended Complaint alleges that Mr. Siegel sold just 28% of his shares over a period of more than five years, and the Plaintiffs are able to generate even that low figure only by continuing to improperly exclude Mr. Siegel's vested options from the calculus. When those options are included, as the law requires, Mr. Siegel sold just 17% of the shares he owned at the beginning of the period, and the combined total of his shares and vested options actually increased because of additional grants. In short, Mr. Siegel's trading history is very much the opposite of the "unusual or suspicious" trading activity necessary to support an inference of scienter.

The Plaintiffs have thus failed again to raise the required "strong inference" of scienter necessary to state a claim under § 10(b) of the Securities Exchange Act and Rule 10b-5 thereunder. That claim (Count One) must be dismissed accordingly. *See infra* 4-24.

The Amended Complaint also fails to adequately state a claim under § 11 of the Securities Act (Count Six). Where, as here, a § 11 claim is premised on "averments of fraud," it must be stated with particularity under Federal Rule of Civil Procedure 9(b). The Plaintiffs' generalized allegations are insufficient to support this claim. *See infra* 24-25.

Finally, the Amended Complaint fails to adequately plead that Mr. Siegel is vicariously liable as a "control person" under § 20(a) of the Securities Exchange Act (Count Four) or § 15 of the Securities Act (Count Seven). The Fourth Circuit has held that a control person must be a "culpable participant" for liability to attach under these provisions. For the reasons set forth above, and as explained in more detail below, the Amended Complaint fails to satisfy that requirement. *See infra* 26-27.

Accordingly, the claims against Mr. Siegel—specifically, Counts One, Four, Six, and Seven—should be dismissed in their entirety.

BACKGROUND

As alleged in the Amended Complaint, the Mills Corporation ("Mills" or "Company") is a real estate investment trust ("REIT") that engaged in the development, ownership, and management of a diversified global portfolio of retail properties, including regional shopping malls, retail and entertainment centers, and international retail and leisure destinations. Am. Compl. ¶ 18. As of January 2001, Mills owned 42 regional shopping malls in the United States and Europe. *Id.*

Mr. Siegel served as Mills' Chief Executive Officer and as Chairman of the Company's Board of Directors from March 1995 until 2006. *Id.* ¶ 20. Although Mr. Siegel retired from his

position as CEO in October 2006, he remained on the Board of Directors until his resignation on March 29, 2007. *Id.*

On October 31, 2005, the Company announced that it had become aware of possible accounting irregularities. *Id.* ¶ 229. That discovery prompted the Company to conduct a series of internal investigations. *See id.* ¶¶ 229, 235. To facilitate this process, the Company appointed an Independent Audit Committee (the "Committee"), which was responsible for investigating the Company's accounting practices over the previous five years. *See id.* ¶ 62. In January 2006, the Company announced that it would restate its financial statements from 2000 until the third quarter of 2005, *id.* ¶ 235, and in January 2007, the Company released the results of the Committee's internal investigation and provided additional information about the then-pending restatement, *see id.* ¶ 62. Soon thereafter, around the end of March 2007, Mills was purchased by Simon Property Group, Inc. and Farallon Capital Management, L.L.C.; as a result, it did not issue a final restatement. *See id.* ¶ 7.

The Plaintiffs' initial complaint, filed July 27, 2007, alleged that Mills and numerous individuals, including Mr. Siegel, committed securities fraud over the course of a 67-month class period by erroneously accounting for various transactions—thereby causing the Company to overstate its financial condition—and by hiding the true financial condition of the Company from investors and the general public. *See, e.g.*, Compl. ¶¶ 1-11, 77. The Plaintiffs asserted both direct and secondary claims against Mr. Siegel under §§ 10(b) and 20(a) of the Securities Exchange Act and §§ 11 and 15 of the Securities Act.

On December 5, 2007, following full briefing and a hearing, this Court dismissed without prejudice the Plaintiff's initial complaint. In doing so, the Court emphasized that the complaint "fail[ed] to plead scienter with requisite particularity as required by the Supreme Court's

decision in *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 127 S. Ct. 2499 (2007)." *In re Mills Corp. Sec. Litig.*, No. 6:06-cv-00077, slip op. at 2 (E.D. Va. Dec. 5, 2007) (order) (citation altered).

On January 18, 2008, the Plaintiffs filed their Amended Complaint. Premised on the same theory as their original complaint—specifically, that Mills and numerous individuals, including Mr. Siegel, committed securities fraud by fraudulently accounting for various transactions, *see, e.g.*, Am. Compl. ¶¶ 1-7, 47—the Amended Complaint also relies on the same allegedly fraudulent statements, and it continues to assert the same basic claims against Mr. Siegel, without providing any additional allegations grounded in fact that were not in the previously dismissed complaint.

Mr. Siegel now moves to dismiss the Amended Complaint.

ARGUMENT

I. COUNT ONE: PLAINTIFFS HAVE FAILED TO ALLEGE SUFFICIENT FACTS TO SUPPORT THE REQUIRED STRONG INFERENCE OF SCIENTER.

Under the strict pleading standard of the Private Securities Litigation Reform Act ("PSLRA"), a complaint alleging a § 10(b) violation must, "with respect to each act or omission alleged to violate [that section], 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) (emphasis added). If a plaintiff fails to meet this requirement, then the district court "shall," on the defendant's motion, "dismiss the complaint." *Id.* § 78u-4(b)(3)(A).

As the Supreme Court recently confirmed, the required "inference of scienter must be more than merely plausible or reasonable—it must be cogent and at least as compelling as any opposing inference of nonfraudulent intent." *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 127 S. Ct. 2499, 2504-05 (2007) (emphasis added). Moreover, "to allege a securities fraud claim

against individual defendants, a plaintiff must allege facts that support a 'strong inference' that each defendant acted with" the required state of mind. *Teachers' Ret. Sys. v. Hunter*, 477 F.3d 162, 184 (4th Cir. 2007) (emphasis in original); *see also In re BearingPoint, Inc. Sec. Litig.*, 525 F. Supp. 2d 759, 767 (E.D. Va. 2007) (O'Grady, J.) (quoting the same).

The required state of mind for a § 10(b) claim is an "intent to deceive, manipulate, or defraud," *Ottmann v. Hanger Orthopedic Group, Inc.*, 353 F.3d 338, 343 (4th Cir. 2003) (internal quotation marks omitted), or "'severe recklessness' regarding the danger of deceiving the plaintiff," *Teachers' Ret. Sys.*, 477 F.3d at 184. The Fourth Circuit has made clear, moreover, that such "severe recklessness" is not merely an aggravated form of negligence. Rather, "'severe recklessness' is, in essence, 'a slightly lesser species of intentional misconduct,'" *Ottmann*, 353 F.3d at 344 (quoting *Nathenson v. Zonagen Inc.*, 267 F.3d 400, 407 (5th Cir. 2001)), as required by the Supreme Court's observation that "§ 10(b) was intended to proscribe knowing or intentional misconduct," *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 197 (1976); *see also BearingPoint*, 525 F. Supp. 2d at 767 (explaining that this standard "does not lower the bar much below intentional fraud"). Thus, at a minimum, "severe recklessness" requires "'a danger of misleading the plaintiff . . . [that] was either known to the defendant or so obvious that the defendant must have been aware of it.'" *Ottmann*, 353 F.3d at 343 (emphasis added) (quoting *Phillips v. LCI Int'l, Inc.*, 190 F.3d 609, 621 (4th Cir. 1999)); *see also In re Trex Co. Sec. Litig.*, 454 F. Supp. 2d 560, 572 n.3 (W.D. Va. 2006) (quoting *Phillips*). Needless to say, "[a] showing of mere negligence will not suffice." *Teachers' Ret. Sys.*, 477 F.3d at 184.

Once again, the Plaintiffs have failed to satisfy these onerous standards. Their Amended Complaint includes allegations that Mills misstated its earnings, but, like its predecessor, the Amended Complaint fails to include sufficient factual allegations establishing that Mr. Siegel

was "involved in these detailed accounting matters or had knowledge of their alleged falsity." *Ezra Charitable Trust v. Tyco Int'l, Ltd.*, 466 F.3d 1, 9 (1st Cir. 2006). Because the Plaintiffs "must specifically allege scienter on the part of each individual defendant," *BearingPoint*, 525 F. Supp. 2d at 767 (emphasis added), and because they have premised their claims exclusively on accounting misstatements, they must include sufficient factual allegations establishing that each defendant was involved in fraudulently misstating the Company's financial statements or had knowledge of their falsity, *see Ezra Charitable Trust*, 466 F.3d at 9; *see also Fin. Acquisition Partners LP v. Blackwell*, 440 F.3d 278, 289 (5th Cir. 2006) (no factual allegations supporting inference that individual defendants knew true value of assets or that discount rate or credit-loss assumption was improper); *BearingPoint*, 525 F. Supp. 2d at 774-75 ("'Allegations of a violation of GAAP provisions or SEC regulations, without corresponding fraudulent intent, are not sufficient to state a securities fraud claim.'" (emphasis added) (quoting *Chill v. Gen. Elec. Co.*, 101 F.3d 263, 270 (2d Cir. 1996))).

This failure to connect Mr. Siegel to any of the alleged wrongdoing at the Mills Corporation is apparent in the two types of allegations that comprise the Amended Complaint. The first type consists of assertions that, because Mr. Siegel was generally aware of a particular transaction, he must have been aware of the accounting for that transaction. The second type, which comprises the vast majority of the allegations against Mr. Siegel, includes instances where the Plaintiffs boldly assert that Mr. Siegel was aware that the accounting for a given transaction was improper, without providing sufficient, particularized facts to support that claim. Neither type of allegation supports an inference of scienter, let alone a "powerful" and "compelling" inference.

Similarly deficient are the Plaintiffs' allegations that Mr. Siegel's performance-based compensation and trading activities are indicative of scienter. *See* Am. Compl. ¶¶ 376-79, 383, 386-87. The Plaintiffs do not allege any facts that suggest that these incentives were unusual or that Mr. Siegel's trading activities were suspicious. As detailed below, these allegations do not meet the exacting standards of the PSLRA.

A. Plaintiffs Must Establish That Mr. Siegel Had Knowledge That The Accounting For A Given Transaction Was Improper, Not Simply Allege That He Was Generally Aware Of The Underlying Transaction.

The Amended Complaint includes three instances in which the Plaintiffs have attempted to establish that Mr. Siegel was aware that the accounting for a given transaction was improper simply by alleging that he was generally aware of the underlying transaction. Numerous courts have held that such allegations are insufficient to raise the required strong inference of scienter. Instead, the Plaintiffs must plead facts establishing that Mr. Siegel was "involved in or had personal knowledge of [the] accounting" for the allegedly misstated transaction. *Ezra Equitable Trust*, 466 F.3d at 9; *see also Fin. Acquisition Partners*, 440 F.3d at 289 (holding that the plaintiffs "fail[ed] to plead facts supporting an allegation that any Defendant knew the value of Amresco's assets was overstated, or that it was fraudulent in using its discount rate or credit-loss assumption"); *In re E.Spire Commc'ns, Inc. Sec. Litig.*, 127 F. Supp. 2d 734, 745 (D. Md. 2001) ("Allegations of GAAP violations 'might be sufficient' to plead scienter <u>only</u> where they are coupled with evidence of 'corresponding fraudulent intent.'" (emphasis added) (quoting *Novak v. Kasaks*, 216 F.3d 300, 309 (2d Cir. 2000))).

(i) <u>Accounting For The Home Sale</u>: The Plaintiffs allege that "Mills fraudulently inflated its income in 2002 by treating the sale of [Home Company] as if it had occurred one year earlier than it actually did, in order to avoiding recording more than $10 million in expenses that Mills incurred in purchasing and operating that entity in 2002." Am. Compl. ¶ 64; *see also id.*

¶ 367(a). Mills apparently finalized the sale in "Spring 2003" but recorded it has "occurring on April 19, 2002." *Id.* ¶ 68.

Noticeably absent from these allegations are particularized facts establishing that Mr. Siegel was involved in or aware of the allegedly improper accounting for this sale. Rather, the Plaintiffs simply assert that Mr. Siegel was "directly involved in the <u>acquisition</u> and <u>operation</u> of Home." *Id.* ¶ 69 (emphasis added). But the Plaintiffs' only factual support for this assertion is the alleged statement of a former employee that Mr. Siegel "actively 'courted' Home . . . as an acquisition," which falls far short of establishing that Mr. Siegel was involved in the "operation" of Home, much less the accounting for the Home sale. *Id.* ¶ 71. Moreover, the only employee who allegedly claims that Mr. Siegel had any knowledge about Home, Steven McKee, worked at Home, not Mills, and he had left Home before the spring of 2003, when Mills is alleged to have fraudulently recorded the sale. *See id.* (alleging that Mr. McKee worked at "Home from February 2002 until October 2002"). As a result, the assertion that Mr. Siegel knew or was severely reckless in disregarding that Mills "[f]raudulently recorded the sale of Home" is factually unsupported. *Id.* ¶ 367(a).

(ii) <u>The Capitalization Of Costs For The Empire Tract And Xanadu Projects</u>: The Plaintiffs also allege that Mr. Siegel knew or was severely reckless in disregarding that Mills "[c]apitalized the $93.2 million in costs that Mills incurred in connect with the failed Empire Tract into the Meadowlands Xanadu project, despite knowing and publicly stating that the two projects were separate and distinct." *Id.* ¶ 367(c). The Plaintiffs, however, fail to include a single fact establishing that Mr. Siegel was involved in or knew that the accounting for these projects was improper. *See id.* ¶¶ 92-98.

Besides the allegation that Mr. Siegel knew that the two projects were separate, the Amended Complaint includes only one fact bearing on Mr. Siegel's knowledge of these projects—specifically, that he received "a monthly financial report" for the Xanadu project, which included "line items" for costs associated with the Empire Tract. *Id.* ¶ 97. This allegation, at most, merely establishes that Mr. Siegel knew that the historical costs of the Empire Tract were, in fact, being capitalized as part of the Xanadu project—not that he knew or had reason to know that it was inappropriate to do so.

Moreover, the Audit Committee report—on which the Plaintiffs elsewhere rely heavily—makes plain that the accounting was inaccurate not because the projects were "separate," but because the Company's development rights were associated with a leasehold interest in the Xanadu site, rather than a fee interest. *See* Form 8-K at 3 (filed Jan. 9, 2007) (attached hereto as Addendum A). Mills "was required to convey the 587 acre Empire [T]ract to the State of New Jersey" in order to "secur[e] the ground lease and development rights for the [Xanadu site]." *Id.* Had the Company possessed a fee interest in the Xanadu site, it would have been proper to record "the historical costs of the Empire Tract . . . as the cost of the development rights obtained in the exchange." *Id.* The Amended Complaint does not allege any fact indicating that Mr. Siegel had reason to know of this distinction. Thus, the mere fact that Mr. Siegel knew that the two projects were separate falls far short of demonstrating that he knew or was severely reckless in disregarding that the accounting for these projects was improper.

(iii) <u>Capitalization Of Interest Costs For Completed Projects</u>: Finally, the Plaintiffs allege that Mr. Siegel knew or was severely reckless in disregarding that Mills "[c]apitalized the interest costs for open projects" because he knew, through his attendance at "monthly meetings that reviewed the status of Mills' portfolio of projects, that the projects were already up and

running." Am. Compl. ¶ 367(h). Absent from this allegation is any claim that Mr. Siegel was involved in or knew about the accounting for these projects. *See id.* ¶¶ 106-07.

The basis for this allegation is a former employee, Jim Button, who allegedly stated that he attended monthly meetings led by Mr. Siegel in which "the status of Mills' portfolio of projects" was "reviewed"—a term that is lacking in descriptive detail. *Id.* ¶ 106 (emphasis added). Moreover, the Plaintiffs fail to allege in what year these meetings allegedly took place, where they supposedly took place, and what specific projects were "reviewed." *See id.*

Nor is this conclusory allegation saved by alleging that another former employee, Michael Castillo, claimed that "for months, even though Colorado Mills was up and running (a fact undeniably known by Defendant[] . . . Siegel), Mills continued to capitalize costs for that project." *Id.* ¶ 107. Even if Mr. Siegel "undeniably" knew that Colorado Mills was "up and running," this allegation does not support the conclusion that he knew about the improper capitalization of interest costs for this project. As such, these allegations cannot raise an inference of scienter.

B. Unsupported Or Insufficiently Particularized Allegations That Mr. Siegel Acted With Fraudulent Intent Or Had Knowledge Of Alleged Accounting Improprieties Cannot Support An Inference Of Scienter.

The Fourth Circuit has held that "vague," "conclusory," and "improperly generalized" allegations cannot satisfy the PSLRA's strict pleading requirements. *In re PEC Solutions, Inc. Sec. Litig.*, 418 F.3d 379, 388-89 (4th Cir. 2005). Rather, "the plaintiff must plead facts" to support an inference of scienter. *Teachers' Ret. Sys.*, 477 F.3d at 172 (emphasis in original); *see also Phillips*, 190 F.3d at 621 (explaining that allegations "must be based on a substantial factual basis in order to create a 'strong inference' that the defendant acted with the required state of mind" (emphasis added; internal quotation marks omitted)). This means facts concerning when each defendant learned that a statement was false, how the defendant learned that the statement

was false, and the particular document or other source of information from which the defendant came to know that the statement was false—*i.e.*, the "'who, what, when, where, and how.'" *In re First Union Corp. Sec. Litig.*, 128 F. Supp. 2d 871, 886 n.14 (W.D.N.C. 2001) (quoting *In re Advanta Sec. Litig.*, 180 F.3d 525, 534 (3d Cir. 1999)); *see also In re Humphrey Hospitality Trust, Inc. Sec. Litig.*, 219 F. Supp. 2d 675, 684 (D. Md. 2002) (holding that the plaintiffs' "assertions, without more particularized facts to show what Defendants knew, when and how they knew it, and how their knowledge rendered particular statements false or misleading, fail to meet the stiff pleading requirements of the PSLRA").

Moreover, courts have repeatedly held that, under the plain language of the PSLRA, non-particularized allegations must be disregarded. *Teachers' Ret. Sys.*, 477 F.3d at 172 (stating that "the plaintiff must . . . '<u>state with particularity facts giving rise to a strong inference</u>'" of scienter, and that "any complaint not meeting [these] requirements [must] be dismissed") (some emphasis added) (quoting 15 U.S.C. § 78u-4(b)(2)); *accord In re Silicon Graphics Inc. Sec. Litig.*, 183 F.3d 970, 983-84 (9th Cir. 1999) (disregarding allegations that were insufficiently particularized). As a result, "[o]nly 'particularized' facts can be considered in determining whether the plaintiff has met the pleading burden." *First Union Corp.*, 128 F. Supp. 2d at 886.

The Plaintiffs have attempted to shore up their allegations by: (1) relying on former employees as purported sources for their conclusory allegations, (2) citing disjointed portions of Ernst & Young's annual letters to Mills' senior management, and (3) continuing to rely on group-style pleading. These efforts fail. To borrow from an observation of this Court, "Although [the] Plaintiffs make bold statements that [Mr. Siegel] knew or w[as] reckless in not knowing of the purported fraud, there are no factual allegations in the [Amended] Complaint

showing that [Mr. Siegel] had direct knowledge of each alleged accounting impropriety." *In re Cable & Wireless, PLC*, 321 F. Supp. 2d 749, 771 (E.D. Va. 2004).

1. Allegations That Are Derived From The Purported Statements Of Former Employees, Which Are Themselves Vague And Conclusory, Cannot Support An Inference Of Scienter.

Numerous courts have held that merely "affixing the phrase 'former employees have stated' to [an] otherwise totally unparticularized allegation does not transform it into an allegation that meets the particularity requirements of the PSLRA." *Gavish v. Revlon, Inc.*, No. 00-cv-7291, 2004 WL 2210269, at *14 (S.D.N.Y. Sept. 30, 2004); *Berger v. Ludwick*, No. C-97-0728-CAL, 2000 WL 1262646, at *6 (N.D. Cal. Aug. 17, 2000) (rejecting plaintiffs' securities fraud allegations in part because "[p]laintiffs seek to have the readers assume that because Bleier was a product manager for a product, all of his conclusory statements are enough to infer defendants' state of mind" (emphasis in original)), *aff'd*, 15 F. App'x 528 (9th Cir. 2001); *see also Teachers' Ret. Sys.*, 477 F.3d at 181 (holding that the plaintiff could not rely "on conclusory and hardly probative statements by four confidential sources"); *accord Cent. Laborers' Pension Fund v. Integrated Elec. Servs., Inc.*, 497 F.3d 546, 552 (5th Cir. 2007) (holding that the plaintiff's "confidential source statements lack sufficient detail to credit them as bases for a strong inference of scienter with respect to the particular allegations of fraud in the [complaint]"); *In re Cree, Inc. Sec. Litig.*, 333 F. Supp. 2d 461, 474-75 (M.D.N.C. 2004).

(i) The Capitalization Of Predevelopment Project Costs: The Plaintiffs claim that Mr. Siegel knew or was severely reckless in disregarding that Mills "[c]apitalized costs for projects despite knowing through his participation in monthly [Forecast to Complete Meetings] that the projects had been abandoned for years." Am. Compl. ¶ 367(e) (citing *id.* ¶¶ 85-91). The Amended Complaint, however, fails to include critical facts necessary to support this claim.

To begin with, the Plaintiffs do not allege that decisions not to write off the costs of abandoned projects were made that the Forecast to Complete Meetings. *See id.* ¶¶ 90-91. Nor do they allege "what was said at the meeting[s], to whom it was said, or in what context." *Garfield v. NDC Health Corp.*, 466 F.3d 1255, 1265 (11th Cir. 2006). At most, the Plaintiffs allege that the "budget" and "status" of each project was "reviewed"—a term that is, once again, lacking in descriptive detail. Am. Compl. ¶ 91. "But simply reviewing corporate reports and approving payments are normal functions of a corporate executive and do not amount to allegations of intent or recklessness." *BearingPoint*, 525 F. Supp. 2d at 773; *see also In re Goodyear Tire & Rubber Co. Sec. Litig.*, 436 F. Supp. 2d 873, 897 (N.D. Ohio 2006) (finding "lacking" allegations that the defendants attended "'weekly meetings'" because, *inter alia*, there was no specific facts demonstrating that "any wrongdoing was discussed" at those meetings).

In any event, the Plaintiffs do not allege that <u>any</u> of the former employees relied upon in the Amended Complaint <u>actually attended</u> the Forecast to Complete Meetings. *See id.* ¶¶ 90-91. This omission contrasts markedly from other parts of the complaint, in which the Plaintiffs specifically allege that former employees attended the meetings that they described. *See id.* ¶¶ 75, 132. Moreover, the Plaintiffs do not allege that any of these former employees reported to Mr. Siegel; nor do they allege that any of these employees had a single conversation with him. *See id.* ¶¶ 85-91. These omissions are critical. They make it impossible to determine whether the former employees are "speaking from personal knowledge, or 'merely regurgitating gossip and innuendo.'" *In re Metawave Commc'ns Corp. Sec. Litig.*, 298 F. Supp. 2d 1056, 1068 (W.D. Wash. 2003) (quoting *In re Commtouch Software Ltd. Sec. Litig.*, No. 01-719, 2002 WL 31417998, at *3 (N.D. Cal. July 24, 2002)).

(ii) Capitalization Of Indirect Project Costs: Similarly unsupported is the Plaintiffs' claim that Mr. Siegel "actively participated in deciding what costs to capitalize and what projects to carry on the Company's books." Am. Compl. ¶ 367(f) (citing *id.* ¶¶ 100-102). Like the preceding allegation, the Plaintiffs simply allege that the "allocations of costs to projects" were "reviewed . . . frequently" by Mr. Siegel "at the monthly 'Forecast to Complete Meetings' at Mills' corporate offices." *Id.* ¶ 102.

Once again, the Plaintiffs do not allege "what was said at the meeting[s], to whom it was said, or in what context." *Garfield*, 466 F.3d at 1265. And once again, they fail to allege that any of the former employees identified in the complaint actually attended these meetings. *See* Am. Compl. ¶ 102. Nor do they explain what projects were "reviewed," or even what it means to review the "allocations of costs to projects." *Id.*

(iii) Reported Inaccurate Project Budgets: The Plaintiffs also contend that Mr. Siegel knew or was severely reckless in disregarding that Mills "[r]eported inaccurate project budgets to the public, including for the Meadowlands Xanadu project, when he knew that the actual project costs were significantly higher." *Id.* ¶ 367(b) (citing *id.* ¶¶ 103-104). The only source for this contention is two former employees, both of whom allegedly stated that it "was well known within Mills that Xanadu was hundreds of millions of dollars over budget." *Id.* ¶ 104. In addition, one of these former employees goes on to claim that Mr. Siegel was "aware that Xanadu was budgeted to cost at least $1.6 to 1.7 billion at the same time [he was] publicly representing that it would cost only $1.2 billion." *Id.* No basis is provided for this employee's claim—no conversations or reports—and courts have routinely rejected allegations based on assertions that something was "well known within" the company. *Cal. Pub. Employees' Ret. Sys. v. Chubb Corp.*, 394 F.3d 126, 155 (3d Cir. 2004); *see also Cree*, 333 F. Supp. 2d at 475

(plaintiffs' claim that the fraud "was well-known within [the company]" was too general to show that the defendant officers and directors had knowledge of the alleged fraud).[1]

(iv) The Carrying Of Worthless Notes Receivable: The Plaintiffs also allege that Mr. Siegel knew or was severely reckless in disregarding that Mills "[c]arried worthless notes receivables on [its] books for eight years," Am. Compl. ¶ 367(g), but the allegations upon which this assertion is based—paragraphs 72-76 of the Amended Complaint—do not even mention Mr. Siegel, let alone support the claim that he knew about this alleged accounting impropriety. *See id.* ¶¶ 72-76.

(v) The Recognition Of Rent Revenue: Relying once again on the conclusory statements of a former employee, the Plaintiffs allege that Mr. Siegel knew or was severely reckless in disregarding that Mills "[r]eported false rent revenue." Am. Compl. ¶ 367(d) (citing *id.* ¶¶ 119-22). The Plaintiffs claim that this employee "met with Defendants Siegel and McDonough" on some unspecified date, "told them that the Company's accounting was 'totally broken,' and gave them a book which recapped every property, lease administration and book keeping problem . . . that [this former employee] had been aware of since 2003." *Id.* ¶ 121. According to this former employee, Mr. Siegel "took no action to correct these problems." *Id.* The Plaintiffs, however, fail to specify what problems this employee "had been aware of." *Id.* Nor do they explain when and where this alleged conversation took place. In addition, the claim that "no action" was taken is unsupported and conclusory, and it is contradicted by the fact that

[1] Notably absent from the Amended Complaint are the allegations, made in the original complaint, that Mr. Siegel knew that the projected budget was significantly higher than he was publicly stating because he purportedly had unspecified "conversations" with a former employee, and because he reviewed undisclosed "reports" related to the projected cost. *See* Compl. ¶ 480(d).

the Company began a series of internal investigations that culminated in an effort to restate its past financials. *See id.* ¶¶ 62, 229, 235; *see also* Addendum A (Form 8-K) at 3.

(vi) The Anonymous Employee Letter: Finally, the Plaintiffs allege that Mr. Siegel's receipt of an anonymous employee letter provides "overwhelming evidence" of his scienter. Am. Compl. ¶¶ 148; *see also id.* ¶ 143-47, 364(8). According to the Amended Complaint, Mr. Siegel received the letter and then participated in a "cover-up," *id.* ¶ 364(8), first by telling investors that Mills would "'evaluate the accounting for several items in its third quarter results,'" *id.* ¶ 145, then by informing them that they Company "had conducted a 'thorough review'" of these items, *id.* ¶ 5; *see also id.* ¶ 147. The Plaintiffs, however, fail to allege facts establishing that the Company's response to the letter was deceptive or misleading, let alone that Mr. Siegel was aware of this fact.

According to the Amended Complaint, on October 31, 2005, the Company announced that its third quarter 2005 results would be "'substantially below expectations,'" and that its "third quarter conference call would be delayed to 'allow the Company additional time to evaluate the accounting for several items in its third quarter results.'" *Id.* ¶ 229. Well over a week later, on November 9, 2005, the Company released the third quarter results, reporting a decline in income for that quarter. *Id.* ¶ 231.

The fact that the Company would later uncover other accounting problems does not lead to the inference that it failed to engage in a thorough review of the items that it told investors it would review, *see BearingPoint*, 525 F. Supp. 2d at 776, and "[m]ere allegations that [a] statement[] made in one report should have been made in [an] earlier report[] do not make out a claim for securities fraud," *E.Spire Commc'ns*, 127 F. Supp. 2d at 745 (internal quotation marks omitted); *accord BearingPoint*, 525 F. Supp. 2d at 774.

Similarly, the fact that the senior management did not disclose that the Company received an anonymous employee letter does not lead to the inference that they engaged in a cover-up. "Prudent managers conduct inquiries rather than jump the gun with half-formed stories as soon as a problem comes to their attention." *Higginbotham v. Baxter Int'l, Inc.*, 495 F.3d 753, 760-61 (7th Cir. 2007). Other allegations in the Complaint suggest that this is exactly what the managers did—they delayed the release of the Company's third quarter results, investigated the accounting for that quarter, and then reported a decline in income for that quarter. *See* Am. Compl. ¶¶ 229, 231. In fact, the Company's disclosure of negative information actually "militates against a finding that [any of the Defendants] acted with a culpable state of mind." *Ottmann*, 353 F.3d at 348.

2. The Plaintiffs' Reliance On Snippets of The Ernst & Young Management Letters Does Not Support An Inference That Mr. Siegel Intended To Defraud Mills' Investors.

The Plaintiffs' reliance on disjointed portions of Ernst & Young's annual letters to management is similarly misbegotten. They claim that these portions support their allegations that Mr. Siegel knew or was severely reckless in disregarding that Mills: (i) had inadequate internal controls, Am. Compl. ¶¶ 139-40, 364(7); (ii) improperly capitalized interest costs for joint ventures, *id.* ¶¶ 111, 253, 306, 364(7); and (iii) used unsupportable time and cost estimates, *id.* ¶¶ 112-14, 141, 273, 309, 364(7). Not one of these allegations withstands scrutiny.

(i) Internal Controls: The Plaintiffs allege that the Ernst & Young ("E&Y") management letters put Mr. Siegel on notice of inadequacies in the Company's internal controls, but that he refused to "ensure that Mills developed or implemented adequate accounting policies and procedures, and corrected its accounting practices." *Id.* ¶ 139. This claim, however, is refuted by the very management letters upon which the Plaintiffs rely. *See* Management Letters (attached hereto as Addendum B). The 2001 Management Letter explicitly states that E&Y

identified "no matters involving internal control and its operation that we consider to be material weaknesses." Addendum B (2001 Mgmt. Ltr.) at MLS-0000834. And while later letters noted "a certain matter involving internal control and its operation," that matter related not to widespread internal control deficiencies, as the Plaintiffs would have this Court believe, but to the Company's accounting for foreign investments. *See id.* (2002 Mgmt. Ltr.) at EY02-007538, EY02-007540; *id.* (2003 Mgmt. Ltr.) at MLS-0002876, MLS-0002878. In any event, both the 2002 and 2003 letters make plain that the Company corrected for these errors, *see id.* (2002 Mgmt. Ltr.) at EY02-007540 (stating that "the Company has restated operating results for foreign currency exchange"); *id.* (2003 Mgmt. Ltr.) at MLS-0002878 (explaining that the "accounting for foreign investments" is "a priority of management and improvements are contemplated in 2004" and noting that "the Company implemented appropriate procedures in 2003" to correct the problems identified in the 2002 Management Letter), and this limited control deficiency was disclosed by E&Y as "a reportable condition," *id.* (2002 Mgmt. Ltr.) at EY02-007538; *accord id.* (2003 Mgmt. Ltr.) at MLS-0002876. Moreover, the only material weakness identified in the 2004 Management Letter regarding Mills' internal controls was similarly disclosed to investors in a Form 10-K filed on the same day as that letter. *See* Form 10-K at 25-26, 65-71 (filed Mar. 31, 2005) (attached hereto as Addendum C); *cf.* Am. Compl. ¶ 266.[2]

[2] To the extent that the Plaintiffs allege that the Mills' subsequent restatements demonstrate that the Company's internal controls were inadequate, that claim also must be rejected. As this Court has made clear, a "Plaintiff cannot piggyback an inference of scienter for the false financials on a subsequent determination . . . that the internal controls were inadequate." *BearingPoint*, 525 F. Supp. 2d at 776; *see also Higginbotham*, 495 F.3d at 760 (explaining that such allegations are inadequate because, "by definition, all frauds demonstrate the 'inadequacy' of existing controls, just as all bank robberies demonstrate the failure of bank security and all burglaries demonstrate the failure of locks and alarm systems." (emphasis in original)).

(ii) The Capitalization Of Interest Costs For Joint Ventures: The Plaintiffs also allege that the E&Y management letters put Mr. Siegel on notice that Mills was "improperly capitaliz[ing] interest costs for its joint venture projects." Am. Compl. ¶ 111 (citing *id.* ¶¶ 253, 306). This claim is supported by a single sentence from the 2003 Management Letter, which states that "'US GAAP depreciation and amortization lives for tenant allowances and deferred costs used by Madrid Xanadu and the Snowdome were not consistent with Mills' policies and audit adjusting entries were required to be recorded.'" *Id.* ¶ 253; *see also* Addendum B (2003 Mgmt. Ltr.) at MLS-0002879. This very sentence, however, makes clear that these entries were "adjust[ed]" to correct the problem. Consequently, the allegation demonstrates an assurance on the part of Mills' auditor that any mistakes in the Company's accounting were, in fact, being corrected.

(iii) The Use Of Time And Cost Estimates: Finally, the Plaintiffs allege that Mr. Siegel was put on notice that Mills used "unsupportable time and cost estimates of the activities performed by its leasing department rather than using the Company's actual time records when capitalizing direct leasing origination costs." Am. Compl. ¶ 112; *see also id.* ¶¶ 113-14, 273, 309. This allegation is based on a single sentence from the 2003 Management Letter, which states that E&Y found that "allocations to properties for development time is based on management discussion and analysis of average time spent on a project rather than based on contemporaneous records such as time sheets." Addendum B (2003 Mgmt. Ltr.) at MLS-0002882; *see also* Am. Compl. ¶¶ 273, 309 (quoting the same). E&Y, however, did not deem this a "reportable condition"; it simply listed it in the portion of the management letter relating to control procedures that should be strengthened. Addendum B (2003 Mgmt. Ltr.) at MLS-0002876. Identifying places where the Company could improve its "accounting protocols does

not show that earlier ones were recognized as deficient." *Higginbotham*, 495 F.3d at 760. Moreover, the Plaintiffs do not allege that this problem was identified again in the 2004 Management Letter, which indicates that Mills had taken appropriate steps to remedy this problem. Indeed, the fact that E&Y continued to certify Mills' financial results militates against any finding of fraudulent intent on the part of Mr. Siegel.

3. The Plaintiffs Cannot Rely On General, Non-Personalized Allegations To Raise A "Strong Inference" As To Mr. Siegel.

Although this Court has already held that the Plaintiffs may not rely on "group pleading," *In re Mills Corp. Sec. Litig.*, No. 6:06-cv-00077, slip op. at 2 (E.D. Va. Dec. 5, 2007) (order), the Amended Complaint continues to recite allegations directed at Mills' "senior management," *see* Am. Compl. ¶¶ 83, 109, 364(1). The Fourth Circuit does not permit this species of insufficiently particularized allegations. *See, e.g.*, *Teachers' Ret. Sys.*, 477 F.3d at 184-84; *BearingPoint*, 525 F. Supp. 2d at 767; *Iron Workers Local 16 Pension Fund v. Hilb Rogal & Hobbs Co.*, 432 F. Supp. 2d 571, 594 (E.D. Va. 2006).

C. Plaintiffs' "Financial Motive" Allegations Do Not Support A Strong Inference That Mr. Siegel Intended To Defraud Mills' Investors.

Finally, the Plaintiffs allege that Mr. Siegel had various personal incentives to maximize the Company's performance, giving rise to an inference that he intended to commit fraud. Specifically, they allege that (i) Mr. Siegel received stock options and traded some of his shares during the class period, Am. Compl. ¶ 379, 383, 386-87; (ii) part of his compensation was performance-based, *id.* ¶¶ 376-77; and (iii) he was a direct beneficiary of improperly accounted for benefits, *id.* ¶ 378. But these allegations do not support an inference of scienter.

(i) Insider Trading Allegations: With regard to Mr. Siegel's trading activities, the Amended Complaint alleges that he sold just 28% of his shares over a period of more than five years, *id.* ¶ 379, and the complaint generates even that low figure by omitting Mr. Siegel's vested

options, which must be included in the relevant calculus, *First Union Corp.*, 128 F. Supp. 2d at 898 n.28 (explaining that "vested stock options are considered in evaluating the proportion of stock an insider has sold" because it "represents the owner's trading potential more accurately than the stock shares alone"). Including his vested options, Mr. Siegel sold just 17% of his total holdings over the class period. *See* Addendum D.[3]

In *Teachers' Retirement System*, the Fourth Circuit refused to consider allegations of insider trading because the plaintiffs failed to allege "the number of shares that the defendants traded within the class period in relation to their total holdings"—*i.e.*, their vested stock options. 477 F.3d at 185. The court held that, in the absence of these facts, the complaint failed to "provide the facts sufficient to generate the required 'strong inference.'" *Id.* Indeed, the court found it "unremarkable" that the defendants sold between <u>82% and 100%</u> of their stock "without taking into account the defendants' vested stock options." *Id.* For the same reason, here, the Plaintiffs' failure to include Mr. Siegel's total holdings is fatal to their claim.

Even if this Court elects to consider Mr. Siegel's trading activities, moreover, the timing and volume are hardly "unusual or suspicious." *Teachers' Ret. Sys.*, 477 F.3d at 184; *see also First Union Corp.*, 128 F. Supp. 2d at 897 (explaining that "only extraordinary trading activities will suffice"). The sale of just 17% of his total holdings is hardly indicative of scienter. *PEC Solutions*, 418 F.3d at 390 (stating that a defendant's sale of 13% of his holdings during the class period was "nearly *de minimis*"); *see also Trex Co.*, 454 F. Supp. 2d at 586-87 (holding that sales by the defendants of 36.5% and 14.4% of their share holdings, without even accounting for unexercised options, "were not so substantial as to raise a strong inference of scienter"). And

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[3] This Court may take judicial notice of Mr. Siegel's vested stock options, which were publicly disclosed in reports filed with the Securities and Exchange Commission. *See, e.g.*, *PEC Solutions*, 418 F.3d at 390 n.10.

because Mr. Siegel's options continued to accrue but remained unexercised, the total number of holdings available to him actually increased by 16% over this time. *See* Addendum D. Courts have held that this actually negates an inference of scienter. *Humphrey Hospitality Trust*, 219 F. Supp. 2d at 686; *First Union Corp.*, 128 F. Supp. 2d at 898.

Nor is the timing of Mr. Seigel's trades unusual. Although the Plaintiffs focus on the fact that Mr. Siegel exercised and sold 6.8% of his total holdings on May 22, 2006, *see* Am. Compl. ¶ 387; *see also* Addendum D, those options were set to expire the next day, May 23, 2006. *See* Siegel's Form 4 (filed May 25, 2006) (attached hereto as Addendum E). And when those options were exercised, the stock price had fallen to $30.22 per share (from $53.50 just seven months prior), which further militates against a finding of scienter, *see Cree*, 333 F. Supp. 2d at 476; *see also In re Ceridian Corp. Sec. Litig.*, 504 F. Supp. 2d 603, 617-18 (D. Minn. 2007).

Moreover, Mr. Siegel's minimal sales of stock occurred over a period of more than 67 months. The Fourth Circuit has described a 46-month class period as "exceedingly long," explaining that "such a lengthy class period weakens any inference of scienter that could be drawn from the timing of defendants' trades." *Teachers' Ret. Sys.*, 477 F.3d at 185 (citing *In re Vantive Corp. Sec. Litig.*, 283 F.3d 1079, 1092-93 (9th Cir. 2002).

At bottom, four trades that occurred over a period of four and a half years, coupled with the fact that Mr. Siegel's holdings actually increased during that time, do not support an inference of scienter.

(ii) Performance-Based Compensation: The Plaintiffs also contend that, because Mr. Seigel received performance-based compensation, he intended to defraud Mills' investors. Am. Compl. ¶¶ 376-377. Courts within the Fourth Circuit, however, have repeatedly held that "[a]llowing a party to plead scienter by alleging executives were motivated by a financial

incentive program 'would effectively eliminate the state of mind requirement as to all corporate officers.'" *Iron Workers*, 432 F. Supp. 2d at 591 (quoting *Melder v. Morris*, 27 F.3d 1097, 1102 (5th Cir. 1994)); *see also Phillips*, 190 F.3d at 622 (quoting the same); *Cree*, 333 F. Supp. 2d at 475; *In re Orbital Scis. Corp. Sec. Litig.*, 58 F. Supp. 2d 682, 685 (E.D. Va. 1999).

Moreover, the Plaintiffs have failed to allege specific facts demonstrating that Mr. Siegel received "concrete benefits that could be realized by one or more of the false statements and wrong nondisclosures alleged." *Humphrey Hospitality Trust*, 219 F. Supp. 2d at 686 (internal quotation marks omitted). Because the Plaintiffs have failed to plead <u>any facts</u> indicating that Mr. Siegel received a concrete benefit from a false statement or wrongful non-disclosure, their allegations that he received performance-based compensation cannot support a strong inference of scienter.

(iii) <u>Accounting For Mr. Siegel's Performance-Based Compensation</u>: Finally, the Plaintiffs allege that Mr. Siegel "was highly motivated to engage in fraud at Mills because he was a direct beneficiary of the fact that Mills was backdating its options grants and improperly accounting for its [Long-Term Incentive Plan (LTIP)] and other stock-based compensation for performance years 1999, 2000 and 2001." Am. Compl. ¶ 378; *see also id.* ¶ 138. The Plaintiffs do not include any facts to support the conclusion that these accounting mistakes were the result of fraud, or that Mr. Siegel was somehow involved in bringing them about. *See id.* ¶¶ 138, 378. Moreover, these alleged accounting mistakes started before the class period and were subsequently disclosed "in the Company's 2003 and 2004 proxy statements." *Id.* ¶ 378. Consequently, these sparse allegations cannot support an inference that Mr. Siegel intended to defraud Mills' investors; nor do they excuse the Plaintiffs' failure to account for Mr. Siegel's vested stock options. *See id.* ¶ 379 n.10.

* * * * *

Because the Plaintiffs have failed to allege particularized facts supporting a "strong inference" that Mr. Siegel acted with fraudulent intent, the Court must dismiss Count One of the Complaint.

II. COUNT SIX: HAVING PREMISED THEIR § 11 CLAIM ON AVERMENTS OF FRAUD, THE PLAINTIFFS WERE REQUIRED TO STATE THAT CLAIM WITH PARTICULARITY.

The Plaintiffs also have failed to allege particularized facts in support of their claim under § 11 of the Securities Act. That failure warrants dismissal—notwithstanding their attempt to "disclaim . . . any allegation of fraud in connection with this Count." Am. Compl. ¶ 482.

Numerous federal circuit courts have held that, because Rule 9(b) "applies to any claim that includes 'averments of fraud or mistake,'" that rule applies "when § 11 and § 12(a)(2) claims are grounded in fraud"—notwithstanding the fact that "neither fraud nor mistake is a necessary element of a cause of action" under those sections. *Chubb Corp.*, 394 F.3d at 161 (quoting FED. R. CIV. P. 9(b)) (first emphasis in original); *accord Wagner v. First Horizon Pharm. Corp.*, 464 F.3d 1273, 1278 (11th Cir. 2006) ("We conclude that a § 11 or § 12(a)(2) claim must be pled with particularity when the facts underlying the misrepresentation at stake in the claim are said to be part of a fraud claim, as alleged elsewhere in the complaint.").[4]

[4] *See also ACA Fin. Guar. Corp. v. Advest, Inc.*, 512 F.3d 46, 68 (1st Cir. 2008) ("Where section 12(a)(2) claims are grounded in fraud, Rule 9(b) applies."); *Rombach v. Chang*, 355 F.3d 164, 171 (2d Cir. 2004) ("We hold that the heightened pleading standard of Rule 9(b) applies to Section 11 and Section 12(a)(2) claims insofar as the claims are premised on allegations of fraud."); *Lone Star Ladies Inv. Club v. Schlotzky's, Inc.*, 238 F.3d 363, 368 (5th Cir. 2001) (same); *In re Stac Elecs. Sec. Litig.*, 89 F.3d 1399, 1494 (9th Cir. 1996) (same); *Sears v. Likens*, 912 F.2d 889, 893 (7th Cir. 1990) (same); *but see In re NationsMart Corp. Sec. Litig.*, 130 F.3d 309, 314 (8th Cir. 1997) (holding that "the particularity requirement of Rule 9(b) does not apply to claims under § 11 of the Securities Act, because proof of fraud or mistake is not a prerequisite to establishing liability under § 11").

Moreover, because the rule refers to "averments of fraud," the court "must 'examine the factual allegations that support a particular legal claim'"—not the plaintiff's characterization of those allegations. *Chubb Corp.*, 394 F.3d at 160 (quoting *Shapiro v. UJB Fin. Corp.*, 964 F.2d 272, 288 (3d Cir. 1992)). Thus, under the Third Circuit's reasoning, the Plaintiffs' "one sentence disavowment of fraud," *see* Am. Compl. ¶ 482, "does not require [this Court] to infer that the claims are strict liability or negligence claims." *Chubb Corp.*, 394 F.3d at 160.

The Eleventh Circuit has reached the same conclusion and, in the process, offered yet another reason for subjecting such allegations to Rule 9(b)'s heightened pleading requirements. As that court explained, because "the purpose of the rule is to protect a defendant's good will and reputation," it would "strain credulity" to allow a plaintiff to "present a general disclaimer in an attempt to immunize the nonfraud claims from the Rule 9 requirements." *Wagner*, 464 F.3d at 1278. Instead, "if the plaintiffs are claiming that the § 11 . . . misrepresentation is part and parcel of a larger fraud, then the rule's protective purpose attaches, and the plaintiffs must plead with particularity." *Id.*

Here, "an examination of the factual allegations that support" the Plaintiffs' § 11 claim reveals that they are "indisputably immersed in unparticularized allegations of fraud." *Chubb Corp.*, 394 F.3d at 160. Indeed, the linchpin of the Plaintiffs' § 11 claim is the very same "GAAP violations" that form the basis of their § 10(b) claim. Am. Compl. ¶ 481; *id.* ¶ 479 (alleging that Mills' "materially false and misleading" financial statements were "included and/or incorporated by reference within the Series G Offering Documents"); *see also id.* ¶ 482 (incorporating these allegations into the § 11 claim). Because those allegations are premised on fraud, and because they are not stated with sufficient particularity, this Court should dismiss Count Six of the Amended Complaint.

III. COUNTS FOUR AND SEVEN: BECAUSE THE PLAINTIFFS CANNOT ESTABLISH THAT SIEGEL WAS A "CULPABLE PARTICIPANT" IN MAKING ANY ALLEGEDLY FRAUDULENT STATEMENT, THEIR § 20(a) AND § 15 CLAIMS LIKEWISE FAIL.

The Plaintiffs' secondary liability claims fail for the same reason that their § 10(b) claim fails: they have not demonstrated that Mr. Siegel was in "some meaningful sense [a] culpable participant[] in the [fraudulent] acts" that were allegedly perpetrated by the other defendants. *Carpenter v. Harris, Upham & Co.*, 594 F.2d 388, 394 (4th Cir. 1979). Because the Plaintiffs bear this burden, *see id.* at 395, and because they have failed to carry it with respect to Mr. Siegel, the Court should dismiss Counts Four and Seven of the Amended Complaint.

In *Carpenter v. Harris, Upham & Co.*, the Fourth Circuit joined the Second Circuit in holding that, before secondary liability can attach under § 20(a) of the Securities Exchange Act, the plaintiff bears the initial burden of proving that the alleged control person was in "some meaningful sense [a] culpable participant[] in the acts" that were committed by the controlled person. *Id.* at 394 (citing *Lanza v. Drexel & Co.*, 479 F.2d 1277, 1299 (2d Cir. 1973) (en banc)); *see also SEC v. First Jersey Sec., Inc.*, 101 F.3d 1450, 1472-73 (2d Cir. 1996) (citing and holding the same); *accord Rochez Bros., Inc. v. Rhoades*, 527 F.2d 880, 890 (3d Cir. 1975). Although the Fourth Circuit recognized that § 20(a) also establishes an affirmative defense for good faith, *see Carpenter*, 594 F.2d at 393-94; *see also Dellastatious v. Williams*, 242 F.3d 191, 194 (4th Cir. 2001) (citing to this portion of *Carpenter*), it faulted the plaintiffs for not "sufficiently alleg[ing]" a "prima facie case of bad faith on the part of [the defendant]," *Carpenter*, 594 F.2d at 395. It did so because the plaintiffs presented "no evidence of 'something more than negligence' on the part of" the control person. *Id.* (citation omitted).

As a result, numerous courts in this Circuit have either held or stated that plaintiffs are required to allege "that the controlling person was in some meaningful sense a culpable

participant in the fraud perpetuated by the controlled person." *BearingPoint*, 525 F. Supp. 2d at 781 (internal quotation marks omitted; emphasis added); *accord In re Cryomedical Scis., Inc. Sec. Litig.*, 884 F. Supp. 1001, 1012 (D. Md. 1995) (holding that the plaintiff must allege facts sufficient to establish that each defendant was a culpable participant); *Walker v. Cardinal Sav. & Loan Ass'n*, 690 F. Supp. 494, 500 (E.D. Va. 1988) (same); *see also Cable & Wireless*, 321 F. Supp. 2d at 774 (dicta); *In re Criimi Mae, Inc., Sec. Litig.*, 94 F. Supp. 2d 652, 657-58 (D. Md. 2000) (same); *In re FAC Realty Sec. Litig.*, 990 F. Supp. 416, 423 (E.D.N.C. 1997) (same). "Once the plaintiff makes out a prima facie case of [control-person] liability, the burden shifts to the defendant to show that he acted in the good faith, and that he 'did not directly or indirectly induce the act or acts constituting the violation.'" *First Jersey Sec.*, 101 F.3d at 1473 (citations omitted) (quoting 15 U.S.C. § 78t).[5]

As recounted in detail above, the Plaintiffs have failed to sufficiently allege a prima facie case of bad faith on the part of Mr. Siegel. *See supra* at 4-24. Because the Complaint does not include factual allegations connecting Mr. Siegel to any of the alleged wrongdoing, the Plaintiffs have failed to state a claim for secondary liability under § 20(a) of the Securities Exchange Act and § 15 of the Exchange Act. The Court should dismiss Counts Four and Seven accordingly.

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[5] In *In re MicroStrategy, Inc. Securities Litigation*, 115 F. Supp. 2d 620, 659-60 & n.76 (E.D. Va. 2000), this Court declined to follow the "culpable participant" standard and interpreted *Carpenter* as merely requiring the defendant to carry his burden of proving the affirmative defense of good faith. *See id. But see Walker*, 690 F. Supp. at 500 (holding that culpable participation is required). It is, however, impossible to reconcile *Microstrategy* with the Fourth Circuit's analysis in *Carpenter*, which faulted the plaintiffs for presenting "no evidence" and for failing to "sufficiently allege" a "prima facie case of bad faith on the part of [the control person]." *Carpenter*, 594 F.2d at 395.

CONCLUSION

For the foregoing reasons, the Court should dismiss with prejudice Counts One, Four, Six, and Seven of the Consolidated Amended Class Action Complaint for failure to state a claim against Defendant Laurence Siegel.

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Respectfully submitted,

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