UNITED STATES DISTRICT COURT
MIDDLE DISTRICT OF FLORIDA
ORLANDO DIVISION

IN RE:

SUNTERRA CORPORATION
SECURITIES LITIGATION **Case No. 6:00-cv-79-Orl-28B**

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**	

THIRD CONSOLIDATED AMENDED CLASS ACTION COMPLAINT

Lead Plaintiffs, by and through their undersigned attorneys, bring this action upon personal knowledge as to themselves and their own acts, and upon the investigation by and through plaintiffs' counsel, including but not limited to, analysis of publicly-available news articles and reports, public filings with the Securities & Exchange Commission ("SEC") and the United States Bankruptcy Court for the District of Maryland, review of various websites and internet information sources, press releases and other matters of public record, interviews of numerous former employees of Sunterra Corporation ("Sunterra" or "the Company") and of various third parties familiar with Sunterra's financial reports and condition during the Class Period defined below, and analysis of the allegations in three extraordinary lawsuits just recently filed by or in the name of Sunterra against many of the defendants named herein: *Sunterra Corp. v. Gessow, et al.*, Civil Action No. 02-Civ.-1853 (D. Md. Complaint filed May 30, 2002;

Amended Complaint filed November 27, 2002) ("Gessow Complaint"); *Sunterra Corp. v. Arthur Andersen, LLP*, Civil Action No. 6:02-Civ.-633-Orl-18JGG (M.D. Fla. Complaint filed May 30, 2002); *Sunterra Corp. v. Ernst & Young, LLP*, *et al.*, Case No. 24-C-02-002963 (Balt. City. Md. Cir. Complaint file May 30, 2002). Plaintiffs believe that further substantial evidentiary support will exist for the allegations set forth below after a reasonable opportunity for discovery. In addition, Sunterra disclosed on May 10, 2002 that it had taken additional write-offs aggregating over $113 million to the retained earnings reflected in its audited financial statements filed with the SEC for the year-ended 1999. In doing so, Sunterra stated that although it would not be restating those publicly-filed financial statements, the audited and unaudited financial statements for 1999 and prior years and periods were not reliable and should not be used or relied upon by anyone. Hence, Sunterra has admitted conclusively that it filed and published false and misleading periodic financial reports and earnings releases before, during and after the Class Period set forth below.

NATURE OF THE ACTION

1. This is a securities class action brought on behalf of all purchasers of the common stock of Sunterra Corporation ("Sunterra" or the "Company") during the period October 6, 1998 through January 19, 2000, inclusive (the "Class" and the "Class Period"), who sustained damages a result of defendants' misconduct detailed below.

2. This is an extraordinary case because recent developments and disclosures after this Court's decision in March 2002 have made it clear that defendants engaged in gross misconduct and intentionally or recklessly misled investors during the Class Period. In a virtually unprecedented move, Sunterra authorized its Creditor's Committee to file suit on behalf of the Company against practically all of the former officers or directors Lead Plaintiffs have

named in this action. That suit and others were filed in the name of the Company on May 30, 2002. Given the legal burdens required to recover under Maryland law on the claims asserted in that suit, it is clear the Company itself, having access to all of the pertinent documents and supporting evidence, reasonably believes that the defendants engaged in intentional or reckless misconduct that operated as a fraud or deceit on the investing public and others. In connection with these suits, the Company has also reiterated its earlier admissions that its published financial statements and earnings releases for 1999 and prior periods were and are materially false and misleading.

3. Inasmuch as a corporation can speak and transact business only through the actions of its officers, directors and employees, the pivotal issue in this case is not whether there has been a fraud, but rather who is responsible for the fraud Sunterra has conclusively admitted. As detailed below, the defendants named herein, Andrew Jody Gessow, Steven C. Kenninger, L. Steven Miller, Richard C. Goodman, Charles C. Frey, Genevieve Giannoni, Ann Cohen and Carole Sullivan are responsible for the fraud because they knowingly or recklessly initiated and perpetuated the extensive acts, practices and courses of business that caused the fraud -- initially to secure and maintain essential financing for Sunterra's growth, and subsequently to effectuate a planned "exit strategy" of selling the Company to a strategic buyer.

4. As noted in the First Amended Complaint, the roots of the fraud reach back before the Class Period and became part of Sunterra's corporate culture by the time the Class Period begins. Before changing its name in July 1998 Sunterra was known as Signature Resorts, Inc. Signature Resorts, Inc. was incorporated in Maryland in 1996 by Osamu "Sam" Kaneko, Andrew Jody Gessow and Steven C. Kenninger (the "Founders") to effect the Company's August 20, 1996 initial public offering (the "IPO"). Just prior to the IPO, the Founders had consolidated

and exchanged interests they held in various entities for shares of Common Stock in the Company. One of the companies consolidated as part of the transaction was Argosy Group, Inc. ("Argosy"), a California-based real estate acquisition and development company founded by Andrew Jody Gessow ("Gessow"). Prior to forming Argosy, Gessow had been president of the Florida and west coast offices of Trammell Crow Residential Services ("TCRS"). Many of the senior officers of Sunterra, including Gessow, Charles Frey, Genevieve Giannoni, Ann Cohen, Carol Sullivan and others had been officers, consultants or employees of Argosy and, prior to that, TCRS.

5. In connection with the IPO, Steven Kenninger ("Kenninger") became the Chief Operating Officer ("COO") of Sunterra; Gessow became the Chief Financial Officer ("CFO"); Charles Frey ("Frey") was the Senior Vice President of Accounting and Administration and Company Treasurer, with "overall responsibility for accounting;" Genevieve ("Giannoni") was the Senior Vice President of Operations, with overall responsibility for maintaining ownership records of the Vacation Intervals sold to or owned by timeshare consumers; Ann Cohen ("Cohen") was a headquarters Controller, with overall responsibility for assembling financial reports from resorts and regional controllers in preparation of consolidated financial statements; and Carol Sullivan ("Sullivan") was a consultant with overall responsibility for obtaining and maintaining lines of credit from lenders such as Finova Capital Corporation.

6. The Company's objective was to become North America's leading developer and operator of timeshare resorts. The Company planned to accomplish this objective by acquiring other timeshare companies, purchasing resorts from financial institutions with which it had relationships, purchasing timeshare mortgages from other companies and developing new or expanded timeshare resorts. As a result, the Company embarked on an aggressive growth

strategy, funded initially by the proceeds from the IPO.

7. In January 1997, the Company completed a secondary offering of common stock at $36.50 per share and a $138 million offering of "convertible notes." In the prospectus for these offerings, Frey was described as the Company's "Senior Vice President and Chief Accounting Officer," while Giannoni remained as the "Senior Vice President of Operations." Gessow, Kenninger, and Frey each signed the Form S-1 registration statement for these offerings. Frey signed the Registration Statement and the later-filed Form 10-K for the year ended 1996 as the Company's "Chief Accounting Officer." In August 1997, the Company completed a private placement of $200 million of "9.75% Senior Subordinated Notes," the net proceeds of which it used to repay indebtedness and to "finance consumer mortgages, complete construction of certain resorts, and finance the acquisition of additional resorts." The Company subsequently exchanged publicly-registered notes for those it had privately-placed. From the time of the IPO through at least September 1998, Frey either signed or was listed as the Company's "Chief Accounting Officer" in no fewer than eight (8) registration statements, exchange offers or periodic reports publicly filed by the Company as required by SEC rules and regulations. During this same time and thereafter, Gianonni was responsible for maintaining timeshare interval inventory and ownership records and supervising the receipt and financial reporting of home owners association (HOA) fees, escrows and interest. Similarly, during this same time, Ann Cohen, in direct consultation with Frey, Gianonni and Sullivan, assembled and adjusted all financial reporting from Sunterra's regional and resort properties to prepare the consolidated financial statements of the Company.

8. According to more than a dozen former Sunterra employees and officers involved in accounting, collections, portfolio management, operations, sales & marketing, new business

development, and new business alliances – all of whom had direct access to the information – although the Company added additional personnel and positions in 1998 and 1999, the Company essentially was still run by a core group who understood, had access to and day-to-day control of all critical financial information: Gessow, Kenninger, Frey, Giannoni, Cohen and Sullivan. When Miller and Goodman were recruited as CEO and CFO in 1998, they were told repeatedly of the longstanding accounting problems and discrepancies by numerous staff accountants and analysts. However, because their mission was to effectuate the "exit strategy" of a sale, they intentionally or recklessly disregarded the information and warnings and delayed recognition of the known accounting misstatements until forced to do so by Airtours Group, Plc.

9. In fact, the business model these defendants developed and followed for Sunterra was fatally flawed. Sunterra focused primarily on revenue generation and purported "profit" rather than on cash flow. As a result, the Company required access to immense amounts of public and private financing to fuel its expansion and its operations. To maintain this access, the Company was under tremendous pressure to demonstrate consistent growth in sales, revenues, earnings and assets and, in turn, to meet Wall Street performance estimates.

10. Among the significant sources of the Company's continued financing were Bank of America (the agent on Sunterra's Secured Credit), Finova Capital Corporation and Heller Financial, both of which provided warehouse credit lines and other financing forms to the Company. These credit lines and the Company's other indebtedness carried so-called debt covenants, the violation of which would constitute a default or result in the lowering of the Company's credit rating, which in turn would impede the Company's ability to raise additional or replacement financing and thus imperil the Company's continued existence.

11. The defendants all understood that the Company depended on two core accounts

to secure and maintain the essential financing on which it depended: its mortgages receivable portfolio and its inventory of timeshare intervals and points. Material portions of these accounts were pledged by Sunterra to secure cash necessary for continuing operations. While the Company also had hundreds of millions in loans outstanding that were secured by Sunterra's various resort properties, the proceeds from those loans had been used either to acquire the resorts themselves or to cover development costs for new or expanded resort properties. Hence, the central focus of Sunterra's day-to-day activities was on the sale and administration of timeshare inventory and the processing, financing and servicing of the mortgages receivable resulting from those sales.

12. 1998 was a critical year for Sunterra. The Company had reached a point at which negative cash flow was so substantial that defendants decided to pursue an "exit strategy" in which they would sell the Company. To prepare the Company for sale and to attract the interest of large strategic purchasers in the industry, the Company's Founders decided to move the Company's headquarters to new facilities in Orlando, Florida (Airtours operated Oasis Lakes in Orlando) and to recruit a well-known leader in the timeshare industry, Miller, as the Company's Chief Executive Officer, and a seasoned public company financial officer, Goodman, as the Chief Financial Officer. Both of these individuals assumed their roles at Sunterra with the explicit or implicit mandate to demonstrate sequential improvements and growth in quarterly performance so the Company could be sold to a strategic buyer. Thus, from the beginning of the Class Period in October 1998 through January 20, 2000, a central but unstated goal of the senior management of Sunterra was to prepare the Company for sale.

13. As detailed below, defendants Miller and Goodman learned within weeks after their respective arrivals at Sunterra what each of the other defendants already knew: 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. In fact, within weeks after Goodman's arrival in late 1998, two senior members of the Company's central accounting function, met with him to specifically discuss the many "problems" with the mortgages receivable portfolio. After being told of the manifold misstatements and wholly deficient internal controls, Goodman recklessly disregarded their concerns and blindly signed off on Sunterra's 1998 Annual Report on SEC Form 10-K filed in March 1999, which materially misrepresented the status and balances of the portfolio and scores of other balance sheet and income statement accounts.

14. Although the roots of the extensive fraud extend deep into the very beginnings of Sunterra's existence, they were so central to Sunterra's critical activities that scores of internal Sunterra personnel were aware of the problems and have described Sunterra as a "mini-Enron," characterized by a corporate culture in which anything and everything would be done to "make the numbers." According to one of the senior business analysts in Sunterra's Las Vegas office, "everybody knew about the problems with receivables, inventory and liquidity; it resulted from the entire corporate culture." For example, when this analyst reported a $40 million shortfall in escrow balances in 1999, she was told by Ann Cohen, Frey and Giannoni that she was wrong. After stating that she could not find where the $40 million was, Cohen said "it's there, just write it." This analyst further reported that the Las Vegas office had uncovered "all the sins of the past" by the founders and other officers of the Company and that, although Sullivan reported directly to Goodman, all of the controllers reported to Cohen, who, in turn, reported to Frey with regard to the consolidated financial statements.

15. In this regard, each of the defendants named in this Second Amended Complaint was not only aware of, or recklessly ignored, the fraud but also was a supplier, communicator, reviewer or day-to-day supervisor of the accounts and activities that perpetuated the fraud. Former internal staff accountants and business managers agree that, regardless of their putative titles as reflected in the fraudulent SEC filings, Frey, Giannoni, Cohen and Sullivan assembled, prepared, manipulated and drafted the schedules, figures, notes and disclosures for the consolidated financials that were included in the fraudulent SEC filings during the Class Period. A Senior Business Manager personally observed Frey communicate his manipulations and schemes to Gessow, his mentor, practically on a day-to-day basis, while Cohen, Sullivan and Giannoni frequently spoke with Gessow and Kenninger, or his assistant, Dave Philips, about the same. Other personnel, including high-ranking employees in sales and marketing, and IT, as well as two controllers and one accountant, made it clear to Goodman and Miller that Sunterra's consolidated financials were inaccurate. Despite this awareness, each defendant, directly or indirectly, caused Sunterra to file with the SEC and publish to the investing public materially false and misleading financial statements and disclosures. Those defendants who did not sign these fraudulent documents nonetheless knowingly or recklessly participated directly and indirectly in the fraud by preparing, manipulating, writing, entering or communicating the false financial information and disclosures to those who directly provided the reports to the investing public.

16. The defendants individually and collectively violated the Exchange Act, directly or indirectly, in multiple ways. They knowingly or recklessly employed devices and schemes to create the illusion of sequential growth at Sunterra in order to secure and maintain essential credit lines and to effectuate a planned "exit strategy" of selling the Company. They knowingly

or recklessly employed several transactional and accounting artifices to defraud investors, including using two sets of books, pledging and selling the same inventory to multiple parties, pledging and selling the same mortgages receivable to multiple parties, and using undisclosed compensated third party "marketing companies" to falsely "bring current" defaulted receivables or to deceptively pay downpayments for uncreditworthy time share purchasers.

17. Each of the defendants also, directly or indirectly, made untrue statements of material fact or omitted to state material facts. Among other things, defendants, in the name of the Company, knowingly or recklessly published materially false and misleading financial statements throughout 1998, 1999 and 2000. To effectuate the dual goals of sequential growth and eventual sale of the Company, defendants, directly or indirectly, falsely portrayed Sunterra's mortgages receivable portfolio as "a ready and reliable source of low cost capital" when, in fact, they knew or were recklessly indifferent to the fact that over one-third of the portfolio was more than 60 days delinquent and that various tricks and accounting manipulations were being used to either not "age" a material portion of the portfolio or to temporarily "bring current" long-defaulted or undocumented receivables with funds paid by or owed to Sunterra itself.

18. Defendants also knowingly or recklessly misrepresented the amount and value of saleable inventory available to Sunterra so the Company could both maintain and increase its credit lines and meet revenue projections it had provided to Wall Street analysts. In each of these respects, defendants omitted to disclose that the Company had no reasonable or reliable basis to support the statements made concerning the Company's financial condition, its account balances, its Vacation Interval inventory, the quality of its assets or the source of its revenues.

19. While each of the defendants knew, or was reckless in not knowing, that at least two-sets of books -- using different computer programs -- were being maintained to reflect

receivables and inventory, defendants each failed to disclose the known deficiencies and the resulting material inaccuracies that were pervasively known throughout the internal staff and part of the inside corporate culture of Sunterra. Defendants thus created and maintained the illusion of reliability and control over Sunterra's assets and accounts when, in fact, they knew, but failed to disclose, the extremely material fact that they lacked such control and that the accounts were not reliably stated.

20. Defendants also engaged, directly or indirectly, in numerous acts, practices or courses of business that operated as a fraud or deceit on investors. Among other things, defendants knowingly or recklessly engaged in the practice of advancing funds to third parties to "bring current" defaulted receivables temporarily or to pay downpayments for uncreditworthy timeshare "purchasers". In this regard, defendants engaged in the undisclosed and materially misleading practice of "switching" defaulted vacation interval owners to vacation club point owners without any reasonable expectation that such persons would make any payments or would ever bring the defaulted or "modified" accounts current. As a result of this undisclosed practice, defendants were able falsely to portray the mortgages receivable portfolio as more sound and current than it in fact was.

21. Defendants also knowingly or recklessly engaged in the practice of selling or pledging the same vacation interval inventory to multiple parties. Defendants were motivated to do so because they recognized, and recklessly dismissed, that true available inventory reports reflected insufficient inventory to meet the Company's budgeted and projected revenue goals and growth targets. In other words, defendants each knew that the actual inventory available for sale was insufficient to allow Sunterra to sell enough Vacation Intervals to sustain its continued growth. Indeed, during a quarterly review meeting in or around May 1999, Goodman observed

that if the Company utilized the inventory records indicated by the "available inventory" being reported from each of the resorts, rather than from the Company's fraudulent and distorted central reports, Sunterra lacked sufficient inventory to meet the revenue projections it had already announced to Wall Street analysts.

22. Given the Company's dependence on mortgages receivable financings and timeshare inventory for operating cash, each of the defendants received, had access to, generated or manipulated numerous daily, monthly, quarterly and other periodic reports, schedules and spreadsheets, including "agings." In particular, each of the defendants received, had access to and was advised of monthly and other periodic reports from Sunterra employees with direct access to information on mortgages receivable financing and timeshare inventory, as well as other financial data. One regular source of information was the deceptively named "Pending Department," which was really an in-house collections department. They also received or recklessly ignored similar periodic reports from lenders, servicers or securitization trustees, including ES Financial Services, Finova Capital Corporation and S.G. Cowen. For example, in the first half of 1999, S.G. Cowen returned to Sunterra over $9 million of defaulted mortgages receivable that had been included in Sunterra's earlier mortgage-backed securities offering placed by S.G. Cowen. The buyers of this securitization advised defendants Goodman, Miller, Sullivan and others that the default rate for the pool was much higher than that warranted by Sunterra and exponentially higher than the default rate Sunterra was reporting for its retained portfolio in its public filings with the SEC. As a result, S.G. Cowen advised that any additional securitizations would be much more expensive for Sunterra. Not only did each of the defendants know about and fail to disclose this significant "red flag," they actually made it far worse.

23. Instead of writing off the bad mortgages receivable returned by S.G. Cowen,

defendants perpetuated the fraud by recording the defaulted mortgages receivable at full-value. The failure to write-off these delinquent accounts alone resulted in a material understatement of quarterly bad debt expense, a material overstatement of quarterly bad debt reserves, a material overstatement (by over $18 million) of the mortgages receivable portfolio (as Sunterra had to replace the returned receivables), and a material understatement of the percentage of delinquent receivables. Thus, defendants once again portrayed the mortgages receivable portfolio as far more sound and substantial than it actually was.

24. Defendants' scheme may have continued much longer if not for their misplaced confidence in the interest of a proposed buyer in acquiring Sunterra. During 1999, defendants succeeded in attracting the serious interest of a potential acquirer, Airtours Group, Plc ("Airtours"), a large United Kingdom travel company controlled by Carnival Cruise Lines, Inc. During the course of due diligence reviews during the third quarter of 1999, Airtours quickly discovered several inaccuracies and variances in the mortgages receivable portfolio, primarily due to differences in the balances and agings Finova was reporting to Sunterra senior management, including Miller, Goodman, Sullivan, Frey and Cohen, and those reflected on Sunterra's internal reports. Airtours indicated that it would still be interested in pursuing an acquisition if Sunterra simply took all of the appropriate write-offs. Defendants construed this overture as an opportunity to acknowledge and write-off the many well known "buried bodies" at the Company while negotiating a final price for the acquisition, perhaps at a lower per-share price presumably within the range Airtours wanted. The scope of the proposed write-off, however, so shocked Airtours that it walked away from the negotiations, resulting in Miller's immediate termination and forcing Sunterra to publicly disclose a small portion of the fraud.

25. The "house of cards" began to come crashing down when, on January 20, 2000,

Sunterra shocked the market by announcing it would take a non-cash charge for 1999 of between $38 million and $45 million to write-off allegedly "delinquent" receivables. In the press release revealing the charge, Sunterra said "the largest part of the charge-off consists of delinquent receivables that remained on the Company's books." Although Sunterra had consistently assured investors that "all adjustments considered necessary for a fair presentation have been included," in financial statements issued during the Class Period, the announcement belatedly admitted that that was untrue, that the Company's internal controls were inadequate, and that "control improvements" were necessary.

26. This stunning news resulted in Sunterra's stock price plummeting, causing substantial losses to persons who purchased Sunterra stock during the Class Period.

27. Following this shocking but materially incomplete disclosure, the Company was unable to secure additional financing, and was forced to file for bankruptcy. Astonishingly, the Company entered bankruptcy within weeks after its auditor, Arthur Andersen, LLP, had certified Sunterra's materially false and misleading 1999 financial statements without including any qualification on Sunterra's ability to continue as a "going concern," or even requiring the Company to restate its previously filed financial statements. Contrary to this reckless "certification," the bankrupt Sunterra later disclosed it was unable to generate reliable internal accounting records, that new systems needed to be created, that over $500 million in "retained earnings" had to be written off, that the audited and unaudited financial statements issued for 1999 and prior periods "should not be used or relied upon," and that it was suing its former managers, directors, auditors and IT consultants.

28. As described in detail below, during the Class Period, Sunterra's stock traded at prices ranging from a low of $4.06 during the fourth quarter of 1998, to a high of $16.06 in the

first quarter of 1999 and a high of $13.50 during the fourth quarter of 1999. Since disclosure of the adverse facts and material write-offs announced on January 20, 2000, Sunterra's stock has been delisted from trading on the national securities markets and the last available bulletin board quote for the stock was $.08 per share on October 16, 2000. In connection with the bankruptcy reorganization, all of Sunterra's equity investors will be wiped-out and the unsecured creditors will receive just a fraction of the debts they are owed. Thus, as a direct and proximate result of defendants' misconduct detailed herein, plaintiffs and other Class members who purchased Sunterra stock at prices artificially inflated due to defendants' misrepresentations and omissions have suffered substantial damages.

JURISDICTION AND VENUE

29. This Court has jurisdiction over the subject matter of this action pursuant to 28 U.S.C. §§ 1331, 1337, and 1367 and Section 27 of the Exchange Act (15 U.S.C. § 78aa).

30. This action arises under Sections 10(b) and 20(a) of the Exchange Act (15 U.S.C. §§ 78j(b) and 78t(a)) and Rule 10b-5 promulgated thereunder (17 C.F.R. § 240.10b-5).

31. Venue is proper in this District pursuant to Section 27 of the Exchange Act (15 U.S.C. § 78aa) and 28 U.S.C. § 1391(b) and (c). Substantial acts in furtherance of the alleged fraud and/or its effects have occurred within this District. Sunterra and the Individual Defendants maintain or maintained their principal executive offices in this District. Defendant Arthur Andersen LLP maintains an office within this District and conducted its work for Sunterra within this District.

32. In connection with the acts and omissions alleged in this complaint, defendants, directly or indirectly, used the means and instrumentalities of interstate commerce, including, but not limited to, the mails, interstate telephone communications, and the facilities of the national

securities markets.

PARTIES AND RELEVANT NON-PARTIES

33. Lead Plaintiffs Arnold and Marian Bowles and Bulldog Capital Management, L.P. purchased Sunterra common stock and securities during the Class Period and were damaged thereby. Lead Plaintiffs Arnold and Marian Bowles and Bulldog Capital Management, L.P. were appointed by the Court as lead plaintiffs.

34. Sunterra is a Maryland corporation with its principal executive offices temporarily located at 6177 Lake Ellenor Drive, Orlando, Florida 32809, and formerly located at 1781 Park Center Drive, Orlando, Florida, 32835. As of March 15, 2000, Sunterra had 35,982,193 shares of common stock outstanding. Until it was delisted from trading in 2000, Sunterra's common stock traded on the New York Stock Exchange under the symbol "OWN." On May 31, 2000, Sunterra and numerous related entities filed voluntary petitions for relief under Chapter 11 of the United States Bankruptcy Code, 11 U.S.C. § 101 et seq., in the United States Bankruptcy Court for the District of Maryland, in Baltimore, Maryland. Sunterra would be named as a defendant herein but for the automatic stay of litigation provided for in 11 U.S.C. § 362.

35. Sunterra described itself as the world's largest vacation ownership company. As of January 20, 2000, Sunterra had 90 resort locations in North America, Europe, the Caribbean and Japan. In addition, Sunterra managed 18 third-party condominium and other resorts in Hawaii. The Company markets and sells vacation ownership interests at its resort locations and off-site sales centers. These interests entitle the buyer to use a fully-furnished vacation residence, generally for a one week period each year in perpetuity, and earn vacation points which may be redeemed for occupancy rights for varying lengths of stay at participating resort

locations.

36. Defendant Gessow is a founder of the Company and, at various times, has served as the Company's Chief Financial Officer, Chief Executive Officer, Co-Chief Executive Officer, President, Co-Chairman of the Board of Directors and Member of the Executive and Audit Committees of the Board. Gessow is the founder of one of Sunterra's predecessors, Argosy Group, Inc. Gessow signed the Letter to Shareholders reflected in Sunterra's 1998 Annual Report, which was delivered in or around April 1999. During 1998 and 1999, Gessow participated, either personally or by conference call, in more than five (5) quarterly review meetings with senior accounting, financial and business managers of the Company in which the problems with the mortgages receivable portfolio and the inventory accounting were discussed in detail. In addition, Gessow had nearly day-to-day contact with Miller, Goodman, Frey, Giannoni, Cohen and Sullivan concerning the business activities of Sunterra, and often directed Miller and Goodman to take steps based on information Gessow learned from Frey, Giannoni, Cohen and Sullivan. For 1998 and 1999, Gessow was required by his employment agreement to devote "substantially full time" to Sunterra's business.

37. Defendant Kenninger is a founder of the Company and, at various times, has served as its Chief Operating Officer, President, Corporate Secretary and Co-Chairman of Board of Directors and Member of the Executive Committee of the Board. Kenninger signed the Letter to Shareholders reflected in Sunterra's 1998 Annual Report, which was delivered in or around April 1999. During 1998 and 1999, Kenninger participated, either personally or by conference call, in more than five (5) quarterly review meetings with senior accounting, financial and business managers of the Company in which the problems with the mortgages receivable portfolio and the inventory accounting were discussed in detail. In addition, Kenninger had

practically day-to-day contact with Gessow, Miller and Goodman and, based on information from his assistant Dave Phillips, frequently directed Miller and Goodman to take actions to perpetuate the fraud. For 1998 and 1999, Kenninger was required by his employment agreement to devote "substantially full time" to Sunterra's business.

38. Defendant Miller joined Sunterra as its President and Chief Executive Officer on September 10, 1998, and he also became a Director and Member of the Executive Committee of the Board of Directors at that time. Miller has both an MBA and a JD, and had been an audit partner at the accounting firm of Ernst & Young earlier in his career. Miller came to Sunterra from the Cendant Corp. subsidiary of Resorts Condominiums International ("RCI"), where he had been the Chief Executive Officer (1997-1998) and the Chief Financial Officer (1991-1997). RCI was the developer and operator of the "timeshare exchange," a program in which timeshare developers and operators could register to enable their timeshare owners to exchange timeshare weeks with owners of different timeshares at different resorts. Miller signed the "Letter from the Chief Executive Officer" contained in Sunterra's 1998 Annual Report delivered to shareholders in or around April 1999. During 1998 and 1999, Miller participated in at least four (4) quarterly review meetings with senior accounting, financial and business managers of the Company in which the problems with the mortgages receivable portfolio and the inventory accounting were discussed in detail. In addition, Miller received and had access to reports and communications from such third parties as S.G. Cowen, Finova and Airtours which made it clear that Sunterra's mortgages receivable portfolio was materially misstated during the class period. Miller was relieved of his position at Sunterra on January 20, 2000 when the Company announced the massive write-off. Despite this, prior to Sunterra's bankruptcy the Company agreed to pay severance amounts over time to Miller aggregating in excess of $1 million.

39. Defendant Goodman joined Sunterra as its Executive Vice President and Chief Financial Officer in or around October 1998. Prior to that, Goodman had been a senior executive at PepsiCo, where he had been Chief Financial Officer of Taco Bell. Goodman has both a PhD and an MBA. Goodman signed Sunterra's 1998 and 1999 annual reports on SEC form 10-K that were filed with the Commission in or around March 1999 and March 2000. During 1999, Goodman participated in at least three (3) quarterly review meetings with senior accounting, financial and business managers of the Company in which the problems with the mortgages receivable portfolio and the inventory accounting were discussed in detail. In addition, Goodman received and had access to reports and communications from such third parties as S.G. Cowen, Finova and Airtours which made it clear that Sunterra's mortgages receivable portfolio was materially misstated during the Class Period. Goodman resigned from Sunterra in May 2000.

40. Defendant Frey is an original officer of the Company and its predecessors and at various times had the following job titles: President, Sunterra USA, Executive Vice President – Chief Reporting Officer, Senior Vice President – Owner Services, Senior Vice President – Accounting and Administration, Senior Vice President and Treasurer. Frey was one of Gessow's protégés and worked closely with Gessow, Giannoni, Cohen and Sullivan on all aspects of Sunterra's business. Regardless of the formal office titles, before, during and after the Class Period, Frey was one of the primary officers at Sunterra who assembled the financial data, accounting and disclosures for use in Sunterra's public earnings releases and periodic filings with the SEC. Frey is a certified public accountant. He was the Senior Vice President of Administration and Treasurer of Argosy, one of Sunterra's constituent predecessor companies. Frey exercised day-to-day control over virtually all aspects of Sunterra's businesses, including

mortgages receivable accounting, mortgages receivable securitizations, Vacation Interval inventories, debt financings, timeshare sales, double and triple booking of timeshares, SEC disclosures, the SWORD system, the Foxpro and Timepro data bases of old or delinquent mortgages receivable, the Finova borrowings and lock box, the Millenium Management, Inc. relationship and lawsuit, and the manipulation of defaulted receivables to temporarily "bring current" the bad receivables.

41. Defendant Giannoni is an original officer of Sunterra and its predecessor, Argosy, and at various times had the following job titles: Senior Vice President, Central Services, Senior Vice President, Owner Services, and Senior Vice President, Operations. Like Frey, Giannoni was a protégé of Gessow and exercised day-to-day control over Vacation Interval inventory reporting and capitalizations and accruals of such accounts as HOA fees and interest, marketing costs, and percentage-of-completion revenue recognition. Along with Frey, she oversaw the consolidation of Sunterra's inventory reporting and supplied manipulated and false information that was included in Sunterra's financial statements filed with the SEC in 1998, 1999 and 2000.

42. Defendant Cohen is an original officer of Sunterra and its predecessor, Argosy, and held the position of Senior Controller before, during and after the Class Period. Cohen worked closely with Gessow, Frey, Giannoni, Goodman and Sullivan to prepare consolidating schedules and financial reports they each knew would be reflected in publicly-filed periodic reports. Cohen assembled all of the financial reports from the regional controllers and the resorts. Along with the other defendants, Cohen knowingly added to these reports figures that were maintained in a second set of books, kept in Foxpro or Timepro computer programs, and maintained in Sunterra offices in Orlando. Although one set of books, maintained by defendant Sullivan in Las Vegas, automatically aged the mortgages receivable, the figures from the second

set of books did not age the receivables automatically and required manual instructions to obtain an aged report. The vast majority of the mortgages receivable reflected in the second set of books in Orlando were defaulted, undocumented or long-delinquent receivables that were not reported in the Company's publicly released aging figures but which the defendants herein knew to be included in the portfolio's balance and had not been written-off.

43. Defendant Sullivan was an original consultant and employee of Sunterra, responsible for overseeing, together with Frey and Cohen, Sunterra's relationship with its primary operating lender, Finova. In or around July 1998, Sullivan was given the title of Senior Vice President – Mortgage Portfolio. Sometime later, her title was changed to Senior Vice President and Treasurer. Sullivan provided the financial figures and maintained the computer records of the so-called "good portfolio," which consisted of those mortgages receivable that were either performing or were actually documented or otherwise verifiable. She also maintained and received periodic reports from Finova and the securitization pools regarding the performance of the various portfolios. However, Sullivan was also responsible for attempting to verify, reflect, modify or revive the many mortgages receivable that Sunterra was including in its consolidated financials but which were either not documented, not performing, not aged or not written-off, some of which were located in boxes in Las Vegas, Orlando, Arizona and Washington state. Sullivan hosted the various securitization investors and Airtours, all of whom were shown Sunterra's portfolio operations in Las Vegas so defendants could foster the misleading impression of control over the portfolio when, in fact, over one-third of the portfolio was not performing and was reflected on a separate set of books maintained in Orlando. Hence, Sullivan provided portfolio figures to be included in the consolidated financials that she knew to be materially incomplete and misleading.

44. The Individual Defendants, as senior officers and/or directors of Sunterra, were controlling persons of the Company. Each exercised his/her power and influence to cause Sunterra to engage in the fraudulent practices complained of herein.

45. Each of the defendants is liable as a direct and indirect participant in a fraudulent scheme and course of business that operated as a fraud or deceit on purchasers of Sunterra securities by disseminating materially false and misleading statements and/or concealing material adverse facts. The scheme: (i) deceived the investing public regarding Sunterra's business, its finances and the intrinsic value of Sunterra common stock; and (ii) caused plaintiffs and other members of the Class to purchase Sunterra common stock at artificially inflated prices.

46. Prior to its federal conviction for obstruction of justice related to the Enron audits, Defendant Arthur Andersen LLP ("Arthur Andersen" or "Andersen") was a Chicago-based firm of certified public accountants. Before the Enron debacle, Arthur Andersen consisted of 70,000 partners and employees located in 385 offices in 83 countries. Until recently, Arthur Andersen had 30,000 U.S. partners and employees serving clients from 82 domestic locations. Arthur Andersen's office in Orlando, Florida is located at 200 South Orange Avenue, Suite 2100, Orlando, Florida 32801. Arthur Andersen was engaged as Sunterra's independent auditor during the Class Period. Arthur Andersen also performed tax, consulting and other services for Sunterra, from which it obtained substantial revenues. Arthur Andersen purported to audit Sunterra's financial statements for the years-ended December 31, 1998 and December 31, 1999 in accordance with Generally Accepted Auditing Standards ("GAAS") and issued materially false and misleading unqualified reports on the consolidated financial statements of Sunterra on February 10, 1999, and March 10, 2000, falsely claiming that they were prepared in accordance with GAAP. Additionally, Arthur Andersen consented to the use of its unqualified opinion

letters with respect to Sunterra's financial statements in Sunterra's 1998 and 1999 reports on Form 10-K filed by the Company with the SEC. On information and belief, Verne Bragg was the engagement partner for Arthur Andersen on the Sunterra audits, and a substantial portion of his compensation was based on the fact that Sunterra was an audit client of the firm.

OVERVIEW OF THE UNLAWFUL CONDUCT

A. General Background

47. When Sunterra went public in 1996, it operated nine resorts for approximately 25,000 owner-families. By early 2000, Sunterra operated 90 resorts, purportedly for more than a quarter-million owner-families. But Sunterra's business model was fatally flawed because it depended upon pervasive fraud.

48. Sunterra's explosive growth was fueled in large measure by its ability to facilitate timeshare ownership by financing timeshare purchases by consumers. For nearly all of its domestic timeshare sales, Sunterra would finance the balance of the timeshare purchase after receiving a downpayment, often 10%, from the timeshare consumer (for its European operations the sales were financed through a third party bank, from which Sunterra would receive a fee). Sunterra, in turn, would create a mortgage receivable reflecting the balance of the sale price and record that receivable as an asset and recognize the sale as revenue. Sunterra would then pledge its mortgages receivable as security for loans it then used to fund continuing operations, including acquisitions and additional timeshare sales.

49. Because the Company typically financed 90% of the purchase price of the vacation interests, it incurred significant operating costs in excess of the actual cash proceeds initially received from the sale of vacation interests. To meet the Company's cash requirements to finance these customer receivables, the Company needed to borrow more and more funds just

to operate. By December 31, 1997, Sunterra had $50.0 million in negative cash flows from operations. Without the sale of additional common stock and Convertible and Subordinated Notes during that year, cash flows from operations would have been insufficient to service the Company's interest costs by an aggregate of $52.4 million. Hence, the Company's concentration on growth and accrued "profits" rather than real cash flow threatened its very existence.

50. To forestall the impending crash, Sunterra looked to the mortgage-backed securities market and S.G. Cowen as a source of liquidity. It also put even more pressure on its longtime credit line lender, Finova, to increase the level of Sunterra's borrowings.

51. The Company's credit lines generally provided that "if a buyer of a vacation interest defaults on the consumer loan made by the Company and the Company has pledged the mortgage receivable as collateral to a lending institution, the Company generally must take back the mortgage with respect to such vacation interest and replace it with a performing mortgage."

52. According to former Company employees, Gessow, Kenninger, Frey, Giannoni, Cohen and Sullivan, directly or indirectly, engaged in several forms of manipulation to ensure that Sunterra's mortgages receivable portfolio appeared to be far larger, stronger and more sound than it actually was. These defendants were motivated to engage in this form of corporate embezzlement because Sunterra's very existence depended on it's ability to raise operating cash from its bank lines, and to avoid having to take-back defaulted or non-performing mortgages.

53. **As alleged in the Gessow Complaint, ¶ 48, on November 5, 1997, the Founders of Sunterra sold 1.5 million shares of stock to NationsBanc Montgomery Securities Inc., a related subsidiary of NationsBanc (now Bank of America), pursuant to the Registered Offering in which the Founders jointly pocketed profits in excess of $25 million. On January 9, 1998, the Board approved interim emergency financing of $50**

million with NationsBanc. In February 1998, the Company finally executed a $117.5 million secured line of credit with NationsBanc (the "Senior Credit Facility").

54. **This protracted borrowing experience with NationsBanc left the Board and management with the need to more rapidly access more readily available and diverse types of financing. In January 1998, the Board approved a change in strategic direction allowing the Company to securitize its mortgage receivable, *i.e.*, to issue securities backed by the revenue stream from its mortgages, to finance Sunterra's future growth. Gessow Complaint, ¶ 49.**

55. **Thus, during 1998, the Company began securitizing its better mortgages receivable. On June 9, 1998, the Company completed an on balance sheet securitization in the amount of $100.3 million. First, the Company created a wholly owned bankruptcy remote subsidiary and then sold $106.3 million in mortgages to the subsidiary. Then, the subsidiary issued $100 million in securitized notes secured by the mortgages. As a result of the transaction, the Company received net proceeds of $96.5 million. The mortgages receivable and securitized notes remained on the Company's balance sheet, thus raising the Company's debt to capital ratio. In this transaction, the Company recognized both the interest income on the mortgages receivable and the interest expense on the securitized notes going forward. Gessow Complaint, ¶ 50.**

56. **In addition, in 1998, the Company began selling portions of its mortgages receivable portfolio. On July 9, 1998, Michael A. Depatia, a former director and officer of Sunterra, sent a memorandum to the Board seeking the Board's approval of a sale of $29.3 million in mortgages receivable to FINOVA Capital Corporation ("FINOVA"), a lender active in financing mortgage portfolios, which set forth the rationale for the transaction as**

follows:

> **Although this transaction is not terribly compelling financially, we believe it is warranted for the following strategic reasons:**
>
> **1.** ***The transaction "proves" the value of our receivable portfolio. This transaction, along with the sale of The Ridge portfolio to FINOVA (at 96% of par with us keeping 65% of the excess spread) and the recently-completed securitization (essentially a sale at 91% of par with us keeping all the excess spread) shows that our receivable portfolio can be liquidated and used to offset the Company's debt balances at its current carrying cost (93.7% of par) or greater. Given the negative future earnings implications, we would not want to sell off our entire mortgage receivable portfolio but only want to show that it has real value. This transaction accomplishes that goal.***
>
> **2. The transaction reduces our financial leverage. On a pro forma basis, as if the transaction was completed 5-30-98, our debt-to-cap ratio would have been reduced to 71.4% from 72.2%. We estimate our second quarter debt-to-cap ratio will be slightly out of compliance with our bank loan covenants. We are currently in the process of obtaining a waiver for the debt-to-cap covenant. Removing this debt from our balance sheet, even though it's (sic) after quarter end, will be helpful in convincing the banks that our leverage levels are acceptable.**
>
> **3. The transaction eliminates all downside exposure from the portfolio while still retaining 50% of the excess spread. If the portfolio should experience a catastrophic default level after the sale, our exposure would be limited to restating the gain on sale from the transaction (estimated at approximately $1 million initially) while FINOVA's exposure would be their total investment in the transaction.**

The Board was also advised that, although the sale to FINOVA was ostensibly (and publicly reported as) non-recourse to Sunterra, Sunterra under the terms of a separate agreement, undertook to repurchase any defaulted inventory from FINOVA at 22% of the original sales price to the customer. Gessow Complaint, ¶ 51.

57. In mid-1998, defendants (excluding Miller and Goodman) took steps to create the impression that the Company was a well-run and integrated company. But these steps failed to implement the necessary policies and processes that would effectively ensure

that the Company *was* an integrated company, with attendant financial controls. On January 28, 1998, the Company's independent auditors, Arthur Andersen, LLP ("Andersen") had delivered to the management and the Board, its "Signature Resorts Inc. Memorandum on Internal Control Structure, January 1998". Several of the significant deficiencies which Andersen noted related specifically to the mortgage receivable portfolio. The defendants were advised by Andersen that: (1) there was no standardized format for the mortgage receivables schedules prepared by the various resorts; (2) mortgage receivable reconciliations were not being prepared by the resorts; and (3) the mortgage receivable balances reported by the mortgage servicers varied from the mortgage receivable balances on the corporation's and the subsidiaries' general ledger. Andersen also recommended the use of an historic delinquency and default rate analysis to determine the allowance for loss reserves on the mortgage receivable portfolio. Gessow Complaint, ¶ 53.

58. The first initiative half-heartedly undertaken to address these concerns was to hire someone who could consolidate and centralize control of the mortgage receivable portfolio. As explained by internal speaking notes of Dewey E. Chambers, a former officer of Sunterra, to his colleagues in or about May or June 1998, the known (but undisclosed publicly) problems at Sunterra regarding the mortgage receivable portfolio were:

> **No apparent consolidated control of the receivable portfolio. Stated differently each resort, rolled-up company, region, has different processes and reporting.**
>
> **Remember, historically each resort designed its process around and <u>for</u> its individual lender (Finova, Heller, Marine Midland, etc.). Cash necessary to run the individual resort was provided only by the paper from the lender of that resort. Thus began the odyssey of 50 ways to leave your lover.**

This approach works well for joe and jenny developer. However, our borrowings are <u>not</u> directly tied to an individual resort any longer. The best borrowing (lowest cost borrowings) come from our consolidated receivable portfolio.

Strengthen.

By using our entire portfolio as a borrowing base, we lower our cost of capital because of the "don't place all your eggs in one basket theory".

a) A diversified geographic portfolio is not likely to experience catastrophic losses (fire, hurricane, environmental contamination, etc.) at all resorts simultaneously.

b) A diversified portfolio is less likely to suffer from economic risk (i.e., rescissions occur in specific geographic regions (i.e., Texas 1980, California 1990, Bust 1987). A diversified owner base will not suffer as much.

c) Less likely to suffer legal risk.

This being said, we can only sell, borrow, pledge or hypothecate in large quantities at low cost if we have significant meaningful accurate consistent data about our portfolio. It is an absolute pipedream to believe we can sell these receivables without it. Why, because we do not in any way utilize credit underwriting (example, AVCOM loan to an "exotic dancer") which is the backbone of credit card, home mortgage, auto or any other form of consumer credit. Therefore, <u>we must</u> prove this paper is damn good. And the only way to do this is by performance history; period!

So, how do we get this done and why isn't it done now? Easy, our data is screwed up. Without a process, or better said with 40 different processes of the acquired resorts, our method for reporting delinquency, first payment defaults, rescissions, etc. through <u>four</u> different service centers does not yield itself to clear concise reporting of historical data.

So how do we fix the problem? Two steps, each is <u>equally</u> important.

a) <u>Standardize</u> the portfolio function <u>at</u> every <u>resort</u>. This fixes the prospective problem.

b) Set the rules. Have one servicer run the reports and scrub the data. This fixes the retrospective problem.

How do we standardize the portfolio function?

a) Must have management's attention.

b) Set the standards, and damn it, enforce them.

c) Management report hierarchy must enforce the discipline to use the standards.

Let's talk standards for just a minute. If a loan is not at a servicer, we cannot borrow, period. If a loan is not at a servicer, we are not receiving cash from the customer because they have no coupon book or payment instructions, and if a loan is not at a servicer, I can guarantee you the salesperson has been paid a commission and notwithstanding mail delays, the loan smells! . . .

Servicing, as quickly as we can consolidate servicing either in-house or with a single outside vendor is make no bones about it critical to the borrowing process. Will it be tough? Yes, however, we can't continue on our current path. By having four servicers you exponentially increase the chances of reporting inconsistency and inaccuracies.

Gessow Complaint, ¶ 54.

59. On June 11, 1998, in a press release reviewed with the Board, the Company announced the appointment of defendant Sullivan to Senior Vice President - Mortgage Portfolio. In this "newly created position," Sullivan would be responsible "for directing the management of the Company's mortgages receivable portfolio including administration, serving, collection and reporting". The announcement touted the fact that Sullivan had previously worked at FINOVA, a lender active in financing mortgage portfolios. Prior to the time of the appointment, however, Sullivan had been working as a consultant to the Company and providing the Company assistance in its dealings with FINOVA, thus despite the fanfare of the announcement, Sullivan merely moved from being an outside consultant to a salaried position. Gessow Complaint, ¶ 55.

60. In its second quarter 1998 Form 10-Q filed with the SEC, the Company represented that it had approximately $190 million of mortgages receivable which were unpledged to any financial institution and which could be sold or pledged to raise additional cash as needed. Defendants knew, however, that this representation was false since they knew many of the Company's receivables were in fact not eligible for pledging under any of the Company's existing credit facilities. The Company had also reported in its Form 10-Q that the Company had acquired Harich Tahoe Development ("HTD") for approximately $77.5 million. As part of financing the transaction, the Company concurrently sold $69.1 million of HTD's mortgages receivable portfolio to FINOVA. As part of the Board's approval of the transaction on June 15, 1998, the Board was advised that the Company would retain the non-current portion of the portfolio, i.e. receivables 31 or more days past due, on its own books. Thus, defendants knew that the Company was accumulating a "House Portfolio" consisting of receivables that were past due and/or

unpledgeable and which it was servicing internally. In fact, one of the stated rationales given to the Board for hiring Sullivan "in-house" was to clean up this portfolio. Gessow Complaint, ¶ 60.

B. The Devices, Practices, Artifices and Schemes Employed by Defendants, Directly and Indirectly, To Falsely Prop-up Sunterra for Sale.

61. The Millenium Management, Inc. Receivable - As with other timeshare companies, Sunterra utilized the services of various marketing firms, "independent" sales agents and tour operators to promote Sunterra's resorts and to solicit consumers to purchase a Sunterra time share. In many cases, these promoters offered, with Sunterra's approval, free-stays, mini-vacations and other inducements designed to entice consumers to visit the resort and to then receive a presentation about purchasing a timeshare. One of the companies Sunterra employed for this purpose was Millenium Management, Inc., a Miami-based tour and travel company operated by Amaury Martinez and George "Buddy" Graham.

62. Sunterra began working with Millenium Management, Inc. in 1995 and 1996. Frey, with the knowledge and approval of Gessow and Kenninger, utilized Millenium Management, Inc. as a compensated third party to help Sunterra "clean-up" the mortgages receivable portfolio temporarily before the Company went public. Among other things, Frey advanced Sunterra funds to be paid to Millenium Management, Inc., which would then make payments on defaulted timeshare intervals it ostensibly would be using for "sales promotions." This practice then continued after Sunterra went public whenever Frey had to "clean-up" the portfolio for other offerings or to secure additional financings. Millenium would take a portion of the money "advanced" by Sunterra and pay it back to Sunterra on mortgages receivable then in default. The receivables would then be deemed "current" until they returned to default status three or four months later. In essence, Sunterra funneled its own money to Millenium, which

then paid it back to Sunterra. Meanwhile, Sunterra was able to portray falsely its mortgages receivable portfolio as far more sound and robust than it in truth was.

63. Another artifice Frey and Giannoni used with Millenium Management, Inc. was to have it pay the downpayments for those timeshare customers who either could not afford the downpayment or did not want to pay a 10% downpayment. Millenium would ostensibly "rent" the first two or three seasons of a timeshare interval from the purported purchaser, paying the downpayment as the "rent" for the Vacation Interval. Millenium used the funds Sunterra had advanced it to pay these downpayments. As a result, Sunterra obtained both increased sales and additional receivables even though the real purchaser was either not financially qualified to afford the timeshare or had no real intention of going through with the transaction. In reality, Sunterra simply paid its own money to itself while creating wholly fictitious revenue and assets.

64. Gessow, Kenninger, Frey, Giannoni and Cohen attempted to hide the true nature of Sunterra's relationship with Millenium Management, Inc. by creating a fictitious "settlement agreement" purportedly documenting that Sunterra was purchasing Millenium in exchange for the substantial cash Sunterra had advanced and would be advancing to Millenium. By 1999, Sunterra had advanced over $5 million to Millenium. Millenium refused to acknowledge that it owed that much money to Sunterra, contending that a material portion of that amount had been paid back to Sunterra in the form of "downpayments" and mortgages receivable "cures."

65. After Sunterra filed suit to recover the advances made to Millenium, George "Buddy" Graham made it clear that Frey had advanced a large portion of the funds so he could clean-up Sunterra's balance sheet and otherwise "make the numbers" in past years and quarters. In response, Frey proposed to Miller and Goodman during the third quarter of 1999 that Sunterra pay even more money to Millenium Management, Inc., suggesting that Sunterra buy out the two

owners for another $500,000. Although Miller, Goodman, Frey, Cohen, Gessow and Kenninger all knew that Millenium Management, Inc. had valid defenses to Sunterra's claim that it was owed money by Millenium Management, Inc., each failed to disclose such facts in any of Sunterra's filings with the SEC or to write-off the debt allegedly owed by Millenium Management, Inc.

66. In connection with Sunterra's massive write-offs, announced on January 20, 2000, the Company revealed that $2.8 million was to "write-down a receivable from a marketing company." Long after entering bankruptcy, on May 10, 2002, the managers from Jay Alix & Associates retained to operate Sunterra while it was in bankruptcy, announced still another write-off, revealing that even a larger debt allegedly owed by Millenium Management, Inc. to Sunterra was a bad debt, stating "[t]he proceeds charged off were originally recorded as additional goodwill but should have been recorded as a bad debt. The adjustments to the recording of this transaction resulted in a decrease to retained earnings of $2.2 million as of December 31, 1999."

67. <u>The Two Sets of Books for Mortgages Receivable</u> - Defendants' manipulations did not end with round-tripping the Company's own cash. Before Sunterra's IPO, and in connection with many of the Company's acquisitions, Sunterra had on its books millions of dollars in purported mortgages receivable that were undocumented, delinquent by over 360 days, rescinded, improperly entered, modified without any confirming documentation or otherwise non-performing. These delinquent receivables were not reflected on the Company's primary mortgages receivable records, but were instead maintained on a second set of books kept at the Company's offices at Orange Blossom Trail.

68. By early 1998, Gessow, Kenninger, Frey, Cohen and Sullivan recognized that

Sunterra needed alternative sources of financing to the bank credit lines the Company had been using to supply operating cash. Sunterra's lender, Finova, was continually complaining about the frequency of the defaults it was experiencing in the mortgages receivable pledged under the bank lines. In fact, there were constant hold-backs and threats by Finova, which would refuse to advance funds to Sunterra on those receivables that were more than 60 days delinquent. This resulted in Frey and others continually replacing non-performing receivables with contracts that had just been written in order to obtain the necessary cash from Finova. But those contracts that were returned by Finova as non-performing were not written-off. Instead, they were placed in the Orange Blossom Trail data base for work by the "Pending Department" or for "modifications" to bring them current.

69. These practices, of course, resulted in the mortgages receivable portfolio ending up in total disarray. By mid-1998, the Company designated Sullivan as the point person to deal with Finova concerning the elements of the mortgages receivable portfolio that would be pledged for Sunterra's bank lines. Sullivan, who had experience working with Finova, set up and maintained a data base of those receivables that were generally "pledged" or otherwise sufficiently documented to be able to be pledged for financing or sale. This data base was maintained in Las Vegas, Nevada, and typically was "aged" automatically, meaning that a delinquency would be identified unless a payment was entered for the particular receivable in the account. However, due to the frequent return by lenders of defaulted receivables, and Sunterra's compelled replacement of them with "performing" receivables, defendants often caused the same receivables to be double and triple-pledged. As a result, the Company lacked any reliable record of the encumbrances held by its main lenders.

70. Another, very significant database of mortgages receivable was also maintained

by the Company. Frey, Giannoni, Cohen and the “Pending Department” at the Company’s Orange Blossom Trail offices in Orlando maintained this database. This data base contained returned, undocumented, rescinded, modified or just plain defaulted mortgages receivable. The data base was not automatically aged, meaning that, unless a missed payment was entered affirmatively, the receivables would not automatically reflect their delinquent status. In other words, program parameters would have to be entered to age the Orlando data base.

71. According to an employee who worked in the Company’s “Pending” (Collections/Account Administration) department during the Class Period, Sunterra gave customers who legitimately owed money to the Company and were in default on their mortgage payments up to two years (720 days) to make back payments. The Company did not write-off these aged, delinquent and obviously uncollectible accounts or establish reserves against them. Instead, they were reflected as fully collectible on the books of the Company for “a very long” time. Contrary to these facts, which were known throughout the Company, Sunterra’s 1997 and 1998 Annual Reports stated falsely that the Company typically wrote-off a mortgage receivable, ceased accruing interest and began foreclosure proceedings once an account was more than “120 days past due.” Each of the defendants knew, but failed to correct or disclose, that such a statement was false.

72. The failure to recognize apparent losses on legitimate mortgages receivable (i.e., not those phantom receivables which arose as a result of a failure to record the cancellation of a sale or those which arose as a result of upgrades being incorrectly recorded as two sales instead of one) resulted in a material understatement of charges to earnings (bad debt expense) and a material overstatement of earnings and mortgages receivable during the Class Period.

73. Each of the defendants herein knew about the fraudulent practices and two sets of

books relating to the Company's mortgages receivable but knowingly or recklessly failed to disclose the true facts or to correct the false and misleading statements made in the Company's name. Ann Cohen was the initial person responsible for assembling consolidating financial information to prepare the quarterly consolidated financial statements of the company. To obtain this information, she received reports on mortgages receivable from Sullivan in Las Vegas and from Frey and Giannoni in Orlando. Sunterra employees in accounting, operations, portfolio management and the "Pending Department" who accessed the information in the Orlando data base, have all stated that the balances, composition and figures reflected in the Orlando data base were, in many cases, seriously delinquent, with many reports showing accounts continuing to be accrued that were over 360 days past due. These individuals have also acknowledged that the Orlando database figures appear to have been simply added to the Las Vegas figures to arrive at "consolidated" financials. Before Cohen sent around draft consolidated financials, Frey, Gessow, Kenninger, Giannoni, Sullivan and Goodman all had an opportunity to, and did, review the initial reports and to make "adjustments considered necessary" or disclosures with respect to the purported balances, the "agings," and the Company's delinquency experience. Each of these individuals knew, by no later than mid-1998, that the consolidating financial statements were reporting long-delinquent, rescinded, disputed or otherwise inadequately documented defaulted mortgages receivable as performing assets when, in fact, they were not performing assets. In fact, according to accounting personnel in the Company's Las Vegas office, that office was created for the express purpose of "cleaning-up" the portfolio. However, each of the defendants knew, but failed to disclose, that the Company was not using only the figures being reported by the Las Vegas office when issuing consolidating statements, because the balances being reported were far larger than those reflected on the Las Vegas reports. These defendants each deliberately

or recklessly perpetuated or ignored the false financial reporting so as not to jeopardize the Company's ability to secure essential financing for continuing operations and to maintain the Company's status until a strategic buyer could be enlisted. Thus, the "adjustments" the defendants made, directed or permitted, were adjustments that effected and maintained the fraud.

74. Within weeks after their arrival at Sunterra in the third and fourth quarters of 1998, Miller and Goodman were made aware of the two sets of books for mortgages receivable and the problems with the mortgages receivable delinquencies and agings. In fact, two senior accountants in Sunterra's central accounting operation, expressly told Goodman about the issues and their concerns. **Moreover, as alleged in the Gessow Complaint, ¶ 106, Ann Cohen, the East Coast Comptroller, sent an e-mail to Goodman on February 1, 1999, outlining open audit issues, including the delinquency and default calculation. The e-mail stated in relevant part:**

> **The final numbers reflect total delinquency and default at 7.41%. I have left a copy of the calculations on our desk for review as well as what the rates were at 9/30/98 and 12/31/97. I have not released the numbers to the auditors. I want to get your feedback first.** ***Dewey [Chambers] is proposing a change in the way we have been reporting the delinquency and default rates. Currently, our default rate only includes receivables that are being processed through legal. He is proposing to change it to include all receivables that are past due over 180 days. I agree most past due receivables over 180 days will default, however, we have addressed this issue in the past and he didn't want to change it. Why now?*** **We are pulling the numbers together for the last 5 quarters to see what the impact will be.**

75. Despite **these** warnings, Goodman and Miller continued to allow two sets of books to be used for the year-end 1998 reports and for each of the three quarterly reports issued in the name of the Company during calendar year 1999. It was not until Airtours insisted on corrections that Goodman or Miller took any steps for an "in-depth balance sheet review" at the end of 1999. Miller and Goodman were motivated to disregard the problems because their

mandate was to sell the Company, in which case they would have received millions in golden parachute payments and benefits.

76. According to a memorandum Goodman sent to the Board on January 7, 1999, $85 million of the Company's receivables were ineligible to pledge as collateral because the mortgages had not yet been recorded, the title policies had not yet been issued and/or the first payments received. In addition, another $15 million in receivables were ineligible because they were right to use or leasehold contracts. Goodman was urgently seeking the Board's approval for a $50 million line of credit with FINOVA which would be secured by unencumbered inventory and a sale to Ardsley Associates of some of the right to use and leasehold contracts at a substantial face value discount.

77. **As alleged in the Gessow Complaint, ¶ 89, defendants were repeatedly advised (1) that reconciliation of mortgages receivable balances was not being done (and could not be done) at the resort level, (2) that Sunterra lacked detailed mortgage receivable subsidiary ledgers required for accounts purposes, and (3) that Sunterra's data on the mortgage receivables portfolio did not match the mortgage servicers data -- all essential elements to ensure the Company's continued borrowing abilities -- by reports given to the Board by its auditor Arthur Andersen ("Andersen") and by senior management. For example, on January 28, 1998, Andersen delivered its "Signature Resorts, Inc. Memorandum on Internal Control Structure, January 1998," to management and the Board, laying out in explicit detail how poorly organized Signature's mortgage reconciliation process was. Gessow Complaint, ¶ 122. Similarly, on January 20, 1999, Andersen wrote to Goodman pointing out that the Company continued to have weaknesses in its analysis of its allowance for mortgages receivable which could lead to**

understatements for the allowance account, and that mortgage receivable reconciliations were not being prepared on a timely basis, potentially causing a misstatement of the mortgage receivable balance. Gessow Complaint, ¶ 132.

78. **At the corporate level, the gap between the two balances, the mortgage servicers balance and the consolidated mortgages receivable balance, was material:**

Period	Consolidated Balance	Gap in Millions of Dollars	Percentage of Gap to Consolidated Balance
YE 1997	349.3	39.5	11%
1Q 1998	375.5	27.3	7%
2Q 1998	397	22.8	5.8%
3Q 1998	413	31.3	8%
YE 1998	358.9	36.1	10%
1Q 1999*	473	32.8	7%
2Q 1999*	491.2	38.1	8%
3Q 1999*	555.5	41.8	8%

(*Includes mortgages receivable on and off balance sheet.) Gessow Complaint, ¶ 90.

79. **The gap was referred to at the corporate level as "in-transit", implying that the gap was merely those loans that had not yet been sent to the mortgage servicers. In fact, included in these "in-transit" category were a large percentage of non-performing and non-existent loans that were improperly allowed to be included in the mortgage receivable balance from quarter to quarter. In a report given to the Sunterra Banking Group on February 14, 2000, Goodman admitted that the net mortgages receivable amount for 1998 shown on Sunterra's balance sheet and included as part of Sunterra's financial statements in the December 31, 1998 Form 10-K filed with the SEC was overstated. Gessow Complaint, ¶ 91.**

80. **Again as alleged in the Gessow Complaint, ¶ 101, during the period, defendants issued on behalf of the Company various statistics which were aimed at**

describing the health of the mortgage portfolio which were subcomponents of the mortgages receivable balance. These statistics were admittedly inaccurate.

81. **As described above, because the records of the mortgage servicers did not match Sunterra's books, for purposes of reporting delinquency and default rates, cancellations, upgrades, and loans in legal process carried on the loan servicers books were identified and excluded from the delinquent amounts reported by the servicers. These delinquency adjustments were as follows:**

Period	Adjustments in Millions of Dollars	Percent of Adjustment
1Q 1997	2.1	0.83
2Q 1997	1.5	0.56
3Q 1997	3.4	1.09
YE 1997	2.7	0.78
1Q 1998	5.7	1.53
2Q 1998	8.4	2.11
3Q 1998	11.2	2.70
YE 1998	25.8	7.20
1Q 1999	29.4	6.21
2Q 1999*	37.6	7.66
3Q 1999	48.6	8.75

***Includes mortgages receivable on and off balance sheet. Gessow Complaint, ¶ 102.**

82. **By late 1998, the size of the delinquency adjustment and its proportion to the overall portfolio balance ceased to be a minor adjustment, and became a red flag that the delinquency and default rates being reported by Sunterra were severely inaccurate. Gessow Complaint, ¶ 103.**

83. **Moreover, the delinquency and default rates reported by Sunterra were systematically being understated by the methodology used to report those rates. First, a delinquency percentage was determined by comparing the amount of loans reported by the servicer to be 60 days or more past due in the numerator to the mortgage balances being**

reported on the corporate books in the denominator. Second, a percentage was calculated comparing the adjustment for the loans reported to be 60 days past due, but not cancelled at the mortgage servicers in the numerator to the mortgage balances being reported in the corporate books in the denominator. The second percentage was then subtracted from the first percentage. Because the numerator was in both cases the overstated mortgage balance in the corporate books, the percentage being reported for loans 60 days past due was constantly being understated. The methodology used to report the default rate, the percentage of loans in legal, was similar and had the effect of similarly understating the default rate. Defendants reported in the 1996 Form 10-K that the placing of loans into the legal process was a purely subjective occurrence: "The Company closely monitors its loan accounts and it determines whether to foreclose on a case by case basis." Gessow Complaint, ¶ 104.

84. **Applying this subjective foreclosure practice, defendants failed to write off many of its non-performing loans and reported inaccurate delinquency and default rates in its public filings as follows:**

- **As of March 31, 1997, approximately 6.9% of the Company's consumer loans from the sale of vacation intervals were considered by the Company to be delinquent (past due by 60 or more days) and the Company has completed or commenced foreclosure or deed-in-lieu of foreclosure on approximately 2.4% of its consumer loans.**

- **On June 30, 1997, the mortgages receivable delinquency rate (past due by 60 or more days and less than 120 days) was 3.9%. There was no disclosure of what the default rate was at June 30, 1997.**

- **As of December 31, 1997, approximately 4.6% of the Company's consumer loans were considered by the Company to be delinquent (scheduled payment past due 60 or more days). In addition, the Company had commenced deed-in-lieu of foreclosure or foreclosure action on approximately 2.2% of its consumer loans as of December 31, 1997.**

-- **As of March 31, 1998, approximately 4.7% of the Company's consumer loans were delinquent (scheduled payment past due by 60 days or more), compared with 4.6% at year end and March 31, 1997. In addition, the Company had commenced deed-in-lieu of foreclosure action on approximately 2.2% of its consumer loans as of March 31, 1998, compared with 2.2% at year end at March 31, 1997.**

-- **As of June 30, 1998, approximately 4.2% of the Company's consumer loans were delinquent (scheduled payment past due by 60 days or more), compared with 4.7% at March 31, 1998, 4.6% at December 31, 1997, and 4.3% at June 30, 1997. In addition, the Company had commenced deed-in-lieu foreclosure action on approximately 2.4% of its consumer loans as of June 30, 1998, compared with 2.2% at March 31, 1998, and December 31, 1997, and 2.3% at June 30, 1997.**

-- **As of September 30, 1998, approximately 4.4% of the Company's consumer loans were delinquent (scheduled payment past due of 60 days or more), compared with 4.2% at June 30, 1998. In addition, the Company had commenced deed-in-lieu of foreclosure action on approximately 2.5% of the consumer loans as of September 30, 1998.**

Gessow Complaint, ¶ 105.

85. **For year-end 1998, Goodman allegedly sought to "simplify" the reporting to the public to one number which would set forth all loans sixty (60) days past due, whatever their legal status. Thus, in the 1998 10-K, the following false representation was made:**

> **Consumer loans in excess of 60 days past due, including defaulted loans and loans in the deed-in-lieu process at December 31, 1998, were 7.4% as a percentage of gross mortgages receivable.**

Gessow Complaint, ¶ 106.

86. **As described above, during 1999, Sunterra securitized and sold a large portion of the mortgages receivable portfolio. Because the "better" performing loans were sold and securitized, if Defendants reported on just the portion of the loan portfolio owned by Sunterra, the delinquency rate would increase dramatically and expose the weakness in Sunterra's remaining portfolio. Defendants, therefore, deliberately decided to report**

delinquencies based on the entire service portfolio containing loans they no longer owned. Specifically, language was changed in the Company's periodic reports to mask the fact that they were comparing the default experience that they were actually incurring to the entire portfolio, not to the portfolio that they retained. Accordingly, during 1999, Sunterra made the following disclosures regarding delinquency:

> **--Consumer loans *serviced by* the Company in excess of 60 days past due including defaulted loans and loans in the deed-in-lieu process at March 31, 1999 were 6.8% as a percentage of gross mortgages receivable, slightly lower than 6.9% at March 31, 1998.**
>
> **--Consumer loans *serviced by* the Company in excess of 60 days past due, including defaulted loans and loans in the deed-in-lieu process at June 30, 1999, were 6.9% , as a percentage of gross mortgages receivable, slightly higher than 6.7% at June 30, 1998.**
>
> **--Consumer loans *serviced by* the Company in excess of 60 days past due, including defaulted loans and loans in the deed-in-lieu process at September 30, 1999, were 6.4%, as a percentage of gross mortgages receivable, a decrease from 6.9% at September 30, 1998.**

Gessow Complaint, ¶ 107.

87. **Goodman misleadingly attributed the underreporting of delinquency and default rates "to a breakdown in interval reporting systems" which caused the quarterly information not to be accurate according to a February 14, 2000 memorandum addressed to Sunterra Banking Group. Gessow Complaint, ¶ 108.**

88. Defendants knew or were reckless in not knowing that the delinquency and default rates were being systematically underreported. Defendants intentionally or recklessly permitted this so-called breakdown in interval reporting systems to occur, compounding the material inaccuracy of the value of Sunterra's mortgages receivable and its financial statements. Notably, Defendants Kenninger and Gessow sent out the shareholder's letters and signed the annual reports, all containing the above intentional misstatements..

89. <u>The Mortgage Modification Devices, Schemes and Artifices</u> − Prior to and during the Class Period, each of the defendants, directly and indirectly, concocted, engineered and manipulated various "accounting" and "transactional" devices to make Sunterra's mortgages receivable appear more "current" than they actually were. Defendants engaged in these schemes in order to pressure Finova into releasing more funds on the Company's credit lines or to package receivables into mortgage-backed securities pools for sale to third party investors.

90. Frey was at the forefront of these deceptive devices. Among other things, Frey instructed Sunterra personnel to call defaulted Vacation Interval owners to offer a "mortgage modification" in which the monthly payment would be reduced or the interest rate would be lowered. Once an owner sent in a payment pursuant to such a "modification," the loan would then be considered "current," and Sunterra could then use it again as a pledged asset for its credit lines. In many instances, however, the documentation establishing such a modification was not prepared, not signed, not properly recorded or not included in the appropriate loan file. As a result, the loan would be considered "current" for financing purposes for Sunterra but the receivable would not be adjusted to reflect the lower or modified terms.

91. Similar practices would be used for rescinded or "first payment default" purchases. Again, once a payment had been received, the loan would then be pledged, but neither Sunterra's books nor Finova's records would accurately reflect the modified or adjusted terms of the receivable. As a result, many receivables were reflected at amounts far greater than their actual terms. Frey, Giannoni, Cohen and Sullivan each new that such mortgages were continuing to be carried at their original terms as initially entered on Sunterra's books when, in fact, they had been modified. Despite this fact, neither defendant made any disclosure of the modifications or attempted to quantify the impact of the manipulative practices on the balances

they were providing to Finova and for inclusion in the Company's publicly filed financial reports. After purported revival, many of these rescinded or "first payment default" receivables were placed in a data base having Frey as the "sales person," leading a Sunterra Business Manager to believe that Frey also took commissions from these "revived" sales, although none of Sunterra's SEC filings disclosed this additional compensation received by Frey**.**

92. In this regard, all of the defendants received and had access to monthly and quarterly aging reports from Finova with respect to those receivables that were pledged under the operating lines. As a lender to Sunterra, Finova was responsible for tracking, reporting and collecting the loan payments directly from many of Sunterra's customers. This arrangement made Finova a monitor of the status of Sunterra's receivables throughout its relationship with this timeshare developer, which it then, in turn, reported to Sunterra. Specifically, throughout the Class Period, Finova provided Sunterra with two detailed reports: the Detailed Aging Report, and the Portfolio Aging Summary. These reports detailed each timeshare customer's loan that was 0-30 days past due and 31-60 days past due, as well as each loan that Sunterra was obligated to assume because it had fallen 60 or more days past due. The Detailed Aging Reports and Portfolio Aging Summary were prepared internally at Finova and circulated to Sunterra's and Finova's top executives, including defendants Gessow, Kenninger, Miller, Goodman, Sullivan, Frey and Cohen.

93. Upon receiving loan payments from Sunterra's customers, Finova would forward these funds to Sunterra to be applied to the timeshare customers' unpaid balance. Importantly, however, in the event that a Sunterra customer defaulted on its financing or failed to pay Finova for more than 60 days, Sunterra was obligated to assume the entire loan from Finova and pay Finova any unpaid balance on the loan.

94. By late 1998, this "revert back" provision had become a major problem for Sunterra, as an increasing number of Sunterra's customers were defaulting on their loans to Finova. This increasing default rate resulted from a combination of factors, including Sunterra's common practice of overselling its timeshare intervals, which led to customers not being able to utilize the timeshares at the time they had been promised by Sunterra's sales personnel. As a result, Sunterra's customers would stop paying their loan payment to Finova in protest of Sunterra's business practices.

95. By the end of 1998, Finova was forced to revert a huge number of defaulted loans back to Sunterra, thereby obligating Sunterra to reimburse Finova for the amount due on these defaulted loans. Sunterra, however, proved unable to repay the amount owed on these loans and, by the end of 1998, had fallen delinquent in its obligations to Finova. By early 1999, Sunterra's outstanding balance to Finova had increased significantly as more and more customers defaulted on their loans to Finova.

96. As a direct result of Sunterra's deteriorating business operations and delinquencies, the other primary lender in the participation loan, Heller Finance, informed Sunterra and Finova that it was withdrawing from the participation loan and would record a write-off to reflect Sunterra's delinquencies.

97. On or about September 30, 1999, Finova's Executive Credit Committee approved the extension of a $50 million revolving credit line to Sunterra. Finova's extension of this additional financing provided the means for Sunterra to continue to make payments to Finova on its already outstanding and delinquent debt, and avoid filing for bankruptcy protection. As a result, Finova became the single largest lender to Sunterra, and the Sunterra credit represented one of the largest loans in Finova's portfolio. Thus, it was clear from the Finova statements and

complaints to all of the defendants long before September 30, 1999, that Sunterra's mortgages receivable portfolio was seriously impaired, yet not one of the defendants made any disclosure of the portfolio's deficiencies to the investing public.

98. After Sunterra declared bankruptcy in May 2000, Finova identified that its own impaired revenue accruing assets increased to $251.4 million "primarily due to the addition of a $95.4 million loan to a Resort Finance customer." Although Finova did not refer to Sunterra by name, it identified the borrower as "a large timeshare developer that has filed for bankruptcy protection under Chapter 11." Later, Finova revealed that non-accruing assets had increased to $421 million, with "the most significant increase during the quarter [ ] in Finova's Resort Finance division due primarily to $117.4 million related to Sunterra Corporation."

99. Eventually, Finova also filed for bankruptcy protection, in large part due to the defaulted Sunterra loans.

100. Still another manipulative and deceptive practice defendants employed to forestall Sunterra's liquidity crisis involved the Club Sunterra and SunOptions point systems that Miller had championed while at RCI. Frey, Giannoni and others, with the knowledge and approval of Gessow, Miller, Kenninger and Goodman, had Sunterra personnel call defaulted Vacation Interval owners to get them to convert their "ownership" interests in a Vacation Interval into what appeared to be a less-expensive and more flexible interest in Vacation Points. However, defendants again failed to record the appropriate adjustments to the mortgages receivable record to reflect such a conversion, to eliminate the previously recognized revenue on the Vacation Interval sale and to record properly the differences in the two sales. Worse, defendants failed to make inventory reserves to enable Vacation Points owners to utilize their Points at resorts during promised periods, thus causing further defaults and customer protests based on dissatisfaction

with the Company's business practices. Defendants utilized these manipulative conversion practices to ostensibly "cure" defaulted receivables while reclaiming inventory that Sunterra desperately needed.

101. The Pending Department - The ostensible purpose of the Sunterra "Pending Department" was to collect on defaulted mortgages receivable, to foreclose on the Vacation Intervals securing the defaulted accounts and to return those receivables as quickly as possible to Sunterra's inventory for resale. In terms of Company cash flow, however, a foreclosed Vacation Interval was actually more expensive to Sunterra than was a defaulted receivable that the Company simply sold to additional buyers one, two or even three additional times. For foreclosed intervals, the Company often did not have the opportunity to recover the substantial marketing costs associated with creating that receivable. In fact, the Company would have to incur those same marketing costs all over again to create another receivable. As a result, Company personnel, including Frey, Giannoni, Gessow and Kenninger made the conscious decision of simply selling over and over again the same Vacation Intervals to different purchasers without ever foreclosing on the defaulted intervals or writing off the defaulted receivables against which the earlier marketing costs had been expensed.

102. As a result of this practice, the Pending Department issued periodic aging reports to Frey, Cohen, Sullivan, Goodman, Dana Myers, Cypress Pointe sales personnel and others, often on a monthly basis, that showed as "performing" many mortgages receivable that were 120, 180, 270 and even 360 days past due. According to former high-ranking members of that department who had direct knowledge of collection activities and other actions related to overdue accounts, the Company did not take active steps to foreclose on these defaulted accounts, and the "Pending Department" was simply the administrator of the "$45 million bad

debt portfolio." Hence, all of the defendants knew of, participated in, and perpetuated the fraud.

103. The Purported St. Maarten Receivables – Yet another deceptive device defendants employed during the Class Period concerned the Company's classification as receivables of over $47 million in lease agreements and related fees Sunterra had purchased as a result of its acquisition of two resorts in St. Maarten. Throughout the Class Period, Sunterra included these leases in its mortgages receivable portfolio and recognized revenues as if the interests were interval ownership interests. In fact, the resorts Sunterra acquired had never established a timeshare homeowners association and had not created a structure for the interval owners to actually own a time interval of the resort itself. Defendants were all aware of this throughout the Class Period because they continually attempted to impose and collect from the St. Maarten customers HOA fees and maintenance expenses despite the consumers' consistent refusal to pay such fees or expenses under their agreements.

104. Notwithstanding the fact that the St. Maarten lessees refused to pay the fees added by Sunterra, Sunterra continually recorded the fees as revenue and receivables on its books.

105. Once again, in connection with the bankruptcy, on May 10, 2002 Sunterra finally disclosed the truth about the St. Maarten resorts. The resorts were not in fact "timeshares" but instead were legally owned by Sunterra and should have been consolidated into the Company's financial reporting. The consumers were long-term lessees, meaning that the receivables previously recognized and the costs expensed against them needed to be reversed. In all, a charge to retained earnings in the amount of $47.3 million was required for 1999, and an increase in net loss by $9.7 million and a decrease in retained earnings by $57 million was required for 2000.

106. According to Sunterra's former Senior Business Manager, who was privy to

information on St. Maarten and knew the level of knowledge of each of the defendants, each of the defendants named herein knew about or recklessly ignored the St. Maarten problem during the Class Period. It was a day-to-day and persistent problem that recurred because those receivables were improperly included in the mortgages receivable portfolio and the uncollected HOA fees were causing multi-year delinquencies.

107. The Mortgages Receivable Securitizations – To finance further growth and improve cashflow, beginning in 1998 Sunterra started to "monetize" its mortgages receivable portfolio by selling or securitizing part of its portfolio. This process required Sunterra to scrutinize its existing mortgages receivable even more closely in order to select those receivables which were "good business," because Sunterra's executives knew that the receivables that would be sold or securitized would be subjected to third-party due diligence and review as part of the sale and securitization process, and because Sunterra would have to make a number of representations and warranties about the quality (i.e. collectibility) of the mortgages receivable portfolio Sunterra was selling or securitizing. As a result of this process, Sunterra's executives also became aware of the quality (i.e. collectibility) of those mortgages receivable that Sunterra was retaining on its own books and records and which it was continuing to use as security for its operating credit lines. Indeed, in early 1999 S.G. Cowen, the placement agent for the securitizations, returned millions of defaulted mortgages receivable to Sunterra, telling defendants that future securitizations would be far more expensive for the Company.

108. As detailed below, Sunterra's executives also recognized that the Company's ability to increase and draw against its operating credit lines was in large part still dependent upon the size and ratio performance (i.e. bad debt experience) of the mortgages receivable portfolio that Sunterra retained and did not sell or securitize. Thus, each of the defendants here

knew, throughout the Class Period, that Sunterra retained millions of dollars of mortgages receivable on its books and records that were "bad business" (i.e. uncollectible), but consciously or recklessly refused to take necessary write-offs of such receivables in order to maintain the illusion of ever-increasing growth by Sunterra, meet stock market expectations, avoid constriction of Sunterra's operating credit lines, and maintain the Company's access to the asset-backed securitization market.

109. According to a former Sunterra employee who worked in the Company's accounting department as a staff accountant during the Class Period, Sunterra generally did not remove canceled or rescinded sales from its books or eliminate the mortgage receivable, making it appear that the Company was expecting more money and had completed more sales than was actually the case.

110. The fraudulent accounting practice, whereby canceled contracts or otherwise uncollectible mortgages receivable were not removed from the books, resulted in a material overstatement of revenue and mortgages receivable during the Class Period.

111. As stated by another Company employee who was responsible for software roll-outs (including software testing and implementation) and training of resort personnel for various phases of resort operations during the Class Period, if a customer upgraded to a "better" week or to a "better" unit, the computer system was supposed to make the change automatically. However, this automated accounting control was systematically bypassed by clerks who were instructed to record upgrade sales as new sales, not upgrades. In this manner, both the original sale and the "new sale" (and their associated mortgages receivable) were reflected at full value, overstating sales revenue and receivables.

112. Additionally, as stated by this employee, if a client upgraded on the Points-Based

System (where a client could use his points in a resort other than where he purchased a unit), the upgrade was reported as an additional new sale (with an added initiation fee).

113. An employee who worked in the Company's Inventory Management Department stated that the Company's EDP system often reflected amounts that were greater than the actual amount owed pursuant to the written agreement. This employee further stated that there existed approximately six hundred sales which were known in 1998 and 1999 to have been incorrectly entered or which otherwise contained discrepancies. Pursuant to instructions from superiors, the incorrect EDP amounts were not fixed. This employee also stated that the same inventory was sold several times because Gessow, Goodman, Frey, Giannoni and others instructed personnel simply to resell defaulted inventory rather than waiting for formal foreclosures.

114. Although various Sunterra press releases, earnings announcements and public filings during the Class Period portrayed the Company's mortgages receivable portfolio as "high quality," and touted "the consistency and predictability of our portfolio performance," defendants all knew or recklessly ignored the fact that the opposite was true. During 1998, the Company was able to sell or securitize a portion of the portfolio, purportedly resulting in cash inflows of $420 million. But these inflows simply funded $351 million in new mortgages receivable created during the year and permitted repayment of interest on existing debt. Unless the remainder of the portfolio could be securitized, and the inventory still pledged for revolving credit facilities, defendants knew that the negative cash flows (of over $50 million) at Sunterra would decimate the Company.

115. Indeed, at the same time Sunterra, through defendants Miller, Goodman, Gessow and Kenninger, was trumpeting its purported "securitization" success, defendants knew, but failed to disclose, that the securitizations had not been the unqualified success they were

portrayed to be and that the remainder of the mortgages receivable portfolio was so deficient and inadequate that it would not support additional, material securitizations or sales.

116. For example, by late 1998 Finova was continually complaining to Sunterra about the defaulted receivables Sunterra was using, and Finova was returning, as pledges for the operating credit lines.

117. In addition, in early 1999, S. G. Cowen returned millions in defaulted receivables that were supposed to secure Sunterra's conduit financing facility. In this connection, S.G. Cowen expressly advised Miller, Goodman, Sullivan and Frey that additional sales or securizations would be far more expensive because Sunterra's portfolio was not as strong as it had been represented to be.

118. Later in that year, the Company attempted to sell or securitize over $100 million in additional receivables to raise essential cash. Sullivan told Miller, Goodman, Gessow, Kenninger and others, though, that she could come up with only $71 million in receivables that would qualify for such a transaction.

119. Due to the negative cash flows resulting from the fact that Sunterra was not receiving payments on practically one-third of its mortgages receivable portfolio, defendants resorted to another fraudulent accounting device and contrivance. For all of the securitizations, they recognized as "profit" estimated funds to be received in the future from purportedly "residual interests" in the sold receivables. This profit was false, however, because it depended upon the artificially low default rate of 4.6% defendants were portraying for the fake Sunterra mortgages receivable portfolio being realized by the sold receivables pool.

120. Hence, defendants falsely portrayed Sunterra's ability to sell and finance a portion of its mortgages receivable portfolio as indicative of the entire portfolio's soundness and worth

when, in fact, they knew or recklessly disregarded that such portrayal was untrue. Not only did external reports from Finova and S.G. Cowen demonstrate these facts, but also internal quarterly reviews and persistent accounting staff reports and comments conclusively warned of these facts. Therefore, each of the defendants knowingly or recklessly participated in and perpetuated the fraud.

121. The Purported Residual Interests on Loans Sold − Another deceptive device defendants used during 1998 and 1999 was to inflate and simply make-up purported "residual interests" in mortgages receivable Sunterra sold. These interests were supposed to reflect the amount Sunterra would eventually receive once the promised returns were obtained by the buyers of the mortgages receivable Sunterra sold. According to accounting and business management personnel in Sunterra's Orlando and Las Vegas offices, Frey, Cohen, Goodman, Miller, Gessow and Kenninger were instrumental in determining these purported "interests."

122. These defendants, however, manipulated and inflated the model used to calculate such interests. What is more, they utilized performance (delinquency) assumptions they knew to be false, because not all of the mortgages receivable included to derive those assumptions were being aged properly or were being treated as delinquent. As a result, over $5.5 million for 1998, over $5 million for 1999, and over $14.6 million for 2000 had to be written-off due to inflated "residual interests."

123. Worse, for 1999, over $1.4 million in a "residual interest" recorded for that year was simply "unsupported," meaning that the entry was wholly made-up by the defendants.

124. The Inventory Manipulations And Fraud − The practice of recording multiple sales of the same inventory and of permitting known erroneous data to be reflected in the Company's books and records also served to inflate materially the Company's revenues and

mortgages receivable during the Class Period.

125. An employee who was responsible for the New Business group during the Class Period confirmed the fact that the same inventory was sold multiple times. For example, at the Royal Dunes Resort, this employee found 30 weeks that had been sold more than once.

126. According to a former Senior Vice President of the Company, during the Class Period, Sunterra engaged in accounting manipulations in an effort to "pump up" its numbers for Wall Street.

127. The fraudulent pumping up of the Company's numbers involved not only the initial recordation of fictitious sales and receivables, but it also involved the continuing recordation of fictitious income. In this regard, Giannoni, Cohen, Frey, Goodman, Gessow and Kenninger caused the Company to record, on a monthly basis, interest income on phantom mortgages receivable and mortgages receivable which were otherwise uncollectible (through the monthly recordation of accrued interest receivable which defendants never expected to be collected and which was, in fact, never collected) and related homeowners' association fee income (through the monthly recordation of accrued fees receivable which defendants also never expected to be collected and which was, in fact, never collected).

128. Another former employee, who worked in the Company's accounting department as a staff accountant during the Class Period, stated there was a pervasive failure to complete sales documents and maintain working files. Some Sunterra employees "threw contract folders in boxes" after the initial sale was made even though none of the final paperwork had been completed. Others failed to record "modifications."

129. According to this employee, the system was so bad (and intentionally so) that the Company could not even locate documents. In one instance, a search led, in early 1999, to the

discovery of approximately 100 on the document.

130. Another employee who served as a Sunterra Executive Vice President during the Class Period confirmed this fact. As stated by this employee, Sunterra frequently could not locate documents when a customer called with a question. Additionally, an employee who worked in the Company's Inventory boxes of sales documents in Arizona and additional boxes in Las Vegas.

131. Another employee stated that someone went to the Bellevue, Washington contract center in mid-1999 and found boxes of sales documents that were incomplete. This employee stated that the documents had been recorded as "good business" (a valid sale) but were not signed or had "the wrong inventory" entered Management department (reporting to Giannoni and Frey) said that there was a problem locating documents, and another employee who served in the New Business group during the Class Period noted that many sales documents were not priced or processed properly.

132. According to the Company's Business Manager for Construction and Inventory, during the Class Period, some customers who signed contracts never received their payment coupon books, so their contracts were not serviced properly.

133. By July 1999, the problems with double and triple-booked inventory and undocumented sales became so dramatic that the defendants without doubt consciously ignored and failed to disclose them. For example, on the July 4th holiday, so many "owners" showed-up for double and triple-booked rooms at the Company's Cypress Pointe resort that the Sheriff had to be called to break-up disputes and threatened assaults. One of the Company's Senior Business Managers eventually arranged for alternative lodgings for the disgruntled owners. However, when he reported the problems to more senior managers including Frey, Giannoni and Goodman,

Frey told him to "stay out of it." Likewise, when a Vice President of sales and marketing whose department was involved in the undocumented and unserviced mortgages receivable attempted to call a meeting to address the subject of undocumented and unserviced mortgages receivable, he too was told by Frey, Giannoni and Goodman "to mind his own business."

134. A similar problem occurred at about the same time at Sunterra's Savoy resort in Miami. Again, authorities had to be called to break-up the confrontations resulting from the double and triple-booking. Because inventory was critical to Sunterra's efforts to secure and maintain financing, it was in defendants' interests not to reduce "available" inventory figures. Thus, Frey, Giannoni and others instructed personnel not to writedown inventory.

135. While Goodman, Frey, Giannoni, Miller and others at times blamed the fraudulent inflation of inventory on Sunterra's failed "SWORD" system, in fact it stemmed from the observations of Goodman and others at earlier quarterly review meetings (in May) that Sunterra actually lacked sufficient saleable inventory to meet its existing revenue projections. In several instances, IT administrators were told not to correct the database information. Moreover, these confrontations at various Sunterra resorts were so well-known throughout the Company that each defendant certainly knew of the problems yet failed to disclose to the investing public or to creditors any inventory control issues or the misstatements of inventory and sales. Indeed, each consciously and recklessly decided to put-off any "balance sheet" review until forced to do so by Airtours.

136. All of these breakdowns and deficiencies in fundamental internal controls were known to or recklessly disregarded by the defendants. Numerous memos and emails were sent to **and written by** senior accounting and management personnel during the Class Period, including Frey, Giannoni, Goodman, Miller, Cohen and Sullivan describing the internal control

problems, the breakdowns in automated reporting systems, the failures of Sunterra's attempted centralization system, known as the "SWORD System," the improper recordation of revenue and assets from regional and local sales offices, and the absence of proper document retention, filing and retrieval systems.

137. **For example, as alleged in the Gessow Complaint, ¶ 127, Chuck Frey wrote various memos acknowledging that the audit trail was weak and that certain accounting systems of some of the companies they bought were in complete disarray. In an informal memo to Depatia on February 27, 1998 entitled "1997 Audit Report Response," Frey took a defensive stance and admitted that the accounting systems of one of its acquired companies were in "complete disarray" and were "traditionally three to six months behind," and also admitted that Signature's integration of another acquired company's accounting systems did not stabilize for months after its acquisition by Signature.**

138. **Approximately one month later, after apparently being advised by Depatie to be more "offensive and in control," Frey wrote another memo to Depatie dated March 24, 1998 entitled "Audit Report Response." In this memo, Frey, among other things:**

a. **acknowledged the need for consolidation of the resorts' financial information;**

b. **acknowledged the different month-end closing procedures at the various resorts, which were left to the "discretion of the Divisional Controllers";**

c. **acknowledged that during the interval upgrade sales process, no documentation is placed into the purchaser's file to substantiate the amount of equity invested in the interval, and that an audit is not**

available for reviews that may take place; and

d. **acknowledged the need to centralize databases.**

Gessow Complaint, ¶ 128.

139. Despite the above-noted information, defendants continued throughout the Class Period to report bad debt ratios and assets as if all internal controls were properly working when, in fact, they were not. Defendants knew, or recklessly ignored, that they had no reasonable basis for reporting the receivables balances, the allowance for doubtful account figures, the bad debt ratios and the net worth of Sunterra that they, in fact, reported during the Class Period. They certainly had no basis for stating as they had in SEC filings and countless obvious reasons not to so represent -- that "all adjustments considered necessary for a fair presentation" had been made.

140. These internal control deficiencies and breakdowns predominantly affected the mortgages receivable accounts of those mortgages Sunterra retained on its own books and to which Sunterra was directly exposed to a risk of loss. Defendants knew that a material change in the Company's allowance for doubtful accounts or a material increase in its non-performing receivables would constrict Sunterra's operating credit lines and possibly cause the Company to violate various debt covenants and performance ratios, including net worth ratios, applicable to those credit lines. Thus, defendants consciously and recklessly failed to take corrective action and to write off non-performing receivables to avoid the almost certain constriction of Sunterra's credit sources, which in fact happened almost immediately after the close of the Class Period and resulted in Sunterra's bankruptcy filing shortly thereafter.

141. This was confirmed by one of the former senior accountants for Sunterra's Latin America properties, who reported numerous internal control breakdowns and deficiencies to senior management without any meaningful response. This former employee also explained that

in the third quarter of 1999, Airtours Group, Plc conducted due diligence at Sunterra in connection with a possible acquisition of Sunterra by Airtours. During that due diligence, Airtours, whose auditor was also Arthur Andersen, LLP, discovered that Sunterra was reflecting as performing mortgages receivable over $45 million in non-performing mortgages receivable. As a result, Airtours decided not to make an offer for Sunterra.

142. Another former employee, who described his job as "portfolio manager for the $45 million in non-performing receivables," confirmed this fact as well. This employee stated that senior management at Sunterra was well aware that Sunterra was reporting as current receivables at least $45 million in assets that were, in fact, non-performing receivables. In fact, the Pending Department's own reports, which were copied to Frey, Cohen, Sullivan and Goodman, showed this fact.

143. Among the specific reports each of the defendants received concerning the inventory and mortgages receivable problems were the "Quarterly Review" meetings defendants attended in May, August and October and the "Budget" meetings held in or around July 1999. Among the attendees at such meetings were Gessow, Kenninger (or his assistant Dave Phillips), Miller, Goodman, Frey (and his assistant Jim Johnson), Sullivan, Giannoni, Cohen, the COO, several Vice Presidents, the controllers, and high-ranking employees in accounting, business management, customer service, portfolio management and sales and marketing. During these meetings, the double-bookings of Intervals, the misstated mortgages receivable and the impending liquidity crisis were central to the discussions.

144. At one such "nasty" meeting in August, Goodman "chewed-out" Cohen because her inventory and receivable figures were grossly overstated. A regional controller pointed out the disparity between her consolidated reports and the reports from each of the resorts.

Nonetheless, the defendants then issued third-quarter consolidated financial reports that utilized false figures prepared by Sullivan, Cohen, Frey and Giannoni and expressly approved and communicated by Gessow, Kenninger, Miller and Goodman. That report trumpeted bogus "record" results and falsely stated that "all adjustments considered necessary for a fair presentation" had been made, which defendants all knew to be untrue.

145. In another instance, a regional sales manager refused during the July 1999 budget meeting, to base his region's 2000 performance goals on the inflated consolidated figures. He insisted instead that they would meet budgeted goals based on the lower "resort" figures, not on the inflated publicly reported ones.

146. By October 1999, the liquidity crisis had become so acute that Sunterra had to cajole Finova into an increase of $50 million in the operating line just so Sunterra could repay portions of the line that had been backed by pledges of bad receivables. Gessow, Miller, Goodman, Frey and Sullivan were directly involved in negotiating this increase from Finova. Indeed, although it was undisclosed to the investing public, they told Finova that Sunterra would have to file for bankruptcy if the credit line were not extended.

147. <u>The Improper Capitalizations To Inventory</u> – Yet another manipulative and deceptive device defendants used involved improper capitalizations to inventory of HOA maintenance fees, taxes, interest on the fees and foreclosure costs.

148. Giannoni was primarily responsible for overseeing the HOA aspect of the consolidated resort operations. In this regard, the Company would add to the booked value of its Vacation Interval inventories the amounts it expected to charge and collect for HOA maintenance fees, taxes and interest charged on those fees. By capitalizing these fees, rather than expensing them, the Company was able to inflate the value of its inventory while avoiding

recognition of increased costs and expenses to maintain that inventory. This, of course, allowed the Company to secure additional financing based on the inflated values of the inventory.

149. Similarly, the Company capitalized foreclosure costs by adding those expenses to the inventory values of the foreclosed Vacation Intervals.

150. In connection with the bankruptcy, Sunterra once again finally came clean. On May 10, 2002, the Company revealed that over $29.3 million in improperly capitalized fees and taxes had to be written-off to reduce retained earnings for 1999. In addition, other adjustments resulted in a total reduction to retained earnings of $57.4 million. With respect to "foreclosure costs," 1999 retained earnings were reduced by another $.8 million.

151. The capitalization of these expenses violated GAAP during the Class Period and, once again, demonstrates that defendants did anything and everything to portray falsely Sunterra as enjoying sequential quarterly growth, which was a lie.

152. The Undisclosed Violation of the Company's Percentage-of-Completion Basis For Revenue Recognition – Still another area in which Giannoni, Frey, Cohen, Goodman and Gessow orchestrated the fraud concerned revenue recognition.

153. For sales in the rescission period and for deferred sales pending completion of the resort development, Sunterra deferred marketing costs purportedly associated with such sales. As a result, the Company was able to report far lower costs while recognizing revenues based on the sales or based on the percentage of the sale deemed "completed."

154. Once again, this misrepresentation was finally exposed and reversed in connection with Sunterra's bankruptcy reorganization, resulting in a charge to retained earnings of $2.9 million for 1999.

155. The Improper Capitalization of System and Software Costs. – For 1999 and prior

periods, defendants also capitalized and depreciated computer and software costs that were noncapitalizable. After netting out the depreciation expense, defendants improperly inflated retained earnings by $2.4 million. Once again, this was reversed only by virtue of the bankruptcy review and reorganization.

156. Senior business and accounting personnel who attended the "Quarterly Review" and budget meetings in May, July and August 1999 have stated that Frey told the attendees that "we would come up with something to make the numbers." As demonstrated by the foregoing, each of the defendants, directly or indirectly, came up with fraudulent accounting entries, tricks and devices "to make the numbers."

FRAUDULENT ACCOUNTING DEVICES DEFENDANTS EMPLOYED THROUGHOUT THE CLASS PERIOD

157. As the foregoing details prove, defendants caused the Company's financial statements to improperly reflect the recognition of revenues and the overstatement of inventory and mortgages receivable, through the practice of recording:

a. Wholly fictitious sales by recognizing unexecuted sales documents as "good business" (a valid sale).

b. Upgrades as a new sale, at the full sales price, without offsetting this sales revenue to the extent of the prior revenue which had been recognized.

c. Rescinded sales agreements as sales.

d. Wholly fictitious revenue by causing the Company's books and records to reflect sales and receivable amounts that were greater than the actual amount owed pursuant to the written agreement.

e. Multiple sales of the same inventory.

f. Accrued interest on phantom mortgages receivable and on mortgages receivable which were otherwise clearly uncollectible.

g. Accrued homeowner fees in connection with phantom mortgages receivable and on mortgages receivable which were otherwise clearly uncollectible.

158. The recognition of revenues through the recordation of: (i) wholly fictitious sales; (2) unexecuted sales as valid sales; (iii) upgrades as a new sale at a full sales price; (iv) sales upon rescission of "preliminary" sales by customers; (v) sales and receivable amounts that were greater than the actual amount owed pursuant to the written contract; (vi) multiple sales of the same inventory; and (vii) accrued interest and fee income when such accruals were clearly not collectible, constituted a fraudulent and flagrant violation of the following GAAP:

a. Profit is deemed to be realized when a sale in the ordinary course of business is effected (Chapter 1A of Accounting Research Bulletin No. 43, paragraph 1).

b. Revenue should ordinarily be accounted for at the time a transaction is completed, with appropriate provision for uncollectible accounts (Accounting Principles Board Opinion No. 10, paragraph 12).

c. It is generally accepted that accumulated allowances and asset valuation allowances for losses such as those on receivables should be deducted from the assets to which they relate (Accounting Principles Board Opinion No. 12, paragraph 2).

d. Revenues and gains generally are not recognized until realized or realizable, and revenues are considered to have been earned when the entity has substantially accomplished what it must do to be entitled to the benefits represented by the revenues (Statement of Financial Accounting Concepts No. 5, paragraph 83).

e. The quality of reliability and, in particular, of representational faithfulness leaves no room for accounting representations that subordinate substance to form (Statement of Financial Accounting Concepts No. 2, paragraph 160).

159. Throughout the Class Period, defendants also caused the Company's financial statements to fail to reflect impairments in assets, through charges against income, as required by GAAP. In this regard, defendants caused the Company to improperly carry uncollectible

mortgages receivable, mortgage-related receivables, and other worthless assets at grossly inflated amounts in contravention of GAAP.

160. Pursuant to GAAP (FASB Statement No. 5, par. 3), an estimated loss from a loss contingency shall be accrued by a charge to income if both of the following conditions are met:

> (1) Information available prior to issuance of the financial statements indicated that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements.
> (2) The amount of the loss can be reasonably estimated.

161. Both of these conditions were satisfied prior to issuance of the September 30, 1998, December 31, 1998, March 31, 1999, June 30, 1999 and September 30, 1999 financial statements with regard to the Company's mortgages receivable, interest accrued thereon, and fees associated therewith as particularized above. However, defendants failed to cause the Company's financial statements to reflect accruals, by charges to income, in an amount even remotely close to being sufficient to reflect the above particularized impairments.

162. Instead, during the Class Period, defendants knowingly permitted the Company's financial statements to reflect as valuable assets over $100 million of fictitious or otherwise clearly uncollectible mortgages receivable, over $10 million of interest thereon, over $11 million of uncollectible homeowners' association receivables related largely to these fictitious or otherwise clearly uncollectible mortgages receivable, and uncollectible receivables from a marketing company in the sum of more than $4 million.

163. GAAP, as particularized above, mandates the recognition of a provision for non-collectible receivables and an associated allowance.

164. The GAAP requirement for recognition of a provision for non-collectible receivables and an associated allowance also applies to interim financial statements as evidenced by Accounting Principles Board Opinion No. 28. This authoritative pronouncement states (in

paragraph 17) that:

> The amounts of certain costs and expenses are frequently subjected to year-end adjustments even though they can be reasonably approximated at interim dates. To the extent possible such adjustments should be estimated and the estimated costs and expenses assigned to interim periods so that the interim periods bear a reasonable portion of the anticipated annual amount. Examples of such items include...allowance for uncollectible accounts... The objective of providing for reserves against receivables is to assure that: "Accounts receivable net of allowances for uncollectible accounts...are effectively stated as the amount of cash estimated as realizable." (Accounting Research Bulletin 43, Chapter 3, Section A, paragraph 9).

165. Throughout the Class Period, the amount of the Company's mortgage and mortgage-related receivables, which were purported to be effectively stated as the amount of cash estimated as realizable, were materially overstated.

166. Accordingly, the Company's September 30, 1998 financial statements, December 31, 1998 financial statements, March 31, 1999 financial statements, June 30, 1999 financial statements, and September 30, 1999 financial statements were not prepared in conformity with GAAP and were materially misleading, as was each and every Company press release disseminated to the investing public during the Class Period, which likewise repeated the materially false and misleading results of operations and financial position which was presented within these financial statements.

IMPAIRMENT OF LONG - LIVED ASSETS

167. GAAP (FASB Statement No. 121, Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of), states that:

> An entity shall review long-lived assets and certain identifiable intangibles to be held and used for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. The following are examples of events or changes in circumstances that indicate that the recoverability of the carrying amount of an asset should be assessed:

a. A significant decrease in the market value of an asset.

b. A significant change in the extent or manner in which an asset is used or a significant physical change in an asset.

c. A significant adverse change in legal factors or in the business climate that could affect the value of an asset or an adverse action or assessment by a regulator.

d. An accumulation of costs significantly in excess of the amount originally expected to acquire or construct an asset.

e. A current period operating or cash flow loss combined with a history of operating or cash flow losses or a projection or forecast that demonstrates continuing losses associated with an asset used for the purpose of producing revenue.

> If the examples of events or changes in circumstances set forth [above] represent or if other events or changes in circumstances indicate that the carrying amount of an asset that an entity expects to hold and use may not be recoverable, the entity shall estimate the future cash flows expected to result from the use of the asset and its eventual disposition. Future cash flows are the future cash inflows expected to be generated by an asset less the future cash outflows expected to be necessary to obtain those inflows. If the sum of the expected future cash flows (undiscounted and without interest charges) is less than the carrying amount of the asset, the entity shall recognize an impairment loss in accordance with this Statement.

168. Defendants were aware of this principle as evidenced by the fact that the Company's 1997 Form 10-K stated:

> In March 1995, the Financial Accounting Standards Board issued SFAS No. 121, Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of (SFAS 121), which requires impairment losses to be recorded on long-lived assets used in operations when indicators of impairment are present and the undiscounted cash flows estimated to be generated by those assets are less than the assets' carrying amount. SFAS 121 also addresses the accounting for the expected disposition of long-lived assets. The Company adopted SFAS 121 during the year ended December 31, 1996. The impact of adopting SFAS 121 was to reduce net income by $2.6 million in 1996 and has been recorded as a resort property valuation allowance to reduce real estate and development costs. During 1997, there was no change in the resort property valuation allowance.

169. Defendants evidenced their ongoing awareness of the requirements of FASB Statement No. 121, by causing the Company's 1998 Form 10-K to state that: "During 1998 and 1997 there was no change in the resort property valuation allowance."

170. As stated above, in January 2000 the Company announced material charges to earnings which, as later revealed, included a $16.7 million charge to write down the carrying value of properties to be marketed to prospective buyers. With respect to this $16.7 million charge, the 1999 Form 10-K stated:

> In 1999, the Company classified certain non-core properties as assets held for sale. In accordance with SFAS No. 121, Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed of, the Company recorded a $16.7 million write-down associated with these properties in the fourth quarter of 1999. The carrying value of these assets was written down to the estimated net realizable value based in part on offers from prospective third party buyers of these properties less related sales costs.

171. These referenced properties were materially impaired and their carrying values were non-recoverable, by no less than $16.7 million, at the beginning of the Class Period. In contravention of GAAP, and the Company's own stated accounting policies, the recognition of an impairment loss was improperly deferred from the beginning of the Class Period to the fourth quarter of 1999. Consequently, the financial statements, which were disseminated to the investing public during the Class Period, and the Company press releases which referred to them, were materially false and misleading.

172. Defendants were required to cause the Company to disclose, in its financial statements, the existence of the material facts described herein and to appropriately recognize and report revenues and expenses in conformity with GAAP. Defendants failed to cause the Company to make such disclosures and to account for and to report expenses in conformity with

GAAP.

173. Due to the pervasive mosaic of non-disclosures, deceptive disclosures, and violations of GAAP, the Forms 10-K and 10-Q (and the financial statements contained therein) which defendants caused the Company to file with the SEC during the Class Period were materially false and misleading. In fact, defendants' fraud inflated the Company's retained earnings for 1999 and prior periods by over 163%, inflated stockholder's' equity by over 50%; inflated revenue by over 40%; inflated mortgages receivable by over 25%; and inflated interest income by over 37%.

174. Defendants knew and concealed, or recklessly ignored, the facts which indicated that the Company's September 30, 1998 financial statements, December 31, 1998 financial statements, March 31, 1999 financial statements, June 30, 1999 financial statements, and September 30, 1999 financial statements, press releases, public statements, and filings with the SEC which were disseminated to the investing public during the Class Period, were materially false and misleading for the reasons set forth above.

DEFENDANTS' FALSE AND MISLEADING STATEMENTS
<u>DURING THE CLASS PERIOD</u>

175. Prior to the beginning of the Class Period, Sunterra represented in its 1997 Form 10-K filed with the SEC on or about March 30, 1998 ("the 1997 Form 10-K") 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.
>
> * * * * *
>
> The Company had completed or commenced foreclosure or deed-in-lieu of foreclosure (which is typically commenced once a scheduled payment is

> more than 120 days past due) on an additional approximately 2.2% of its consumer loans.

176. The above representations also appeared in the Company's May 14, 1998 filing, made pursuant to Rule 424(b)(3) under the Securities Act of 1933, in connection with Registration No. 333-51803.

177. At no time during the Class Period did Sunterra disclose that it had in any way altered this significant accounting practice for writing off non-performing mortgages receivable. Indeed, it is standard accounting practice to write-off such mortgages receivable where they are delinquent for more than 120 days. As detailed below, however, at some point during the Class Period, Sunterra did, in fact, secretly alter this accounting practice without ever disclosing the change, in either the notes to its financial statements or in the Management Discussion and Analysis ("MD&A") sections of its periodic reports and filings with the SEC. This material omission rendered each of those filings materially false and misleading, because the periodic filings falsely compared then-current results to prior-period results without ever disclosing that the two comparisons were materially affected by the undisclosed change in accounting practice and principles.

178. SEC Rule 13a-13 requires issuers to file periodic reports. SEC Rule 12b-20 requires that periodic reports contain such further information as is necessary to make the required statements, in light of the circumstances under which they are made, not misleading. In addition, Item 303 of Regulation S-K requires that, for interim periods, the MD&A must include, among other things, a discussion of any material changes in the registrant's results of operations with respect to the most recent fiscal year-to-date period for which an income statement is provided. Instructions to Item 303 require that this discussion identify any significant elements of the registrant's income or loss from continuing operations that do not arise from or are not

necessarily representative of the registrant's ongoing business.

179. Item 303(a)(ii) to Regulation S-K requires the following discussion in the MD&A of a company's publicly-filed reports with the SEC:

> Describe any known trends or uncertainties that have had or that the registrant reasonably expects will have a material favorable or unfavorable impact on net sales or revenues or income from continuing operations. If the registrant knows of events that will cause a material change in the relationship between costs and revenues (such as known future increases in costs of labor or materials or price increases or inventory adjustments), the change in relationship shall be disclosed.

180. Paragraph 3 of the Instructions to Item 303 states in relevant part:

> The discussion and analysis shall focus specifically on material events and uncertainties known to management that would cause reported financial information not to be necessarily indicative of future operating results or of future financial condition. This would include descriptions and amounts of (A) matters that would have an impact on future operations and have not had an impact in the past . . .

181. Throughout the Class Period, defendants failed to disclose, in the quarterly MD&A's, negative, adverse trends known to them (e.g., lack of internal controls over accounting for inventory and mortgages receivable that had and would have had a material impact on future operations and the financial condition of the Company; insufficient actual inventory for sale; and inadequate sources of liquidity to continue as a "going concern").

182. Further, throughout the Class Period, defendants failed to comply with APB Opinion No. 28 in that, as particularized herein, each of the Company's interim financial statements, which was disseminated to the investing public, failed "to provide commentary relating to the effects of significant events upon the interim financial results."

183. The Class Period commences on October 6, 1998. On that date, Sunterra announced that it had completed the sale of $32.8 million of mortgages receivable for $33.4 million in cash, or 102% of face value, in two transactions. The Company further reported that it

used the proceeds of the sale to repay $17.5 million of debt secured by these receivables and added $15.9 million in cash to the Company's assets. Falsely characterizing its entire portfolio of receivables as "high quality," the Company included the following statement:

> "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," said Steve Miller, Sunterra's President and CEO. "Our average borrower is 49 and has household income of over $70,000 per year. Our delinquency experience has been remarkably consistent over the past eight quarters, ranging from 4.3% to 4.7%. Likewise, our default experience is very consistent, ranging from 2.0% to 2.3% over the same period. The demonstrated ability to monetize our mortgages receivable portfolio provides Sunterra with a ready and reliable source of low cost capital and the resulting financial flexibility to support our operations and expansion plans," concluded Miller. [Emphasis added.]

184. In the same press release, the Company maintained that its allowance for doubtful accounts as a percentage of gross mortgages receivable was 6.3%, unchanged from the quarter ended June 30, 1998, and further misrepresented that:

> Delinquent consumer loans at September 30, 1998 were 4.4% as a percentage of gross mortgages receivable, down from 4.5% at September 30, 1997 and up from 4.2% at June 30, 1998. Consumer loans are considered delinquent if scheduled payments are more than 60 days past due. In addition, the Company had commenced deed-in-lieu of foreclosure or foreclosure proceedings on 2.5% of its consumer loans as of September 30, 1998, as compared to 2.4% as of June 30, 1998.

185. On November 4, 1998, the Company announced "record" results for the third quarter ended September 30, 1998. The press release stated in pertinent part:

> "For the ninth consecutive quarter since going public, we have delivered record year over year performances in revenues, net income and earnings per share,'' said Miller. "Our strong third quarter results reflect 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."
>
> * * * * *
>
> At September 30, 1998, gross mortgages receivable were $413.0 million, up from $397.7 million at June 30, 1998. The Company's allowance for

> doubtful accounts as a percentage of gross mortgages receivable was 6.3%, unchanged from the quarter ended June 30, 1998.
>
> Delinquent consumer loans at September 30, 1998 were 4.4% as a percentage of gross mortgages receivable, down from 4.5% at September 30, 1997 and up from 4.2% at June 30, 1998. Consumer loans are considered delinquent if scheduled payments are more than 60 days past due. In addition, the Company had commenced deed-in-lieu of foreclosure or foreclosure proceedings on 2.5% of its consumer loans as of September 30, 1998, as compared to 2.4% as of June 30, 1998.

186. In response to the Company's announcement of "record" financial performance and the "high quality" of Sunterra's customer base and portfolio, Sunterra common stock soared from $6 per share on October 5, 1998, to $13.50 per share on November 17, 1998, after the Company filed its third quarter 1998 Form 10-Q.

187. On November 16, 1998, defendants caused the Company to repeat its financial results for the third quarter of fiscal year 1998, the quarterly period ended September 30, 1998, in a Form 10-Q filed with the SEC ("the September 30, 1998 Form 10-Q"). The Company again reported "record financial performance," including: revenues of $127.1 million, a 35% increase from the third quarter of 1997; $14.2 million in interest income, a 23% increase from the third quarter of 1997; an increase in other income of 204% from the previous year; an increase in net income of 44% to $14.3 million from $9.9 million in the third quarter of 1997; and EBITDA (Earnings before interest, taxes, depreciation, and amortization) for the third quarter increased 58% to $41.1 million from EBITDA of $26.1 million for the third quarter of 1997.

188. A management representation contained within this Form 10-Q stated with respect to these financial statements:

> In the opinion of management, all adjustments considered necessary for a fair presentation have been included and are of a normal recurring nature...

The September 30, 1998 Form 10-Q also represented:

The provision for doubtful accounts increased $1.0 million to $3.3 million during the third quarter of 1998, from $2.3 million in the third quarter of 1997. As a percentage of total revenues, the provision for doubtful accounts was 2.6% for the third quarter of 1998, compared with 2.4% for the third quarter of 1997.

The allowance for doubtful accounts as a percentage of gross mortgages receivable remained at 6.3% at September 30, 1998, unchanged from June 30, 1998, and down from 6.5% at September 30, 1997. As of September 30, 1998, approximately 4.4% of the Company's consumer loans were delinquent (scheduled payment past due by 60 days or more), compared with 4.2% at June 30, 1998, and 4.5% at September 30, 1997. In addition, the Company had commenced deed-in-lieu of foreclosure action on approximately 2.5% of its consumer loans as of September 30, 1998, compared with 2.4% at June 30, 1998, and 2.1% at September 30, 1997.

* * * *

The provision for doubtful accounts increased $3.4 million to $9.4 million for the first nine months of 1998 from $6.0 million in the first nine months of 1997. As a percentage of total revenues, the provision for doubtful accounts was 2.9% for the first nine months of 1998, compared with 2.4% in the first nine months of 1997. The increase in the provision as a percentage of revenues, as compared with the prior period, is related primarily to the Company's internal review of the aging and collectability of accrued interest at certain of its properties during the second quarter of 1998.

* * * * *

The Company has a number of alternatives to raise cash from its mortgages receivable portfolio. For example, the Company may sell mortgages receivable for cash, as the Company recently did with its sales of $101.9 million in receivables in the third quarter of 1998; originate them for a third party financial institution, and receive a fee, which the Company does in its European operations; convert them into cash through securitizations such as that recently completed by the Company in the second quarter of 1998; pledge them against its bank credit facility; or pursue other alternatives.

When the Company draws on various credit facilities to meet its operating cash outlays, the Company borrows against or otherwise pledges its mortgages receivable. Such facilities enable the Company to generate positive cash flows from financed sales. The Company repays its credit facilities through cash flows from operations, the sale of mortgages receivable, the principal and interest payment stream on its mortgages receivable portfolio, or proceeds from the issuance of pass-through mortgage-backed securities in which the Company sells certain mortgages

receivable and their related principal and interest payments.

* * * * *

> As of September 30, 1998, the Company had approximately $68.0 million of additional borrowing capacity available under the Senior Credit Facility at rates ranging from LIBOR plus 7/8% to LIBOR plus 1 3/8%. The Company also had approximately $89 million of additional borrowing capacity under its hypothecated debt lines at prime plus 2%. These hypothecated lines expire between October 1998 and April 1999. As of September 30, 1998, excluding the Senior Credit Facility and the Securitization, the Company had $45.5 million outstanding under its notes payable collateralized by mortgages receivable and $5.2 million outstanding under its notes payable collateralized by unsold Vacation Ownership Interest inventory or other assets. Additionally, the Company had approximately $200 million of mortgages receivable which were unpledged to any financial institutions and which could be sold or pledged to raise additional cash as needed.
>
> The Company believes that, with respect to its current operations, the Senior Credit Facility and borrowing capacity under certain third-party lending agreements, together with cash on hand and cash generated from operations, future borrowings, or the sale of receivables, will be sufficient to meet the Company's working capital and capital expenditure needs for the next twelve months.

189. The October 6, 1998 release, the November 4, 1998 earnings release and the September 30, 1998 Form 10-Q, were materially false and misleading because the financial statements and financial performance reflected in all three were materially overstated and not in conformity with GAAP. In particular, Sunterra's performing mortgages receivable were materially overstated, its allowance for doubtful accounts was materially understated, its reported revenues were materially overstated because they included sums recognized on non-performing and non-existent mortgages receivable and non-existent fee revenues, and its bad debt expense was materially understated. In addition, the Form 10-Q was materially false and misleading because it represented that all appropriate "adjustments" were made in compliance with GAAP when, in fact, they were not. The Form 10-Q was also materially false and

misleading because it represented that the Company had adequate sources of liquidity and even had over $200 million in unpledged mortgages receivable which could be used to obtain additional financing when, in fact, a material portion of the pledged and unpledged receivables were uncollectible. The Form 10-Q was also materially false and misleading for omitting to disclose that Sunterra had changed its accounting practice and policies with respect to non-performing, delinquent mortgages receivable, and for failing to disclose the known, adverse trend and development that was certain to have a material impact on future financial performance, namely the absence of effective internal controls.

190. The information included in these reports and releases was known to be false and materially misleading by at least the following: Gessow, Kenninger, Frey, Giannoni, Cohen and Sullivan. Each of these defendants knew or recklessly disregarded that the statements were false because they had received reports, agings and complaints from internal staff members, including high-ranking employees in accounting, business management, customer service, portfolio management, sales & marketing and the Pending Department, and from third parties such as Finova and S.G. Cowen. These reports, agings and complaints alerted each of the defendants at, or prior to, the time the above information was disseminated to the investing public, to the fact that such information was materially false and misleading. Indeed, because each of these defendants had been long-time participants in the various schemes to inflate falsely Sunterra's mortgages receivable and inventory, they were well aware of and actually accomplished the fraud by themselves making "consolidating adjustments." Before the November 1998 release of "record" results for the third quarter, Miller had received but recklessly ignored, aging information from Finova and budget reports calling into doubt the accuracy of Sunterra's public financial statements. Hence, he too recklessly ignored the fraud.

191. On February 10, 1999, the Company released its financial results for the three months and year-ended December 31, 1998. Fourth quarter 1998 net income was reported to have increased by 26.5% to a record $12.9 million, or $0.35 per diluted share, compared with recurring net income of $10.2 million or $0.28 per diluted share in the fourth quarter of 1997.

192. Commenting on the results, defendant Miller stated that:

> Sunterra's record fourth quarter sales and earnings performance marks our tenth consecutive quarter of increasing value for our shareholders since the Company went public in August, 1996....
>
> During 1998, we made significant progress in our strategy to convert our mortgages receivable into cash, reduce our leverage and also reduce the risk of portfolio default - and we expect to continue on this path in 1999. We accomplished this through a series of mortgages receivable sales, a securitization and a conduit transaction that generated combined cash inflows of $420 million; this cash allowed us to not only to fund the nearly $351 in mortgages receivable originated/acquired during the year, but also to refinance approximately $69 million in debt at significantly lower interest rates. As a result, our net mortgages receivable increased only 1% during the year, to $336.0 million at year-end 1998, despite a 28% increase in interval point sales over the same period.

193. For the year ended December 31, 1998, the Company reported total revenues of $450 million, a 33.3% increase over the prior year. This release was materially false and misleading for the reasons identified above in paragraph 164.

194. Defendants Gessow, Kenninger, Frey, Giannoni, Cohen and Sullivan oversaw and actually made the "consolidating adjustments" that resulted in these false statements. As noted, Cohen first combined the figures from the two-sets of books, and Frey, Giannoni and Sullivan, with the knowledge and approval of Gessow and Kenninger, then made additional changes to the figures, knowing that the percentages failed to reflect defaulted receivables at the Orange Blossom Trail data base. Moreover, by this time, Goodman and Miller had been told by Jeanne Qualls and Layne Marchiselli that the mortgages receivable data bases were unreliable and

deficient. Thus, all the defendants actually knew or recklessly disregarded the fraud.

195. On or about March 31, 1999, defendants caused the Company to file its 1998 Report on Form 10-K with the SEC ("the 1998 Form 10-K"). This document, which was signed by defendants Goodman, Miller, Gessow, and Kenninger, stated that:

> On December 31, 1998, the Company sold $79.0 million of Mortgages Receivables...at 95% of face value, without recourse. The Company then retains 100% of the excess spread over the commercial paper rate plus 0.60%.
>
> The Company recognized a gain on the sale of mortgages receivable of $5.6 million, net of expenses, as a result of the $79.0 million sale and a retained interest held for sale in these mortgages receivable of $11.3 million...
>
> During 1998, the Company also sold $101.9 million of gross mortgages receivable for $99.7 million in cash in three separate transactions. As a result of these sales, the Company recorded a $1.1 million gain on the sale of mortgages receivable and a retained interest of $1.3 million. The Company sold these receivables at prices from 96% to 105% of par value with a participation in the remaining interest of 0% to 65%.

196. As of December 31, 1998, the Company's balance sheet reflected the above-described retained interests at a carrying value of $12,518,000.

197. Because these securities were not actively traded on a recognized exchange in an efficient market, the Company used a valuation estimate model to determine a fair market value.

198. As stated in the 1998 Form 10-K: "The carrying amount reported is reported at its fair value based on the assumptions disclosed in Note 5." The referenced note 5 stated that: "The retained interest was valued by the Company assuming a 4.8% default rate (net of recoveries), a 15% prepayment rate, an 18% discount rate, a 2.5% interest rate on the 5% required reserve account, and a 6.5% annual interest rate on the monthly balance of the financing."

199. The value established for the above described retained interests was grossly

overstated because the 4.8% default rate was woefully inadequate.

200. As stated above, at the end of the Class Period, defendants belatedly caused the Company's financial statements to reflect a $5.5 million charge to earnings associated with retained interest in mortgages receivable in order "to reflect the variance in the actual performance of the mortgages receivable sold and the assumptions used to calculate the retained interest." Later, in connection with the bankruptcy, even greater charges had to be taken.

201. Each of the defendants knew the statements about "retained interests" were false when made because they knew that the Company was using two-books – one aged for defaults, the other not - to fraudulently represent the delinquency status of the portfolio. Indeed, this fact had been told to Goodman by Qualls and Marchiselli, but he recklessly dismissed their concerns.

202. The Company's portfolio of retained interests was grossly overstated as of December 31, 1998 by no less than $10 million and, accordingly, pre-tax income was grossly overstated by a like amount.

203. In the 1998 Form 10-K, the Company also repeated the following false and misleading statements, among others:

> The Company has historically derived income from its financing activities. At December 31, 1998, the Company's mortgages receivable portfolio included approximately 52,000 promissory notes totaling approximately $358.9 million, with a stated maturity of typically seven to ten years and a weighted average interest rate of 14.5% per annum. Additionally, at December 31, 1998, the weighted average maturity of all outstanding consumer loans was approximately 9.5 years and the total borrowings secured by promissory notes were approximately $142 million, bearing a weighted average interest rate of 7.5%. However, because the Company's borrowings bear interest at variable rates and the Company's loans to buyers of Vacation Interests bear interest at fixed rates (which, as of December 31, 1998, equaled 14.5% per annum on a weighted average basis), the Company bears the risk of increases in interest rates with respect to the loans it has from its lenders. The promissory notes are prepayable at any time without penalty. To the extent interest rates on the Company's borrowings decrease, the Company

faces an increased risk that customers will pre-pay their loans and reduce the Company's income from financing.

The Company bears the risk of defaults by buyers who financed the purchase of their Vacation Interests through the Company. The Company does not, however, bear the risk of defaults with respect to mortgages receivable that it has sold to third parties. Consumer loans in excess of 60 days past due, including defaulted loans and loans in the deed-in-lieu process, at December 31, 1998 were 7.4%, as a percentage of gross mortgages receivable. The Company's allowance for doubtful accounts, which is net of recoveries, was 6.4% as a percentage of gross mortgages receivable. Management believes that this percentage is an adequate reserve for expected loan losses because the past due loan amounts do not include amounts recovered from the underlying Vacation Interests nor do all past due loans become defaulted loans.

If a buyer of a Vacation Interest defaults on a mortgage receivable, the Company may foreclose and recover the underlying Vacation Interest. However, the Company will incur relatively substantial costs in foreclosing on the Vacation Interest, returning it to inventory and reselling it. Although private mortgage insurance or its equivalent is available to cover Vacation Interests, the Company has never purchased such insurance and has no present intention of doing so. In addition, although the Company in many cases may have recourse against Vacation Interest purchasers and sales agents for the purchase price paid and for commissions paid, respectively, no assurance can be given that the Vacation Interest purchase price or any commissions will be fully or partially recovered in the event of a buyer default under a mortgage receivable. The Company is subject to the costs and delays associated with the foreclosure process and no assurance can be given that the value of the underlying Vacation Interests being foreclosed upon at the time of resale will exceed the purchase price of the defaulted loans, taking into consideration the costs of foreclosure and resale or that the costs of any such foreclosures will not have a material adverse effect on the Company's results of operations.

204. The statements detailed above were intended to, and did, convey a false message to the investing public. Not only were investors led to believe that the Company's receivables remained strong despite a significant increase in sales, they were also led to believe by the defendants that the Company was successful in reducing the risk of portfolio default. In fact, as later revealed, a significant portion of the Company's receivables were delinquent and were not

properly accounted for. Indeed, as the Company belatedly announced on January 20, 2000, at least a $61 million charge against earnings in connection with the delinquent receivables was required in connection with receivables reflected on Sunterra's books and records for 1998 and 1999. Additional charges exceeding $113 million were revealed in May 2002 to reflect the true state of Sunterra's financial condition as of December 1999.

205. The 1998 Form 10-K also materially misrepresented the business risks confronting Sunterra in connection with its mortgages receivable portfolio. In particular, the Form 10-K failed to disclose the known material risk that Sunterra's internal controls were inadequate and deficient, that the Company was utilizing two sets of books, and that the Company did not have a centralized accounting system on which it could rely to fairly and adequately report its current and non-performing mortgages receivable.

206. With respect to delinquent receivables, the Form 10-K represented the following in a variety of places:

> Consumer loans in excess of 60 days past due, including defaulted loans and loans in the deed-in-lieu process, at December 31, 1998 were 7.4%, as a percentage of gross mortgages receivable. The Company's allowance for doubtful accounts, which is net of recoveries, was 6.4% as a percentage of gross mortgages receivable. Management believes that this percentage is an adequate reserve for expected loan losses because the past due loan amounts do not include amounts recovered from the underlying Vacation Interests nor do all past due loans become defaulted loans.
>
> * * * *
>
> As of December 31, 1998, the Company's allowance for doubtful accounts, which is net of recoveries, was 6.4% as a percentage of gross mortgages receivable. <u>Management believes that this percentage is an adequate reserve for expected loan losses</u> (Emphasis added).
>
> * * * *
>
> The provision for doubtful accounts increased $4.0 million to $12.6

> million during 1998 from $8.6 million during 1997. As a percentage of total revenues, the provision for doubtful accounts was 3% during 1998 and 1997. The increase in the provision as a percentage of revenues, as compared with the prior period, is related primarily to the Company's internal review of the aging and collectability of accrued interest at certain of its properties during the second quarter of 1998.
>
> * * * * *
>
> Revenue Recognition -- The Company recognizes sales of Vacation Interests on an accrual basis after a binding sales contract has been executed, a 10% minimum down payment has been received, the rescission period has expired, construction is substantially complete, and certain minimum sales levels have been achieved. If all the criteria are met except that construction is not substantially complete, then revenues are recognized on the percentage-of-completion (cost to cost) basis. For sales that do not qualify for either accrual or percentage-of-completion accounting, all revenue is deferred using the deposit method.

207. These statements in particular, and the 1998 Form 10-K in general, were materially false and misleading because the financial statements and financial performance reflected therein were materially overstated and not in conformity with GAAP. In particular, Sunterra's performing mortgages receivable were materially overstated, its allowance for doubtful accounts was materially understated, its reported revenues were materially overstated because they included sums recognized on non-performing and non-existent mortgages receivable and non-existent fee revenues, and its bad debt expense was materially understated. In addition, the Form 10-K misrepresented that all appropriate "adjustments" had been made as required by GAAP when, in fact, that was not true. Indeed, contrary to the stated revenue recognition policy, over one dozen former Sunterra employees have stated that the Company in fact recognized revenue **before** the expiration of the rescission period and then failed to reverse that recognition of revenue when the contracts were rescinded or otherwise failed to close. The Form 10-K further misrepresented that the Company had adequate sources of liquidity and millions in mortgages receivable which could be used to obtain additional financing when, in

fact, a material portion of the pledged and unpledged receivables were uncollectible. The Form 10-K was also materially false and misleading for omitting to disclose that Sunterra had changed its accounting practice and policies with respect to writing off non-performing, delinquent mortgages receivable.

208. The statements detailed above were also materially false and misleading because defendants knew or recklessly disregarded that the Company's reported results of operations materially overstated revenue, income, assets, and earnings for the reasons particularized above. Additionally, the statements detailed above were materially false and misleading because defendants knew or recklessly disregarded that 6.4% was nowhere near "adequate" to account for the Company's "expected loan losses." As revealed on January 20, 2000, the Company belatedly recognized material charges to earnings as particularized above, including material charges to earnings in connection with the Company's mortgage and mortgage-related receivables. Over $363 million in additional reductions to "retained earnings" were charged in October 2001 and May 2002 to reverse this fraud.

209. Additionally, the reported 1998 fourth quarter and year-end financial results were materially false and misleading because, unbeknownst to the investment community, defendants had caused the Company to drastically change its definition of "uncollectible" receivables and its accounting policies with respect to the recognition of losses on these receivables and fraudulently concealed this fact from the investing public as particularized below.

210. Besides the 10-K, Sunterra also mailed and posted on its website a glossy Annual Report to Shareholders for 1998, in which it falsely represented, among other things, that it was "one of the most consistently successful vacation ownership companies, delivering 10 consecutive quarters of record year-over-year performance since going public in August 1996."

Included in the forepart of this report were "Financial Highlights" and bar graphs that misrepresented Sunterra's financial condition in materially false and misleading portrayals.

211. In a document entitled "Fellow Shareholders," which was signed by Gessow and Kenninger, the two founders and "Co-Chairmen" falsely stated the following:

> 1998 was another record year for Sunterra … We managed costs and growth while exploiting economies of scale to achieve industry leading margins and record financial performance.
>
> * * * *
>
> Included in revenues in the fourth quarter of 1998 was a $5.7 million pretax gain on sale of mortgages receivable into a newly established $100 million conduit facility. The new facility enables the Company to turn its mortgages receivable into cash, which is a continuing strategy to provide liquidity to fuel future growth.

212. These statements were knowingly false and misleading because the Company had not, in fact, "managed costs and growth while exploiting economies of scale." Instead, defendants knew from the quarterly review meetings and their active participation with and directions to Frey that Sunterra's growth and "record" results were a fiction. While defendants portrayed the securitizations as a successful "continuing strategy," they knew that the two-books were falsely reflecting receivables that were, in fact, non-performing and could not be securitized. Indeed, Gessow and Kenninger were aware that negative cash flow continued to increase at Sunterra, despite the securitizations, which indicated that cash was not being received on a far larger portion of the mortgages receivable portfolio than was being reported as non-performing. This was confirmed by the fact that, S.G. Cowen had returned to Sunterra millions in mortgages receivable (constituting nearly 10% of the conduit facility) that were non-performing. Hence, Gessow and Kenninger actually lied or recklessly disregarded the obvious facts. They were motivated to do so to forestall a liquidity crisis and to obtain a buyer for the

Company.

213. The Annual Report also included a "Letter from the Chief Executive Officer," signed by Miller, that was false and misleading. Among other things, the "Letter" misrepresented the following:

> We also made significant progress in our strategy to convert our mortgages receivable into cash, thereby reducing our leverage and the risk of portfolio default. As a result of the successful implementation of this continuing strategy, our net mortgages receivable balance increased by only 1% during the year, despite a 28% increase in vacation interest sales over the same period.

214. The Letter falsely portrayed Sunterra as able to continue securitizing all or a large portion of the mortgages receivable portfolio when, in fact, Miller knew that over one-third of the portfolio was so delinquent that it could never be sold or securitized. By the time the Letter was issued, Finova had returned material amounts of defaulted mortgages receivable to Sunterra. Miller knew or recklessly ignored from this fact that the portfolio was not suitable to "reduce leverage and the risk of portfolio default." Fewer than nine months after this "Letter," the "risk" was a reality, forcing Sunterra into bankruptcy.

215. On May 5, 1999, defendants caused the Company to announce its financial results for the three months ended March 31, 1999. The Company again reported "record" first quarter results, with first quarter total revenues up 27%, net income up 38%, and Earnings Per Share ("EPS") up 35%. First quarter 1999 net income was reported to have increased to a "record" $10.0 million compared with net income of $7.3 million in the first quarter of 1998. First quarter 1999 earnings per diluted share were reported to have increased to $0.27 from $0.20 in the first quarter of 1998. Revenues purportedly reached a "record" $114.3 million, up from $89.7 million in the first quarter of 1998.

216. Commenting on the results, defendant Miller stated:

We are very pleased to report our eleventh consecutive quarter of record year-over-year growth in sales, income and earnings per share. Our business is strong, with consumer demand and awareness of vacation ownership increasing as we enter our strongest selling season between now and the end of Summer.

217. With respect to the Company's mortgages receivable, defendant Miller stated:

> At March 31, 1999, net mortgages receivable were $344.5 million, an increase of $8.5 million from $336.0 million at December 31, 1998, and a $9.9 million decrease from $354.4 million at March 31, 1998.
>
> * * * * *
>
> Consumer loans serviced by the Company in excess of 60 days past due, including defaulted loans and loans in the deed-in-lieu process at March 31, 1999, improved to 6.8%, as a percentage of gross mortgages receivable, from 6.9% at March 31, 1998. Net of inventory recoveries, these same percentages would decrease to 4.6% and 4.7% respectively. The Company's allowance for doubtful accounts, as a percentage of gross mortgages receivable, was 6.4% at both March 31, 1999 and at December 31, 1998.

218. These results were repeated in the quarterly report, on Form 10-Q, for the quarterly period ended March 31, 1999, filed with the SEC on or about May 13, 1999, and signed by defendant Goodman ("the March 31, 1999 Form 10-Q"). A management representation contained within this Form 10-Q stated with respect to these financial statements:

> In the opinion of management, all adjustments considered necessary for a fair presentation have been included and are of a normal recurring nature...

219. The statements concerning Sunterra's "record" first quarter 1999 results were materially false and misleading. The financial results which purported to represent the "eleventh consecutive quarter of record year-over-year growth in sales, income and earnings per share" were materially overstated as a result of defendants' failure to adequately reserve for uncollectible mortgage and other receivables. Similarly, the Company's assurances that the financial statements "included all adjustments considered necessary for a fair presentation" of the financial results were false and misleading. As revealed on January 20, 2000, the Company

belatedly recognized material charges to earnings as particularized above, including material charges to earnings in connection with the Company's mortgage and mortgage-related receivables. In addition, over $353 million in additional write-offs had to be recognized after Sunterra's bankruptcy to reverse defendants' fraud.

220. In response to the Company's announcement of strong financial performance and improved default rates, the price of Sunterra common stock increased from $11.50 per share on May 5, 1999 to over $12 per share on May 6, 1999, reaching over $14.80 per share on May 20, 1999, after the Company's first quarter Form 10-Q was disseminated to the market.

221. Despite announcing unprecedented financial success, Sunterra's founders and "Co-Chairman," who were privy to the Company's true financial and operating condition, sold hundreds of thousands of shares of Sunterra stock. Between May 20, 1999 and June 4, 1999, defendant Kenninger sold over 300,000 shares of Sunterra common stock for as much as $14.56 per share, reaping proceeds totaling well over $5 million. It appears from a comparison of Sunterra's 1999 Proxy Statement to its 2000 Proxy Statement that Gessow's share ownership also declined after March 1999 by over 50,000 shares. Although sales reports on SEC Form 4 do not appear to have been filed by Gessow in 1999, a former Sunterra Senior Business Manager has stated that he believes Gessow sold Sunterra stock in 1999. The investing public, unaware of the Company's true state of affairs, at least in part due to the Company's fraudulent accounting, were not as fortunate, and continued to purchase Sunterra common stock at grossly inflated prices reaching $14.82 per share in July of 1999.

222. On August 4, 1999, defendants caused the Company to announce "record" financial performance for the second quarter and six months ended June 30, 1999. The Company reported that second quarter 1999 net income had increased by 39% to a record $13.5

million compared with net income of $9.7 million in the second quarter of 1998. Over the same period, diluted earnings per share were reported to have increased 33%, to $0.36 per share from $0.27 per share. The Company's press release stated that a "27% increase in revenues drove the record profitability." Revenues were $134.5 million in the second quarter of 1999, up from $106.3 million in the second quarter of 1998. EBITDA for the second quarter of 1999 increased by 24% to $38.8 million from $31.2 million in the second quarter of 1998.

223. According to the Company's August 4, 1999 press release detailed above, as of June 30, 1999, consumer loans serviced by the Company in excess of 60 days past due totaled 6.9% as a percentage of gross mortgages receivable, up slightly from 6.7% in the comparable period of 1998. Net of inventory recoveries, these same percentages decreased to 4.7% and 4.5%, respectively. The Company increased its allowance for doubtful accounts, as a percentage of gross mortgages receivable, to 6.5% at June 30, 1999, up from 6.3% in the year-earlier period.

224. These results were repeated in the quarterly report on Form 10-Q, for the quarterly period ended June 30, 1999, filed with the SEC on August 16, 1999, and signed by defendant Goodman ("the June 30, 1999 Form 10-Q"). A management representation contained within this Form 10-Q stated with respect to these financial statements:

> In the opinion of management, all adjustments considered necessary for a fair presentation have been included and are of a normal recurring nature.

225. The Company's second quarter results were materially false and misleading, and included grossly overstated earnings. As revealed on January 20, 2000, the Company belatedly recognized material charges to earnings as particularized above, including material charges to earnings in connection with the Company's mortgage and mortgage-related receivables. Indeed, by this time all of the defendants had attended at least three "quarterly review" meetings and one budget meeting in which the defaulted mortgages receivable were highlighted, the double-sold

inventory was portrayed as "nasty," the securitizations were becoming more difficult and expensive, and Finova was being pressured to loan more so the Company could avoid bankruptcy. Cash flow was so deficient that the so-called "record" results were obviously false and misleading, and defendants knew it. Moreover, Airtours had pointed out material variances between the Finova reports and Sunterra's public reports.

201. On November 3, 1999, defendants again caused the Company to announce "record" third quarter results, "building on its record first half performance." Third quarter revenues were reported to have been up 21% to a "record" $153 million." According to the Company, "this top line growth generated a 22% rise in net income and a 21% increase in diluted earnings per share." Net income for the quarter purportedly reached $17.5 million versus $14.3 million in the comparable year-earlier period and diluted EPS was $0.46 per share, up from $0.38 in the previous year.

202. Commenting on the purported "top line growth," defendant Miller stated:

> Our third quarter performance was very strong across the board. We had solid top line growth; and with the cost of sales and advertising/sales/marketing costs within target ranges, we were able to generate commensurate bottom line growth.

203. With respect to the Company's receivables, the Company reported a pre-tax gain of $2.5 million on the sale of about $72 million of mortgages receivable. According to the Company's announcement, at the end of the third quarter, mortgages serviced by the Company (including securitized mortgages) in excess of 60 days past due totaled 6.4% as a percentage of gross mortgages receivable, down from 6.9% in the comparable year-earlier period. Net of inventory recoveries, these percentages were reported as 4.4% and 4.7%, respectively. The allowance for doubtful accounts as a percentage of gross mortgages receivable was reported as 6.4%, up from 6.3% in the previous year.

204. The "record" results reported in the November 4, 1999 press release detailed above were repeated in the Company's 1999 third quarter Form 10-Q filed on November 12, 1999, signed by defendant Goodman ("the September 30, 1999 Form 10-Q"). A management representation contained within this Form 10-Q stated with respect to these financial statements:

> In the opinion of management, all adjustments considered necessary for a fair presentation have been included and are of a normal recurring nature.

205. The Company's third quarter results were false and misleading. Defendants knew or recklessly disregarded that the Company was not experiencing "top line growth" and was in fact experiencing a significant increase in the amount of delinquent mortgage and mortgage-related receivables. They also knew the Company was in the midst of a serious but undisclosed liquidity crisis, as Finova had just extended additional credit so Sunterra could repay its delinquent payments on its bankline.

206. The Company's third quarter results were materially false and misleading and included grossly overstated earnings. As revealed on January 20, 2000, the Company belatedly recognized material charges to earnings as particularized above, including material charges to earnings in connection with the Company's mortgage and mortgage-related receivables.

207. On November 3, 1999, after news of the Company's repeated "record" financial results, Sunterra common stock traded at artificially inflated prices, reaching $10.875 per share on November 4, 1999 and climbing even further to $12.25 per share on November 5, 1999, as the Company's financial results were absorbed by the market.

THE AIRTOURS DEBACLE

208. During the time defendants were issuing all of the foregoing false and misleading statements, Miller, Goodman, Gessow, Frey, Kenninger and Sullivan were also courting a potential buyer for Sunterra, Airtours, Plc. As part of this process, they delivered to Airtours and

its investment banker, Deutsche Bank Alex. Brown, copies of Sunterra's SEC filings and Annual and Quarterly Reports along with earnings releases and press releases. In addition, Airtours signed a confidentiality agreement so it could pursue more in-depth due diligence and review internal and third party information pertaining to the Company.

209. Because Airtours had indicated an interest in Sunterra, when initial quarterly performance figures were discussed at the quarterly review meetings in May and August 1999, Miller and Goodman expressed concern that Sunterra appeared unable "to make the numbers." In response, Frey stated "they would come up with something." As is now clear, they (the defendants herein) came up with many deceits, tricks, manipulations and outright financial falsehoods to make it appear that Sunterra had achieved "sequential quarterly improvements and growth" when, in fact, it had not.

210. In or around September 1999, Airtours began a more in-depth review of Sunterra's business. As with S.G. Cowen, defendants permitted Airtours to visit the purported mortgage portfolio operations in Las Vegas, Nevada. By this time, however, a second, undisclosed portfolio operation had been moved by Frey and Giannoni to secondary Sunterra offices at Orange Blossom Trail in Orlando and in a trailer located near those offices. Airtours did not visit those offices, nor was it told about all of the documents and boxes located at processing centers and resorts in Arizona and Bellevue, Washington.

211. Airtours, however, was permitted to communicate with Finova and to review various Finova aging reports. Airtours also reviewed the securitization documents related to the past mortgages receivable sales through S.G. Cowen.

212. During the course of this review, Airtours discovered that there were variances between information Finova and S.G. Cowen had and the information Sunterra's Las Vegas

office was reporting. Airtours also raised questions about the Millenium Management, Inc. relationship. Airtours advised Miller, Goodman, Frey and Sullivan that, although the variances were not significant enough to thwart a transaction, they needed to be rectified before Airtours could publicize a formal buyout proposal.

208. In or around October 1999, Goodman and Miller advised Gessow and Kenninger of Airtours' concerns and then instructed Frey, Cohen, Giannoni, and Sullivan to "clean up" the balance sheet so Airtours could formalize its proposal. At that point, Frey attempted to settle the Millenium Management, Inc. dispute, stating "I cannot afford another write-off now."

209. Contrary to Goodman's false statements in the January 20, 2000 press release, the "special in-depth review" was not "due to adverse factors in the fourth quarter." Instead, it was due to defendants' perception that Airtours would still offer to buy the Company – at a lower per-share price – once the Company took some minor write offs.

210. However, Airtours was shocked by the size and nature of the write-offs defendants planned to take and called off all negotiations on the subject. Corroborating this sequence of events is the fact that AXA, a large insurance company based in France, and advised by the same investment banker Airtours utilized, unloaded its entire position in Sunterra stock at progressively lower prices and at a loss just before the January 20th announcement of the write-off.

DEFENDANTS SHOCK THE INVESTING PUBLIC ON JANUARY 20, 2000

211. On January 20, 2000, Sunterra issued a press release via the PRNewswire, announcing that:

> ...due to adverse factors in the fourth quarter of this year, preliminary results indicate that, before a special charge, earnings for the three month period will be in the range of $.01 to $.08 per diluted share, compared with $.31 per diluted share reported in the same period last year.

212. The Company also announced that it expected to record a non-cash charge for the year **of between $38 million and $45 million, after tax,** related to various items on its balance sheet. Sunterra attributed the charge to "the result of a special in-depth review" of its balance sheet, which the Company initiated at year-end. The largest part of the charge was said to relate to the write-off of delinquent mortgages receivable. Elaboration was later contained in the Company's 1999 Form 10-K which defendants caused the Company to file with the SEC on or about March 31, 2000 ("the 1999 Form 10-K").

213. This document noted that, in the fourth quarter of 1999, the Company had recorded **pre-tax charges to earnings** to reflect a:

a. $44.3 million write-off of mortgages receivable that were either 180 days or more past due or were 60 days or more delinquent after paying only the initial down payment.

b. $9.6 million write-off of accrued interest on mortgages receivable that were either 180 days or more past due or were 60 days or more delinquent after paying only the initial down payment.

c. $0.8 million write-off of deferred loan origination costs related to the $43 million of mortgages receivable which were written off.

d. $5.5 million charge to earnings associated with retained interest in mortgages receivable "to reflect the variance in the actual performance of the mortgages receivable sold and the assumptions used to calculate the retained interest."

e. $7.2 million write-off of homeowners' association receivables.

f. $16.7 million write-down of resort properties.

g. $1.3 million write-off of costs associated with acquisitions that were terminated.

h. $2.8 million write-down of a receivable from a marketing company.

214. In addition, the Company also announced, on January 20, 2000, that Miller was

being replaced. The new Chief Executive Officer, Richard Harrington, characterized the Company's fourth quarter results and the non-cash charge as "unacceptable" and attempted to reassure investors by stating that "the Company is taking actions to ensure that neither is repeated." In a conference call with analysts that same day, Company spokespersons admitted that the Company lacked the internal controls described above, that there had been a "breakdown of fundamental control issues," and that the inadequacies created "major issues" for the Company. Defendant Kenninger admitted, "[t]his company grew very fast and it grew faster than our systems could support. Now we're paying for it." This statement, of course, was directly contrary to Kenninger's statement just eight months earlier that "we managed costs and growth while exploiting economies of scale." Representatives of the Company also stated that the Company was now removing uncollectible receivables automatically *after 180 days* (not the 120 days previously represented), instituting quick reversals for "first payment defaults," and establishing "progressive reviews" of increased collection efforts for receivables more than 90 days past due.

215. On January 20, 2000, after the Company released the fourth-quarter operating results and multi-million dollar charge, the price for Sunterra common stock plunged, falling as much as $2-3/8 per share or 38.38%, from $6-3/16 on January 19, 2000, on unusually heavy trading volume of 6,409,000 shares – an enormous increase from the Company's average daily trading volume of 182,681 shares.

216. As now known, at all times during the Class Period, defendants issued false and misleading financial statements and press releases concerning Sunterra's revenues, expenses, receivables, net income, and earnings per share. The representations which were made during the Class Period with regard to the Company's results of operations and financial position, all of

which implicitly and/or expressly were represented to have been prepared in conformity with GAAP, were materially false and misleading because the Company materially understated expenses and materially overstated the Company's revenues, income, receivables, and earnings in contravention of GAAP.

217. Although the news was a complete surprise to the investing community, as particularized above, defendants were already aware of the Company's fraudulent accounting and the fact that the magnitude of the previously concealed uncollectible mortgage and mortgage-related receivables had increased to the point where it could no longer be concealed. Commenting on the fourth-quarter charge, defendant 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...During 1999, the Company centralized its receivable servicing operation, which should strengthen our internal controls going forward. We are also currently working to identify and implement control improvements that will help keep our balance sheet strong.

The Company also informed callers that the charge would put the Company in technical violation of lending covenants with its bank and that the charge would include writing off roughly $40 million of uncollectible receivables, particularly consumer mortgages receivable, plus related accrued interest.

218. Contrary to this statement by Goodman, after Sunterra's bankruptcy it was revealed that "the general ledger and mortgage receivable portfolio had never been reconciled." Without such a reconciliation (which is fundamental to the preparation of truthful consolidated financial statements), Goodman and each of the other defendants knowingly or recklessly lacked any reasonable basis for issuing and signing Sunterra's periodic SEC reports and its earnings releases. As CFO, Goodman acted so recklessly in failing to obtain a reconciliation that the

likelihood of fraud and misstatement was obvious, yet deliberately ignored.

219. In addition, Jay Alix & Associates also revealed, during the Sunterra bankruptcy, that the Company was unable "to properly identify each lender's collateral and encumbrance portfolio." So, Goodman's statement that mortgage servicing had been "centralized" during 1999 was, again, false. In truth, Gessow, Frey, Cohen and Sullivan had caused the same mortgages receivable to be pledged to different lenders and conduits at the same time. They were motivated to do so because Sunterra was so strapped for cash, and so delinquent in its payments to Finova, that they were forced to double and triple-pledge the receivables.

220. Indeed, in a belated attempt to cover up its own misconduct, Arthur Andersen issued a tepid and misleading "Management Letter' after the bankruptcy filing. In that letter, the "auditor" noted "significant deficiencies in the design or the operation of the internal control structure that, in the auditor's judgment, could affect the organization's ability to record, process, summarize and report financial data consistent with the assertions of management in the financial statements." Among other things, the Letter identified the following

a. Mortgages Receivable Reconciliation – Arthur Andersen stated that "certain of that mortgages receivable reconciliations were not being performed on a timely basis and the certain reconciling items were inaccurate as receivable in-transit schedules had not been updated. Additionally, there were large unreconciled variances at several of the resorts. The untimely and inaccurate preparation of mortgages receivable reconciliations increases the risk that the balance is misstated." [Emphasis added]

b. Mortgages Receivable Allowance – Arthur Andersen stated that the Company "should establish standard procedures to monitor the Written Off Accounts so that subsequent receipts of payments are applied properly, deed-in-lieu and foreclosure procedures

are preformed and subsequent receipt of inventory deeds are monitored."

c. Internal Audit – Arthur Andersen stated that it was "essential to the integrity of the Company's accounting and other operating processes" that the Company establish an internal auditing department. Arthur Andersen added that "such a department will assist the Company in mitigating many of the inconsistencies in accounting applications."

d. Formal Policies and Procedures – Arthur Andersen described the Company's accounting policies and reporting processes as inconsistent and recommended that the Company's various resorts adopt similar accounting procedures to avoid further inconsistent practices and "reduce inefficiencies in the preparation and review of month-end financial statements."

226. Defendant Goodman's statements revealed that not only were defendants aware of the Company's lack of internal controls, but had in fact already (during 1999) taken steps to "centralize" its receivable servicing operation and "strengthen" its internal controls. These statements, however, were themselves knowingly false and misleading. In fact, the Company still had not "centralized its receivable serving operation." As KPMG disclosed after the Company filed bankruptcy Sunterra's systems were so disintegrated that entirely new systems had to be created. In fact, the Company was unable to prepare rudimentary financial statements for over sixteen months after filing for bankruptcy.

227. Shortly after the January 20, 2000 announcement, brokerage house Merrill Lynch's equity research analyst following Sunterra issued a research report downgrading the investment rating on Sunterra from Buy to Neutral. The downgrade was based on Sunterra's poor across the board results, as well as the announced non-cash charge. Commenting on Sunterra's announcement, the report stated:

> Clearly, we are disturbed by today's developments. Over the last two weeks, we have spoken with management several times, and they reaffirmed confidence in their earnings expectations....Although the shares are relatively inexpensive, we have reduced confidence in management, and are unclear of the company's fundamentals going forward.

228. The subsequently filed 1999 Form 10-K noted further that funding availability under the Company's credit facilities was curtailed based on the debt covenant violations reported for the fourth quarter of 1999. Although some debt covenant waivers had been obtained and were in place for the first quarter of 2000, access to the availability under the Company's credit facilities was "on a limited basis as compared to the original terms of the facilities.

229. Although Sunterra began funding against a newly-opened $25 million mortgages receivable warehouse facility Finova was compelled to provide to save it's other credit extensions, that facility was closed to any further borrowings shortly thereafter because a related proposal to open a $100 million facility for the non-recourse sale of mortgages receivable was withdrawn, as the receivables did not exist or were non-performing.

230. Sunterra's quarterly report for the first quarter of 2000 reported the dire financial condition of the Company:

> At the same time that it is seeking additional sources of liquidity, the Company is in discussions with banks and financial institutions to seek waivers of the violations of its existing credit agreements and to obtain their agreement not to pursue various remedies in the event of default on these facilities, including declaring the entire indebtedness due and payable. However, the Company can give no assurance that such an agreement can be reached or what the terms of such an agreement would be. Additionally, an uncured event of default under these credit facilities and indentures could trigger a default under other agreements to which the Company is a party, including the senior notes, senior subordinated notes and convertible subordinated notes. An event of default under any of these agreements could materially adversely affect the Company by, among other things, causing all of the Company's indebtedness to become immediately due and payable. (10-Q p.3).

* * * * *

> As of March 31, 2000, the Company was not in compliance with certain covenants on its credit facilities. The Company is in violation of net worth and net worth related debt covenants in its senior credit facility, pre-sale line and inventory line as a result of the decline in the Company's net worth due to the quarter's net loss. In addition, the Company did not make a mandatory pay down on May 1, 2000 of $4.0 million under its senior credit facility and $1.1 million on the pre-sale line, which has resulted in an event of default under those agreements.
>
> In addition, the Company did not make the May 15, 2000 scheduled payment of $6.5 million on its $140 million senior notes. There is a 30 day cure period before this becomes an event of default.
>
> As a result of the covenant violations and events of default, there is no availability under any of the Company's credit facilities. (10-Q pp9-10).

230. On May 31, 2000, Sunterra and thirty-six (36) of its affiliates and subsidiaries filed voluntary petitions for relief under Chapter 11 of the Bankruptcy Code. Sunterra retained the accounting firm of KPMG Peat Marwick to assist it in putting together its schedules and accounts, as its previous auditor, Arthur Andersen, had withdrawn from the engagement. In a number of filings with the Bankruptcy Court since the petition filing, individual creditors and the Official Committee of Unsecured Creditors stated that "[t]he evidence . . . will demonstrate that [Sunterra's] accounting and financial controls are so woefully inadequate that it is questionable as to whether [the Debtors] could demonstrate feasibility [of any reorganization plan] on their own." The Official Committee further stated: "Not only were the Debtors unable to timely submit their schedules and statements of financial affairs, they apparently relied almost exclusively on KPMG to produce these documents. Based on the amount of effort which KPMG had to expend to prepare the schedules, the Debtors have insufficient financial software or reporting ability in place. Moreover, since the schedules were primarily a work product of KPMG, it is unlikely that the Debtors' management had much of its time devoted to this task."

231. In stark contrast with the purported one billion dollars in assets and $760 million

in liabilities defendants had caused Sunterra to report to investors as of year-end 1999, the Summary of Schedules filed late with the Bankruptcy Court by the Debtors at the end of August 2000 listed total assets of just "$222,368,562" and total liabilities of "$675,758,843." Even if the assets of all of the Sunterra affiliates and subsidiaries which did not also file for bankruptcy were added to these figures (the most significant of which is Sunterra Europe, worth about $75 million, net), it would still not account for the dramatic discrepancy between what defendants and Sunterra had been telling the investing public and creditors in 1998 and 1999 and what the Debtors were representing to the creditors in the bankruptcy proceedings in August 2000.

DEVELOPMENTS SINCE THE BANKRUPTCY FILING

232. After the bankruptcy filing, it has become clear that Sunterra's "audited" financial statements for year-end 1999 were also false and misleading and, in the words of the Company itself, should not be relied upon or used. Although those statements and all the prior SEC filings in the name of the Company should have been restated to comply with GAAP, the Company's records and systems were so inadequate that such restatements could not be accomplished. In fact, the Company had to hire the Clayton Group and a title insurance company to recreate a legitimate database of mortgages receivable. Accordingly, Jay Alix & Associates, as the work-out specialists in the bankruptcy, opted to simply write down retained earnings by hundreds of millions of dollars, wiping out all equity and a material portion of the unsecured credit invested in Sunterra.

233. In March 2001, long before Enron, Sunterra fired Arthur Andersen and the engagement partner on the audit, Verne Bragg.

234. In October 2001, Sunterra wrote off over $250 million in retained earnings for 2000 due to asset impairments and inflated accounts. At the same time, it stated that all prior

audited and unaudited financial statements were unreliable and should not be used.

235. On May 10, 2002, the Company wrote off an additional $113 million in retained earnings for 1999 and even more for 2000 and 2001, stating it would not reissue financial statements for 1999 and prior periods, all of which were unreliable.

236. On May 30, 2002, Sunterra filed suit against the consultant for its SWORDs reservation system, Ernst & Young, LLP, alleging professional negligence and breach of contract. Also on that date, the Company's creditors' committee, based on a stipulated order from the Bankruptcy Court, filed suit in the Company's name against practically all of the officers and directors named herein and others and, separately, against Arthur Andersen, LLP. In those suits, the Company alleged willful breach of fiduciary duty and professional negligence, among other things.

ARTHUR ANDERSEN'S PARTICIPATION IN THE FRAUD AND ADDITIONAL ALLEGATIONS DEMONSTRATING SCIENTER ON THE PART OF ALL DEFENDANTS

237. Until 2000, Arthur Andersen had served as Sunterra's purportedly "independent" outside auditor throughout the Class Period. Andersen's personnel were regularly present at Sunterra's corporate facilities throughout the Class Period, and had continual access to, and knowledge of, Sunterra's confidential corporate, financial, and business information through interaction with Sunterra's employees and periodic reviews of Sunterra's non-public documents. Because of the magnitude of the Company's violations of GAAP as set forth herein, and because Andersen knew of or recklessly disregarded the deficiencies and the circumvention of Sunterra's required internal controls, Andersen violated GAAS. In addition, because Andersen was not independent by virtue of its performance of tax, consulting and other non-audit services for Sunterra, Andersen acted knowingly or recklessly in failing to detect and disclose Sunterra's

GAAP and related disclosure violations.

238. Despite this actual knowledge or reckless disregard, on February 10, 1999, Andersen issued its unqualified report on the consolidated financial statements of Sunterra. This report was included in the Company's 1998 Form 10-K with the written consent of Andersen. This written consent, which was dated March 29, 1999 and which was set forth in Exhibit 23.1 to the 1998 Form 10-K, stated:

> As independent certified public accountants, we hereby consent to the incorporation of our report included in this Form 10-K into Sunterra Corporation's (formerly Signature Resorts, Inc.) previously filed Registration Statement File Nos. 333-63621, 333-47215, 333-46511, 333-15361, 333-30285 and 333-09096.

239. The auditor's report, which Andersen issued, stated:

> We have audited the accompanying consolidated balance sheets of Sunterra Corporation (formerly Signature Resorts, Inc.) (a Maryland corporation) and subsidiaries as of December 31, 1998 and 1997, and the related consolidated statements of income, equity and cash flows for each of the years in the three-year period ended December 31, 1998. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits. We did not audit the 1996 financial statements of LSI Group Holdings Plc, a company acquired during 1997 in a transaction accounted for as a pooling of interests, as discussed in Note17. Such statements are included in the consolidated financial statements of Sunterra Corporation and subsidiaries and reflect total revenues of 13 percent of the consolidated totals. These statements were audited by other auditors whose report has been furnished to us and our opinion, insofar as it relates to amounts included for LSI Group Holdings Plc, is based solely upon the report of the other auditors.
>
> <u>We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits and the report of other auditors provide a reasonable basis for our opinion.</u>

> In our opinion, based on our audits and the report of the other auditors, the financial statements referred to above present fairly, in all material respects, the financial position of Sunterra Corporation and subsidiaries as of December 31, 1998 and 1997, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 1998, in conformity with generally accepted accounting principles. (Emphasis added).

240. Andersen's unqualified auditor's opinion on the financial statements of the Company as of and for the year ended December 31, 1998, was materially false and misleading because these financial statements were not presented in accordance with GAAP nor were they audited in accordance with GAAS.

241. GAAS, as set forth in AICPA Professional Standards Volume 1, U.S. Auditing Standards ("AU"), in Section AU 411, describes "The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles in the Auditor's Report." It states:

> The auditor's opinion that financial statements present fairly an entity's financial position, results of operations, and cash flows in conformity with generally accepted accounting principles should be based on his judgement as to whether (a) the accounting principles selected and applied have general acceptance; (b) the accounting principles are appropriate in the circumstances; (c) the financial statements, including the related notes, are informative of matters that may affect their use, understanding, and interpretation...; (d) the information presented in the financial statements is classified and summarized in a reasonable manner, that is, neither too detailed nor too condensed...; and (e) the financial statements reflect the underlying events and transactions in a manner that presents the financial position, results of operations, and cash flows within a range of acceptable limits, that is, limits that are reasonable and practicable to attain in financial statements.

242. During the Class Period, the audited financial statements of the Company, which were publicly disseminated, were not presented "fairly in conformity with generally accepted accounting principles" because the:

a. Accounting principles selected and applied did not have general acceptance.

b. Accounting principles were not appropriate in the circumstances.

c. Financial statements, including the related notes, were not informative of matters that affected their use, understanding, and interpretation.

d. Financial statements did not reflect the underlying events and transactions in a manner that presented the financial position and the results of operations within a range of acceptable limits that were reasonable and practicable to attain in financial statements.

Andersen knew it was required to adhere to standards and principles of GAAS, including the requirement that the financial statements comply in all material respects with GAAP. Andersen, in issuing its unqualified opinion, as alleged herein, knew that by doing so it was engaging in a gross departure from GAAS, or issued such certification with reckless disregard for whether or not GAAS was being complied with.

243. In the introductory portion of Accounting Series Release 173, the SEC made the following comments pertaining to economic substance:

> Another problem...is the need for emphasizing the importance of substance over form in determining accounting principles to be applied to particular transactions and situations. In addition to considering substance over form in particular transactions, it is important that the overall impression created by the financial statements be consistent with the business realities of the company's financial position and operations.
>
> We believe that the auditor must stand back from his resolution of particular accounting issues and assess the aggregate impact of the particular issues upon a reasonable investor's perception of the economic substance of the enterprise for which the financial statements are being presented.

244. In opining on the fairness of the financial statements of the Company, Andersen failed to assess the propriety of the accounting principles used by the Company and Andersen failed to consider the importance of substance over form in determining accounting principles to be applied.

245. As noted by the SEC in its Accounting And Auditing Enforcement Release No. 817 (September 19, 1996), "In the Matter of Cypress Bioscience Inc. and Alex P. De Soto, CPA":

> It is a well-established tenet of GAAP that transactions must be accounted for in accordance with their substance rather than their form.

246. Due to the failure of the Company to account for transactions in accordance with their substance rather than their form, the overall impression created by the financial statements was inconsistent with the business realities of the Company's financial position and operations, and as a result they were deceptive and materially misleading.

Andersen's History Of Participating In Accounting Fraud

247. Andersen's abysmal conduct in connection with its audit and review of Sunterra's financial statements is hardly an isolated incident. Andersen is a repeat offender with a history of failed audits, conflicts of interest and document destruction in some of the most egregious cases of accounting fraud in history.

248. For example, in connection with a 1998 SEC investigation into a massive accounting scandal at Waste Management Corp., the Commission found that Andersen not only knew of the accounting fraud at its client, but was deeply involved in the secret cover-up. As a result, the SEC slapped Andersen with the first anti-fraud injunction in 20 years and the largest civil penalty ($7 million) in SEC history assessed against an accounting firm. In addition, the SEC sanctioned several high-ranking Andersen partners for their highly inappropriate conduct,

and required Andersen to sign a consent decree forbidding the firm from engaging in any future wrongdoing. Not incidentally, as here and in Enron, Andersen rendered consulting services to Waste Management while performing the company's audits.

249. Another example concerns Andersen's audit of Sunbeam Corp.'s financial statements. The SEC, in May 2001, filed an injunctive action against Andersen partner Philip E. Harlow, the former engagement partner on the Sunbeam account, for the issuance of fraudulent audit opinions on the Company's financial statements. Ultimately, Andersen paid $110 million to settle shareholder litigation in connection with Sunbeam's restatement of its financial results.

250. Further, on March 14, 2002, in connection with its role in the Enron catastrophe, a federal grand jury indicted Andersen on charges that Andersen knowingly persuaded its employees to withhold records from regulators and criminal proceedings, and alter, destroy and shred literally "tons" of documents with the intent to impede an official investigation.

251. Ultimately, on June 15, 2002, a federal jury criminally convicted Andersen of obstruction of justice. Andersen subsequently announced that it would cease auditing public companies as of August 30, 2002, unless ordered to do so by an earlier date.

252. The above are just the more notable of a number of examples of Andersen's participation in fraudulent accounting schemes. As with Waste Management and Enron, Andersen's willingness to keep quiet about Sunterra's fraudulent accounting to protect fees it earned played a role in the Company's ability to perpetuate the massive accounting fraud as alleged herein.

Andersen's Culture Greatly Diminished Its Ability To Act As An Independent Auditor

253. The very culture of Andersen fostered internal tension that provided the firm's auditors with a compelling incentive to look the other way in the face of accounting

improprieties by Andersen's clients.

254. Profits from all of the practice areas at Andersen flowed into one big pot to be divided among the partners. However, by 1997, Andersen consultants were bringing in 58% of the overall firm's revenues, and subsidizing the auditors by approximately $150 million.

255. After being named top partner at Andersen, Steve Samek, in 1998, instituted a "2X" strategy, pursuant to which, partners were expected to bring in twice their revenues in work outside their practice. In other words, an auditor who brought the firm $2 million for auditing services, should now bring in an additional $4 million in non-audit services, such as tax and consulting. This "2X" strategy was memorialized in an internal manual entitled "U.S. Strategy" that included advice on how to "empathize" with clients.

256. Consequently, there was tremendous pressure on auditors to market themselves to Andersen's audit clients for consulting services. Clearly, the lure of consulting fees compromised auditor independence at Andersen.

257. This is far from the first time that Andersen has found itself mired in a conflict-of-interest situation with one of its clients, compromising the firm's lack of independence. For example, on March 11, 2002, in the wake of the Enron debacle, Chairman Paul Volker, who was appointed to evaluate Andersen's audit procedures, reached the conclusion that, among other things, if Andersen was to resolve the kinds of conflict of interest and impairment of independence that caused the problems in Andersen's Enron audits, the firm needed to split its audit from its consulting practice and ban the financial incentives tying an auditor's compensation to consulting work.

Andersen Was Not Independent

258. Andersen, while auditing the Company's financial statements during the Class

Period, also performed tax, consulting and other non-audit services for Sunterra.

259. Further, Andersen, as Sunterra's "independent" auditor, had a unique role and responsibility. Indeed, the SEC has stressed the importance of meaningful audits being performed by independent accountants: ". . . the audit function must be meaningfully performed and the accountants' independence not compromised." *Relationship Between Registrants and Independent Accountants*, SEC Accounting Series Release No. 296, 1981 SEC LEXIS 858, at *8-*9 (Aug. 20, 1981).

260. Andersen, however, was not independent with respect to Sunterra. Andersen, in fact, had a substantial conflict in its relationship with Sunterra because, in addition to its auditing work for Sunterra, Andersen received substantial fees in connection with tax and consulting services performed for the Company. These fees were particularly important to Andersen's partners as their incomes were, in part, dependent upon the continued business from Sunterra. This economic pressure directly led to a conflict of interest for the auditors on the Sunterra engagement and was a significant factor that led to Andersen abandoning its independence, objectivity and integrity on the audit and review of Sunterra's financial statements.

261. Professional Audit Standards promulgated by both the AICPA and the SEC require that auditors be independent, objective and free of conflicts of interest. See ET §§ 54, 55, 102. Andersen violated these professional standards and others as alleged herein, and breached its duty to the public trust when its thirst for fees caused it to assist Sunterra in the Company's improper accounting during the Class Period. Andersen's interest in generating tax and consulting fees from Sunterra caused a conflict of interest while performing Sunterra's audits and reviews.

262. Andersen knew and recklessly disregarded, or was reckless in not knowing, the

facts set forth herein concerning the non-GAAP accounting and the materially false and misleading disclosures which were contained in the Company's filings with the SEC during the Class Period. Andersen further knew and disregarded, or was reckless in not knowing, that such non-GAAP accounting and the materially false and misleading disclosures resulted in material misstatements of the Company's financial position and results of operation.

263. Andersen's opinion, insofar as it stated that its audit of the Company's financial statements was conducted in accordance with GAAS, was false and misleading because the following GAAS (AU Section 150) were knowingly or recklessly violated:

a. General Standard No. 1 was violated, which standard requires that the examination is to be performed by a person or persons having adequate technical training and proficiency as an auditor.

b. General Standard No. 2 was violated, which standard requires that the auditors maintain an independence in mental attitude in all matters relating to the engagement.

c. General Standard No. 3 was violated, which standard requires that due professional care is to be exercised in the performance of the examination and in the preparation of the report.

d. Standard Of Field Work No. 1 was violated, which standard requires that the work is to be adequately planned and assistants, if any, are to be properly supervised.

e. Standard Of Field Work No. 2 was violated, which standard requires that a sufficient understanding of the internal control structure is to be obtained to plan the audit and to determine the nature, timing and extent of tests to be performed.

f. Standard Of Field Work No. 3 was violated, which standard requires that sufficient competent evidential matter is to be obtained through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under examination.

g. Standard Of Reporting No. 1 was violated, which standard requires that the report shall state whether the financial statements are presented in accordance with generally accepted accounting

principles.

h. Standard Of Reporting No. 3 was violated, which standard requires that informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report.

264. The Company was required to disclose in its financial statements the existence of the material facts described herein and to appropriately report transactions in conformity with GAAP. The Company failed to make such disclosures and to account for and to report transactions in conformity with GAAP. Andersen was, therefore, required pursuant to GAAS (AU Section 508) to express an adverse opinion on the Company's financial statements.

265. Andersen violated GAAS in failing to express an adverse opinion on the financial statements of the Company as of and for the fiscal year ended December 31, 1998. Andersen also knowingly or recklessly violated GAAS by failing o insist that Sunterra restate its financial statements for 1998, by then certifying the false financial statements for year-end 1999, by failing to include "going concern" qualifications in either the 1998 or 1999 audit opinions and by attempting to cover-up the fraud by means of the fraudulent 1999 "audit."

266. Andersen knew or recklessly disregarded the facts which indicated that the financial statements of the Company as of and for the fiscal year ended December 31, 1998, which were disseminated to the investing public during the Class Period, were false and misleading for the reasons set forth herein, and were presented in a manner which violated the principles of fair financial reporting and the GAAP specified herein, among others.

267. GAAS (AU Sections 230, 311 and 316) provides that the auditor should exercise (a) due care in planning, performing, and evaluating the results of audit procedures, and (b) the proper degree of professional skepticism to achieve reasonable assurance that material errors or irregularities will be detected.

268. Andersen failed to comply with GAAS in that it failed to perform its examinations with a proper degree of professional skepticism. In this regard, Andersen either identified and ignored evidence that the Company's financial statements were materially

misstated via fraudulent accounting and irregularities, or recklessly failed to identify such fraudulent accounting and irregularities. For example, according to a former accountant with Sunterra, the Company provided Andersen with work papers reflecting the Company's failure to recognize losses on mortgages receivable which, because Andersen ignored such evidence of an accounting irregularity, ultimately resulted in a material overstatement of mortgages receivable during the Class Period. This accountant further stated that he believed Andersen had Frey, Goodman or Cohen sign a workpaper acknowledging the internal control deficiencies and that Sunterra was taking full responsibility for the mortgages receivable entries because it was undertaking steps to remedy the deficiencies.

269. **The *Gessow* Complaint is replete with specific examples of problems and deficiencies with Sunterra's accounting and financial systems of which Andersen and each of the defendants was aware. For example, on January 28, 1998, Andersen had delivered to the management and the Board, its "Signatures Resorts Inc. Memorandum on Internal Control Structure, January 1998." Several of the significant deficiencies which Andersen noted related specifically to the mortgage receivable portfolio. The defendants were advised by Andersen that: (1) there was no standardized format for the mortgage receivables schedules prepared by the various resorts; (2) mortgage receivable reconciliations were not being prepared by the resorts; and (3) the mortgage receivable balances reported by the mortgage servicers varied from the mortgage receivable balances on the corporation's and the subsidiaries' general ledger. Andersen also recommended the use of an historic delinquency and default rate analysis to determine the allowance for loss reserves on the mortgage receivable portfolio. Gessow Complaint, ¶ 53.**

270. **Andersen reiterated its findings from the January 1998 Memorandum in a**

revised report at the end of its final audit work, which was faxed on February 20, 1998 by Verne Bragg of Andersen to Depatie and Chambers, along with Jim Wheat and Chuck Frey. The report repeated the earlier reported deficiencies, and added the following comments or deficiencies of Signature Resorts to the growing list:

a. Lack of uniformity by the various resorts in software usage, resulting in certain resorts not reconciling receivables on a periodic basis; and

b. Lack of time reporting system to support the capitalization of certain general and administrative costs such as corporate salaries, corporate expenses and overhead for initial activities related to acquisition and development costs to specific resort properties.

Gessow Complaint, ¶ 125.

271. **In April of 1998, Sunterra's management wrote to Andersen, agreeing to make some of the suggested changes. Specifically, Depatie, circulated an April 24, 1998 memo entitled "Management Response to Arthur Andersen Memorandum on Internal Control Structure" to among others, Gessow and Kenninger. In this April 24, 1998 memo, Depatie agreed that, among other things:**

a. The Company needed to implement formal policies and procedures to insure consistency;

b. The Company needed an internal audit department and had started an external search for an experienced internal auditor;

c. The Company needed to develop and implement procedures for the financial statement consolidation process;

d. The Company should adjust the mortgages receivable general ledger

balance based on the reconciliations prepared; and

e. **The Company should prepare a static pool analysis for each resort in order to better determine the mortgage receivable reserve at each resort.**

Gessow Complaint, ¶ 129.

272. **In January 1999, Andersen authored another report entitled "Memorandum on Internal Control Structure, January 1999," which was sent to Management and the Board, including those on the Audit Committee, on January 20, 1999. In this January 1999 Report, Andersen listed no less than fifteen (15) examples of inconsistent applications and interpretations of accounting policies and processes at the various Sunterra resorts, again criticized the financial statement consolidation process, and pointed out the dangers of Sunterra not having an internal audit department, again stating *"an internal audit department is essential to the integrity of the Company's accounting and other operating processes* (emphasis added)," not having a system for properly determining if certain pre-development costs are capitalizable, and a system of review to determine asset impairment. Specifically, Andersen reiterated many of its observations from the January 1998 report, including that there was no standardization of schedules supporting mortgages receivable, sales entries, rescission entries, costs of sales and property, plant and equipment among the resorts and that inventory reconciliations were not being performed at certain resorts. It also observed that pre-sale credit checks were not being performed at certain resorts. Gessow Complaint, ¶ 131.**

273. **Andersen also pointed out on a separate correspondence that same day, January 20, 1999, to Richard Goodman that the Company continued to have weaknesses in**

its analysis of its allowance for mortgages receivable, which could lead to understatements for the allowance account, and that mortgage receivable reconciliations were not being prepared on a timely basis, potentially causing a misstatement of the mortgage receivable balance. Gessow Complaint, ¶ 132.

274. **According to an undated, unsigned management response to the preliminary Andersen January 1999 Memorandum on Internal Control Structure, Andersen presented to management a more detailed list of internal control issues. Among other things, the management response showed that Andersen had previously noted that:**

a. During the securitization process, Andersen had observed documentation errors and inconsistencies in the documentation process at the resorts which could be solved by quality review and written mortgage documentation procedures;

b. There was no process in place for monitoring and reporting compliance with debt covenants on a monthly basis;

c. The Company still estimated its mortgages receivable reserves using a percentage approach rather than taking into account mortgages receivable delinquency/aging reports and a static pool analysis; and

d. At the resort level, mortgage receivable reconciliations were not being prepared on a monthly basis and that variances that resulted from the reconilitations were not being "explained adequately."

In that same management response, management:

a. Acknowledged the need for improvement in management's assistance in the interpretation of formal accounting policies and procedures in

order to ensure that they were consistently followed at all resorts;

b. Agreed that management needs to develop and implement written procedures for the financial consolidation process;

c. Agreed that Sunterra should implement a time reporting methodology that allocates general and administrative costs related to acquisition and development activities for specific reports to ensure that these costs are deferred properly and allocated to project costs correctly;

d. Acknowledged that Sunterra still had no internal audit department; and

e. Agreed that the Company should implement a property review procedure to target properties which are regularly below budget or have recurring losses to ensure that properties with earnings impairments would be identified and could be accounted for properly.

Gessow Complaint, ¶ 133.

275. **Ann Cohen later provided Goodman with a more formal response to Andersen's January 1999 Memorandum on Internal Control Structure. In this more formal response, which according to Cohen, was submitted to Andersen, it was:**

a. Acknowledged that there is a problem with salespeople directly receiving cancellations during the rescission period and being expected to process them, since their compensation is based in part on the percentage of rescinded contracts during the month;

b. **Acknowledged that steps need to be and will be taken to improve communication between accounting and all departments to facilitate timely expense recording, since there was a possibility that expenses were being understated in current periods and reported incorrectly on financial statements; and**

c. Acknowledged the need to analyze the adequacy of the mortgage receivable allowance in conjunction with the mortgage receivable aging reports and static pool analysis.

Gessow Complaint, ¶ 134.

276. **On May 11, 1999, Andersen sent to Sunterra management its report entitled "Audit Committee Report for the Year Ended December 31, 1998," to be presented by Andersen representatives at the Board Meeting on May 14, 1999, addressing many of these still-unresolved deficiencies. The Andersen May 1999 report again noted, among other things "inconsistent applications and interpretations of accounting policies and processes," lack of proper financial statement consolidation process, and the lack of an internal audit department. Gessow Complaint, ¶ 139.**

277. **A follow-up Memorandum on Internal Control Structure was sent by Andersen to Richard Goodman on June 7, 1999, which yet again reported Sunterra's inconsistent applications and interpretations of accounting policies and processes, its potential understatement of its mortgage receivable allowance account due to its inadequate accounting procedures, and its untimely mortgage reconciliations. Thus, it was readily apparent neither Sunterra, the self-described rapid growth company, nor defendants were correcting this litany of accounting deficiencies of which defendants were**

clearly made aware, as evidenced by the numerous red flags and reports explicitly spelling out these material weaknesses to management and the Board, including those on the Audit Committee. Gessow Complaint, ¶ 141.

278. **In August 1999, Andersen issued more severe warnings in its detailed Preliminary Risk/Control Assessment Report to Sunterra and its Board. This document, intended to "identify specific areas where Sunterra internal controls may not be operating effectively," was in excess of 50 pages and detailed many internal controls issues and weaknesses at Sunterra. In addressing the Audit Committee's duties to monitor the finance and accounting functions of Sunterra, the report stressed, among other things:**

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.

Gessow Complaint, ¶ 142.

279. Thus, Andersen either identified and ignored, or recklessly failed to investigate extremely questionable transactions, and made audit judgments that no reasonable auditor would have made if confronted with the same facts. Accordingly, Andersen's audit was so deficient that it amounted to no audit at all.

280. Andersen violated the provisions of GAAS (AU Section 311) which state that:

> The auditor should obtain a level of knowledge of the entity's business that will enable him to plan and perform his audit in accordance with

> generally accepted auditing standards. That level of knowledge should enable him to obtain an understanding of the events, transactions, and practices that, in his judgment, may have a significant effect on the financial statements...Knowledge of the entity's business helps the auditor in:
>
> a. Identifying areas that may need special consideration.
>
> b. Assessing conditions under which accounting data are produced, processed, reviewed, and accumulated within the organization.
>
> c. Evaluating the reasonableness of estimates, such as valuation of inventories, depreciation, allowances for doubtful accounts, and percentage of completion of long-term contracts.
>
> d. Evaluating the reasonableness of management representations.
>
> e. Making judgments about the appropriateness of the accounting principles applied and the adequacy of disclosures.

281. Andersen either failed to identify areas (such as revenue recognition and receivable) that needed special consideration or identified such areas and audited them in a manner which was so deficient that it amounted to no audit at all, while making audit judgments that no reasonable auditor would have made if confronted with the same facts.

282. Andersen either failed to assess the conditions under which accounting data (such as sales data, mortgage data and collection data) were produced, processed, reviewed, and accumulated within the organization, or assessed such conditions and made audit judgments based upon said assessment that no reasonable auditor would have made if confronted with the same facts.

283. According to a former Director, Executive Vice President, and Chief Financial Officer, Michael A. Depatie, the Company's reserves were reviewed quarterly by independent auditors, who signed off on the reserves which the Company claimed to be adequate for financial statement purposes. In performing these periodic reviews of the Company's reserves, Andersen

either failed to evaluate the reasonableness of management's representations, particularly management's representations regarding the adequacy of the Company's reserve for loan losses, or evaluated them in a manner which was so deficient that it amounted to no evaluation at all.

284. Andersen either failed to judge the appropriateness of the accounting principles applied and the adequacy of disclosures in the Company's financial statements, or did so and arrived at judgments that no reasonable auditor would have arrived at if confronted with the same facts. In this regard, Andersen failed to recognize that management's selection and application of significant accounting policies, particularly those related to revenue recognition may be misused. (AU Section 316).

285. Had Andersen undertaken the performance of those audit procedures which were required by GAAS and with the due professional care which was required by GAAS, it would have known that the financial statements of the Company as of and for the year ended December 31, 1998, were materially false and misleading because these financial statements were not presented in accordance with GAAP. In reckless disregard of professional standards, Andersen failed to audit the financial statements of the Company as of and for the fiscal year ended December 31, 1998 in conformity with GAAS. Without doubt, by January 20, 2000 Andersen knew the 1998 financial statements were fraudulent, yet it failed to withdraw its audit opinion or to require a restatement. In effect, Andersen allowed its audit opinion to be reissued with respect to the 1998 financial statements by its "audit" and unqualified certification of Sunterra's fraudulent 1999 financial statements.

286. Andersen also performed tax, consulting and other services for Sunterra. In connection with the non-audit services which Andersen provided to the Company, Andersen personnel were frequently present at the Company's corporate headquarters throughout the year

or spoke to Company personnel frequently throughout the year, and had continual access to and knowledge of the Company's confidential corporate financial, operating and business information. In addition, Andersen personnel responsible for auditing the Company's financial statements attended meetings of the Audit Committee of the Company's Board of Directors during the Class Period. Moreover, a representative of Andersen was present at the Company's annual meeting of stockholders and was available to answer questions regarding the Company's accounting policies and procedures.

287. Throughout the Class Period, the Company was in violation of SEC rules which (i) required it to devise and maintain a system of internal accounting controls sufficient to reasonably assure, among other things, that its transactions were recorded as necessary to permit preparation of financial statements in conformity with GAAP, and SEC rules which (ii) required it to make and keep books, records, and accounts, which in reasonable detail, accurately and fairly reflected all of the transactions of the Company. This failure to comply with SEC bookkeeping and control requirements is evidenced by the statements of former employees as particularized above.

288. Andersen further knew and recklessly disregarded, or was reckless in not knowing, the fact that the Company's change in accounting policy, as particularized above, constituted a material departure from GAAP, and that such departure resulted in material misstatements of the Company's results of operation.

289. Andersen knew and recklessly disregarded or was reckless in not knowing of the Company's woefully deficient bookkeeping and internal control environment. Andersen also knew and recklessly disregarded or was reckless in not knowing that, because these woeful deficiencies existed, GAAS required it to modify and expand the scope of its audit.

290. In significant part, the Company's fraud centered upon the intentional manipulation of data associated with the FoxPro, TimePro and SWORD computer systems, which Sunterra used for sales and accounting purposes.

291. As explained by a former employee, Frey and Cohen, the controller, would aggregate the revenue and accounts receivable information from the FoxPro, TimePro and SWORD computer systems and, in the process, massage the final aggregated figures. For example, Cohen would aggregate the accounts receivable reflected on these computer systems and then delete a portion of the delinquent accounts receivable from the accounts receivable aging schedule.

292. As an auditor, Arthur Andersen was required by GAAS (AU Section 311) to consider the methods which the Company used to process accounting information in planning the audit, because such methods influence the design of he Company's internal control. In addition, Andersen was required by GAAS (AI Section 311) to consider whether specialized skills are needed to consider the effect of computer processing on the audit, to understand the controls, or to design and perform audit procedures and, if needed, to seek the assistance of a professional possessing such skills.

293. Andersen falsely purported to have appropriately planned and conducted its audit in compliance with GAAS stating: "We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement."

294. Andersen knew that the Company's accounting system was heavily dependent upon computer applications using FoxPro, TimePro and SWORD and, in violation of GAAS,

never planned or performed its audit of the Company's fraudulently aggregated computer-generated data in a manner which would have provided "reasonable assurance" of detecting the fact that material amounts of delinquent and uncollectible receivables which, in many instances several years old, existed and were carried as fully collectible in the Company's financial statements.

295. On May 30, 2000, Andersen submitted to Sunterra's Audit Committee, an "Audit Committee Report for the Year Ended December 31, 1999" ("the Audit Committee Report"), which noted "significant deficiencies in the design or the operation of the internal control structure that, in the auditor's judgment, could adversely affect the organization's ability to record, process, summarize and report financial data consistent with the assertions of the management in the financial statements." Elaborating on this observation, the Audit Committee Report observed that:

i. "…certain of the mortgages receivable reconciliations were not being performed on a timely basis…

ii. "…certain reconciling items were inaccurate as receivable in-transit schedules had not been updated.

iii. The Company did not have "standard procedures to monitor Written Off Accounts so the subsequent receipts of payments are applied properly, deed-in-lieu and foreclosure procedures are performed and subsequent receipt of inventory deeds are monitored."

iv. There were "many …inconsistencies in accounting applications."

296. According to numerous former employees, these "significant deficiencies" existed

throughout the Class Period. Andersen either knew of these "significant deficiencies" and turned a blind eye to them during its audit or recklessly failed to know of them.

297. One high level former employee observed that, at all relevant times, Andersen had to have known of the "significant deficiencies" in the Company's computerized accounting processes due to the Andersen's ongoing audit and consultancy engagements. In fact, on May 13, 2002, the Company admitted that there were "ongoing issues related to the functionality of the SWORD system."

298. As stated in the May 2002 Form 8-K:

> The Company purchased a computer software system in 1998. During 1998 through 2000 the Company modified and implemented the new system (known as known internally as SWORD) to meet its internal need. The Company capitalized all costs incurred to develop and prepare the SWORD system for its internal use. Certain payroll, payroll related benefit costs and general and administration costs were not eligible for capitalization. In addition, schedules prepared by the Company did not support the total payroll and payroll related costs capitalized. The Company corrected these capitalization errors related to periods prior to December 31, 2000. This correction resulted in a reduction to retained earnings of approximately $7.3 million as of December 31, 1999…as a result of …ongoing issues related to the functionality of the SWORD system, the Company believed the capitalized costs of SWORD were impaired as of December 31, 2000. As a result, the remaining SWORD capitalized costs were written down in 2000 by an impairment charge of $24.1 million to a carrying amount deemed by the Company to better reflect the system's ongoing utility and fair value. The cumulative reduction in retained earnings as of December 31, 2000 for these two adjustments amounted to $31.4 million.

299. GAAS (AU Section 330) states that:

> Confirmation of accounts receivable is a generally accepted auditing procedure. As discussed in paragraph .06, it is generally presumed that evidence obtained from third parties will provide the auditor with higher-quality audit evidence than is typically available from within the entity. Thus, there is a presumption that the auditor will request the confirmation of accounts receivable during an audit unless one of the following is true:

a. Accounts receivable are immaterial to the financial statements.

b. The use of confirmations would be ineffective.

300. Andersen failed to comply with the foregoing provisions of GAAS in that Andersen knew, prior to commencement of the 1998 audit, of the materiality of the Company's receivables and of the procedures, pursuant to which, the Company recognized revenue and either failed to utilize this information in planning and performing its audit, or utilized this information in a manner that no reasonable auditor would have used if confronted with the same facts. In this regard, Andersen either failed: (1) to obtain confirmation of receivables through direct communication with the Company's customers; (2) to properly utilize the information obtained through direct communication with the Company's customers; or (3) to apply appropriate alternative procedures sufficient to detect the fact that the Company's receivables were materially overstated, that a substantial portion of the Company's receivables were fictitious, and that a material portion of the Company's receivables were uncollectible.

301. GAAS (AU Section 311) states that audit planning involves developing an overall strategy for the expected conduct and scope of the audit. Accordingly, GAAS recognizes that the nature, extent, and timing of planning vary with the size and complexity of the entity, experience with the entity, and knowledge of the entity's business. In this regard, GAAS (AU Section 311) provides that in planning the audit, the auditor should "prepare a written audit program (or set of written audit programs) for every audit" and that this audit program:

> should set forth in reasonable detail the audit procedures that the auditor believes are necessary to accomplish the objectives of the audit...In developing the program, the auditor should be guided by the results of the planning considerations and procedures. As the audit progresses, changed conditions may make it necessary-to modify planned audit procedures.

302. In preparing this audit program, GAAS provided that the auditor should consider

the entity's accounting policies and procedures and the methods used by the entity to process significant accounting information. (AU Section 311).

303. Andersen either failed to consider the Company's accounting policies and procedures and the methods which the Company used to process significant accounting information or considered them in a manner which was so deficient that it amounted to no consideration at all.

304. As acknowledged by Andersen, in its auditor's report, GAAS required Andersen to "plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement."

305. Andersen failed to comply with the foregoing provisions of GAAS in that Andersen knew, prior to commencement of the 1998 audit, of the materiality of the Company's receivables and of the procedures pursuant to which the Company recognized revenue and either failed to utilize this information in planning and performing its audit, or utilized this information in a manner that no reasonable auditor would have used it if confronted with the same facts.

306. GAAS (AU Section 325) states that reportable conditions involves "matters coming to the auditors's attention that, in his judgment, should be communicated to the audit committee because they represent significant deficiencies in the design or operation of internal control, which could adversely affect the organization's ability to record, process, summarize and report financial data consistent with the assertions of management in the financial statement."

307. Further, GAAS (AU Section 325) lists the following deficiencies, certain of which were present at the Company during fiscal 1997, among "examples of matters that may be reportable conditions":

Deficiencies In Internal Structure Design

308. Inadequate overall internal control structure design.

a. Absence of appropriate segregation of duties consistent with appropriate control objectives.

b. Absence of appropriate reviews and approvals of transactions, accounting entries, or systems output.

c. Inadequate procedures for appropriately assessing and applying accounting principles.

d. Inadequate provision for the safeguarding of assets.

e. Absence of other control techniques considered appropriate for the type and level of transaction activity.

f. Evidence that a system fails to provide complete and accurate output that is consistent with objectives and current needs because of design flaws.

Failures In The Operation Of The Internal Control Structure

a. Evidence of failure of identified controls in preventing or detecting misstatements of accounting information.

b. Evidence that a system fails to provide complete and accurate output consistent with the entity's control objectives because of the misapplication of control procedures.

c. Evidence of failure to safeguard assets from loss, damage or misappropriation.

d. Evidence of intentional override of the internal control structure by those in authority to the detriment of the overall control objectives of the system.

e. Evidence of failure to perform tasks that are part of the internal control structure, such as reconciliations not prepared or not timely prepared.

f. Evidence of willful wrongdoing by employees or management.

g. Evidence of manipulation, falsification, or alteration of accounting records or supporting documents.

h. Evidence of intentional misapplication of accounting principles.

i. Evidence of misrepresentation by client personnel to the auditor.

j. Evidence that employees or management lack the qualifications and training to fulfill their assigned functions.

Other

Absence of a sufficient level of control consciousness within the organization.

b. Failure to follow up and correct previously identified internal control structure deficiencies.

c. Evidence of significant or extensive undisclosed related party transactions.

c. Evidence of undue bias or lack of objectivity by those responsible for accounting decisions.

309. As particularized above, numerous significant deficiencies in internal structure design and failures in the operation of the internal control structure were blatantly apparent at all relevant times.

310. During its 1998 audit, Andersen either failed to identify these blatantly apparent material weaknesses in internal control (i.e., failure of controls to prevent or detect misstatements of accounting information), or identified and ignored the existence of such conditions in violation of GAAS.

311. The Company held its annual shareholders' meeting on Friday May 14, 1999, in Atlanta, Georgia. A representative of Andersen was present at this annual meeting and was afforded an opportunity to make a statement regarding the Company's accounting practices and to answer questions asked by stockholders. At this annual meeting, said Andersen representative failed to disclose the fact that the Company had changed its method of accounting for, among other things, uncollectible receivables, that the Company's financial statements were not

prepared in conformity with GAAP, or that the Company was in violation of SEC rules which require (i) a reporting company to devise and maintain a system of internal accounting controls sufficient to reasonably assure, among other things, that transactions are recorded as necessary to permit preparation of financial statements in conformity with GAAP, and SEC rules which require (ii) a reporting company to make and keep books, records, and accounts, which in reasonable detail, accurately and fairly reflect the transactions of the company.

ADDITIONAL SCIENTER ALLEGATIONS

312. As alleged herein, defendants acted with scienter in that defendants knew or recklessly disregarded that the public documents and statements, issued or disseminated by or in the name of the Company, lacked a reliable basis and were materially false and misleading; knew or recklessly disregarded that such statements or documents would be issued or disseminated to the investing public; and knowingly and substantially participated or acquiesced in the issuance or dissemination of such statements or documents as primary violators of the federal securities laws. As set forth elsewhere herein in detail, defendants, by virtue of their receipt of information reflecting the true facts regarding Sunterra and its business practices, their control over and/or receipt of Sunterra's allegedly materially misleading misstatements and/or their associations with the Company which made them privy to confidential proprietary information concerning Sunterra were active and culpable participants in the fraudulent scheme alleged herein. Defendants knew and/or recklessly disregarded the falsity and misleading nature of the information which they caused to be disseminated to the investing public. This case does not involve allegations of false forward-looking statements or projections but instead involves false statements concerning the Company's then-present business, finances and operations. The ongoing fraudulent scheme described in this complaint could not have been perpetrated over a

substantial period of time, as has occurred, without the knowledge and complicity of the personnel at the highest level of the Company, including each of the defendants, as well as the complicity of the purportedly "independent" outside auditor, defendant Arthur Andersen.

313. Each of the defendants engaged in such a scheme to inflate the price of Sunterra common stock in order to: (i) maintain and increase the Company's operating credit lines and access to credit, and avoid violations of debt covenants; (ii) enhance the value of their personal holdings of Sunterra common stock and options; (iii) advance the Company's aggressive growth strategy which depended, in large measure, on the Company's ability to access the asset-backed securitization market; (iv) permit profitable insider sales by Sunterra insiders; and (v) effectuate an "exit strategy" of selling the Company. Indeed, Sunterra insiders, who were privy to the Company's true financial and operating condition - including the Company's former Co-Chairman of the Board, - sold over 350,000 of their Sunterra shares after March 1999, at artificially inflated prices, reaping proceeds of over $10,000,000. The investing public, unaware of the Company's true state of affairs, at least in part due to the Company's fraudulent accounting, were not as fortunate, and continued to purchase Sunterra common stock at grossly inflated prices reaching $14.82 per share in July of 1999.

314. Andersen's scienter is demonstrated by its conflict of interest and lack of independence by virtue of the firm's performance of tax, consulting and other non-audit services while also acting as the Company's "independent" auditor during the Class Period, and while deferring ("empathizing") to the false assurances of Sunterra management. Its scienter is further demonstrated by Andersen's reckless failure to require a restatement of the 1998 financial statements when it certified the fraudulent 1999 financial statements in the face of known (and admitted) deficiencies in the books, records and systems of Sunterra.

315. Scienter is further demonstrated by defendants' failure to disclose the change in accounting practices and policies during the Class Period concerning non-performing mortgages receivable. Sunterra's 1998 Form 10-K contained no disclosure of a change in the Company's accounting policies with respect to (i) deeming loans which were 120 days past due to be uncollectible; (ii) cessation of the accrual of interest and expensing accrued and unpaid interest on loans which were 120 days past due; (iii) commencement of foreclosure proceedings on loans which were 120 days past due; or (iv) comparing Sunterra's delinquency experience to the entire portfolio of mortgage receivables (including those that had been sold) versus comparing it solely to those the Company had retained. In this regard, the investment community is aware of the fact that GAAP (APB Opinion No. 20, Accounting Changes) states that:

> A change in accounting principle results from adoption of a generally accepted accounting principle different from the one used previously for reporting purposes. The term accounting principle includes "not only accounting principles and practices but also the methods of applying them.
>
> * * * *
>
> The nature of and justification for a change in accounting principle and its effect on income should be disclosed in the financial statements of the period in which the change is made. The justification for the change should explain clearly why the newly adopted accounting principle is preferable.

316. However, unbeknownst to the investment community, defendants had caused the Company to drastically change its definition of "uncollectible" receivables and its accounting policies with respect to the recognition of losses on these receivables and concealed this fact from the investing public. These facts only became apparent when the Company disseminated the 1999 Form 10-K which announced a huge write-off of receivables and interest charges accrued thereon which were "180 days or more past due."

317. The elimination of a prior disclosure and the concealment of a change in the

Company's accounting policies create a strong inference of scienter. This is particularly true given the fact that the 1998 Form 10-K disclosed another accounting change as follows:

> During the fourth quarter of 1998, the Company recorded a $1.5 million cumulative effect of change in accounting principle, net of taxes, as the result of the early adoption of the AICPA's Statement of Position 98-5 (SOP 98-5), "Reporting on the Costs of Start-up Activities." The SOP required the Company to expense all previously capitalized start-up costs as of January 1, 1998 [sic 1999] and requires the Company to expense all such expenses as incurred after January 1, 1998[sic 1999].

APPLICABILITY OF PRESUMPTION OF RELIANCE: FRAUD-ON-THE-MARKET DOCTRINE

318. At all relevant times, the market for Sunterra common stock was an efficient market for the following reasons, among others:

(a) Sunterra common stock met the requirements for listing, and was listed and actively traded, on the New York Stock Exchange, a highly efficient market;

(b) As a regulated issuer, Sunterra filed periodic public reports with the SEC;

(c) Sunterra stock was followed by securities analysts employed by major brokerage firms who wrote reports which were distributed to the sales force and certain customers of their respective brokerage firms. Each of these reports was publicly available and entered the public marketplace; and

(d) Sunterra regularly issued press releases which were carried by national newswires. Each of these releases was publicly available and entered the public marketplace. As a result, the market for Sunterra securities promptly digested current information with respect to Sunterra from all publicly-available sources and reflected such information in Sunterra's stock price. Under these circumstances, all purchasers of Sunterra common stock during the Class Period suffered similar injury through their purchase of stock at artificially inflated prices and a presumption of reliance applies.

NO SAFE HARBOR

The statutory safe harbor provided for forward-looking statements under certain circumstances does not apply to any of the allegedly false statements pleaded in this complaint. The specific statements pleaded herein concerned the then-present and historical operations of Sunterra and were not identified as "forward-looking statements" when made. Nor was it stated with respect to any of the statements forming the basis of this complaint that actual results "could differ materially from those projected." To the extent there were any forward-looking statements, there were no meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the purportedly forward-looking statements. Alternatively, to the extent that the statutory safe harbor does apply to any forward-looking statements pleaded herein, defendants are liable for those false forward-looking statements because at the time each of those forward-looking was made the particular speaker knew that the particular forward-looking statement was false, and/or the forward-looking statement was authorized and/or approved by an executive officer of Sunterra who knew that those statements were false when made.

PLAINTIFFS' CLASS ACTION ALLEGATIONS

319. Plaintiffs bring this action as a class action pursuant to Federal Rule of Civil Procedure 23(a) and (b)(3) on behalf of a Class, consisting of all persons who purchased or otherwise acquired Sunterra common stock between October 6, 1998 through January 19, 2000, inclusive, and who were damaged thereby. Excluded from the Class are defendants, members of the immediate family of each of the Individual Defendants, any subsidiary or affiliate of Sunterra and the current or former directors, officers, and employees of Sunterra or its subsidiaries or

affiliates, or any entity in which any excluded person has a controlling interest, and the legal representatives, heirs, successors and assigns of any excluded person.

320. The members of the Class are so numerous that joinder of all members is impracticable. While the exact number of Class members is unknown to plaintiffs at this time and can only be ascertained through appropriate discovery, plaintiffs believe that there are thousands of members of the Class located throughout the United States. As of March 20, 2000, there were more than 35.98 million shares of Sunterra common stock outstanding. Throughout the Class Period, Sunterra common stock was actively traded on the New York Stock Exchange, an open and regulated national securities market. Record owners and other members of the Class may be identified from records maintained by Sunterra and/or its transfer agents and may be notified of the pendency of this action by mail, using a form of notice similar to that customarily used in securities class actions.

321. Plaintiffs' claims are typical of the claims of the other members of the Class as all members of the Class were similarly affected by defendants' wrongful conduct in violation of federal law and state law that is complained of herein.

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

323. Common questions of law and fact exist as to all members of the Class and predominate over any questions solely affecting individual members of the Class. Among the questions of law and fact common to the Class are:

(a) whether the federal securities laws were violated by defendants' acts and omissions as alleged herein;

(b) whether defendants participated in and pursued the common course of

conduct complained of herein;

(c) whether documents, press releases, and other statements disseminated to the investing public and the Company's shareholders during the Class Period misrepresented material facts about the business, assets, net worth, finances, financial condition, and prospects of Sunterra;

(d) whether statements made by defendants to the investing public during the Class Period misrepresented and/or omitted to disclose material facts about the business, assets, net worth, finances, value, performance, and prospects of Sunterra;

(e) whether the market price of Sunterra common stock during the Class Period was artificially inflated due to the material misrepresentations and failures to correct the material misrepresentations complained of herein; and

(e) to what extent the members of the Class have sustained damages and the proper measure of damages.

324. A class action is superior to all other available methods for the fair and efficient adjudication of this controversy since joinder of all members is impracticable. Furthermore, as the damages suffered by individual Class members may be relatively small, the expense and burden of individual litigation make it impossible for members of the Class to individually redress the wrongs done to them. There will be no difficulty in the management of this suit as a class action.

FIRST CLAIM

(VIOLATIONS OF SECTION 10(b) OF THE EXCHANGE ACT AND RULE 10b-5 PROMULGATED THEREUNDER AGAINST ALL DEFENDANTS)

325. Plaintiffs repeat and reallege each and every allegation contained above.

326. Each of the defendants: (a) knew or recklessly disregarded material adverse non-

public information about Sunterra's financial results and then existing business conditions, which was not disclosed; and (b) participated in supplying schedules, drafting, reviewing and/or approving the misleading statements, releases, reports, and other public representations of and about Sunterra.

327. During the Class Period, defendants, with knowledge of or reckless disregard for the truth, directly or indirectly, disseminated or approved the false statements specified above, which were misleading in that they contained misrepresentations and failed to disclose material facts necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading.

328. Defendants have violated Section 10(b) of the Exchange Act and Rule 10b-5 promulgated thereunder in that they directly or indirectly: (a) employed devices, schemes, and artifices to defraud; (b) made untrue statements of material facts or omitted to state material facts necessary in order to make statements made, in light of the circumstances under which they were made, not misleading; or (c) engaged in acts, practices, and a course of business that operated as a fraud or deceit upon the purchasers of Sunterra stock during the Class Period.

329. Plaintiffs and the Class have suffered damage in that, in reliance on the integrity of the market, they paid artificially inflated prices for Sunterra stock. Plaintiffs and the Class would not have purchased Sunterra stock at the prices they paid, or at all, if they had been aware that the market prices had been artificially and falsely inflated by defendants' false and misleading statements.

SECOND CLAIM

(VIOLATION OF SECTION 20(a) OF THE EXCHANGE ACT AGAINST ALL DEFENDANTS EXCEPT ARTHUR ANDERSEN)

330. Plaintiffs repeat and reallege each and every allegation contained above.

331. The Individual Defendants acted as controlling persons of Sunterra within the meaning of Section 20(a) of the Exchange Act. By reason of their senior executive and/or Board positions and their ownership and contractual rights, participation in and/or awareness of the Company's operations and/or intimate knowledge of the false financial statements filed by the Company with the SEC and disseminated to the investing public, the Individual Defendants had the power and authority to cause Sunterra to engage in the wrongful conduct complained of herein, and did influence and control, directly or indirectly, the decision-making of the Company, including the content and dissemination of the various statements which plaintiffs contend are false and misleading. The Individual Defendants were provided with or had unlimited access to copies of the Company's reports, press releases, public filings and other statements alleged by plaintiffs to be misleading prior to and/or shortly after these statements were issued and had the ability to prevent the issuance of the statements or cause the statements to be corrected.

332. In particular, each of the Individual Defendants had direct and supervisory involvement in the day-to-day operations of the Company and, therefore, is presumed to have had the power to control or influence the particular transactions giving rise to the securities violations as alleged herein, and exercised the same. In fact, as alleged above, each of the Individual Defendants actually prepared schedules, submitted information, manipulated transactions and performed consolidating "adjustments" that each knew would be and were in fact included in Sunterra's publicly reported financial statements.

333. As set forth above, Sunterra and the Individual Defendants each violated Section 10(b) and Rule 10b-5 by their acts and omissions as alleged in the Complaint. By virtue of their positions as controlling persons, the Individual Defendants are liable pursuant to Section 20(a) of

the Exchange Act. As a direct and proximate result of these defendants' wrongful conduct, plaintiffs and the other members of the Class suffered damages in connection with their purchases of Sunterra stock during the Class Period.

DEMAND FOR RELIEF

WHEREFORE, plaintiffs pray for relief and judgment, as follows:

1. Determining that this action is a proper class action and certifying plaintiffs as class representatives under Rule 23 of the Federal Rules of Civil Procedure;

2. Awarding compensatory damages in favor of plaintiffs and the other Class members against all defendants, jointly and severally, for all damages sustained as a result of defendants' wrongdoing, in an amount to be proven at trial, including interest thereon;

3. Awarding plaintiffs and the Class their reasonable costs and expenses incurred in this action, including counsel fees and expert fees; and

4. Such other and further relief as the Court may deem just and proper.

JURY TRIAL DEMANDED

Plaintiffs hereby demand a trial by jury.

DATED: April 25, 2003 **DONOVAN SEARLES, LLC**

By:______________________________

Michael D. Donovan, Esq.
David A. Searles, Esq.
1845 Walnut Street, Suite 1100
Philadelphia, Pennsylvania 19103
(215) 732-6067

BERNSTEIN LIEBHARD & LIFSHITZ, LLP

By:__________________________________

Stanley Bernstein, Esq.
Robert J. Berg, Esq.
10 East 40th Street, 22nd Floor
New York, New York 10016
(212) 779-1414

Co-Lead Counsel for Lead Plaintiffs and the Class

BERMAN, DEVALERIO, PEASE,
TABACCO, BURT & PUCILLO, P.C.

By:__________________________________

C. Oliver Burt, III, Esq.
Florida Bar No. 0005215
Lauren Dadario, Esq.
515 North Flagler Drive, Suite 1701
West Palm Beach, Florida 33401
(561) 835-9400

**MILBERG, WEISS, BERSHAD, HYNES
& LERACH, LLP**
Kenneth J. Vianale, Esq.
Florida. Bar No. 169668
5355 Town Center Road, Suite 900
Boca Raton, Florida 33486
(561) 361-5000

Mark C. Gardy, Esq.
ABBEY GARDY, LLP
212 East 39th Street
New York, New York 10016

Michael C. Addison, Esq.
LAW OFFICE OF MICHAEL C. ADDISON
220 East Madison Street, Suite 1130
Tampa, Florida 33602

James V. Bashian, Esq.
LAW OFFICES OF JAMES V. BASHIAN, P.C.
500 Fifth Avenue
New York, New York 10110

Sherrie R. Savett, Esq.
BERGER & MONTAGUE, P.C.
1622 Locust Street
Philadelphia, Pennsylvania 19103

Joshua M. Lifshitz, Esq.
BULL & LIFSHITZ
246 West 38th Street
New York, New York 10018

Andrew N. Friedman, Esq.
COHEN, MILSTEIN HAUSFELD
& TOLL, P.L.L.C.
1100 New York Avenue, N.W.,
Suite 500 West Tower
Washington, D.C. 20005-3694

Leo W. Desmond, Esq.
LAW OFFICE OF LEO W. DESMOND
2161 Palm Beach Lakes Blvd.
West Palm Beach, Florida 33409

Francis J. Farina, Esq.
LAW OFFICES OF FRANCIS J. FARINA
577 Gregory Lane
Devon, Pennsylvania 19333

Brian M. Felgoise, Esq.
LAW OFFICES OF BRIAN FELGOISE
230 South Broad Street, Suite 404
Philadelphia, PA 19102

Michael A. Hanzman, Esq.
HANZMAN CRIDEN CHAYKIN & ROLNICK, P.A.
First Union Financial Center, Suite 2100
200 South Biscayne Boulevard
Miami, Florida 33131

Marc H. Edelson, Esq.
HOFFMAN & EDELSON
45 W. Court Street
Doylestown, PA 18901

Michael J. Boni, Esq.
KOHN, SWIFT & GRAF
1101 Market Street, Suite 2400
Philadelphia, Pennsylvania 19107

Stephen Levy, Esq.
LEVY & LEVY P.C.
245 Park Avenue, 39th Floor
New York, New York 10167

Richard A. Lockridge, Esq.
LOCKRIDGE GRINDAL NAUEN PLLP
100 Washington Avenue South, Suite 2200
Minneapolis, Minnesota 55401

Tracy Murray, Esq.
LAW OFFICES OF TRACY MURRAY
47 Cambridge Avenue
Garden City, New York 11530

Linda P. Nussbaum, Esq.
POMERANTZ HAUDEK BLOCK GROSSMAN &
GROSS LLP
100 Park Avenue, 26th Floor
New York, New York 10017

Lisa Rodriguez, Esq.
TRUJILLO, RODRIGUEZ & RICHARDS, LLC
3 Kings Highway East
Haddonfield, New Jersey 08033

Andrew Schatz, Esq.
SCHATZ & NOBEL P.C.
216 Main Street
Hartford, Connecticut 06106

Mark A. Topaz, Esq.
SCHIFFRIN & BARROWAY LLP
Three Bala Plaza East, Suite 400
Bala Cynwyd, Pennsylvania 19004

Wallace A. Showman, Esq.
LAW OFFICE OF WALLACE A. SHOWMAN
1350 Avenue of the Americas
New York, New York 10019

Douglas Bowdoin, Esq.
SMITH, MACKINNON, GREELEY, BOWDOIN,
EDWARDS, BROWNLEE & MARKS, P.A.
255 Orange Avenue, Suite 800
Orlando, Florida 32802

Robert M. Roseman, Esq.
SPECTOR, ROSEMAN & KODROFF, P.C.
1818 Market Street, Suite 2500
Philadelphia, Pennsylvania 19103

Curtis Trinko, Esq.
LAW OFFICE OF CURTIS TRINKO
16 West 46th Street
New York, New York 10017

Samuel K. Rosen, Esq.
WECHSLER, HARWOOD,
HALEBIAN, & FEFFER, LLP
488 Madison Avenue
New York, New York 10022

Mark S. Goldman, Esq.
WEINSTEIN KITCHENNOFF SCARLATO &
GOLDMAN, LTD.

1608 Walnut Street, Suite 1400
Philadelphia, Pennsylvania 19103

Fred Taylor Isquith, Esq.
WOLF, HALDENSTEIN, ADLER
FREEMAN & HERZ, LLP
270 Madison Avenue
New York, New York 10016

Chet B. Waldman, Esq.
WOLF POPPER LLP
845 Third Avenue, 12th Floor
New York, New York 10022

Attorneys for Plaintiffs