

1 Theodore A. Griffinger, Jr. (SBN 66028)
Ellen A. Cirangle (SBN 164188)
2 Jonathan Sommer (SBN 209179)
STEIN & LUBIN LLP
3 600 Montgomery Street, 14th Floor
San Francisco, California 94111
4 Telephone: (415) 981-0550
Facsimile: (415) 981-4343
5 tgriffinger@steinlubin.com
ecirangle@steinlubin.com
6 jsommer@steinlubin.com

REDACTED

7 Attorneys for Plaintiffs
OVERSTOCK.COM, INC., KEITH CARPENTER,
8 OLIVIER CHENG, FERN BAILEY and WENDY
MATHER, as Co-Personal Representatives of the
9 Estate of MARY HELBURN, ELIZABETH
FOSTER, HUGH D. BARRON, DAVID TRENT,
10 and MARK MONTAG

11 SUPERIOR COURT OF THE STATE OF CALIFORNIA
12 COUNTY OF SAN FRANCISCO

14 OVERSTOCK.COM, INC., a Delaware
15 corporation, et al.,

Case No. CGC-07-460147

16 Plaintiffs,

**PLAINTIFFS' MEMORANDUM OF
POINTS AND AUTHORITIES IN
SUPPORT OF MOTION FOR LEAVE TO
FILE FOURTH AMENDED COMPLAINT**

17 v.

18 MORGAN STANLEY & CO.,
INCORPORATED, et al.,

Date: January 11, 2011
Time: 1:30 p.m.
Dept.: 305
Judge: Hon. John E. Munter

19 Defendants.
20

Action Filed: February 2, 2007
Trial Date: September 12, 2011

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1 Plaintiffs Overstock.com, Inc.; Keith Carpenter; Oliver Cheng; Fern Bailey and
2 Wendy Mather, as Co-Personal Representatives of the Estate of Mary Helburn; Elizabeth Foster;
3 Hugh D. Barron; and Mark Montag (collectively, "Plaintiffs") submit this memorandum in
4 support of their Motion for Leave to File a Fourth Amended Complaint (the "Motion") as
5 follows:

6 **I.**
INTRODUCTION

7 The Motion seeks leave to add a claim for violations of the New Jersey Racketeer
8 Influenced and Corrupt Organization Act ("New Jersey RICO") against Merrill Lynch Pierce
9 Fenner & Smith, Inc. and Merrill Lynch Professional Clearing Corporation (together, "Merrill")
10 and Goldman Sachs & Co., Goldman Sachs Execution & Clearing, L.P., and the Goldman Sachs
11 Group, Inc. (collectively, "Goldman").

12 While Plaintiffs have always alleged that Defendants were participating in a
13 manipulative naked short selling scheme concerning Overstock securities, Plaintiffs have recently
14 discovered evidence that part of that manipulation included a specific unlawful enterprise.
15 Merrill, Goldman and certain of their market maker clients agreed to and created a scheme to
16 effect the naked short selling in Overstock securities that is the subject of this action, in order to
17 perpetuate short selling and drive down the price of Overstock, to their mutual profit. This
18 manipulative naked short selling activity occurred with the knowledge of all participants in the
19 enterprise and was specifically tracked and analyzed by Merrill and Goldman.

20 As victims of the scheme, Plaintiffs may avail themselves of their additional rights
21 and remedies under civil RICO. Because actionable conduct occurred in New Jersey, and
22 because it is well-settled that California courts should enforce other states' statutes, Plaintiffs seek
23 leave to amend their complaint to add a claim under the New Jersey RICO statute predicated on
24 state securities law violations.

25 Plaintiffs are moving promptly to amend their complaint. Within the past couple
26 of months, Plaintiffs have (1) taken testimony in this action, (2) obtained documents via a
27 subpoena to a company, TASER, Inc., that filed and has pending a securities fraud and RICO
28 action against Merrill and Goldman in Georgia, and (3) received documents from Merrill and

1 Goldman that were previously produced by them [REDACTED]. This recent discovery
2 combined to reveal the scheme. The discovery in all three actions ([REDACTED], the
3 *TASER* litigation and this action) appears to be substantially overlapping.

4 Defendants will not be prejudiced by the addition of the new claim. The additional
5 claim is based upon the same set of facts as both the original and the current complaint.
6 Furthermore, Goldman and Merrill have been working on similar discovery in the context of the
7 *TASER* lawsuit and the [REDACTED] for over three years. Where, as here, Plaintiffs have
8 timely moved for leave to amend, and Defendants will not be prejudiced if leave is granted,
9 Plaintiffs should be allowed to amend their complaint.

10 **II.**
11 **FACTUAL AND PROCEDURAL BACKGROUND**

12 **A. Plaintiffs Alleged that a Manipulative Naked Short Selling Scheme Caused Fails to**
13 **Deliver in Overstock Securities**

14 In 2007, Plaintiffs filed their original complaint alleging that “[s]ince at least
15 January 2005, large quantities of Overstock shares have been the subject of naked short selling.”
16 Complaint, ¶ 30. A “naked short sale” refers to when a short sale of stock occurs, but the stock is
17 never delivered, resulting in “fails to deliver.” *Id.*, ¶¶ 27-28. Plaintiffs further alleged that
18 “Defendants have . . . participate[d] in a massive, illegal stock market manipulation scheme . . .
19 Defendants have executed, as principal and agent, short sales of the stock of Overstock with no
20 intention of delivering stock to settle the short sale . . . Defendants have intentionally failed to
21 deliver Overstock stock.” *Id.* ¶ 1. “These persistent failures to deliver have created immense
22 downward pressure on the price of Overstock’s stock by creating an unlimited supply of that
23 stock for sale.” *Id.* ¶ 31.

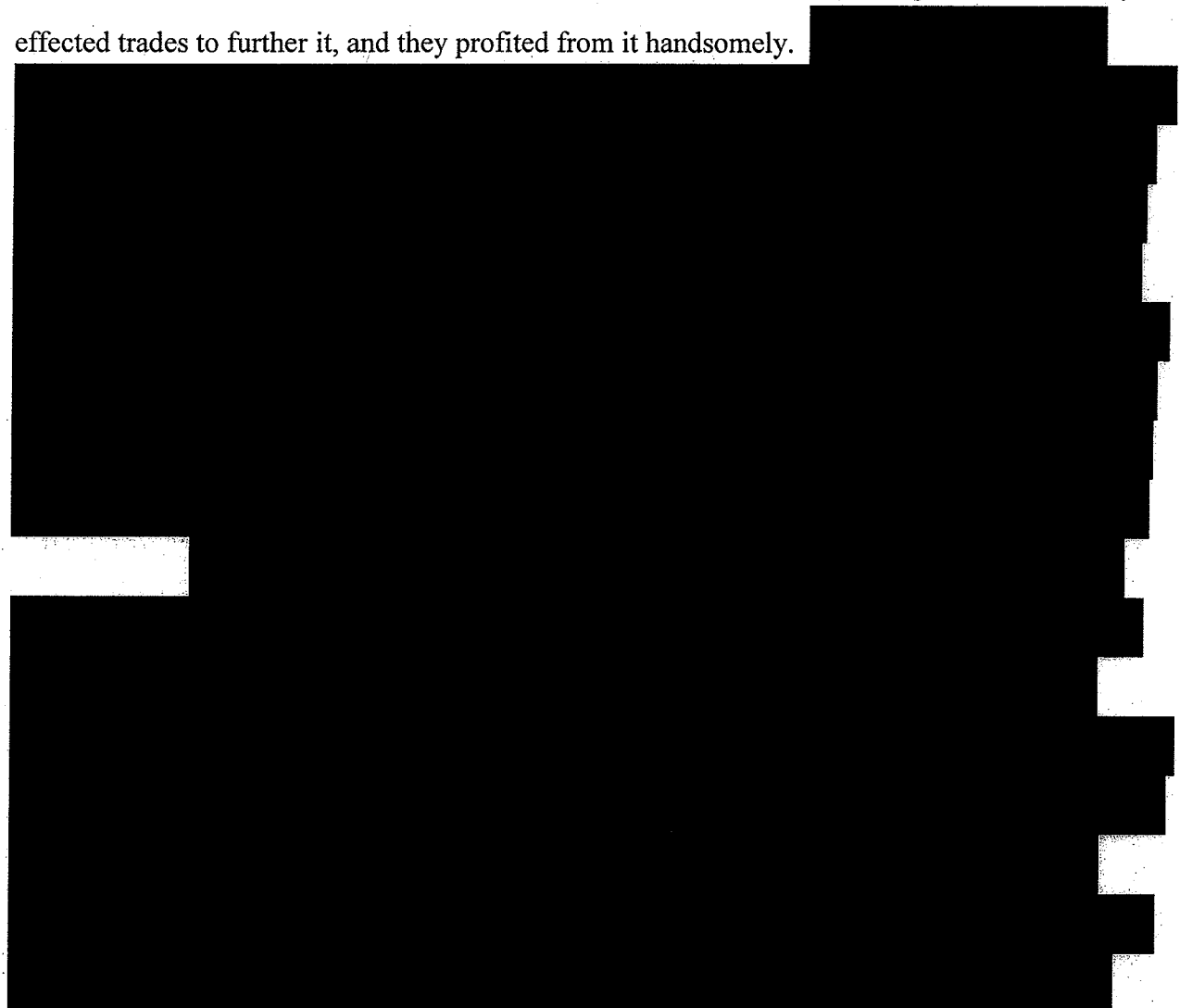
24 **B. Defendants Denied that any Cause of Fails to Deliver Could Be Known**

25 Throughout the discovery process, Plaintiffs propounded discovery aimed at
26 obtaining additional evidence to support their claims of a manipulative scheme that resulted in the
27 fails to deliver. Among other things, Plaintiffs sought discovery from Defendants as to the
28 question of why they were failing to deliver Overstock stock. Declaration of Ellen Cirangle in
Support of Motion (“Cirangle Decl.”), ¶ 5.

1 Goldman and Merrill repeatedly told Plaintiffs that they lacked the ability to
2 determine why they were failing to deliver Overstock securities. Cirangle Decl., ¶¶ 6, 7 and Ex.
3 A at 8:17-9:5, Ex. B at 6:1-9, Ex. C at 3. Likewise, in the October 17, 2008 Joint Case
4 Management Statement, Defendants stated that they have no “records showing which trades are
5 related to specific failures to deliver or receive.” Cirangle Decl., Ex. B at 6:1-9. Defendants
6 stated that “CNS fails might be associated with trades only in very rare instances” and that
7 that “theoretical possibility is not present in trading in Overstock.com.” *Id.* (emphasis
8 added.)

9 **C. Goldman and Merrill Knew What Was Causing Most of the Fails**

10 In reality, Merrill and Goldman knew why fails in Overstock had occurred because
11 they were knowingly participating in a scheme that caused fails. They set up the scheme, they
12 effected trades to further it, and they profited from it handsomely.



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[REDACTED]

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1 **D. Plaintiffs Recently Discovered that this Scheme Caused Most of the Massive Fails to**
2 **Deliver that Are the Subject of this Action**

3 Around June and July 2010, Plaintiffs began receiving documents from third-party
4 subpoenas to FINRA and self-regulatory organizations that suggested the majority of the fails to
5 deliver Overstock securities may somehow be related to Merrill, Goldman and two traders, Scott
6 Arenstein and Steven Hazan. Cirangle Decl., ¶ 22. Plaintiffs served document requests on
7 Merrill and Goldman that requested information pertaining to Arenstein and Hazan; however,
8 Goldman and Merrill both objected to the discovery. On October 28, 2010, Merrill first agreed to
9 provide Plaintiffs with the documents they had previously produced [REDACTED]. Goldman did not
10 concede the relevancy of the issue until Overstock raised it with the Court at a November 4, 2010
11 discovery conference. *Id.*, ¶ 23. In the interim, neither Goldman nor Merrill revealed the

12 [REDACTED]
13 [REDACTED]
14 [REDACTED]
15 [REDACTED]
16 [REDACTED]
17 [REDACTED]

18 Roughly simultaneously, Plaintiffs obtained access to four of the five hard drives
19 of documents subpoenaed from the *TASER* action in Georgia¹ (the first portion of the five hard
20 drives was received on or about August 25, 2010, but could not be accessed until November 1,
21 2010 due to technical difficulties with the data). *Id.*, ¶ 10. This production contains millions of
22 pages of documents produced by Goldman and Merrill, again relating to the same claims in this
23 action – intentional naked short selling market manipulation schemes.

24 This trove of new documents, deposition transcripts, and Merrill's recent
25 testimony ties Goldman, Merrill and the market makers together. The Goldman and Merrill
26 productions in *TASER* [REDACTED] both were far more extensive than the productions here and

27 _____
28 ¹ *TASER International, Inc., et al. v. Morgan Stanley & Co., et al.*, Georgia State Court, Fulton
County, Case No. 2008-EV-004739-B.

1 provided the evidence which led Plaintiffs to conclude they had a proper basis to allege a New
2 Jersey RICO claim. *Id.*, ¶ 16.

3 **E. The RICO Scheme**

4 The scheme worked roughly as follows: Merrill, Goldman and market makers
5 agreed that the market makers would, in combination with Merrill, short sell stock to Goldman in
6 the form of a “conversion” trade or similar trading strategy. Fourth Am. Complaint, ¶¶ 52-53.
7 Merrill and Goldman knew that the scheme would result in massive fails to deliver in Overstock
8 stock. *Id.*, ¶ 53. Arenstein, one of the market makers in the scheme, communicated with both
9 Goldman and Merrill to plan this naked short selling strategy. *Id.* Merrill, Goldman, and the
10 market makers knew and intended that the naked short selling would depress the price for
11 Overstock securities and intended to manipulatively perpetuate short selling in Overstock by
12 creating a false and artificial supply of Overstock stock. *Id.* Goldman, Merrill and the market
13 makers all profited from the decline in Overstock's stock price. *Id.*

14 **III.**
15 **ARGUMENT**

16 **A. California Has a Policy of Great Liberality in Allowing Amendments at any Stage of**
17 **the Proceedings.**

18 California Code of Civil Procedure section 473(a)(1) provides that “[t]he court
19 may . . . in its discretion, after notice to the adverse party, allow, upon any terms as may be just,
20 an amendment to any pleading or proceeding in other particulars.” Cal. Civ. Proc. Code §
21 473(a)(1). “The discretionary power to allow amendments . . . must be exercised liberally at all
22 stages of the proceeding . . .” *Edwards v. Superior Court*, 93 Cal. App. 4th 172, 180 (2001); *see*
23 *also Laabs v. City of Victorville*, 163 Cal. App. 4th 1242, 1258 (2008) (even at the summary
24 judgment stage, “amendments to the pleadings are readily allowed.”). Indeed, “[l]eave to amend
25 should be denied only where the facts are not in dispute, and the nature of the plaintiff’s claim is
26 clear, but under substantive law, no liability exists and no amendment would change the result.”
27 *Edwards*, 93 Cal. App. 4th at 180. No such circumstances exist here. Thus, California’s policy of
28 great liberality in permitting amendments requires that Plaintiffs be granted leave to amend.

1 **B. Plaintiffs' Motion Is Timely.**

2 Plaintiffs only discovered the facts showing the existence of an enterprise under
3 the New Jersey RICO laws in the last couple of months. From the inception of the case,
4 Plaintiffs sought to discover the causes of fails to deliver in Overstock, but Defendants repeatedly
5 represented to Plaintiffs and the Court that it was impossible to determine the source and reason
6 for the fails. With much effort, Plaintiffs have uncovered facts further establishing that the naked
7 short selling was not only intentional market manipulation, but was also in large part the product
8 of a specific RICO enterprise involving Merrill and Goldman.

9 One of the purposes of California's broad discovery provisions is to enable
10 plaintiffs to determine if there are grounds for amending their complaints to add additional
11 claims. *Mabie v. Hyatt*, 61 Cal. App. 4th 581, 596 (1998). Leave should be granted "[i]f
12 discovery and investigation develop factual grounds justifying a timely amendment to a
13 pleading" *Id.* This case shows the wisdom of that rule.

14 Where proposed amendments are timely, they should be allowed "almost as a
15 matter of course." *Rainer v. Buena Community Memorial Hospital*, 18 Cal. App. 3d 240, 258
16 (1971) (citing as timely a case where "the amendment was made at the pretrial stage"). Here, the
17 trial is approximately nine months away. Moreover, Merrill and Goldman have already been
18 reviewing the facts at issue for years and therefore have a substantial head start on Plaintiffs.

19 **C. Defendants Would Not Be Prejudiced by the Proposed Amendment.**

20 "[I]t is an abuse of discretion to deny leave to amend where the opposing party
21 was not misled or prejudiced by the amendment." *Atkinson v. Elk Corp.*, 109 Cal. App. 4th 739,
22 761 (2003). As discussed above, Plaintiffs' proposed amendment arises out of the same set of
23 general facts as those alleged in the original complaint; Plaintiffs merely seek to plead an
24 additional legal theory under which certain Defendants are liable for their wrongful conduct. As
25 the Court of Appeal has stated, "[i]t is difficult to understand how . . . a defendant can be
26 prejudiced by an amendment to add an additional theory of liability against it." *Hirsa v. Superior*
27 *Court*, 118 Cal. App. 3d 486, 490 (1981); *see also Kittredge Sports Co. v. Superior Court*, 213
28 Cal. App. 3d 1045, 1048 (1989) (in evaluating claims of prejudice, "it is irrelevant that new legal

1 theories are introduced as long as the proposed amendments 'relate to the same general set of
2 facts'').

3 It is also the policy of California courts to resolve all disputed issues in the same
4 lawsuit. See *Edwards*, 93 Cal. App. 4th at 180. All issues concerning Merrill's and Goldman's
5 participation in manipulative naked short selling of Overstock securities should be resolved in this
6 action.

7 Far from being prejudiced, Goldman and Merrill have an advantage over Plaintiffs.

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12 Second, the *TASER* action in Georgia involves a RICO claim, and, based on
13 documents obtained by Plaintiffs from that action pursuant to a subpoena, the RICO claims
14 appear to involve similar facts and documents. As to Defendants' discovery of Plaintiffs,
15 Defendants have taken two days of deposition of a single witness, whose further deposition is
16 pending. Cirangle Decl., ¶ 25.

17 The addition of this claim will not expand discovery in this action. The current
18 operative complaint has allegations of a market manipulation scheme, as well as allegations of
19 conspiracy and aiding and abetting. Discovery will continue on the same track whether or not the
20 claim is added. "[W]here additional investigation and discovery is not required to meet the new
21 issue, it would appear that it would constitute an abuse of discretion not to permit the amendment
22 of a complaint even at the outset of trial, where the amendment merely adds a new theory of
23 recovery on the same set of facts constituting the cause of action." *Rainer v. Buena Community*
24 *Memorial Hospital*, 18 Cal. App. 3d 240, 254 (1971) (emphasis added).

25 In short, Goldman and Merrill have been studying and preparing for this issue in
26 the context of two lawsuits [REDACTED], whereas Overstock has only recently
27 unearthed the evidence as to how manipulative naked short selling was occurring. Goldman and
28 Merrill have spent years reviewing the evidence and will not suffer any prejudice from the

1 addition of a RICO cause of action predicated on securities fraud.

2 **D. Plaintiffs Properly Allege a Claim Under New Jersey's RICO Statute.**

3 To the extent that Goldman and Merrill may try to challenge the RICO claim, the
4 preferred policy of California courts is to decide any objections to a proposed amendment on
5 demurrer or other appropriate motion, and not on a motion for leave. *See Atkinson*, 109 Cal. App.
6 4th at 760; *see also Kittredge*, 213 Cal. App. 3d at 1048 (policy applies “even if the proposed legal
7 theory is a novel one”). While possible objections to Plaintiffs’ proposed amendment therefore
8 should not be considered at this stage, Plaintiffs have properly alleged New Jersey civil RICO
9 claims that may be decided by this Court.²

10 **1. California Courts May Decide New Jersey Civil RICO Claims.**

11 “[C]ourts generally enforce substantive rights created by the laws of other
12 jurisdictions” *Roberts v. Home Ins. Indemnity Co.*, 48 Cal. App. 3d 313, 318 (1975)
13 (Louisiana statute may be enforced in California); *see also Ryan v. N. Alaska Salmon Co.*, 153
14 Cal. 438, 439 (1908) (right or liability created by the statute of another state may be enforced in
15 California), *overruled on other grounds by Reich v. Purcell*, 67 Cal. 2d 551, 555 (1967).

16 Here, New Jersey law permits its civil RICO claims to be decided by non-New
17 Jersey courts. *See* N.J. Stat. 2C:41-4(c) (New Jersey civil RICO claims may be brought in “any
18 appropriate court”). Consistent with the statute’s plain language, New Jersey civil RICO claims
19 have been allowed to proceed outside of New Jersey. *See, e.g., Fed. Ins. Co. v. Marcy Fitness*
20 *Prods.*, 772 F. Supp. 1503, 1511 (E.D. Pa. 1991) (granting Plaintiff partial summary judgment on
21 New Jersey RICO claims).

22 **2. Plaintiffs Have Sufficiently Alleged the Elements of New Jersey Civil RICO.**

23 Plaintiffs allege that Defendants violated New Jersey Statute 2C:41-2(c), which
24 prohibits participating in an enterprise’s affairs through a pattern of racketeering activity, and

25 ² Plaintiffs seek to plead New Jersey RICO violations in addition, and/or as alternatives, to
26 Plaintiffs’ claims under California Corporations Code Section 25400 and California Business and
27 Professions Code Sections 17200 and 17500. The laws of more than one state may apply to the
28 same conduct. *See, e.g., Diamond Multimedia Systems, Inc. v. Superior Court*, 19 Cal. 4th 1036,
1062 (1999) (discussing with approval a case holding that Colorado securities law and North
Carolina common law of fraud could apply to claims of misrepresentation).

1 New Jersey Statute 2C:41-2(d), which prohibits conspiring to violate the RICO statute. Plaintiffs
2 have sufficiently alleged the elements of each claim.

3 **a. Plaintiffs Sufficiently Allege the Elements of a Claim Under New**
4 **Jersey Statute 2C:41-2(c).**

5 The elements of a claim under New Jersey Statute 2C:41-2(c) are: (1) the
6 existence of an enterprise; (2) the enterprise engaged in or its activities affected trade or
7 commerce; (3) defendant was employed by, or associated with, the enterprise; (4) defendant
8 participated in the conduct of the affairs of the enterprise; (5) defendant participated through a
9 pattern of racketeering activity; and (6) damage to plaintiff's business or property by reason of the
10 violation. N.J. Stat. 2C:41-2(c) and 2C:41-4(c); *Ford Motor Co. v. Edgewood Properties, Inc.*,
2009 WL 150951, at *10 (D.N.J. 2009). Plaintiffs sufficiently allege each of these elements.

11 First, Plaintiffs allege various enterprises, including enterprises that include: (1)
12 Goldman, Merrill, and traders that include Hazan and Arenstein; (2) Goldman and traders; (3)
13 Goldman; (4) Merrill and traders, and (5) Merrill. *See* Proposed Fourth Amended Complaint, ¶¶
14 57-61.

15 Second, Plaintiffs allege that these enterprises engaged in, or affected, trade or
16 commerce by, among other things, manipulating the price of stock. *See* Proposed Fourth
17 Amended Complaint, ¶ 62.

18 Third, Plaintiffs allege that Defendants were employed by, or associated with, the
19 enterprise(s). *See* Proposed Fourth Amended Complaint, ¶ 63.

20 Fourth, Plaintiffs have alleged that Defendants participated in the affairs of the
21 enterprise(s) by, among other things, effecting the transactions at issue. *See* Proposed Fourth
22 Amended Complaint, ¶¶ 64.

23 Fifth, Plaintiffs allege that Defendants participated in the conduct or affairs of the
24 enterprise through a pattern of racketeering activity. *See* Proposed Fourth Amended Complaint
25 ¶¶ 65-67. New Jersey's RICO statute defines "racketeering activity" to include securities fraud.
26 N.J. Stat. 2C:41-1(a)(p). Plaintiffs allege that Defendants committed such fraud by (1) violating
27 New Jersey Statute 49:3-52.1(a)(2)-(4), which prohibits essentially the same conduct as
28

1 California Corporations Code section 25400(a); (2) violating New Jersey Statute 49:3-52.1(a)(5),
2 which provides that a person may not “employ any other deceptive or fraudulent device, scheme,
3 or artifice to manipulate the price of a security;” and (3) violating New Jersey Statute 49:3-52,
4 which contains general securities anti-fraud provisions; and (4) violating California Corporations
5 Code section 25400. Plaintiffs further allege that Defendants’ conduct constitutes crimes under
6 (1) New Jersey Statute 49:3-70, which makes it a crime to willfully violate the above-referenced
7 provisions of the New Jersey Securities Law, or to recklessly violate certain provisions of New
8 Jersey Statute 49:3-52; (2) violating New Jersey Statute 2C:2-6, which prohibits aiding and
9 abetting of securities violations; (3) California Corporations Code section 25540, which imposes
10 criminal penalties for willful violations of section 25400; and (4) California Corporations Code
11 25541, which imposes criminal penalties for the willful employment of fraud in connection with
12 the offer, purchase, or sale of any security. *See Proposed Fourth Amended Complaint, ¶ 65.*
13 Plaintiffs further allege that Defendants engaged in many instances of racketeering conduct over a
14 period of years, that the incidents of each Defendants’ racketeering acts embrace criminal conduct
15 that has either the same or similar purposes, results, participants or victims or methods of
16 commission, and that Defendants’ racketeering acts are interrelated by distinguishing
17 characteristics and are not isolated, sporadic, or disconnected incidents. *See Proposed Fourth*
18 *Amended Complaint, ¶¶ 66-67.*

19 Sixth, Plaintiffs allege that they were damaged in their business or property by
20 reason of the violations, in that Plaintiffs sold stock at prices that were artificially depressed as a
21 result of Defendants’ racketeering activities. *See Proposed Fourth Amended Complaint, ¶ 68.*³
22 As such, Plaintiffs sufficiently allege violations of New Jersey Statute 2C:41-2(c).

23 **b. Plaintiffs Sufficiently Allege Violations of New Jersey Statute 2C:41-**
24 **2(d).**

25 Plaintiffs also sufficiently allege violations of New Jersey Statute 2C:41-2(d),
26 which prohibits conspiring to violate another section of the statute. Among other things,

27 ³ Plaintiffs also allege that at least some of the conduct at issue occurred in New Jersey.
28 *See Proposed Fourth Amended Complaint ¶ 51.*

1 Plaintiffs allege that each Defendant: (a) agreed with other person or persons that they or one or
2 more of them would engage in conduct which constitutes such a crime or an attempt or
3 solicitation to commit such crime; or (b) agreed to aid such other person or persons in the
4 planning or commission of such a crime or of an attempt or solicitation to commit such a crime.
5 See Proposed Fourth Amended Complaint, ¶¶ 69-70. As such, Plaintiffs sufficiently allege a
6 violation of the RICO conspiracy provision.

7
8 **IV.**
CONCLUSION

9 For the foregoing reasons, this Court should grant Plaintiffs' Motion for Leave to
10 File a Fourth Amended Complaint.⁴

11 Dated: December 15, 2010

STEIN & LUBIN LLP

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14 By: 

Theodore A. Griffinger, Jr.
Attorneys for Plaintiffs
OVERSTOCK.COM, INC., KEITH CARPENTER,
OLIVIER CHENG, FERN BAILEY and WENDY
MATHER, as Co-Personal Representatives of the
Estate of MARY HELBURN, ELIZABETH
FOSTER, HUGH D. BARRON, DAVID TRENT,
and MARK MONTAG

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20 ⁴ The Fourth Amended Complaint no longer names Morgan Stanley & Co., Incorporated,
21 Bear Stearns Securities Corp., The Bank of New York, Citigroup, Inc., Credit Suisse (USA) Inc.,
22 Deutsche Bank Securities, Inc., Lehman Brothers, Inc., UBS Securities LLC, Citigroup Global
23 Markets, Inc. and Credit Suisse Securities (USA) LLC as defendants. The effect is to leave the
24 Goldman Defendants, the Merrill Defendants and Banc of America Securities LLC as defendants.
25 The remaining amendments in the Fourth Amended Complaint are clerical. They delete the
26 conversion and trespass to chattels claims, remove the request for restitutionary relief and
27 punitive damages, and exclude the paragraphs on conspiracy and aiding and abetting from the
28 California Corporations Code §25400 cause of action. These amendments were all done to make
the proposed Fourth Amended Complaint compliant with the Court's prior Orders sustaining
demurrers and/or striking portions of the prior complaints. The Fourth Amended Complaint lists
Fern Bailey and Wendy Mather, as co-personal representatives of the Estate of Mary Helburn in
place of Mary Helburn, pursuant to the Court's previous Order allowing this substitution. The
amendment of the dollar amount of the damages sought was done to seek damages according to
proof at trial.