In the Kalamazoo County Circuit Court
For the State of Michigan

SCOTTSDALE CAPITAL ADVISORS CORPORATION,

Plaintiff,

v.

MORNINGLIGHTMOUNTAIN, LLC, MICHAEL GOODE, and DOES 1-10,

Defendants.

Civil No. 18-0153-CZ

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MEMORANDUM SUPPORTING MOTION FOR SUMMARY DISPOSITION OF SECOND AMENDED COMPLAINT

Under MCR 2.116(C)(8), MLM and Goode offer this Memorandum in support of their Motion to dismiss the Second Amended Complaint ("Complaint") with prejudice on summary disposition for failure to state a claim upon which relief can be granted.

INTRODUCTION

This is a defamation action. Scottsdale has sued MLM and Goode for allegedly libelous statements posted in an online article at goodetrades.com, a blog reporting on news about penny-stock trading.

A "penny stock" refers to a security issued by a very small company that trades at less than $5.00 per share.[1] Also known as "microcap stocks," penny stocks are issued by companies, many of which do not file financial reports with the U.S. Securities & Exchange Commission.[2] The SEC describes these securities as "among the most risky," suffering from a scarcity of publicly-available information that allows "fraudsters [to] easily spread false information about microcap companies, making profits while creating losses for unsuspecting investors."[3] They are very speculative investments, and Congress has tightly regulated broker-dealers who facilitate penny-stock trading under the Exchange Act.[4]

One fraud particularly affecting penny stocks is the classic pump-and-dump scheme. The scheme involves touting a company's stock through false and misleading statements to the marketplace to ignite a buying frenzy that "pumps" the price of

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1 U.S. Secs. & Exch. Comm'n, Penny Stock Rules (May 9, 2013) ("PENNY STOCK RULES") (available at http://bit.ly/SEC-Penny-Stock-Rules).

2 U.S. Secs. & Exch. Comm'n, Microcap Stock: A Guide for Investors, Introduction (Sept. 13, 2013) (available at http://bit.ly/ SEC-Microcap-Guide).

3 *Id.*

4 PENNY STOCK RULES, *supra* at n.1

a stock (usually a penny stock). The hucksters then sell (or "dump") their stocks at the "pumped" up price, realizing a handsome profit. Once they dump their shares and stop hyping the stock, the price falls and investors lose their money.[5]

MLM and Mr. Goode reported on pump-and-dump schemes, including one involving stock in Biozoom, which was touted as a biomedical technology company. Before April 2013, Biozoom was known as Entertainment Art, Inc., and it produced leather bags. In April 2013, it announced that it was changing its name to Biozoom and exiting the leather-bag business to develop biomedical technology. From March 2013 (the month before the announcement) to June 2013, at least eight people opened accounts with broker-dealers and deposited millions of shares of Biozoom that they (falsely) claimed were purchased from the original shareholders of Entertainment Art in the previous few months and could be freely traded.[6] From May 16, 2013 to June 17, 2013, these people sold 14 million shares yielding almost $34 million, of which nearly $17 million was wired to overseas bank accounts.[7] Eventually, the stock collapsed. The SEC brought an enforcement action, *U.S. Securities & Exchange Comm'n* v. *Tavella*, to recover the ill-gotten gains and make swindled investors whole.

Scottsdale, a broker-dealer that facilitated penny-stock trading and claims to be one of the dominant companies in the microcap securities market for handling more than $125 million worth of trades in 2015 alone,[8] accepted Biozoom stocks for deposit and facilitated trading in the microcap market. Many of the trading accounts frozen

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[5] U.S. Secs. & Exch. Comm'n, "Pump-and-Dumps" and Market Manipulations (Jun. 25, 2013) (available at http://bit.ly/SEC-Pump-and-Dumps).

[6] *U.S. Secs. & Exch. Comm'n* v. *Tavella*, Civ. No. 13-4609 (SDNY), Complaint at 2, ¶¶ 3-5 (Jul. 3, 2013).

[7] *Id.* at 2-3, ¶¶ 6-7.

[8] Complaint at 3, ¶ 11.

through the SEC's enforcement action were held at Scottsdale.[9] And, notably, since Scottsdale filed this lawsuit against MLM and Mr. Goode, the SEC entered an order sanctioning Scottsdale's representative Timothy Scarpino for facilitating the sale of 8.2 million Biozoom shares that generated $18.5 million in gains—just over half the shares and half the gains—for the fraudsters.[10] His offense was "fail[ing] to conduct a searching inquiry into facts surrounding the proposed sales" of unregistered Biozoom stock, despite the presence of "significant red flags."[11]

Among other things, it was this same kind of failure to conduct searching inquiries that resulted in the Financial Industry Regulatory Authority taking disciplinary action against Scottsdale.[12] FINRA imposed a $1.5 million fine against Scottsdale for "institutionaliz[ing] misconduct as its standard way of doing business," among other aggravating factors.[13] Part of the institutionalized misconduct included Scottsdale's failure to revise its procedures to focus on potential sham transactions after botching its gatekeeping role in the Biozoom pump-and-dump scheme that led to the SEC's enforcement action.[14]

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[9] *Tavella*, Civ. No. 13-4609 (SDNY), Stipulated Order Granting Prelim. Inj., Asset Freeze, and Other Relief (R. 16, Jul. 16, 2013); Final J. Defs. Graciarena and Loureyro (R. 67, Dec. 8, 2014); Final Default J., Order Granting Inj. & Other Relief Against Tavella [and Others] (R. 69, Jan. 9, 2015).

[10] *In re Timothy C. Scarpino*, SEC No. 3-18483, Order Instituting Admin. and Cease-and-Desist Proceedings, Making Findings, Imposing Remedial Sanctions, and a Cease-and-Desist Order (May 15, 2018).

[11] *Id.* at 2, Part III, Summary.

[12] Answer Exh. A, *FINRA* v. *Scottsdale Capital Advisors Corp.*, No. 2014041724601, Amended Extended Hr'g Panel Decision (Jun. 20, 2017) (available at http://bit.ly/FINRA-Panel-Decision) ("FINRA PANEL DEC.")

[13] *Id.* at 107, Part IV(A)(3).

[14] *Id.* at 11-12, 101-102, 104.

FINRA had equally harsh words for Scottsdale's owner, John Hurry. FINRA found that he "violat[ed] his duty to observe high standards of commercial honor and just and equitable principles of trade," and it was "purposeful and egregious," which led FINRA to conclude that "[he] is a threat to investors and the integrity of the markets."[15] Worse yet, FINRA found that Hurry "repeatedly testified falsely, and that there was a pattern of doing so when he thought no contradictory evidence would come to light."[16] FINRA barred Hurry from associating with any other FINRA member for any reason.[17]

Which brings us to this lawsuit. The statements that Scottsdale claims are libelous are contained within an article written by Goode and published by MLM about three years after the Biozoom fraud. (The article is attached to the Complaint, and is part of the pleading for all purposes. *Slater* v. *Ann Arbor Pub. Sch. Bd. of Educ.*, 250 Mich. App. 419, 427 (2002).) The article include extensive quotations from FINRA's enforcement decision. It also include a link to the decision.

Scottsdale doesn't argue that the reporting about the FINRA action is inaccurate. Rather, it plucks a few sentences from the articles and claims that they wrongfully accuse it of actively engaging in a pump-and-dump scheme. In context, however, the articles do nothing more than note that penny stocks were illegally traded through Scottsdale brokerage accounts. And the notion that these articles damaged Scottsdale in any way—much less in some way unique and independent of (*a*) FINRA castigating and fining Scottsdale, or (*b*) FINRA excommunicating Mr. Hurry from the securities industry—is risible.

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[15] *Id.* at 107, Part IV(B).

[16] *Ibid.*

[17] *Id.* at 108. The FINRA National Adjudicatory Council affirmed this ruling. *FINRA* v. *Scottsdale Capital Advisors Corp.*, No. 2014041724601 (FINRA Dec. Jul. 20, 2018) at 104, Part V (available at http://bit.ly/FINRA-National-Decision).

This lawsuit is about one thing: shutting down free speech. It is commonly known as a "strategic lawsuit against public participation." It is brought with the intent to censor the speaker's message because it is unwanted, not because it is false or defamatory. But the First Amendment no more allows a "litigation veto" than it does a "heckler's veto."

For the reasons that follow, the Court should dismiss the Complaint with prejudice for failing to state a claim upon which relief can be granted.

SPECIAL STANDARD OF REVIEW FOR FIRST AMENDMENT CASES

Motions for summary disposition brought under MCR 2.116(C)(8) in defamation actions test the legal sufficiency of the complaint. *Singerman* v. *Municipal Serv. Bureau*, 455 Mich. 135, 139 (1997). The Court must limit its review to the pleadings—which by court rule includes both the complaint *and* the answer. MCR 2.116(G)(5) (review of a (C)(8) motion is limited to the pleadings); MCR 2.110(A) (defining a pleading to include complaints and answers). The Court must take the well-pleaded factual allegations as true and construe them in the light most favorable to the non-moving party. *Dalley* v. *Dykema Gossett*, 287 Mich. App. 296, 304–305 (2010).

Importantly, however, courts have a special, heightened duty under the First Amendment to review the sufficiency of defamation complaints to make sure that pleading requirements are met. *Bose Corp.* v. *Consumers Union*, 466 U. S. 485 (1984). Although *Bose Corp.* involved a public figure and this case (allegedly) involves a private figure, the distinction between public and private figures is irrelevant to the scrutiny that must be brought to bear when assessing whether a defamation claim is properly pleaded—the distinction goes only to *the level of fault* that applies in a given case. The heightened scrutiny of the pleadings applies to *all* defamation cases, regardless of whether the plaintiff is a public or private figure. *Rouch* v. *Enquirer & News (After Remand)*

("*Rouch II*"), 440 Mich. 238, 272–27 (1992) (Riley, J. concurring) (in a *private-figure case* reviewed on appeal from a (C)(10) ruling, Justice Riley noted that the pleadings in a defamation case are also to be reviewed with heightened scrutiny when challenged under (C)(8)). Although stated in a concurrence, "Justice Riley's position [in his concurring opinion in *Rouch II* is consistent with previous decisions of this Court." *Royal Palace Homes, Inc.* v. *Channel 7 of Detroit, Inc.*, 197 Mich. App. 48, 52–53 (1992) (also apparently a *private-figure case*). *See also Trost* v. *BuckStop Lure Co., Inc.*, 249 Mich. App. 580, 587 n.2 (2002) (observing, in a *private-figure case*, that Justice Riley outlined the proper procedure for (C)(8) challenges).

Michigan courts take this duty seriously. Recognizing that summary disposition is "an essential tool" to protect against "forbidden intrusions into the field of free expression," *Kevorkian* v. *American Med. Ass'n*, 237 Mich. App. 1, 5 (1999) (citing *Ireland* v. *Edwards*, 230 Mich. App. 607, 613 and n.4 (1998)), our courts long ago adopted an *Iqbal*-like pleading standard that requires plaintiffs to specifically plead: (1) the defamatory words and the facts that would establish that the words are false; (2) the facts identifying the publication of those words to a third party; (3) the level of fault that must be proved and the facts that would establish that the speaker acted with that level of fault; and (4) the harm suffered by the publication. *Gonyea* v. *Motor Parts Fed. Credit Union*, 192 Mich. App 74, 76–77 (1991). *Accord Ashcroft* v. *Iqbal*, 556 U.S. 662 (2009) (requiring plaintiffs in federal cases to "plausibly" plead claims through specific factual allegations). Pleading specific facts is a "relatively simple requirement"; defendants are entitled to summary disposition under MCR 2.116(C)(8) "on this ground alone" when plaintiffs fail to follow it. *Rouch II*, 440 Mich. at 279.

Also important, the heightened pleading requirement in defamation cases permits courts to resolve several questions of law on the pleadings, including: (1) whether a statement is capable of being defamatory; (2) the nature of the speaker and the level

of constitutional protections afforded to the statement; and (3) whether actual malice exists, if the plaintiff is required to show that level of fault. *Thomas M. Cooley Law School* v. *Doe 1*, 300 Mich. App. 245, 342 (2013). In making these assessments, a court must read the challenged statement in context, fairly and reasonably construing the entire article to determine whether the challenged statement is libelous. *Sanders* v. *Evening News Ass'n*, 313 Mich. 334, 340 (1946); *Croton* v. *Gillis*, 104 Mich. App. 104, 108 (1981). A statement "does not become actionable merely because it could be taken out of context." *Nehls* v. *Hillsdale Coll.*, 178 F. Supp. 2d 771, 779 (ED Mich. 2001), *aff'd* 65 Fed. Appx. 984 (CA6 2003) (citing Michigan law).

ARGUMENT

In Michigan, a libel plaintiff must prove that the defendant: (1) made a false statement, (2) that was defamatory, (3) which was "of and concerning the plaintiff, (4) in the form of an unprivileged publication to a third party, (5) with a level of fault amounting to at least negligence on the part of the publisher, and (6) thereby damaged the plaintiff. *Northland Wheels Roller Skating Ctr.* v. *Detroit Free Press*, 213 Mich. App. 317, 323 (1995) (citing *Rouch II*).

I. FAULT NOT PLEADED: The Complaint fails to plead facts establishing that MLM and Goode acted negligently.

To adequately plead fault, a plaintiff must identify the level of fault that applies to the claim *and* allege facts that would establish that level of fault if proved. *Gonyea*, 192 Mich. App. at 76–77; *Rouch II*, 440 Mich. at 279. There are two levels of fault: negligence and actual malice. *Ibid.* The negligence standard applies in cases involving private figures; the actual-malice standard applies in cases involving public officials, public figures, and limited-purpose public figures. *Ibid.* Scottsdale alleges that it is a private figure and that MLM and Goode are the direct and proximate cause of its damages, Compl. ¶ 23, so it impliedly pleads the level of fault to be negligence.

Negligence is defined as the failure to use the care that an ordinary person would use under the circumstances. MICH. CIV. J. INSTR. 10.02. Thus, in order to meet the *Iqbal*-like pleading standard, Scottsdale must alleged what a reasonably careful reporter and reasonably careful publisher would have done under the circumstances, and then plead facts alleging that MLM and Goode failed to do those things. *Michigan Microtech, Inc.* v. *Federated Publ'ns, Inc.*, 187 Mich. App. 178, 186 (1991). These standards are intertwined with the "reasonable audience" standard. *Air Wis. Airlines Corp.* v. *Hoeper*, 71 U.S. 237, 246–251 (2014). The Complaint does not satisfy these pleading requirements for either of the two statements. A reasonably careful journalist and publisher can reasonably expect that those who visit the Website are sophisticated readers—*i.e.*, people familiar with the microcap market. Those readers, being well versed in the industry, would conclude that Scottsdale was the *means* by which a pump-and-dump was accomplished, not that Scottsdale had itself engaged in illegal activity—particularly with the benefit of links to source documents.[18]

Under *Rouch II*, a failure to plead both the level of fault that must be proved *and the facts that would establish the speaker acted with that level of fault* entitles MLM and Goode to summary disposition under MCR 2.116(C)(8) "on this ground alone." *Rouch II*, 440 Mich. at 279 (Riley, J., concurring). The failure to plead any facts supporting negligence (or actual malice) is fatal to the Complaint.

Previously, the Court applied the doctrine of *res ipsa loquitur* to conclude that fault is adequately pleaded if the Complaint adequately pleads the challenged statements to be

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[18] To the extent that Scottsdale apparently tries to plead actual malice in the alternative—"notwithstanding [its] status as a private figure, . . . [MLM and Goode] knew that the [challenged statements] were false and/or acted in reckless disregard of whether [they] were true or false"—the Complaint is likewise devoid of any factual allegations supporting *how* they knew the statements were false or *why* they were reckless in their alleged disregard of the truth.

false. But error alone is not negligence. "The doctrine implies that the court does not know, *and cannot find out*, what actually happened in the individual case. Instead, the finding of likely negligence is derived from knowledge of the causes of the type or category of accidents involved." RESTATEMENT (THIRD) OF TORTS § 17 (2010) (emphasis added). It is applied in negligence cases where there is an injury for which there is no direct evidence that a particular individual caused it, but *the nature of the injury* is such that it *must* have been caused as a result of negligence. Hence *the thing speaks for itself.*

No Michigan court has ever applied this doctrine to a claim of defamation. Indeed, the doctrine cannot apply in defamation cases because a false statement is never automatically the result of actual malice or negligence. Scottsdale must plead *how* the reasonable reporter and publisher would have acted differently than Defendants did in this situation. *Rouch II*, 440 Mich. at 279 (Riley, J., concurring) ("The relatively simple requirement of pleading facts to support allegations of material falsity, *negligence, or reckless disregard for the truth* should be followed ... in defamation actions, and, pursuant to MCR 2.116(C)(8), defendant should have been entitled to summary disposition on this ground alone a decade ago." (emphasis added)). The Complaint does not allege what a reasonable reporter or publisher would have done differently in this case. Without that connection spelled out in the Complaint, Scottsdale has failed to plead facts establishing *why* Defendants are at fault *if* the challenged statements are false. Thus, they have failed to adequately plead a required element with the required specificity.

II. STATEMENT NO. 1: Scottsdale has not pleaded facts sufficient to show that this statement is actionable.

> *If you have followed penny stocks and pump and dumps for a few years then you know Scottsdale Capital Advisors.*

A. Statement No. 1 is an opinion; opinions are not actionable.

To be actionable, the challenged statement must be provably false. *Ireland*, 230 Mich. App. 607 (citing *Milkovich* v. *Lorain Journal Co.*, 497 U.S. 1, 17–22 (1990)). In other words, the statement must state "actual, objectively verifiable facts." *Milkovich*, 497 U.S. at 17–21. Nonfactual hyperbole is not provably false. As noted in Part II.B, *infra*, Scottsdale has been connected to at least two pump-and-dump schemes in the years preceding publication of the Article. The challenged statement thus amounts to "everyone knows" about the connection—which is classic rhetorical hyperbole that is not actionable. *See, e.g.*, *Komarov* v. *Advance Magazine Publ'rs, Inc.*, 691 N.Y.S.2d 298, 301–302 (NY Sup. Ct. 1999) (plaintiff was as "well known" in the community as notorious mobster John Gotti was rhetorical hyperbole that cannot be proven false and not actionable). Scottsdale cannot objectively prove that those who followed penny stock pump-and-dump schemes did *not* know of Scottsdale.

B. Statement No. 1 is not false.

If the Court holds that Statement No. 1 is not an opinion, it should still find that Scottsdale has failed to plead facts sufficient to show that Statement No. 1 is false. Scottsdale says Statement No. 1 is false because it has "never been involved in any 'pump and dump' schemes, has never been a defendant in any 'pump and dump' lawsuits, and has never been convicted of engaging in 'pump and dump' activity." (Compl. ¶ 13.) On its face, Statement No. 1 doesn't accuse Scottsdale of these things, as the Court previously held in dismissing this statement from the First Amended Complaint.

C. Statement No. 1 is not defamatory.

Undeterred, Scottsdale alleges that the juxtaposition of the headline "FINRA fines Scottsdale Capital Advisors $1.5 million" implies that FINRA fined Scottsdale for its involvement in the pump and dump of penny stocks—and that this the *only* conclusion that a "reader" could make. (Compl. ¶ 13a.) In the context of the substantial truth defense, a defamation defendant "is not responsible for every defamatory implication a reader might draw from his report of true facts, absent evidence that he intended the defamatory implication." *Royal Palace Homes, Inc.* v. *Channel 7 of Detroit, Inc.*, 197 Mich. App 48, 56. A statement "does not become actionable merely because it could be taken out of context." *Nehls* v. *Hillsdale Coll.*, 178 F. Supp. 2d 771, 779 (ED Mich. 2001), *aff'd* 65 Fed. Appx. 984 (CA6 2003). There are no facts pleaded that would establish Defendants intended to imply that Scottsdale was committing pump-and-dump schemes, as opposed to the means by which such schemes were accomplished.

As noted earlier, the Court must read the challenged statement in context, fairly and reasonably construing the entire article to determine whether the challenged statement is libelous. *Sanders*, 313 Mich. at 340; *Croton*, 104 Mich. App. at 108. The linked FINRA decision provides the context. It details how Scottsdale's business is susceptible to sham transactions. For example, among Scottsdale's many shortcomings, FINRA noted that the SEC had previously sued two of Scottsdale's registered representatives in case involving a pump-and-dump scheme. (Answer, Exhibit A, FINRA PANEL DEC. at 11, Part III.B(1)(a)(iv) (citing Compl., *SEC* v. *Ruettiger*, Civ. No. 11-2011 (D Nev. 2011)). FINRA fined Scottsdale in part because FINRA directly tied the success of the $34 million Biozoom pump-and-dump scheme to Scottsdale's lax anti-fraud safeguards, which it never improved despite being on notice that its existing safeguards were inadequate to detect and prevent fraud. (Answer, Exhibit A, FINRA PANEL DEC. at 107, Part IV.A(3).)

Of course, even if the Court were to conclude that the statement is capable of a defamatory implication, the alleged implication is substantially true. Substantial truth is an absolute defense to a defamation claim. *Collins* v. *Detroit Free Press*, 245 Mich. App. 27, 33 (2001). The doctrine precludes liability if the gist or sting of the statement is true; a statement is not considered false unless the literal truth would have produced a different effect in the mind of the reader. *Ibid.*

Scottsdale's claim rests on the distinction between actively committing fraud and being used as a tool for fraudsters. Although these are concededly two different things, a person who followed pump-and-dump schemes—*i.e.*, the reasonable audience—would know the difference between these two things *and* understand from the linked FINRA report that Scottsdale was involved in pump and dumps *as a tool.* Moreover, the linked FINRA report shows that regulators found Scottsdale to effectively be a *willing* tool because it "institutionalized misconduct as its standard way of doing business." (*Ibid.*) Anyone who followed pump-and-dump schemes would know of Scottsdale. Anyone who read the entire article (including the linked FINRA report)—as the Court must under *Sanders*—would also understand *how* Scottsdale was involved. Thus, Statement No. 2 is substantially true.

III. STATEMENT NO. 2: Scottsdale has not pleaded facts sufficient to show that this statement is false or capable of defamatory meaning.

> *They are one of the few brokers left that have continued to allow the deposit and sale of shares of illiquid penny stocks. Larger brokers and discount brokers stopped allowing that over five years ago.*

A. Statement No. 2 is not false.

Scottsdale says Statement No. 2 is false because many other brokers still trade in penny stocks. (Compl. ¶ 13b.) But the statement is conjunctive. *Depositing* shares and *selling* shares are two different activities. As written, Statement No. 2 says few brokers still allow *both* activities. The Complaint only identifies brokers who still *sell* penny stock. (Compl. ¶ 13b.) Nowhere in the Complaint does SCA identify *any* other brokers who still accept shares for *deposit*. Therefore, it has not sufficiently alleged that the statement as written—"deposit *and* sale"—is false.

B. Statement No. 2 is not defamatory.

Scottsdale alleges that Statement No. 2 is *per se* defamatory. (Compl. ¶ 22.) For something to be "inherently defamatory" it must "either hold a person up to contempt, ridicule, or scorn, impute crime, impute unchastity in a woman, or impute a loathsome disease." *Bufalino* v. *Maxon Bros., Inc.*, 368 Mich. 140, 151–152 (1962). Statement No. 2 does not say or imply that there is anything illegal about accepting penny stocks for deposit. Indeed, the statement acknowledges that a few other brokers do so. It simply notes that most brokers have exited this segment of the securities market.

As a matter of law, there is nothing defamatory about stating that Scottsdale serves a niche area. In *Bufalino*, the Court held that saying someone is in a particular line of business is "not in and of itself defamatory," if it is a "perfectly legitimate business"—*i.e.*, a legal one. *Ibid.* Plainly, a federally regulated business is a lawful business. *See* Penny Stock Reform Act of 1990, 104 Stat. 931, 951–958 (subjecting penny-stock broker-dealers to enhanced regulatory oversight).

IV. DISMISSAL WITH PREJUDICE: Scottsdale cannot cure the flaws in the Complaint by further amendment.

Leave to amend should be withheld when amendment would be futile. *Allegheny-Ludlam Corp.* v. *Michigan Dept. of Treas.*, 207 Mich. App. 604, 605 (1994). Amendment would be futile in this case. Statement No. 1 is nonactionable opinion, and no amount of re-pleading will change that. Both of the statements are substantially true when considered in light of FINRA's disciplinary decision. And Statement No. 2 is not defamatory as a matter of law.

PRAYER FOR RELIEF

For these reasons, MLM and Goode respectfully request that the Court grant summary disposition in their favor under MCR 2.116(C)(8) and dismiss the Complaint with prejudice.

Respectfully submitted,

BUTZEL LONG, P.C.

Dated: NOVEMBER 14, 2018

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