

UNITED STATES DISTRICT COURT  
DISTRICT OF MINNESOTA

BEAVER COUNTY EMPLOYEES'	)	Civ. No. 0:14-cv-00786-ADM-TNL
RETIREMENT FUND; ERIE COUNTY	)	<b>(Consolidated)</b>
EMPLOYEES' RETIREMENT SYSTEM; and)	)	
LUC DE WULF, Individually and on Behalf of)	)	<u>CLASS ACTION</u>
All Others Similarly Situated,	)	
	)	CONSOLIDATED AMENDED
Plaintiffs,	)	COMPLAINT FOR VIOLATIONS OF THE
	)	FEDERAL SECURITIES LAWS
vs.	)	
	)	
TILE SHOP HOLDINGS, INC.; ROBERT A.	)	
RUCKER; THE TILE SHOP, INC.;	)	
TIMOTHY C. CLAYTON; PETER J.	)	
JACULLO III; JWTS, INC.; PETER H.	)	
KAMIN; TODD KRASNOW; ADAM L.	)	
SUTTIN; WILLIAM E. WATTS; ROBERT	)	
W. BAIRD & CO. INCORPORATED;	)	
CITIGROUP GLOBAL MARKETS INC.; CJS	)	
SECURITIES, INC.; HOULIHAN LOKEY	)	
CAPITAL, INC.; PIPER JAFFRAY & CO.;	)	
SIDOTI & COMPANY, LLC; TELSEY	)	
ADVISORY GROUP LLC; and WEDBUSH	)	
SECURITIES, INC.,	)	
	)	
Defendants.	)	

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**TABLE OF CONTENTS**

NATURE OF THE ACTION .....1

JURISDICTION AND VENUE .....5

PARTIES .....6

FORMER EMPLOYEES.....11

    FE1 – Retail Sales Associate and National Sales Manager (1995 through 2007) .....11

    FE2 – Business Development (2006 through 2008) .....13

    FE3 – Corporate Controller (1996 through 2008) .....14

    Sill (FE4) – Co-Founder of Tile Shop .....14

PERTINENT IMPORT/EXPORT RECORDS.....14

APPLICABLE SEC AND GAAP RULES, REGULATIONS AND PROVISIONS.....16

    Item 404 of Regulation S-K [17 C.F.R. §229.404] and Rule 4-08(k)(1) of  
    Regulation S-X [17 C.F.R. §210.4-08(k)(1)].....16

    Related Party Disclosures Required Under GAAP.....17

    Item 303 of Regulation S-K [17 C.F.R. §229.303].....19

BACKGROUND .....21

    Tile Shop’s Founding and Rucker’s Lack of Candor .....21

    Tile Shop’s Path to Becoming a Public Company .....25

    Tile Shop’s Internal Controls and Accounting Practices Were in Disarray .....27

    The Officer Defendants Signed False and Misleading Sarbanes-Oxley  
    Certifications.....30

THE 1933 ACT ALLEGATIONS .....32

THE 1934 ACT ALLEGATIONS .....37

    (a) Misrepresentations and Omissions in August 22, 2012 Press Release .....37

    (b) Misrepresentations and Omissions in November 1, 2012 Press Release.....37

    (c) Misrepresentations and Omissions in November 9, 2012 Form 10-Q.....38

    (d) Misrepresentations and Omissions in February 20, 2013 Press Release and  
    Conference Call .....40

(e)	Misrepresentations and Omissions in March 18, 2013 Form 10-K .....	42
(f)	Misrepresentations and Omissions in May 1, 2013 Press Release .....	44
(g)	Misrepresentations and Omissions in May 10, 2013 Form 10-Q .....	45
(h)	Misrepresentations and Omissions in June 13, 2013 Schedule 14A .....	46
(i)	Misrepresentations and Omissions in August 8, 2013 Form 10-Q .....	47
(j)	Misrepresentations and Omissions in November 6, 2013 Form 10-Q .....	48
	Tile Shop’s Stock Price Drops as New Information is Disclosed .....	49
	ADDITIONAL SCIENTER ALLEGATIONS .....	53
	CLASS ACTION ALLEGATIONS .....	59
	FRAUD ON THE MARKET PRESUMPTION OF RELIANCE .....	61
	LOSS CAUSATION/ECONOMIC LOSS .....	62
	NO SAFE HARBOR .....	62
	COUNT I .....	63
	For Violation of Section 11 of the 1933 Act Against Tile Shop, the Individual Defendants and the Underwriter Defendants .....	63
	COUNT II .....	64
	For Violation of Section 12(a)(2) of the 1933 Act Against Tile Shop, the Officer Defendants, TSI, JWTS, Inc. and the Underwriter Defendants .....	64
	COUNT III .....	65
	For Violation of Section 15 of the 1933 Act Against TSI, JWTS, Inc. and the Individual Defendants .....	65
	COUNT IV .....	66
	For Violation of Section 10(b) of the 1934 Act and Rule 10b-5 Against Tile Shop and the Officer Defendants .....	66
	COUNT V .....	67
	For Violation of Section 20(a) of the 1934 Act Against the Individual Defendants, TSI and JWTS .....	67
	PRAYER FOR RELIEF .....	68
	JURY TRIAL DEMAND .....	68

Lead Plaintiffs Beaver County Employees' Retirement Fund, Erie County Employees' Retirement System, and Luc De Wulf (collectively, "Plaintiffs"), individually and on behalf of all others similarly situated, allege the following based upon personal knowledge as to themselves and their own acts, and upon information and belief as to all other matters based on the investigation conducted by and through Lead Counsel, which included, among other things, a review of Tile Shop Holdings, Inc.'s ("Tile Shop" or the "Company")<sup>1</sup> press releases, U.S. Securities and Exchange Commission ("SEC") filings, analyst reports, media reports, and other publicly disclosed reports and information about the defendants. Plaintiffs believe that substantial evidentiary support will exist for the allegations set forth herein after a reasonable opportunity for discovery.

#### **NATURE OF THE ACTION**

1. This is a securities class action on behalf of all purchasers of Tile Shop common stock: (i) pursuant and/or traceable to the Registration Statements and Prospectuses issued in connection with Tile Shop's secondary public offerings (collectively, the "Registration Statements") on December 12, 2012 (the "December 2012 SPO," and the registration statements and prospectuses filed in connection therewith, the "December 2012 Registration Statement") and June 5, 2013 (the "June 2013 SPO," and the registration statements and prospectuses filed in connection therewith, the "June 2013 Registration Statement") (collectively, the "Offerings"), seeking to pursue remedies under the Securities Act of 1933 (the "1933 Act"); and (ii) between August 22, 2012 and January 28, 2014, inclusive (the "Class Period"), seeking to pursue remedies under the Securities Exchange Act of 1934 (the "1934 Act").

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<sup>1</sup> Tile Shop is a holding company that primarily operates through Tile Shop, LLC and its other subsidiaries, which are collectively referred to herein with the holding company as "Tile Shop" or the "Company" unless the allegations or their context indicate otherwise.

2. Tile Shop is a specialty retailer of manufactured and natural stone tiles, setting and maintenance materials, and related accessories in the United States. During the Class Period, Tile Shop was a relatively tight-knit company, with between 25 and 52 employees working in corporate, store support, infrastructure or similar operations from September 30, 2012 through May 15, 2013. In fact, before August 2012, the Company did not have a Chief Financial Officer (“CFO”), and admittedly had material weaknesses in its financial statement close process as a result. Even today, Tile Shop employs only about 60 employees, including its entire executive staff, at its headquarters in Minneapolis, Minnesota.

3. Defendant Robert A. Rucker (“Rucker”) is, and was at all relevant times, Tile Shop’s Chief Executive Officer (“CEO”), President, and a director of Tile Shop. He founded the Company in 1985 and, as alleged herein, maintained tight control over its business and operations. He was also involved in establishing supplier relationships and sourcing materials for use in manufacturing the Company’s tile products. Indeed, according to January and November 2013 investor presentations prepared by Tile Shop, the Company “controls the entire process” – from the direct sourcing of raw materials and acquiring finished stone and ceramic in the origin country, to product shipments and the retail sale – and Rucker is “personally involved in ‘sourcing.’” As he testified on March 17, 2005, during a proceeding related to his divorce:

I have gone out and found proprietary product. We now build, design product. We go to Turkey, India, China, the Philippines. We have now hired a Brazilian. We are going to go to Brazil, Columbia, to Peru, to find both ceramic tile and stone. But if we didn’t do this, we would get our lunch eaten. That is the nature of the business.

4. Notwithstanding Rucker’s integral involvement in sourcing product and managing the Company’s operations, Tile Shop failed to disclose several material, related-party relationships. These relationships involved Fumitake Nishi (“Nishi”), who is Rucker’s brother-in-law and was a purchasing supervisor employed by Tile Shop, Jian Zhang, who is related to Rucker’s wife (to whom

Rucker has been married since 2003), and Pan Zhang, who is Jian's son and Rucker's nephew (together, the "Zhangs"). Despite the fact that these individuals owned and/or controlled Beijing Pingxiu ("BP"), a Chinese export trading company that conducted millions of dollars in business with Tile Shop from at least fiscal years 2011 through 2013, the Company did not disclose these relationships. Nor did the Company disclose that Nishi owned a majority interest in Nanyang Helin Stone Co. Ltd. ("Nanyang"), which also sold millions of dollars of stone accessory products to Tile Shop from at least fiscal years 2011 through 2013. Furthermore, Nishi had an undisclosed, indirect relationship during that period with another supplier of Tile Shop, Best Cheer Stone Group LTD ("Best Cheer Stone").

5. Tile Shop's failure to disclose these related-party transactions and relationships violated Item 404 of SEC Regulation S-K, Rule 4-08(k)(1) of Regulation S-X and applicable accounting rules, which required such disclosure. The failure to disclose these relationships also violated Item 303 of SEC Regulation S-K, because the issues emanating from the relationships posed known trends, uncertainties and risks that could adversely affect Tile Shop's business. As such, the Registration Statements, which did not disclose these relationships as required by law, were negligently prepared by defendants. Moreover, Tile Shop consciously or recklessly failed to disclose these relationships in other SEC filings, as alleged below. In fact, Tile Shop did not even reveal the full truth about these relationships in its January 27, 2014 press release, despite claiming to announce the results of its "independent investigation" into the issues. It was not until February 28, 2014, when Tile Shop filed its Form 10-K for the fiscal year ended December 31, 2013, that the Company confirmed information regarding the Zhangs and divulged Nishi's connection to Best Cheer Stone.

6. On November 14, 2013, investment firm Gotham City Research ("Gotham") issued a report exposing Tile Shop's relationship and transactions with BP – a captive supplier and export agent – and Rucker's relationship with Nishi and the Zhangs. Gotham reported that Tile Shop used

BP to manipulate its costs and profit margins during the Class Period, by purchasing significant amounts of product from BP at artificially low prices. This arrangement allowed the Company to capture higher profits for product that would have cost more to purchase from independent suppliers.

7. In response to this news, on November 14, 2013, the Company's stock price dropped by \$8.27 per share, or nearly 39%, on unusually high volume, tripping NASDAQ's short sale circuit breaker, imposing a restriction on the price at which the stock could be sold short to prevent the price from significantly declining further. That same day, Tile Shop issued a press release disclosing that it would undertake an investigation into the allegations in the Gotham report. At this time, Tile Shop also announced that it was already aware of previously undisclosed changes in the ownership of BP. On January 27, 2014, Tile Shop disclosed its investigative findings, confirming Nishi's relationship with Rucker and BP, and financial information regarding the Company's business with BP. In response, the Company's stock dropped by nearly 6.7% the following day. Then, on February 28, 2014, Tile Shop filed its annual report on Form 10-K, confirming the Zhangs' relationship with BP and Rucker and disclosing additional details regarding Nishi's connection to other entities doing business with Tile Shop.

8. Since the issuance of the Gotham report, several former employees of the Company (sometimes referred to herein as "FEs") have confirmed their understanding that Rucker and other executives knew or reasonably should have known that Nishi was supplying product to Tile Shop. In fact, two former employees confirmed that Tile Shop established entities in other countries – including Turkey and China – for the purpose of controlling supplier relationships, giving rise to an inference that Tile Shop had a practice of manipulating its supply and supplier relationships. Two former employees also *confirmed* that Rucker purchased supply from Nishi, with one such employee explaining that discussions with other employees – including a Purchase Analyst – revealed the business relationship, arranged by Rucker, between Tile Shop and Nishi. Incidentally, Rucker

traveled to China with Nishi in or about 2008, when BP was first established and owned by the Zhangs, and certain import/export records confirm that BP was regularly supplying thousands of pounds of product to Tile Shop from at least 2009 – even *earlier* than the Company has admitted.

9. Further supporting the conclusion that Tile Shop, Rucker and others knew, or were reckless in not knowing, about these previously (publicly) undisclosed relationships is the fact that Tile Shop's internal controls and accounting systems were in disarray during the Class Period. For example, Tile Shop: (i) did not have a CFO until August 2012; (ii) had material weaknesses in its internal controls with respect to its financial statement close process, partially due to the previous lack of a CFO; and (iii) was forced to restate, in March 2013, its unaudited condensed consolidated financial statements for the three and nine months ended September 30, 2012, as a result of using an improper method of accounting for common stock purchase warrants. All told, the Company admittedly had internal control deficiencies and had issued false and misleading financial statements.

10. Finally, Rucker was motivated to commit the fraud alleged with respect to the 1934 Act claims in order to consummate the Offerings at artificially inflated prices. Indeed, had the investing public known that Rucker's family members owned and operated Company suppliers – as the Company was required by SEC regulations to disclose in its Registration Statements and various other SEC filings issued during the Class Period – the price of the common stock sold in those Offerings would have been substantially lower. As discussed herein, the Offerings were orchestrated in such a way so as to allow Rucker to sell millions of dollars of his personally-held shares of stock, a principal motivation for the misrepresentations and omissions alleged.

#### **JURISDICTION AND VENUE**

11. The claims asserted herein arise under and pursuant to Sections 11, 12(a)(2) and 15 of the 1933 Act [15 U.S.C. §§77k, 77l(a)(2) and 77o], Sections 10(b) and 20(a) of the 1934 Act [15 U.S.C. §§78j(b) and 78t(a)], and SEC Rule 10b-5 promulgated under Section 10(b) of the 1934 Act



[17 C.F.R. §240.10b-5]. This Court has jurisdiction over the subject matter of this action pursuant to 28 U.S.C. §1331, Section 22 of the 1933 Act and Section 27 of the 1934 Act.

12. Venue is proper in this District pursuant to 28 U.S.C. §1391(b) because Tile Shop is headquartered in this District and many of the acts and practices complained of herein occurred in substantial part in this District.

13. In connection with the acts alleged herein, 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**

14. Plaintiffs Beaver County Employees' Retirement Fund, Erie County Employees' Retirement System, and Luc De Wulf purchased the common stock of Tile Shop as set forth in their respective Certifications, which were submitted in connection with their application for appointment as Lead Plaintiffs, and were damaged thereby.

15. Defendant Tile Shop is a specialty retailer of manufactured and natural stone tiles, setting and maintenance materials, and related accessories in the United States. As of October 1, 2013, it operated 80 stores in 25 states. Tile Shop was founded in 1985 and is headquartered in Plymouth, Minnesota. The Company's common stock has been listed and traded on the NASDAQ under the ticker symbol "TTS" since August 22, 2012. As of November 1, 2013, the Company had more than 51 million shares of common stock issued and outstanding.

16. Defendant Rucker is and was, at the time of the Offerings and throughout the Class Period, CEO, President, a director, and a co-founder of Tile Shop. Rucker signed the misleading Registration Statements used to conduct the Offerings, as well as false and misleading certifications pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley"), during the Class Period. Rucker, along with The Tile Shop, Inc. ("TSI"), his wholly owned company, sold 1,029,407

shares in the December 2012 SPO, receiving more than \$15.44 million in gross proceeds, and sold 1,000,000 shares in the June 2013 SPO, receiving \$24.25 million in gross proceeds.

17. Defendant TSI is a Minnesota corporation wholly owned and operated by Rucker. According to the Registration Statements used to conduct the Offerings, “Rucker is the sole director of [TSI] and may be deemed to have sole voting and investment power over the securities held by [TSI].”

18. Defendant Timothy C. Clayton (“Clayton”) is and was, at the time of the Offerings and throughout the Class Period, Chief Financial Officer (“CFO”) and Senior Vice President of Tile Shop, having served in those positions since August 2012. Additionally, from June 2012 to August 2012, he served as a “financial consultant” to Tile Shop. During the Class Period, Clayton signed the misleading Registration Statements used to conduct the Offerings and the false and misleading Sarbanes-Oxley certifications.

19. Defendant Peter J. Jacullo III (“Jacullo”) is and was, at the time of the Offerings and throughout the Class Period, a director of Tile Shop, and previously served as a member of Tile Shop’s board of managers from December 2007 to August 2012.<sup>2</sup> He is a principal of Morningside Private Investors, a partnership he formed with the wealthy Chan family, from Hong Kong in 1987, and which made an investment in Tile Shop in 2012 purportedly “to allow the CEO to consolidate ownership, to provide partial shareholder liquidity and to provide growth capital for new stores.” Jacullo signed the misleading Registration Statements used to conduct the Offerings and he and his wholly owned company, defendant JWTS, Inc. (“JWTS”), collectively sold 713,274 shares in the December 2012 SPO, receiving nearly \$10.7 million in gross proceeds, and sold 600,000 shares in the June 2013 SPO, receiving \$14.55 million in gross proceeds.

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<sup>2</sup> Because Tile Shop operated as a limited liability company before it went public in August 2012, it was governed by a board of managers (as opposed to a board of directors).

20. Defendant JWTS is a Delaware corporation wholly owned by defendant Jacullo. According to the Registration Statements used to conduct the Offerings, “Jacullo is the sole director of JWTS and may be deemed to have sole voting and investment power over the securities held by JWTS.”

21. Defendant Peter H. Kamin (“Kamin”) is and was, at the time of the Offerings and throughout the Class Period, a director of Tile Shop. Kamin also previously served as a member of Tile Shop’s board of managers from January to August 2012. He signed the misleading Registration Statements used to conduct the Offerings and sold 100,000 shares in the June 2013 SPO, receiving \$2.425 million in gross proceeds.

22. Defendant Todd Krasnow (“Krasnow”) is and was, at the time of the Offerings and throughout the Class Period, a director of Tile Shop. Krasnow also previously served as a member of Tile Shop’s board of managers from January to August 2012. He signed the misleading Registration Statements used to conduct the Offerings and sold 15,000 shares in the June 2013 SPO, receiving \$363,750 in gross proceeds.

23. Defendant Adam L. Suttin (“Suttin”) is and was, at the time of the Offerings and throughout the Class Period, a director of Tile Shop. He co-founded private equity investment firm J.W. Childs Associates, L.P. (“J.W. Childs”), and served as President of JWC Acquisition Corp. (“JWC”), a blank check company formed by J.W. Childs that was used to effectuate the going-public transaction involving Tile Shop. Suttin signed the misleading Registration Statements used to conduct the Offerings and sold 46,560 shares in the December 2012 SPO, receiving \$698,400 in gross proceeds.

24. Defendant William E. Watts (“Watts”) is and was, at the time of the Offerings and throughout the Class Period, a director of Tile Shop and the Chairman of its board of directors. He has been an operating partner of J.W. Childs since June 2001 and served as Vice President of JWC.

Watts signed the misleading Registration Statements used to conduct the Offerings and sold 34,696 shares in the December 2012 SPO, receiving \$520,440 in gross proceeds.

25. Rucker and Clayton are referred to herein as the “Officer Defendants.” Rucker, Clayton, Jacullo, Kamin, Krasnow, Suttin and Watts each signed and/or authorized the signing of the false and misleading Registration Statements used to conduct the Offerings and are liable under the 1933 Act, and they are collectively referred to herein as the “Individual Defendants.”

26. Defendant Robert W. Baird & Co. Incorporated (“Baird”), based in Milwaukee Wisconsin, is the principal U.S. operating subsidiary of Baird, a financial services firm that provides wealth management, capital markets, private equity, and asset management services to individuals, corporations, institutional investors, and municipalities. Baird acted as an underwriter and served as a co-joint book-running manager of the Offerings, helping to draft and disseminate the Registration Statements.

27. Defendant Citigroup Global Markets Inc. (“Citigroup”), based in New York City, is the US-based brokerage and securities arm of Citigroup. Citigroup provides investment banking services to corporate, institutional, government, and retail clients. Citigroup acted as an underwriter and served as a co-joint book-running manager of the Offerings, helping to draft and disseminate the Registration Statements.

28. Defendant CJS Securities, Inc. (“CJS”), based in White Plains, New York, is a broker-dealer and research firm. CJS acted as an underwriter of the June 2013 SPO, helping to draft and disseminate the June 2013 Registration Statement.

29. Defendant Houlihan Lokey Capital, Inc. (“Houlihan Lokey”), based in Los Angeles, California, is an independent, advisory-focused, global investment bank. Houlihan Lokey acted as an underwriter of the December 2012 SPO, helping to draft and disseminate the December 2012 Registration Statement.

30. Defendant Piper Jaffray & Co. (“Piper”), based in Minneapolis, Minnesota, is a full-service investment bank and asset management firm focused on mergers and acquisitions, financial restructuring, public offerings, public finance, institutional brokerage, investment management and securities research. Piper acted as an underwriter and served as a co-joint book-running manager of the June 2013 SPO, helping to draft and disseminate the June 2013 Registration Statement.

31. Defendant Sidoti & Company, LLC (“Sidoti”), based in New York City, is a small-cap equity research firm that assists with roadshows. Sidoti acted as an underwriter of the December 2012 SPO, helping to draft and disseminate the December 2012 Registration Statement.

32. Defendant Telsey Advisory Group LLC (“Telsey”), based in New York City, is a research, trading, banking, and consulting brokerage firm. Telsey acted as an underwriter of the Offerings, helping to draft and disseminate the Registration Statements.

33. Defendant Wedbush Securities, Inc. (“Wedbush”), based in Los Angeles, California, is a privately-held financial services and investment firm. Wedbush acted as an underwriter of the Offerings, helping to draft and disseminate the Registration Statements.

34. Baird, Citigroup, CJS, Houlihan Lokey, Piper, Sidoti, Telsey and Wedbush are referred to collectively as “Underwriter Defendants.” The Underwriter Defendants are investment banking firms that specialize in underwriting public offerings of securities. They variously served as the underwriters of the December 2012 SPO, sharing more than \$4.2 million in fees collectively, and the June 2013 SPO, sharing more than \$5.3 million in fees collectively. Pursuant to the 1933 Act, the Underwriter Defendants are liable for the misleading statements and omissions contained in the Registration Statements.

35. Upon information and belief, representatives of the Underwriter Defendants assisted the other defendants in planning and effectuating the Offerings, and conducted an investigation (known as due diligence) into the business and operations of Tile Shop, as is typical of underwriters

in connection with public offerings of common stock. During the course of such due diligence, the Underwriter Defendants presumably had access to confidential corporate information concerning Tile Shop's operations and financial prospects. Upon information and belief, various Underwriter Defendants participated in road shows to publicize the Offerings and solicit investors to participate in purchasing shares of stock sold therein. As a result of their involvement in the Offerings, the Underwriter Defendants knew or were negligent in not knowing about Tile Shop's related-party relationships and transactions, which were, at the time, undisclosed publicly.

### **FORMER EMPLOYEES**

36. The factual allegations herein, as well as the inferences arising from those allegations, are corroborated by information obtained from four former employees with knowledge of Tile Shop's business and operations. These former employees confirmed that Rucker and other Tile Shop executives knew or reasonably should have known about the involvement of Rucker's family members – particularly Nishi – in operating BP and supplying product to the Company. Moreover, as least two former employees – FE1 and FE2 – indicated that Tile Shop executives established corporate entities in other countries for the purpose of acting as a middleman with vendors.

#### **FE1 – Retail Sales Associate and National Sales Manager (1995 through 2007)**

37. FE1 began working at Tile Shop in 1995 as a Retail Sales Associate and was later promoted to National Sales Manager, a position he held until 2007. As National Sales Manager, FE1 oversaw more than 32 locations with 300 sales associates and revenue exceeding \$120 million, and created budgets and sales goals for Tile Shop. FE1 attended monthly sales meetings at Tile Shop's corporate office, also attended by Rucker, Jim Beukelman (CFO), Carl Randazzo (Regional Sales Manager and later National Sales Manager), Joe Kinder (Supply Chain Manager), and Keith Cooney (Information Technology Manager). FE1 reported to the National Sales Director, who was at least partly responsible for preparing the Company's financial projections.

38. Acknowledging that Nishi is Rucker's brother-in-law, FE1 expressed the belief that Nishi was scapegoated to accept responsibility for Rucker's actions. As FE1 related, Nishi was a pawn. The notion that Nishi was a pawn of Rucker's is corroborated by the fact that BP purportedly took title to product, yet operated at a multimillion dollar loss and conceivably required significant funding to make such purchases.

39. It is highly unlikely that Nishi could finance BP's or Nanyang's operations – or own, through BP, 10% of Best Cheer Construction Materials (Shanghai) Co. Ltd – without access to a separate source of funding, as confirmed by Tile Shop's disclosure of Nishi's annual Tile Shop salary (discussed below in paragraph 169). Nishi's apparent inability to independently finance these businesses corroborates FE1's assertion that Nishi was a pawn of Rucker's.

40. Also according to FE1, Tile Shop's pre-Class Period CFO, Beukelman, was responsible for setting up foreign entities – known as "accounts" – to serve as middlemen with vendors based in Turkey and China. In fact, as FE1 indicated, prior to purchasing tile products from China, Tile Shop dealt with suppliers in Turkey. Soon after Rucker's buyout of Tile Shop co-founder Rodney Sill ("Sill") (discussed below), Tile Shop encountered sourcing problems in Turkey, so Rucker enlisted Nishi to scout vendors in China. According to FE1, Rucker and Nishi traveled to China together to negotiate with sourcing vendors.

41. FE1 stated that prior to 2002, Tile Shop was owned by Rucker and Sill. Sometime during 2002, as per their partnership agreement, Sill attempted to buy out Rucker. Rucker was able to secure enough funds through a Hong Kong investor, represented by Jacullo, to turn the deal around and buy out Sill. Soon after the deal closed, Rucker's wife and brother-in-law started working for the Company, and the Company started dealing with Chinese vendors. FE1 noted that Tile Shop probably really started moving heavily toward Chinese vendors in approximately 2004.

42. FE1 understood that Beukelman set up companies to act as middlemen for Tile Shop, where product – whether from Turkey, China or elsewhere – would pass through the companies before reaching Tile Shop in the U.S. Reiterating that Beukelman established foreign entities in China to deal with supply on behalf of Tile Shop, FE1 related that Beukelman had gone to Turkey to do the same thing there.

43. In fact, FE1 indicated that Tile Shop had Beukelman set up BP well before 2007, and surmised that the company was transferred to Nishi just before Tile Shop went public. This understanding is consistent with records obtained by Plaintiffs from the State Administration for Industry and Commerce for the People's Republic of China (“SAIC”), which confirm that BP was formed on March 3, 2008 and then owned and/or controlled by the Zhangs. And, as Tile Shop has admitted, Nishi purportedly “acquired BP in late 2011” – shortly before the Company went public, in 2012.

44. According to FE1, Rucker had full knowledge of the Chinese company and Nishi’s role in it. As FE1 stated, it was only logical that Rucker would have knowledge about Nishi’s role and involvement in BP. Indeed, as FE1 pointed out, Nishi was a Tile Shop employee and there was no doubt that Rucker would know exactly what Nishi was doing.

#### **FE2 – Business Development (2006 through 2008)**

45. FE2 handled various business development responsibilities for Tile Shop from 2006 through 2008. Corroborating FE1’s account regarding Tile Shop’s sourcing relationship with Nishi and/or BP, FE2 recalled that Nishi was based in China and confirmed that Rucker was buying tile from Nishi during the course of FE2’s tenure at the Company. Specifically, FE2 was told by other employees in various conversations that Rucker was buying tile on the Company’s behalf from Nishi. FE2 recalled that at least one such conversation took place with a Purchasing Analyst for Tile



Shop (who occupied the position from 2004 through 2012). FE2 also confirmed that it was common knowledge in the office that Nishi was Rucker's brother-in-law.

**FE3 – Corporate Controller (1996 through 2008)**

46. FE3 served as Tile Shop's Controller from 1996 through 2008 and was responsible for handling various accounting and/or financial functions, working alongside Beukelman. FE3 met Nishi at the corporate office and understood that Nishi was responsible for developing tile suppliers in China. Additionally, FE3 confirmed that in or about 2007 and 2008, Rucker took several trips to China to line up suppliers, and that Joe Kinder traveled to China, as well. Furthermore, according to FE2, there was at least one trip during that period where several executives traveled to China to try to expand the Company's supplier base there. Corroborating FE1's account, FE3 also confirmed that Beukelman was responsible for setting up the Turkish entity.

**Sill (FE4) – Co-Founder of Tile Shop**

47. Sill is the co-founder of Tile Shop and, as alleged herein, testified in connection with Rucker's divorce proceedings regarding Rucker's manipulation of Tile Shop's financial projections. Corroborating the testimony he gave in those proceedings, Sill confirmed that Rucker would have known every detail regarding the business.

**PERTINENT IMPORT/EXPORT RECORDS**

48. Import/export records corroborate the accounts of former employees who confirmed that Rucker bought product from Nishi and/or the Zhangs earlier than the Company has revealed, reinforcing the fact that Tile Shop cultivated a longstanding relationship with Rucker's relatives. The following chart, derived from these records, shows that Tile Shop regularly received thousands of pounds of product from BP since at least 2009 and continuing through 2010:

Arrival Date	Shipper	Consignee	Carrier	Container Count	Weight (LB/KG)
5/4/2009	Beijing Pingxu Décor Material Co.	The Tile Shop	AQBC	2	77,000/35,000
5/25/2009	Beijing Pingxu Décor Material Co.	The Tile Shop	AQBC	2	77,000/35,000
6/8/2009	Beijing Pingxu Décor Material Co.	The Tile Shop	AQBC	2	77,000/35,000
7/27/2009	Beijing Pingxu Décor Material Co.	The Tile Shop	AQBC	2	77,000/35,000
9/8/2009	Beijing Pingxu Décor Material Co.	The Tile Shop	AQBC	3	116,820/53,100
10/19/2009	Beijing Pingxu Décor Material Co.	The Tile Shop	AQBC	2	77,000/35,000
12/10/2009	Beijing Pingxu Décor Material Co.	The Tile Shop	Zimu-Zim Isreal Navigation Co. Ltd	5	181,880/82,673
12/21/2009	Beijing Pingxu Décor Material Co.	The Tile Shop	Zimu-Zim Isreal Navigation Co. Ltd	3	109,128/49,604
12/21/2009	Beijing Pingxu Décor Material Co.	The Tile Shop	Zimu-Zim Isreal Navigation Co. Ltd	5	181,880/82,673
12/21/2009	Beijing Pingxu Décor Material Co.	The Tile Shop	Zimu-Zim Isreal Navigation Co. Ltd	5	181,880/82,673
1/18/2010	Beijing Pingxu Décor Material Co.	The Tile Shop	Zimu-Zim Isreal Navigation Co. Ltd	3	115,999/52,727
1/18/2010	Beijing Pingxu Décor Material Co.	The Tile Shop	Zimu-Zim Isreal Navigation Co. Ltd	3	109,128/49,604
1/18/2010	Beijing Pingxu Décor Material Co.	The Tile Shop	Zimu-Zim Isreal Navigation Co. Ltd	4	145,504/66,138
2/2/2010	Beijing Pingxu Décor Material Co.	The Tile Shop	Zimu-Zim Isreal Navigation Co. Ltd	4	155,889/70,859
2/2/2010	Beijing Pingxu Décor Material Co.	The Tile Shop	Zimu-Zim Isreal Navigation Co. Ltd	2	77,889/35,404
2/10/2010	Beijing Pingxu Décor Material Co.	The Tile Shop	Zimu-Zim Isreal Navigation Co. Ltd	3	109,128/49,604
2/10/2010	Beijing Pingxu Décor Material Co.	The Tile Shop	Zimu-Zim Isreal Navigation Co. Ltd	4	145,504/66,138
3/3/2010	Beijing Pingxu Décor Material Co.	The Tile Shop	Zimu-Zim Isreal Navigation Co. Ltd	5	195,107/88,685
3/15/2010	Beijing Pingxu Décor Material Co.	The Tile Shop	AQBC	5	194,700/88,500
3/15/2010	Beijing Pingxu Décor Material Co.	The Tile Shop	Zimu-Zim Isreal Navigation Co. Ltd	5	181,880/82,673
4/19/2010	Beijing Pingxu Décor Material Co.	The Tile Shop	Zimu-Zim Isreal Navigation Co. Ltd	5	181,880/82,673
4/19/2010	Beijing Pingxu Décor Material Co.	The Tile Shop	Zimu-Zim Isreal Navigation Co. Ltd	3	109,128/49,604
4/19/2010	Beijing Pingxu Décor Material Co.	The Tile Shop	Zimu-Zim Isreal Navigation Co. Ltd	2	78,043/35,474

49. The notion that Rucker or other executives of Tile Shop were unaware of the origin, nature, or extent of the Company's relationship with BP, Nishi and/or the Zhangs is implausible, given the corroborating accounts of the former employees discussed above.

**APPLICABLE SEC AND GAAP RULES, REGULATIONS AND PROVISIONS**

**Item 404 of Regulation S-K [17 C.F.R. §229.404]  
and Rule 4-08(k)(1) of Regulation S-X [17 C.F.R. §210.4-08(k)(1)]**

50. Item 404 governs the disclosure of transactions with related parties. Specifically, Item 404(a) requires an issuer to “[d]escribe any transaction, since the beginning of the registrant's last fiscal year, or any currently proposed transaction, in which the registrant was or is to be a participant *and the amount involved exceeds \$120,000*, and in which any related person had or will have a direct or indirect material interest.”

51. Furthermore, according to the Instructions to Item 404(a), the term “related person” means:

Any person who was in any of the following categories at any time during the specified period for which disclosure under paragraph (a) of this Item is required:

- “Any director or executive officer of the registrant”;
- “Any nominee for director, when the information called for by paragraph (a) of this Item is being presented in a proxy or information statement relating to the election of that nominee for director”; or
- “Any immediate family member of a director or executive officer of the registrant, or of any nominee for director when the information called for by paragraph (a) of this Item is being presented in a proxy or information statement relating to the election of that nominee for director, which means any child, stepchild, parent, stepparent, spouse, sibling, mother-in-law, father-in-law, son-in-law, daughter-in-law, brother-in-law, or sister-in-law of such director, executive officer or nominee for director, and any person (other than a tenant or employee) sharing the household of such director, executive officer or nominee for director;” and

Any person who was in any of the following categories when a transaction in which such person had a direct or indirect material interest occurred or existed:

- “A security holder covered by Item 403(a) (§ 229.403(a))”; or
- “Any immediate family member of any such security holder, which means any child, stepchild, parent, stepparent, spouse, sibling, mother-in-law, father-in-law, son-in-law, daughter-in-law, brother-in-law, or sister-

in-law of such security holder, and any person (other than a tenant or employee) sharing the household of such security holder.”

52. Additionally, Rule 4-08(k)(1) of Regulation S-X, which governs the disclosure of “[r]elated party transactions which affect the financial statements,” provides that “[r]elated party transactions should be identified and the amounts stated on the face of the balance sheet, income statement, or statement of cash flows.”

53. As alleged herein, Tile Shop failed to disclose numerous related-party relationships and transactions – all of which involved Rucker’s relatives – that it was required to disclose under these rules and regulations.

#### **Related Party Disclosures Required Under GAAP**

54. U.S. Generally Accepted Accounting Principles (“GAAP”) are principles recognized by the accounting profession as the conventions, rules, and procedures necessary to define accepted accounting practices at a particular time. The Financial Accounting Standards Board established the Accounting Standards Codification (“ASC”) as the source of authoritative accounting principles to be applied by nongovernmental entities in preparing financial statements in conformity with GAAP.

55. Compliance with GAAP is a fundamental obligation of publicly traded companies. Accordingly, SEC Rule 4-01(a) of Regulation S-X [17 C.F.R. §210.4-01(a)(1)] provides that financial statements that are filed with the SEC and not prepared in conformity with GAAP are presumed to be misleading and inaccurate.

56. In the Registration Statements, Forms 10-Q and Form 10-K alleged herein, Tile Shop represented that its financial statements were prepared in accordance with GAAP. In truth, however, the Company’s financial statements were presented in violation of ASC Topic 850, *Related Party Disclosures* (“ASC 850”), because they did not disclose information concerning the related-party transactions and relationships alleged herein.

57. Ordinarily, transactions involving unrelated parties are presumed to be carried out at arm's length and are therefore recorded in financial statements based on their economic substance. In contrast, transactions involving related parties are *not* presumed to have been carried out at arm's length, because participation of the related party negates such presumption.

58. Accordingly, GAAP requires the financial statements to provide sufficient detail of related-party transactions and relationships to compensate for the fact that, due to the related party's involvement, the terms of the transaction may produce an accounting measurement for which a more faithful measurement may not be determinable.

59. ASC 850-10.10 provides that information about related-party transactions must be disclosed to allow users of the financial statements to evaluate the significance of such transactions. Pursuant to ASC 850-10.50, among the information regarding related-party transactions that must be disclosed is the following:

- (a) The nature of the relationship(s) involved;
- (b) A description of the transactions, including transactions to which no amounts or nominal amounts were ascribed, for the periods for which income statements are presented, and such other information necessary to provide an understanding of the effects of the transactions on the financial statements;
- (c) The dollar amounts of transactions for each of the periods for which income statements are presented, and the effects of any change in the method of establishing the terms from that used in the preceding period; and
- (d) Amounts due from or to related parties as of the date of each balance sheet presented and, if not otherwise apparent, the terms and manner of settlement.

60. As detailed herein, Tile Shop engaged in numerous material related-party transactions over several years. Because the Company's financial statements did not disclose these transactions,

the financial statements violated ASC 850 and GAAP and were therefore presumptively misleading and inaccurate.

**Item 303 of Regulation S-K [17 C.F.R. §229.303]**

61. Pursuant to Item 303 and the SEC's related interpretive releases thereto, an issuer is required to disclose known trends, uncertainties or risks that have had, or are reasonably likely to have, a materially adverse impact on net sales or revenues or income from continuing operations. Such disclosures are required to be made by an issuing company in its SEC Form 10-K and 10-Q filings and registration statements filed in connection with public stock offerings.

62. On or about May 18, 1989, the SEC issued an interpretive release on Item 303 (the "1989 Interpretive Release"), stating, in pertinent part, as follows:

Required disclosure is based on currently known trends, events and uncertainties that are reasonably expected to have material effects, such as: A reduction in the registrant's product prices; erosion in the registrant's market share; changes in insurance coverage; or the likely non-renewal of a material contract.

\* \* \*

A disclosure duty exists where a trend, demand, commitment, event or uncertainty is both presently known to management and reasonably likely to have material effects on the registrant's financial condition or results of operation.

63. Furthermore, the 1989 Interpretive Release provided the following test to determine if disclosure under Item 303(a) is required:

Where a trend, demand, commitment, event or uncertainty is known, management must make two assessments:

- (1) Is the known trend, demand, commitment, event or uncertainty likely to come to fruition? If management determines that it is not reasonably likely to occur, no disclosure is required.
- (2) If management cannot make that determination, it must evaluate objectively the consequences of the known trend, demand, commitment, event or uncertainty, on the assumption that it will come to fruition. Disclosure is then required unless management determines that a material effect on the registrant's financial condition or results is not reasonably likely to occur.

64. As alleged further herein, at the time of the Offerings and during the Class Period, Tile Shop was acquiring a significant amount of product from and through BP and other entities that are or were affiliated with Nishi and/or other members of Rucker's family. Additionally, Nishi was receiving significant kickbacks from vendors – at least from September 2011 through December 2013 – in exchange for directing business with Tile Shop to them. These related-party relationships and transactions, which defendants knew or reasonably should have known about, presented trends, uncertainties or risks that had, or were reasonably likely to have, a materially adverse impact on net sales or revenues or income from continuing operations.

65. For example, other suppliers could have learned of the kickbacks paid to Nishi, and could have stopped supplying product to Tile Shop or, alternatively, demanded similar treatment. Similarly, when the SEC learned that Tile Shop had failed to disclose these related-party transactions in violation of SEC regulations, it could have required restatements or otherwise taken regulatory action against Tile Shop. The prospect of these developments, and the transactions themselves, could also require Tile Shop to incur expenses and reputational harm associated with investigating and making public disclosure about these issues. As Tile Shop disclosed in the “Risk Factors” sections of the Registration Statements:

- “If our suppliers do not use ethical business practices or comply with applicable laws and regulations, our reputation could be harmed due to negative publicity and we could be subject to legal risk.”
- “Violation of environmental, labor or other laws by our suppliers or their failure to operate in a legal, ethical, or responsible manner, could reduce demand for our products if, as a result of such violation or failure, we attract negative publicity. Further, such conduct could expose us to legal risks as a result of the purchase of products from non-compliant suppliers.”

Clearly, Tile Shop understood how its involvement in unethical practices could manifest as an adverse trend or risk to the Company's business.

66. Accordingly, these undisclosed transactions and relationships presented a known risk, trend or uncertainty to Tile Shop that was reasonably likely to have a material adverse impact on the Company.

## **BACKGROUND**

### **Tile Shop's Founding and Rucker's Lack of Candor**

67. Tile Shop was co-founded by defendant Rucker in or about 1985. At the time of its founding, the Company was known as Rucker & Sill, Ltd. d/b/a The Tile Shop, and was owned by Rucker and then-business partner Sill, who each held a 50% interest in the Company. At that time, Rucker served as Tile Shop's CEO and Sill served as its CFO and Secretary. Although Rucker held the primary responsibility for managing the business and operations of the Company, Sill delegated the functions of the CFO position to another employee and instead handled marketing for the Company.

68. Tile Shop was a burgeoning business that capitalized on the increasingly prominent "do-it-yourself" customer. By 2000, Tile Shop had 14 retail tile stores in several different states.

69. As the November 2013 Gotham report revealed, in the early 2000's, Rucker was the subject of a civil fraud judgment in litigation involving his ex-wife's successful attempt to reopen their divorce proceedings on the basis of Rucker's fraudulent misrepresentations to the court concerning the value of his interest in Tile Shop and, thus, the value of the marital estate. Specifically, Rucker intentionally misrepresented the value of Tile Shop to an independent expert engaged to determine the value of his assets. Testimony from Tile Shop employees – including Rucker's (now former) business partner and Tile Shop co-founder, Sill – confirmed that Rucker hatched an elaborate plan to lie about the Company's business, prospects, and value to understate the divorce payout to his wife.



70. On or about April 6, 2000, Rucker commenced a marital dissolution proceeding against Katherine M. Rucker (“K. Rucker”), his wife since October 1976, in Hennepin County District Court. In furtherance of resolving the proceedings, Rucker and his wife engaged Howard Kaminsky, CPA (“Kaminsky”), to serve as an independent valuation expert responsible for valuating Rucker’s 50% interest in Tile Shop.

71. In or about September 2000, Kaminsky requested financial projections for Tile Shop. At that time, the Company prepared an annual financial plan to forecast, among other metrics, sales, gross margins, expenses and net income. Typically, the plan was prepared by soliciting information from store managers, regional managers, the sales manager, and other departments, which was then consolidated, refined, and approved by senior management, including Rucker.

72. Yet, Rucker did not provide Kaminsky with the annual plan that the Company had developed on or about February 14, 2001, during the ordinary course of business, which projected net income of \$6.699 million for 2001. Rather, Rucker directed his employees to fabricate financial projections and a valuation of Tile Shop – specifically for the purpose of the divorce proceedings– that portrayed virtually the worst financial outlook possible.

73. According to Sill, who testified on March 9, 2005 and May 20, 2008 in connection with the divorce case and a subsequent action related to it, employees had difficulty generating the negative projections because the Company was performing so well. Eventually, Tile Shop prepared a set of forecasts for Kaminsky that projected net income before taxes of \$2.8 million for 2001 and \$2.3 million for each of 2002 and 2003, with declining gross margins of 61.2% for 2001, 56% for 2002, and 54% for 2003. Additionally, in May 2001, Rucker represented to Kaminsky that Tile Shop did not plan to open any new stores from 2001 through 2003. Rucker falsely represented that a worsening economy and increasing competition from Home Depot and other large home improvement stores were responsible for Tile Shop’s pessimistic performance forecasts.

74. In truth, and unbeknownst to Kaminsky, Tile Shop's actual operating plan projected net income of nearly \$6.7 million for 2001, and contemplated opening 4 or more new stores in 2001 and 11 new stores from 2002 through 2004 – which Rucker placed on hold during the pendency of his divorce. In fact, by June 30, 2001, Tile Shop had generated pre-tax operating income in excess of \$3.2 million for the first six months of the year – already exceeding the false projection of \$2.8 million for all of 2001. Further, Home Depot was not regarded internally at Tile Shop as a legitimate competitor to the Company, nor was the Company suffering in any appreciable manner from the worsening economic climate.

75. After considering the fabricated operating plan, Kaminsky ultimately valued Tile Shop at approximately \$14 million and determined that Rucker's 50% interest was valued at approximately \$7 million. Based on this valuation, K. Rucker accepted a property settlement payment of \$2.4 million to resolve the divorce, and Rucker was entitled to retain his interest in Tile Shop (among other assets). The Marital Termination Agreement between Rucker and K. Rucker was signed on September 25, 2001 (the "MTA"), and on or about October 1, 2001, the Court entered a divorce decree, which incorporated the terms of the agreement. In the MTA, Rucker represented that he had made "full disclosure" regarding his assets, among other things.

76. As Sill confirmed in his testimony, however, Sill subsequently valued his 50% interest in Tile Shop at \$25 million. Nevertheless, in August 2002, when Sill sought to buy out Rucker's interest in the Company, Sill could only obtain \$18 million in financing without involving other investors and offered to purchase Rucker's interest for \$18 million. In response, Rucker invoked his right to purchase Sill's interest in Tile Shop at 90% of the \$18 million offer, or \$16.2 million, on or about September 24, 2002. Even this lower \$16.2 million figure for the value of a 50% interest in Tile Shop was higher than that reached by the valuation expert in reliance on the falsified operating plan.

77. In 2003, K. Rucker sued Rucker for fraud and the case was tried in March 2005. On July 13, 2005, Judge Kaman of the Hennepin County District Court rendered judgment in favor of Rucker, based on, among other things, a misunderstanding of the applicable law. In response, K. Rucker filed a motion for amended findings, seeking to overturn the ruling.

78. In deciding K. Rucker's motion for amended findings and issuing Findings of Fact, Conclusions of Law and Order for Judgment on September 26, 2005 (the "Amended Findings"), Judge Kaman vacated her prior findings and concluded that Rucker had committed fraud on the court under Section 548.14 of the Minnesota Statutes, which provides, in pertinent part, as follows:

Any judgment obtained in a court of record by means of . . . any fraudulent act, practice, or representation of the prevailing party, may be set aside in an action brought for that purpose by the aggrieved party . . . .

79. In the Amended Findings, Judge Kaman made the following findings, among other things:

- "Kaminsky was given partial information, and the Court was given partial information at trial, as well."
- "[A]t the time the [approximately] \$2.9 million [net income] projection was provided to Kaminsky, it was significantly and materially lower than all other financial documentation, known or projected, in The Tile Shop's records."
- "[Rucker] knew much more about the financial workings of The Tile Shop than he attempted to portray during the trial."
- "In the MTA, [Rucker] represented that he had 'made full disclosure and cooperated with discovery, specifically including a neutral appraisal of the parties' business interests in Rucker & Sill, Ltd.' However, the clear evidence of non-disclosure shows otherwise."
- "[T]here is a vast difference between 'holding off on new stores until the discover was over' and telling Kaminsky in 2001 that there would be 'no new stores' through 2003. The evidence shows that plans for new stores were not given to Kaminsky and that it was a 'secret' to Kaminsky that The Tile Shop was only holding off on new stores until the divorce was over. Again, this demonstrates a lack of full disclosure as represented by [Rucker] in the MTA."

- “[A Tile Shop employee] was told to do a ‘worst possible damn scenario forecast’ and that those figures were then given to Kaminsky.”

80. Furthermore, in the “Summary of Findings” portion of the Amended Findings, Judge Kaman held that Rucker had “engaged in an intentional course of material misrepresentation and non-disclosure during the marital dissolution proceeding” by, *inter alia*:

- “[F]ailing to give . . . Kaminsky [documents which] . . . showed the true value of The Tile Shop at the time of the valuation. Instead, [Rucker], whether through himself or through his agents, gave Kaminsky [documents] which showed significantly lower projections . . . .”
- “[T]elling Kaminsky that no new stores would be opened through 2003 when, in reality, plans were in the works to open new stores when the divorce was over.”

81. Thus, Judge Kaman found that Rucker’s “misrepresentations misled the dissolution court and opposing counsel, making the property settlement grossly unfair [to K. Rucker].” As such, Judge Kaman credited K. Rucker’s expert in finding that Rucker’s 50% interest in Tile Shop had an actual value of nearly \$15.4 million, ruling that K. Rucker could recover almost \$3.3 million in additional consideration (after taking into account certain offsets for capital gains taxes to Rucker).

82. As the Gotham report observed: “Rucker’s failure to disclose Beijing Pingxiu as a related party resembles his intentional failure to disclose vital information during his divorce proceedings.” Rucker’s conduct in concealing information regarding the Company in his divorce proceedings exemplifies his propensity to make selective disclosure to shareholders regarding the related-party transactions at issue.

### **Tile Shop’s Path to Becoming a Public Company**

83. Tile Shop was taken public in an unconventional manner, through the acquisition of a special purpose acquisition company (or SPAC). In this way, the Company entered the stock market without undergoing the level of vetting and scrutiny – by the SEC or investors – that typically accompanies an initial public stock offering.

84. Specifically, the common stock of JWC, a blank check company incorporated in Delaware in July 2010, was listed on the over-the-counter market under the symbol “JWCAU.” JWC was founded and controlled by defendants Suttin and Watts. In June 2012, The Tile Shop LLC (which was then controlled by Rucker) incorporated in Delaware and, through a series of transactions, acquired JWC.

85. Tile Shop’s stock was listed and began trading on the NASDAQ on August 22, 2012 under the symbol TTS, replacing the JWCAU listing. As part of that series of transactions, the other owners of The Tile Shop LLC (identified below) contributed all of the membership interests in The Tile Shop LLC in exchange for approximately \$75 million in cash, \$70 million in promissory notes (the “Promissory Notes”), and 32 million shares of Tile Shop common stock, as the following chart from the June 2013 Registration Statement illustrates:<sup>3</sup>

Related Person	Cash Consideration	Promissory Notes	Shares of Common Stock
Nabron International, Inc.	\$37,732,065	\$37,479,696	17,445,432
The Tile Shop, Inc. (entity controlled by Mr. Rucker)	\$23,792,481	\$18,887,729	8,313,792
JWTS, Inc. (entity controlled by Mr. Jacullo)	\$11,843,840	\$11,764,632	5,476,003
Peter H. Kamin Revocable Trust dated February 2003 (entity controlled by Mr. Kamin)	\$584,101	\$580,194	270,059
Peter H. Kamin Childrens Trust dated March 2007 (entity controlled by Mr. Kamin)	\$350,460	\$348,116	162,035
3K Limited Partnership (entity controlled by Mr. Kamin)	\$233,639	\$232,077	108,023
Peter H. Kamin GST Trust (entity controlled by Mr. Kamin)	\$65,239	\$73,984	35,361
Todd Krasnow	\$298,878	\$306,060	143,384

86. As part of the JWC acquisition, each share of JWC was also converted into a share of Tile Shop and those shares were distributed as follows: 208,734 shares to defendant Suttin, 39,284 shares to a trust affiliated with defendant Suttin, and 151,123 shares to defendant Watts.

<sup>3</sup> Nabron invested in 2002 and provided funding to complete the JWC acquisition.

87. In August 2012, Tile Shop also issued and sold 1.5 million shares of its common stock to 9 accredited investors at a purchase price of \$10 per share, generating total gross proceeds of \$15 million. As part of these transactions, Tile Shop issued: 1,080,000 shares of common stock to J.W. Childs, making it a 5% stockholder of the Company; 110,000 shares of common stock to defendant Suttin; and 100,000 shares of common stock to defendant Watts.

88. On October 3, 2012, Tile Shop paid the entire outstanding principal balance of the Promissory Notes, together with all accrued interest thereon, which totaled over \$70 million, in full satisfaction of its obligations pursuant to the Promissory Notes.

89. In connection with the JWC acquisition, the Company entered into a registration rights agreement under which the holders of a majority interest of Tile Shop common stock were entitled to require the Company, on up to four occasions, to register under the 1933 Act the shares of Tile Shop common stock they received in connection with the business combination that brought the Company public. The December 2012 SPO and the June 2013 SPO were undertaken to allow the Individual Defendants, defendants TSI and JWTS, Inc., and non-party J.W. Childs, to cash out.

#### **Tile Shop's Internal Controls and Accounting Practices Were in Disarray**

90. Because Rucker had always operated Tile Shop as he pleased and failed to implement an operating structure capable of handling the Company's outsized growth, Tile Shop's internal controls and accounting practices were in disarray by the start of the Class Period. The Company's poor internal controls and accounting practices were further demonstrated by the fact that shortly before August 2012 – when Tile Shop went public – it did not have a CFO. Moreover, immediately prior to and during the Class Period Tile Shop churned through three outside auditors in only two years: McGladrey LLP (“McGladrey”), Deloitte & Touche LLP (“Deloitte”), and Ernst & Young LLP (“E&Y”).

91. In fact, during the Class Period, Tile Shop was a small company, with only 25 to 52 employees working in corporate, store support, infrastructure or similar operations from September 30, 2012 through May 15, 2013. Moreover, Tile Shop presumably employed even fewer employees in corporate, store support, infrastructure or similar operations before that period, when Tile Shop was a private company. It was during this time, prior to the start of the Class Period, that Tile Shop first established its relationship with BP and began to engage in the related-party transactions at issue.

92. Given Tile Shop's deficient internal controls discussed below, it should come as no surprise that Tile Shop failed to disclose the related-party transactions at the center of this case, and that the Officer Defendants consciously or recklessly disregarded – if not purposely concealed – the need to disclose those relationships.

93. As Tile Shop disclosed in the December 2012 Registration Statement and other SEC filings, the Company had not even taken steps to verify the adequacy of its internal controls before its stock began trading publicly:

Prior to the Business Combination [when Tile Shop went public], we were not required to comply with Section 404 of the Sarbanes-Oxley Act of 2002. As such, we did not make an assessment of the effectiveness of our internal controls over financial reporting nor did we engage our auditors to express, nor have our auditors expressed, an opinion on the effectiveness of our internal controls over financial reporting.

94. Moreover, by the start of the Class Period, Tile Shop had a material weakness in its internal controls over financial reporting. Specifically, as reported in the Company's December 2012 Registration Statement and other SEC filings:

In connection with the audit of our consolidated financial statements for the year ended December 31, 2011, our auditors informed us that they had identified a material weakness in our internal controls over financial reporting related to deficiencies in the financial statement close process.

95. As Tile Shop further disclosed, “[t]he primary factors contributing to the material weakness in [its] financial statement close process were” that the Company “lacked sufficient personnel with requisite competencies within [its] finance function for a company of [its] size and complexity” and “did not maintain financial close processes, procedures, and reporting systems that were adequately designed to support the accurate and timely reporting of [its] financial results.”

96. In an attempt to remedy these internal control deficiencies, Tile Shop hired defendant Clayton to serve as CFO effective on or about August 16, 2012. In the December 2012 Registration Statement, Tile Shop explained that the CFO had “initiated an analysis of [its] internal accounting controls and procedures” and taken steps to improve the Company’s operations, “by designing and implementing a formalized financial reporting process that includes: conducting properly prepared, supported, and reviewed balance sheet reconciliations; conducting properly prepared, supported, and reviewed journal entries; following a properly completed and approved financial close checklist; and abiding by a financial reporting calendar.”

97. Despite these purported efforts, however, the Company’s internal controls continued to exhibit material weaknesses during the Class Period, which forced the Company to restate aspects of its financial statements (discussed below, in the “Additional Scierter Allegations”). Additionally, Tile Shop churned through two outside auditors, and hired three, in less than two years. As reported in the June 2013 Registration Statement, Tile Shop dismissed McGladrey effective as of November 25, 2011, and dismissed Deloitte, and hired E&Y, effective as of April 9, 2013.

98. Accordingly, by the start of the Class Period, the Company was beset by deficient internal financial controls and the lack of a CFO – problems that only worsened during the Class Period, when further internal control deficiencies were identified and the Company was forced to restate certain financial results (discussed below). Amidst this disarray, the Company concealed the



related-party transactions at the center of this case, and the potential impact those relationships and transactions could have on the Company's operations.

**The Officer Defendants Signed False and Misleading  
Sarbanes-Oxley Certifications**

99. In quarterly and annual SEC filings during the Class Period, the Officer Defendants – Rucker and Clayton – each signed Sarbanes-Oxley certifications verifying the adequacy of Tile Shop's disclosure controls and internal controls over financial reporting, and confirming the internal reporting of any "fraud, whether or not material . . ." The certifications were included in the Forms 10-Q filed November 9, 2012 (for the third quarter ended September 30, 2012), May 10, 2013 (for the first quarter ended March 31, 2013), August 8, 2013 (for the second quarter ended June 30, 2013), and November 6, 2013 (for the third quarter ended September 30, 2013), as well as the Form 10-K filed March 18, 2013 (for the year ended December 31, 2012).

100. Specifically, in each of these Forms 10-Q and the Form 10-K, the Officer Defendants certified as follows:

I, [defendants Rucker and Clayton], certify that:

1. I have reviewed this [quarterly report on Form 10-Q or annual report on Form 10-K] of Tile Shop Holdings, Inc.;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

101. Additionally, the Officer Defendants represented that the applicable quarterly report on Form 10-Q or annual report on Form 10-K "complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934," and that the "information contained [therein] . . . fairly presents, in all material respects, the financial condition and results of operations of the Company."

102. These Sarbanes-Oxley certifications were false and misleading because they did not reflect the Company's actual financial or operational conditions and concealed material weaknesses in the Company's internal and disclosure controls. Moreover, as alleged herein, Tile Shop had failed to reveal the existence of potentially fraudulent related-party transactions, as required by Item 404 and Rule 4-08(k)(1).

### **THE 1933 ACT ALLEGATIONS**

103. On or about November 28, 2012, Tile Shop filed a Form S-1 Registration Statement (File No. 333-185180), which was amended on December 10, 2012 and declared effective by the SEC on December 12, 2012.

104. On December 13, 2012, Tile Shop priced the December 2012 SPO at \$15 per share and filed its final prospectus, which formed part of the December 2012 Registration Statement, pursuant to which certain selling stockholders, including several Tile Shop executives and directors, sold 5.175 million shares of common stock to the public.<sup>4</sup> Tile Shop did not sell any shares in the December 2012 SPO.

105. The "Selling Stockholders" in the December 2012 SPO included: (i) Rucker and TSI, which collectively sold 1,029,407 shares, receiving more than \$15.44 million in gross proceeds; (ii) Jacullo and JWTS, which collectively sold 713,274 shares, receiving nearly \$10.7 million in gross proceeds; (iii) Suttin, who sold 46,560 shares, receiving \$698,400 in gross proceeds; and (iv) Watts, who sold 34,696 shares, receiving \$520,440 in gross proceeds.

106. On or about May 24, 2013, Tile Shop filed a Form S-1 Registration Statement (File No. 333-188861), which was amended on June 3, 2013 and declared effective by the SEC on June 4, 2013.

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<sup>4</sup> Nabron also sold 2,272,304 shares, and additional shares were sold by others.

107. On June 5, 2013, Tile Shop priced the June 2013 SPO at \$24.25 per share and filed its final prospectus, which formed part of the June 2013 Registration Statement, pursuant to which certain selling stockholders, including several Tile Shop executives and directors, sold 4,887,500 shares of common stock to the public.<sup>5</sup> Once again, Tile Shop sold no shares in the June 2013 SPO.

108. The “Selling Stockholders” in the June 2013 SPO included: (i) Rucker and TSI, which collectively sold 1 million shares, receiving \$24.25 million in gross proceeds; (ii) Jacullo and JWTS, which collectively sold 600,000 shares, receiving \$14.55 million in gross proceeds; (iii) Kamin, who sold 100,000 shares, receiving \$2.425 million in gross proceeds; and (iv) Krasnow, who sold 15,000 shares, receiving \$363,750 in gross proceeds.

109. Accordingly, the Offerings were successful. In the December 2012 SPO, the Selling Stockholders sold 1,823,937 shares of common stock to the public at \$15 per share, obtaining \$27,359,055 in gross proceeds; and in the June 2013 SPO, the Selling Stockholders sold 1,715,000 shares of common stock to the public at \$24.25 per share, obtaining \$41,588,750 in gross proceeds. Aside from their fees, the Underwriter Defendants stood to profit significantly from the sales of shares offered to them via overallotments in the Offerings. In the December 2012 SPO, the Underwriter Defendants had the opportunity to sell 675,000 shares of stock for \$10,125,000 in gross proceeds; and in the June 2013 SPO, the Underwriter Defendants had the opportunity to sell 637,500 shares of stock for \$15,459,375 in gross proceeds.

110. Underscoring the importance of sourcing low-cost, quality products from suppliers, Tile Shop emphasized its sourcing relationships in the Registration Statements. The Company represented, in pertinent part, as follows:

We believe that our long-term producer relationships, together with our design, manufacturing and distribution capabilities, enable us to offer a broad assortment of

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<sup>5</sup> Nabron again sold 2,100,156 shares, and additional shares were sold by others.

high-quality products to our customers, who are primarily homeowners, at competitive prices. We have invested significant resources to develop our proprietary brands and product sources and believe that we are a leading retailer of stone tiles, accessories, and related materials in the United States.

111. The Company also represented that its direct-purchasing arrangements with vendors kept costs low for consumers, representing: “We are able to maintain every-day low prices by purchasing tile and accessories directly from producers and manufacturing our own setting and maintenance materials.”

112. In the same vein, the Registration Statements outlined the advantages of long-term producer relationships under the heading “*Worldwide Sourcing Capabilities*” in the “Business Overview” section, as follows:

We have long-standing relationships with producers of our tiles throughout the world and work with them to design products exclusively for us. We believe that these direct relationships differentiate us from our competitors, who generally purchase commodity products through distributors. We are often the largest or exclusive customer for many of our producers.

113. The Company also expressed its dependence on suppliers to deliver quality product, and stated in the “Risk Factors” section that issues involving its supply relationships could adversely impact revenues and gross margin, as follows:

We depend on a number of suppliers, and any failure by any of them to supply us with products may impair our inventory and adversely affect our ability to meet customer demands, which could result in a decrease in revenues and/or gross margin.

Our current suppliers may not continue to sell products to us on acceptable terms or at all, and we may not be able to establish relationships with new suppliers to ensure delivery of products in a timely manner or on terms acceptable to us. We do not have long-term contractual supply agreements with our suppliers which obligate them to supply us with products at specified quantities or prices. We may not be able to acquire desired merchandise in sufficient quantities on terms acceptable to us in the future. We are also dependent on suppliers for assuring the quality of merchandise supplied to us. Our inability to acquire suitable merchandise in the future or the loss of one or more of our suppliers and our failure to replace them may harm our relationship with our customers and our ability to attract new customers, resulting in a decrease in net sales.

114. Further, Tile Shop expressed its dependence on Asian suppliers. In fact, in the “Risk Factors” section of the December 2012 Registration Statement, Tile Shop represented that a majority of its product is supplied by vendors located primarily in Asia, stating, in relevant part, that:

We source the approximately 4,000 products that we stock and sell from over 100 domestic and international vendors. We source a large number of those products from foreign manufacturers, including approximately 55% of our products from a group of 10 suppliers located primarily in Asia. We generally take title to these products overseas and are responsible for arranging shipment to our distribution centers.

115. Similarly, in the “Risk Factors” section of the June 2013 Registration Statement, the Company stated, in relevant part, that:

We source the approximately 4,500 products that we stock and sell from over 115 domestic and international vendors. We source a large number of those products from foreign manufacturers, including approximately 52% of our products from a group of 10 suppliers located primarily in Asia. We generally take title to these products overseas and are responsible for arranging shipment to our distribution centers.

116. Additionally, the December 2012 Registration Statement represented that Tile Shop sourced approximately 53% of its “purchased product” from Asia in 2011, whereas the June 2013 Registration Statement represented that Tile Shop sourced approximately 58% of its “purchased product” from Asia in 2012.

117. Through these representations in the Registration Statements, Tile Shop emphasized the importance of its supplier relationships, directly linking its revenues and gross margins to its ability to supply high-quality product at competitive prices.

118. Notwithstanding these representations in the Registration Statements, Tile Shop failed to disclose its related-party transactions involving Nishi, the Zhangs, BP, Nanyang and Best Cheer Stone in violation of Item 404, Rule 4-08(k)(1). Through these critical omissions, defendants concealed the fact that Tile Shop’s large inventory and low costs, as reported in the Company’s

financial statements and summarized in or incorporated by reference into the Registration Statements, were enabled by these undisclosed related-party transactions and relationships.

119. Not only did the non-disclosures of the related-party transactions and relationships violate Item 404, Rule 4-08(k)(1), but as a result of these non-disclosures, the representations in the Registration Statements that exclusive, “long-term producer relationships” allowed Tile Shop to deliver competitive prices, quoted above in paragraphs 110 through 115, were rendered materially misleading. Defendants omitted the critical fact that these “long-term producer relationships” were with companies controlled by Tile Shop’s own purchasing supervisor (Nishi) and other relatives of Rucker (the Zhangs).

120. Moreover, Tile Shop affirmatively misrepresented its control over BP, Nanyang, Best Cheer Stone and possibly other vendors, stating, in pertinent part: “We do not control the operations of our suppliers.” In truth, these entities were significant business partners for Tile Shop, and it – or its purchasing agent and employee, Nishi – had the ability to control, and did control, their business and operations through a scheme of kickbacks for below-market priced materials.

121. In addition, defendants’ failure to disclose the related-party transactions and relationships described herein violated Item 303. Specifically, the scheme alleged involving the use of undisclosed, familial business partners to achieve favorable financial results presented trends, uncertainties or risks that had, or were reasonably likely to have, a materially adverse impact on net sales or revenues or income from Tile Shop’s continuing operations.

122. Without the disclosure of these material facts, the Registration Statements were materially misleading.

## THE 1934 ACT ALLEGATIONS

### (a) Misrepresentations and Omissions in August 22, 2012 Press Release

123. The Class Period starts on August 22, 2012. On the prior evening, August 21, 2012, Tile Shop issued a press release entitled “Tile Shop Holdings, Inc. and JWC Acquisition Corp. Announce Closing of Business Combination, *Trading of Common Stock on Nasdaq to Commence on Wednesday, August 22, 2012.*” The press release quoted defendant Rucker as stating, in pertinent part, as follows:

“We are extremely excited about our transition into a publicly-traded company and view this as an important milestone in the evolution of our company and the expansion of our brand. As we have said before, we intend to not only continue our self-funded store growth across the country but will also be better positioned to take advantage of the anticipated increased demand for our products as a result of our additional resources. The business combination with JWCAC will strengthen our ability to pursue attractive growth opportunities in new and existing markets, as we work towards building a national presence.”

The press release also quoted defendant Watts, who stated:

We are pleased to complete this merger with The Tile Shop, a truly unique retailer and leader in the industry. The Tile Shop has the ability to grow dramatically with strong sustained margins and we expect to build this company into the formidable leading provider of stone tiles, setting and maintenance materials, and related accessories.

Yet, as alleged herein, Tile Shop failed to disclose that its margins were largely derived from captive supplier relationships involving Rucker’s family members, as further detailed herein. The failure to disclose the nature of these relationships rendered statements regarding the Company’s margins and “ability to grow dramatically” false and misleading, and gave rise to an affirmative obligation to disclose the related-party transactions and relationships.

### (b) Misrepresentations and Omissions in November 1, 2012 Press Release

124. On November 1, 2012, the Company issued a press release announcing its financial results for the third quarter ended September 30, 2012. The Company reported that “[n]et sales



increased 19.4% to \$44.3 million for the quarter ended September 30, 2012 compared with \$37.1 million for the comparable quarter last year,” and that “Adjusted EBITDA was \$11.2 million, compared to \$9.3 million in the same period of the prior year, an increase of \$1.9 million, or 19.9%.”

Commenting on these results, defendant Rucker stated, in pertinent part:

Our model of direct sourcing, exceptional customer service, strategically located stores and a proven distribution center model allows us to operate at high margins within this growing industry.

125. Notwithstanding these statements, Tile Shop failed to disclose its related-party transactions and relationships.

126. Moreover, because Tile Shop’s self-described “high margins” were a product of the undisclosed, related-party supplier relationships—which allowed the Company to manipulate the cost of its supply—the omission of these relationships rendered false and misleading the representations on November 1, 2012 regarding the purported reason why the Company was able to report such high margins. Indeed, had Tile Shop disclosed that a substantial portion of its product was sourced from Rucker’s relatives, who operated BP and other entities in China, investors would have been apprised of the significant risk that Tile Shop could not sustain the bloated margins it had reported, and that the margins were not, in fact, the result of the Company’s “direct sourcing” and “distribution center model.”

**(c) Misrepresentations and Omissions in November 9, 2012 Form 10-Q**

127. On November 9, 2012, Tile Shop filed its Form 10-Q for the third quarter ended September 30, 2012, which was signed and certified pursuant to Sarbanes-Oxley by defendants Rucker and Clayton. Under the heading “Gross profit,” the Form 10-Q stated, in pertinent part, that “[i]n 2011, 2010, and 2009 our gross margin was 73.6%, 73.3%, and 72.7%, respectively,” that “[f]or the nine months ended September 30, 2012 and 2011 our gross margin was 72.9% and 73.7%,”

respectively,” and that: “[w]e have been able to maintain stable gross margins as a result of product cost control and expect that our gross margin will continue in the same range.”

128. In the 2012 third quarter Form 10-Q, Tile Shop made the following statement regarding its supplier relationships:

We believe that our long-term producer relationships, together with our design, manufacturing and distribution capabilities, enable us to offer a broad assortment of high-quality products to our customers, who are primarily homeowners, at competitive prices.

129. Additionally, in the “Risk Factors” section of the 2012 third quarter Form 10-Q, Tile Shop denied having control of its suppliers, representing:

We do not control the operations of our suppliers. Accordingly, we cannot guarantee that our suppliers will comply with applicable environmental and labor laws and regulations or operate in a legal, ethical, and responsible manner. Violation of environmental, labor or other laws by our suppliers or their failure to operate in a legal, ethical, or responsible manner, could reduce demand for our products if, as a result of such violation or failure, we attract negative publicity. Further, such conduct could expose us to legal risks as a result of the purchase of products from non-compliant suppliers.

130. Moreover, the 2012 third quarter Form 10-Q disclosed the following “related-party transactions” in Note 7 to the Consolidated Financial Statements:

The Special Cash Distribution Units issued by The Tile Shop were owned by Mr. Robert Rucker, the President and CEO. The units received annual payments of \$300,000 for a term of 10 years through 2012 and were fully paid as of June 30, 2012.

The Tile Shop had a note receivable from Robert Rucker, the President and CEO. The note was due in annual installments of \$300,000 of principal and interest at a rate of 2.6% per annum with a final installment due in 2012 which was fully received as of June 30, 2012.

The Company has issued Promissory Notes to members of The Tile Shop for an aggregate principal amount of \$69.8 million in connection with the Business Combination which were outstanding at September 30, 2012. The Company has recorded interest expense of \$305,846 for the three and nine months ended September 30, 2012 related to these notes.

During the three months ended September 30, 2012, the Company obtained an unsecured short term loan of \$5.5 million from Nabron. The loan was obtained to

provide short term working capital and liquidity for the Company. The loan was paid off during the three months ended September 30, 2012 with interest of \$20,777.

131. Notwithstanding the fact that Tile Shop disclosed certain other related-party transactions and referenced its supplier relationships in the 2012 third quarter Form 10-Q, Tile Shop failed to disclose any transactions or relationships between and among Rucker, Nishi, the Zhangs, BP, Nanyang or Best Cheer Stone, in violation of Item 404 and Rule 4-08(k)(1). Tile Shop further failed to disclose that Nishi and others at Tile Shop – including Rucker and those related to Rucker – had control over major suppliers. These omissions of material fact rendered the 2012 third quarter Form 10-Q misleading, particularly given statements therein touting Tile Shop’s ability to secure competitive prices through suppliers. Moreover, the reported margin figures were misleading in the absence of disclosure regarding such related-party relationships for the same reasons as those set forth above in paragraph 126.

132. In addition, the failure to disclose the related-party transactions and relationships described herein violated Item 303. Specifically, the scheme alleged herein involving the use of undisclosed, familial business partners to achieve favorable financial results presented trends, uncertainties or risks that had, or were reasonably likely to have, a materially adverse impact on net sales or revenues or income from Tile Shop’s continuing operations.

**(d) Misrepresentations and Omissions in February 20, 2013 Press Release and Conference Call**

133. On February 20, 2013, Tile Shop issued a press release announcing its financial results for the 2012 fourth quarter and year ended December 31, 2012. The Company reported that “[n]et sales increased 22.5% to \$46.2 million for the quarter ended December 31, 2012 versus \$37.7 million for the comparable quarter last year,” and that “Adjusted EBITDA was \$12.0 million compared to \$9.9 million in the same period of the prior year, an increase 21.2%.” The Company also reported that “[f]or the year ended December 31, 2012, net sales increased by \$29.9 million or

19.6% to \$182.7 million for the full year 2012 from \$152.7 million in 2011,” and that “Adjusted EBITDA increased 18.9%, or \$8.0 million, to \$50.6 million for the full year 2012.” Commenting on these results, defendant Rucker again stated, in pertinent part:

“Our unique operating model, which combines direct sourcing, exciting in-store displays, exceptional customer service and strategically located stores, has enabled the Company to grow while maintaining our strong financial performance.”

134. The representations in Tile Shop’s February 20, 2013 press release concerning the Company’s margins and supplier relationships were false and misleading, because Tile Shop failed to disclose that its margins were largely derived from captive supplier relationships involving Rucker’s family members, as further detailed herein. Thus, Tile Shop’s failure to disclose the nature of these relationships rendered the Company’s statements about its margins and supplier relationships materially false and misleading and gave rise to an affirmative obligation to disclose the related-party transactions and relationships.

135. Also on February 20, 2013, after issuing the press release, defendants Watts, Rucker and Clayton conducted a conference call with investors. In his opening remarks, Watts stated that Tile Shop’s “operating model produces extraordinary margins; in fact, they’re elite in hard good retailing,” and that “the strong revenue trends we saw in the fourth quarter are continuing early in the current year.” In turn, Rucker opened his remarks “reiterating that [Tile Shop’s] direct sourcing model remain[ed] a material competitive advantage over the other players in the tile industry.” Rucker also stated that “[w]hile all of our competitors have product, we uniquely provide a tile solution for our customers and do it through our vertically integrated proprietary sourcing,” noting that “[s]ince the last earning call, [he had] traveled to Turkey, Spain, Vietnam and Indonesia and [would] be returning to China, Indonesia and Vietnam, shortly.”

136. Again, the representations in Tile Shop’s February 20, 2013 conference call regarding the Company’s margins and operative and sourcing model were false and misleading for the same

reasons as those set forth above in paragraph 134. Indeed, the Officer Defendants failed to disclose that Tile Shop's sourcing model was dependent on longstanding, related-party suppliers in China that operated at the behest of the Company and Rucker.

**(e) Misrepresentations and Omissions in March 18, 2013 Form 10-K**

137. On March 18, 2013, Tile Shop filed its annual report on Form 10-K for the year ended December 31, 2012, which was signed by all of the Individual Defendants and certified as to veracity pursuant to Sarbanes-Oxley by defendants Rucker and Clayton. In the Form 10-K, the Company made the following statements regarding its supplier relationships:

- We believe that our long-term producer relationships, together with our design, manufacturing and distribution capabilities, enable us to offer a broad assortment of high-quality products to our customers, who are primarily homeowners, at competitive prices.
- We are able to maintain every-day low prices by purchasing tile and accessories directly from producers and manufacturing our own setting and maintenance materials.
- We have long-standing relationships with producers of our tiles throughout the world and work with them to design products exclusively for us. We believe that these direct relationships differentiate us from our competitors, who generally purchase commodity products through distributors. We are often the largest or exclusive customer for many of our producers.

138. Additionally, as in the Registration Statements and the 2012 third quarter Form 10-Q, the Company denied having control of its suppliers in the "Risk Factors" section of the Form 10-K, stating:

We do not control the operations of our suppliers. Accordingly, we cannot guarantee that our suppliers will comply with applicable environmental and labor laws and regulations or operate in a legal, ethical, and responsible manner. Violation of environmental, labor or other laws by our suppliers or their failure to operate in a legal, ethical, or responsible manner, could reduce demand for our products if, as a result of such violation or failure, we attract negative publicity. Further, such conduct could expose us to legal risks as a result of the purchase of products from non-compliant suppliers.

139. The Form 10-K also listed “related-party transactions,” in Note 9 to the Consolidated Financial Statements, as follows:

In January 2012, TS, Inc., ILTS and JWTS sold (i) an aggregate of 129,333 Common Units of The Tile Shop to Mr. Krasnow, (ii) an aggregate of 646,667 Common Units of The Tile Shop to the Peter H. Kamin Revocable Trust dated February 2003, the Peter H. Kamin Childrens Trust dated March 2007, and 3K Limited Partnership, entities of which Mr. Kamin is trustee or general partner, as applicable, (iii) an aggregate of 25,867 Common Units of The Tile Shop to Family Office Investors LLC, an entity in which Mark Riser, a member of the board of managers of The Tile Shop prior to the consummation of the Business Combination, is the sole member, and (iv) an aggregate of 19,400 Common Units of The Tile Shop to Warren Garden, in each case for \$7.732 per unit. In connection with these transactions, The Tile Shop made certain representations and warranties.

During the years ended 2012 and 2011 The Tile Shop made payments of \$300,000 to TS, Inc. in connection with the final redemption of an aggregate of 3,000,000 special cash distribution units of The Tile Shop issued to TS, Inc., which were fully-redeemed by The Tile Shop during 2012. In lieu of paying such amounts to TS, Inc. in cash, The Tile Shop reduced the outstanding amount under a promissory note, dated December 30, 2002, made by TS, Inc. and payable to The Tile Shop. Total principal payments made in cash related to this promissory note were approximately \$1,205,000 and \$263,000 for the years ended December 31, 2012 and 2011, respectively.

140. Notwithstanding the fact that Tile Shop disclosed certain other related-party transactions and referenced its supplier relationships in the March 18, 2013 Form 10-K, Tile Shop failed to disclose any transactions or relationships between and among Rucker, Nishi, the Zhangs, BP, Nanyang or Best Cheer Stone, in violation of Item 404, Rule 4-08(k)(1) and Item 303. Tile Shop further failed to disclose that Nishi and others at Tile Shop – including Rucker and those related to Rucker – had control over major suppliers. These omissions of material fact rendered the March 18, 2013 Form 10-K misleading, particularly given statements therein touting Tile Shop’s ability to secure competitive prices through suppliers. Moreover, the reported margin figures were misleading in the absence of disclosure regarding such related-party relationships for the same reasons as those set forth above in paragraph 126 and 131.

141. Further, under the heading “Gross Profit,” the March 18, 2013 Form 10-K stated, in pertinent part, that “[i]n 2012, 2011, and 2010 our gross margin was 72.8%, 73.6%, and 73.3%, respectively,” and stated, in pertinent part:

We have been able to maintain relatively stable gross margins as a result of product cost control and retail price adjustments, in the past. However, increases in freight and distribution costs, along with increased promotional activity may adversely impact our gross margins by 100 to 200 basis points over the next several years.

142. Again, the failure to disclose Tile Shop’s related-party transactions violated Item 404, Rule 4-08(k)(1) and Item 303. This omission also rendered the above-quoted statements concerning Tile Shop’s “relatively stable gross margins” and the relationship between margins and “product cost control,” materially false and misleading for the same reasons as those set forth above in paragraphs 126 and 131.

**(f) Misrepresentations and Omissions in May 1, 2013 Press Release**

143. On May 1, 2013, Tile Shop issued a press release announcing its financial results for the first quarter ending March 31, 2013. The Company reported that net sales had increased 23.9% to \$56.8 million for the 2013 first quarter, compared with \$45.9 million for the 2012 first quarter, and that Adjusted EBITDA grew 17.9% to \$16.4 million, compared to \$13.9 million in the 2012 first quarter. Again, Rucker, without disclosing the related-party transactions described above, attributed these favorable results to the Company’s supplier relationships and sourcing capabilities, stating, in pertinent part, as follows:

This level of sales growth clearly demonstrate [sic] that our store layout and broad product assortment is providing a much needed solution to the needs of our customers. This unique ‘in-store experience’ is made possible by our operating model, which enables us to source distinctive products directly from quarries throughout the world. Our customer-focused store presentation, together with our direct sourcing capabilities, allows us to operate at high margins and drive value for all our stakeholders.

144. The Company's failure to disclose the related-party transactions and relationships rendered false and misleading the representations in the May 1, 2013 press release concerning the Company's "operating model" and the reason why the Company was able to "operate at high margins." Moreover, these representations were false and misleading for the same reasons as those set forth above in paragraph 134.

**(g) Misrepresentations and Omissions in May 10, 2013 Form 10-Q**

145. On May 10, 2013, Tile Shop filed its Form 10-Q for the first quarter ended March 31, 2013, which was signed and certified as to veracity pursuant to Sarbanes-Oxley by defendants Rucker and Clayton. Under the heading "Gross profit," the Form 10-Q stated, in pertinent part, that "[f]or the three months ended March 31, 2013 and 2012 our gross margin was 71.0% and 73.5%, respectively"; that "[g]ross profit increased \$6.7 million, or 19.8%, for the three months ended March 31, 2013 compared to the three months ended March 31, 2012, primarily due to the increase in net sales"; and that "[g]ross margin decreased from 73.5% for the three months ended March 31, 2012 to 71.0% for the three months ended March 31, 2013," "primarily driven by slightly higher product related costs, transportation expenses and increase promotional discounts."

146. The failure to disclose Tile Shop's related-party transactions in the Company's May 10, 2013 Form 10-Q violated Item 404, Rule 4-08(k)(1) and Item 303. In addition, for the same reasons set forth above in paragraphs 126 and 131, the failure to disclose the Company's related-party transactions rendered false and misleading those statements in Tile Shop's May 10, 2013 Form 10-Q regarding its gross margin.

147. In the 2013 first quarter Form 10-Q, as in previous SEC filings, Tile Shop made the following statement regarding its supplier relationships:



We believe that our long-term producer relationships, together with our design, manufacturing and distribution capabilities, enable us to offer a broad assortment of high-quality products to our customers, who are primarily homeowners, at competitive prices.

148. Additionally, the 2013 first quarter Form 10-Q incorporated the “Risk Factors” section of the March 18, 2013 Form 10-K and indicated that “[t]here have been no material changes from the risk factors previously disclosed in our Annual Report on Form 10-K for the year ended December 31, 2012.” The Form 10-Q did not disclose any related-party transactions.

149. Accordingly, in the 2013 first quarter Form 10-Q, Tile Shop continued to omit information concerning any transactions or relationships between and among Rucker, Nishi, the Zhangs, BP, Nanyang or Best Cheer Stone in violation of Item 404, Rule 4-08(k)(1) and Item 303. Further, the Company failed to disclose that Nishi and others at Tile Shop – including Rucker and those related to Rucker – had control over major suppliers. These omissions of material fact rendered the 2013 first quarter Form 10-Q misleading, particularly given Tile Shop’s representations in the Form 10-Q touting its ability to secure competitive prices through these related suppliers. The Company’s representations concerning its supplier relationships were also false and misleading for the same reasons as those set forth above in paragraphs 126 and 131.

**(h) Misrepresentations and Omissions in June 13, 2013 Schedule 14A**

150. On June 13, 2013, Tile Shop filed with the SEC proxy materials on Schedule 14A, in which it disclosed information concerning certain related-party transactions in contemplation of its July 23, 2013 annual meeting. With respect to “related person transactions,” the proxy materials disclosed the details of various transactions involving the Company’s going-public transactions and the sale of warrants to purchase common stock (among other matters), but failed to disclose the related-party transactions involving Nishi, the Zhangs, BP, Nanyang or Best Cheer Stone.

151. Accordingly, in the June 13, 2013 proxy materials, Tile Shop continued to omit information concerning any transactions or relationships between and among Rucker, Nishi, the Zhangs, BP, Nanyang or Best Cheer Stone, in violation of Item 404, Rule 4-08(k)(1).

**(i) Misrepresentations and Omissions in August 8, 2013 Form 10-Q**

152. On August 8, 2013, Tile Shop filed its Form 10-Q for the second quarter ended June 30, 2013, which was signed and certified as to veracity pursuant to Sarbanes-Oxley by defendants Rucker and Clayton.

153. In the 2013 second quarter Form 10-Q, as in previous SEC filings, Tile Shop made the following statement regarding its supplier relationships:

We believe that our long-term producer relationships, together with our design, manufacturing and distribution capabilities, enable us to offer a broad assortment of high-quality products to our customers, who are primarily homeowners, at competitive prices.

154. Additionally, the 2013 second quarter Form 10-Q incorporated the “Risk Factors” section of the March 18, 2013 Form 10-K and indicated that “[t]here have been no material changes from the risk factors previously disclosed in our Annual Report on Form 10-K for the year ended December 31, 2012.” The Form 10-Q did not disclose any related-party transactions.

155. Accordingly, in the 2013 second quarter Form 10-Q, Tile Shop continued to omit information concerning any transactions or relationships between and among Rucker, Nishi, the Zhangs, BP, Nanyang or Best Cheer Stone in violation of Item 404, Rule 4-08(k)(1) and Item 303. Further, the Company failed to disclose that Nishi and others at Tile Shop – including Rucker and those related to Rucker – had control over major suppliers. These omissions of material fact rendered the 2013 second quarter Form 10-Q misleading, particularly given Tile Shop’s representations in the Form 10-Q touting its ability to secure competitive prices through these related

suppliers. The Company's representations concerning its supplier relationships were also false and misleading for the same reasons as those set forth above in paragraphs 126 and 131.

**(j) Misrepresentations and Omissions in November 6, 2013 Form 10-Q**

156. On November 6, 2013, Tile Shop filed its Form 10-Q for the third quarter ended September 30, 2013, which was signed and certified as to veracity pursuant to Sarbanes-Oxley by defendants Rucker and Clayton. In the 2013 third quarter Form 10-Q, as in previous SEC filings, Tile Shop made the following statement regarding its supplier relationships:

We believe that our long-term producer relationships, together with our design, manufacturing and distribution capabilities, enable us to offer a broad assortment of high-quality products to our customers, who are primarily homeowners, at competitive prices.

157. Additionally, the 2013 third quarter Form 10-Q incorporated the "Risk Factors" section of the March 18, 2013 Form 10-K and indicated that "[t]here have been no material changes from the risk factors previously disclosed in our Annual Report on Form 10-K for the year ended December 31, 2012." The Form 10-Q did not disclose any related-party transactions.

158. Accordingly, in the 2013 third quarter Form 10-Q, Tile Shop continued to omit information concerning any transactions or relationships between and among Rucker, Nishi, the Zhangs, BP, Nanyang or Best Cheer Stone in violation of Item 404, Rule 4-08(k)(1) and Item 303. Further, the Company failed to disclose that Nishi and others at Tile Shop – including Rucker and those related to Rucker – had control over major suppliers. These omissions of material fact rendered the 2013 third quarter Form 10-Q misleading, given Tile Shop's representations in the Form 10-Q touting its ability to secure competitive prices through these related suppliers. The Company's representations concerning its supplier relationships were also false and misleading for the same reasons as those set forth above in paragraphs 126 and 131. As a result of these material misstatements and omissions, Tile Shop stock traded at artificially inflated prices throughout the

Class Period, reaching a Class Period high of \$30.88 in intraday trading on July 11, 2013 and permitting the sale of hundreds of millions of dollars of Tile Shop stock at artificially inflated prices in the Offerings.

**Tile Shop's Stock Price Drops as New Information is Disclosed**

159. On November 14, 2013, Gotham published a 58-page report disclosing that, unbeknownst to public investors, Tile Shop had acquired a significant amount of product from BP in related-party transactions. Specifically, as Gotham reported, Tile Shop bought 8.3% of its product sold in fiscal 2011, 16.3% of its product sold in fiscal 2012, and 32.2% of its product sold in fiscal 2013 (through October 28, 2013) from BP, which was owned and operated by Rucker's brother-in-law, Nishi, who was a Tile Shop employee. Citing import/export records, Gotham reported that "[BP] invoices sent to Tile Shop are directed to [Nishi]."

160. Gotham also reported that Tile Shop was purchasing product from BP at or near cost, permitting Tile Shop to obtain "an artificial cost advantage" and report outsized margins and profits. Gotham also claimed that Tile Shop had been using BP and other captive, phantom suppliers to overstate inventories, understate cost of sales and overstate gross profits. Gotham claimed that Tile Shop inflated its earnings by 200% during fiscal 2013 alone by using its China-based controlled "phantom" suppliers to augment its numbers. As Gotham reported, another Tile Shop supplier – Xingyang Xinfeng – shares at least one of the same addresses at which BP purportedly operates, suggesting that both are (or were) captive suppliers.

161. As Gotham disclosed, BP's profit margins were approximately zero percent. Moreover, financial information derived from records obtained by Plaintiffs from SAIC shows that BP reported a loss of RMB 2,697,892.07 for the year ended December 31, 2011 and a loss of RMB 187,947.74 for the year ended December 31, 2012. These records also indicate that BP was incorporated on March 3, 2008, and, as Gotham indicated, that the Zhangs had also owned and/or

controlled BP before Nishi formally acquired control over the company. As alleged above, import/export records show that the Company received product from BP at least as early as 2009. And, Nishi and Jian Zhang reportedly lived in Eden Prairie, Minnesota.

162. In response to the November 14, 2013 Gotham report, Tile Shop issued an unusual press release that same day, purporting to “reaffirm” its 2013 annual guidance and addressing the general subject matter of the report. Without identifying Gotham by name or admitting the allegations raised in the Gotham report, the Company referenced the supplier accusations regarding BP, as follows:

The Company negotiates all inventory purchases directly with each vendor. As is common practice, certain vendors utilize an export trading company, such as Beijing Pingxiu, for sales to U.S. based companies. Other Chinese vendors maintain their own export licensing authority. The Company has been made aware of changes of the ownership of Beijing Pingxiu which were not previously disclosed to the Company. As a result of this disclosure, The Company has suspended its relationship with this entity.

The Company intends to thoroughly investigate this relationship. The Company believes that any issues associated with the ownership of Beijing Pingxiu, or the utilization of other export trading companies, have had no material impact on the economics of inventory purchases.

163. Based on the information disclosed in the Gotham report, and despite Tile Shop’s attempt to minimize its SEC disclosure violations, shares of the Company plummeted almost 39%, or \$8.27 per share, to close at \$12.95 per share on November 14, 2013, on extremely usual high trading volume of more than 19.5 million shares, which tripped the NASDAQ’s short sale circuit breaker.

164. On January 28, 2014, Tile Shop filed with the SEC a Form 8-K attaching a press release, dated January 27, 2014, in which the Company announced the results of its “independent investigation” into the assertions made in the Gotham report, including “the findings of the Audit

Committee investigation into the nature and extent of [the Company's] relationship with [BP] . . . .”

In the press release, the Company disclosed the following:

- Fumitake Nishi, the brother-in-law of CEO Robert Rucker and a former Company employee, acquired BP in late 2011. The investigation found that while BP primarily processed export transactions on an agency basis on behalf of the Company's vendors, it also operated a business model that would take title to product and resell that product to the Company. The report confirmed that Mr. Nishi failed to disclose to the Company the existence of this “reseller” model and his ownership of BP. The total amount of payments processed by and through BP during the years ended December 31, 2011, 2012 and 2013 were \$6.3 million, \$12.5 million and \$16.9 million, respectively. During fiscal years 2011, 2012 and 2013, the Company's purchases that were fulfilled under BP's agency model totaled \$6.2 million, \$9.5 million and \$9.5 million, respectively, and the purchases that were fulfilled under BP's reseller model were \$0.1 million, \$3.0 million and \$7.4 million, respectively. The report found no evidence that the Company overpaid vendors through the BP relationship, nor did it underpay vendors through the BP relationship.
- Mr. Nishi acquired a majority ownership interest in a vendor of the Company, Nanyang Helin Stone Co. Ltd. (“Nanyang”) in 2010. The Company purchases natural stone products including hand-crafted mosaics, listellos and accessories from Nanyang. The same products purchased from Nanyang were also purchased from other vendors and the investigation indicated that the prices for the products purchased from Nanyang were consistent with what the company paid the other unrelated vendors for the same or similar SKUs. Total amounts purchased from Nanyang during fiscal years 2011, 2012 and 2013 were \$1.7 million, \$2.1 million and \$2.8 million, respectively.
- Mr. Nishi personally received payments from representatives of certain vendors over the period September 2011 through December 2013. The investigation, which included local on-site interviews in China with some of these vendors, reported that certain vendors stated that the payments were in appreciation for consulting services provided by Mr. Nishi. The investigation identified approximately \$1.1 million that was deposited into Mr. Nishi's personal bank accounts in China over the above-referenced period.

165. Furthermore, as a result of the investigation's findings, Tile Shop claimed that it had taken, or would be taking, a number of actions to address and remediate the identified issues. These actions, which consisted of the following, confirmed that the Company had not previously established adequate controls to manage and monitor its supplier relationships:

- The Company discontinued its relationship with BP as of December 1, 2013.

- Mr. Nishi's employment was terminated effective January 1, 2014 for multiple violations of the Company's business ethics policy. The Company will actively pursue recovery from Mr. Nishi of all monies he received from sources other than the Company while he was an employee of the Company.
- The Company is establishing new procedures to ensure that it has complete visibility to its vendors' invoices.
- The Company has notified Nanyang that it will continue business with Nanyang only if Mr. Nishi's ownership is transferred to an unrelated party and Mr. Nishi is not an officer or director of Nanyang.
- The Company is establishing a new export trading company which would be operated by Company employees, so as to properly identify and fully control all vendor invoices, vendor relationships and vendor payments.
- The Company will install multiple points of contact with vendors and rotate primary vendor relationships every 24 months.
- The Company will reorganize purchasing oversight responsibilities and implement additional segregation of duties and control procedures.

166. Finally, Tile Shop represented in the press release that “[t]he investigation did not uncover any other third party relationships that require disclosure.” And, the Company represented that it would “file an amended Annual Report on Form 10-K for fiscal 2012, which will include disclosure of Mr. Nishi's previously unknown ownership interests in BP and Nanyang, and the salary paid to Mr. Nishi as a Company employee.”

167. In response to the Company's disclosure of additional detail regarding the previously-undisclosed related-party relationships and transactions, the stock price dropped by almost \$1 per share, or nearly 6.7%, to close at \$13.74 per share on January 28, 2014, on extraordinarily high volume of approximately 4.8 million shares traded.

168. When Tile Shop filed its annual report on Form 10-K on February 28, 2014, it disclosed additional relationships between Rucker's family members and BP, and Nishi and another business partner of the Company's – relationships that the Company failed to disclose at any prior

time, including in the January 27, 2014 press release (or associated Form 8-K). In the “Additional Relationships” section, Tile Shop disclosed the following:

- Prior to Mr. Nishi’s acquisition of BP, the entity was jointly owned by Zhang Jian, who is related through marriage to Mr. Rucker’s wife, and Zhang Jian’s son, who is Mr. Rucker’s nephew.
- We are also aware that Mr. Nishi is a director of, and through BP a 10% owner of, Best Cheer Construction Materials (Shanghai) Co. Ltd, a Chinese company which was formed in September 2013 (“Best Cheer Construction”). Neither the Tile Shop nor the Company has purchased any product from Best Cheer Construction. The Company does purchase product from Best Cheer Stone Group LTD (“Best Cheer Stone”), which we understand is a 10% owner of Best Cheer Construction (we also understand an entity known as Best Cheer Development Limited, which may be related to Best Cheer Stone, owns approximately 50% of Best Cheer Construction). The Tile Shop and the Company purchased approximately \$0, \$0.4 million and \$1.1 million of product from Best Cheer Stone during the 2011, 2012 and 2013 fiscal years, respectively.

169. Additionally, the Company disclosed the following information concerning Nishi’s compensation while employed at Tile Shop:

During the 2011, 2012 and 2013 fiscal years, Mr. Nishi was employed by us as a purchasing supervisor. For his services, Mr. Nishi was paid aggregate W-2 wages of \$95,000 in each of 2011 and 2012 and \$107,500 in 2013, and in each year received the standard benefits provided to other non-executive Company employees. Consistent with the compensation provided to other non-executive Company employees, on August 21, 2012, Mr. Nishi received an option to purchase 35,000 options of Company common stock with an exercise price equal to the fair market value of the common stock on the date of grant. As of January 1, 2014, Mr. Nishi is no longer employed by the Company and has forfeited all options, none of which were exercised.

#### **ADDITIONAL SCIENTER ALLEGATIONS**

170. As alleged herein, Tile Shop and the Officer Defendants represented during the Class Period that the Company’s operations, margins and other financial results depended on a vertically integrated, direct sourcing model. In turn, Tile Shop and the Officer Defendants represented during the Class Period that the Company’s sourcing model was dependent on arm’s-length, longstanding



supplier relationships. As the Company disclosed, more than 50% of its product was supplied by a group of 10 suppliers located primarily in Asia.

171. In truth, Tile Shop's sourcing model was dependent on related-party transactions and relationships involving Rucker and his relatives. As the Company has admitted, Tile Shop has done business with BP, a vendor and purchasing agent located in China, since at least 2011. Moreover, import/export records show that the Company has done business with BP since at least 2009. Since its formation, BP was owned by relatives of Rucker, including Nishi, who also served as a Tile Shop employee. It is not plausible that Rucker was oblivious to the relationship between his relatives, BP, and the Company.

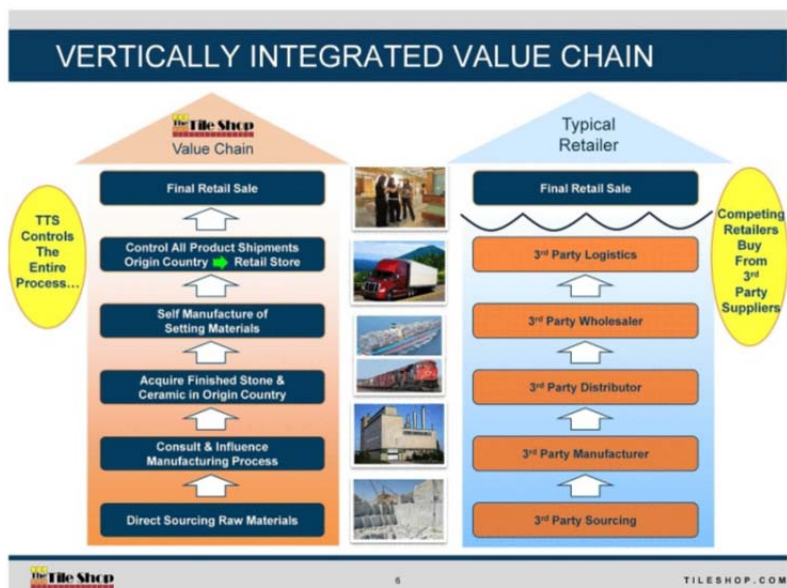
172. In fact, accounts given by former employees confirm that Rucker arranged for Nishi to sell product to Tile Shop, and that various Tile Shop executives traveled to China with Rucker to cultivate supplier relationships. As alleged, Rucker and Nishi traveled to China in or about 2008, when BP was incorporated, and BP supplied product to Tile Shop no later than 2009. Furthermore, at Rucker's direction, Beukelman set up entities in Turkey and China to surreptitiously control the Company's supply and possibly manipulate its margins. As alleged, Tile Shop's headquarters were lightly staffed during this period, and Rucker exercised complete control over nearly every material aspect of the Company's operations.

173. Moreover, prior to and during the Class Period, the Company and Rucker recognized the integral role that Rucker played in sourcing product for the Company and dealing with suppliers – a role that Rucker himself confirmed during his divorce proceedings, and that the Company reiterated in investor presentations. Sourcing supply was a significant operation of the Company and the basis on which its entire business was modeled.

174. For example, on January 17, 2013, Tile Shop filed an “Investor Presentation” with the SEC. Among the slides included in the presentation is the following, which describes Tile Shop’s “unique sourcing model” as a key to continued success:



175. The Investor Presentation also contained the following slide regarding Tile Shop’s vertically-integrated value chain, which depicts the Company’s control over sourcing materials and product (and, by extension, supplier relationships) as follows:



176. Moreover, the Investor Presentation confirmed that Rucker is “[p]ersonally involved in ‘sourcing’” products for the Company.<sup>6</sup> Indeed, as Rucker himself testified on March 17, 2005, during a proceeding related to his divorce:

I have gone out and found proprietary product. We now build, design product. We go to Turkey, India, China, the Philippines. We have now hired a Brazilian. We are going to go to Brazil, Columbia, to Peru, to find both ceramic tile and stone. But if we didn’t do this, we would get our lunch eaten. That is the nature of the business.

177. In view of Rucker’s direct involvement in establishing, cultivating and monitoring the Company’s sourcing relationships, coupled with his familial – and, in Nishi’s case, also employment – relationship with those who operated BP and the other entities at issue, it is implausible that he was unaware of the related-party transactions and relationships at issue.

178. In addition, as alleged herein, product sourcing was vital to the overall viability and profitability of Tile Shop and thus constituted a core operation of the Company. Specifically, Tile Shop emphasized that the Company had “invested significant resources to develop our . . . **product sources**.” Rucker also echoed the importance of product sourcing and sourcing relationships during his divorce proceedings, stating, “if we didn’t [source product], we would get our lunch eaten.” Moreover, the Officer Defendants were some of the highest-ranking officers within the Company during the Class Period and were heavily involved with, and had day-to-day responsibilities concerning, *inter alia*, Tile Shop’s product sourcing. By way of example, Tile Shop represented that Rucker was “[p]ersonally involved in ‘sourcing’” products for the Company.

179. Additionally, the Officer Defendants’ scienter is underscored by the Sarbanes-Oxley certifications, in which they acknowledged their responsibility to investors for establishing and

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<sup>6</sup> A November 13, 2013 Investor Presentation, updated to reflect more recent information, contains slides similar to those included in the January 2013 materials. It also represents that Rucker is “[p]ersonally involved in ‘sourcing’” products for the Company.

maintaining controls to ensure that material information about Tile Shop was made known to them and that Tile Shop's disclosure-related controls were operating effectively.

180. Further, as alleged herein, Tile Shop's internal controls exhibited material weaknesses during the Class Period, which forced the Company to restate aspects of its financial statements – a fact that underscores the Officer Defendants' reckless, if not conscious, disregard of Tile Shop's obligation to comply with applicable accounting rules and regulations. As Tile Shop reported in the June 2013 Registration Statement and other SEC filings:

[I]n connection with the preparation of our consolidated financial statements for the year ended December 31, 2012, management identified that previously-issued financial statements for the three and nine months ended September 30, 2012 contained a misstatement relating to our accounting for our outstanding common stock purchase warrants. As a result of the restatement, a material weakness was identified in our internal controls relating to our identification and analysis of the complex accounting, and financial reporting attributes associated with certain non-routine transactions such as our common stock purchase warrant agreements, including not utilizing qualified external experts to supplement internal resources.

181. Tile Shop confirmed in its February 20, 2013 Form 8-K and press release that the Company's improper accounting practices and required restatements resulted in a finding, corroborated by Deloitte, "that the Company's unaudited consolidated financial statements for the three and nine months ended September 30, 2012 should no longer be relied upon . . . ." SEC Regulation S-X [17 C.F.R. §210.4-01(a)(1)] provides that financial statements filed with the SEC that are not prepared in accordance with U.S. GAAP are presumptively misleading.

182. Moreover, as confirmed by the restated figures set forth in the February 20, 2013 Form 8-K (reproduced below), these misrepresentations materially distorted the Company's financial condition and operating results during the Class Period:

	<u>As Previously Reported</u>	<u>Adjustments</u>	<u>Amended</u>
<b>Condensed Balance Sheet as of 9/30/2012</b>			
Warrant liability	\$ -	\$ 56,690	\$ 56,690
Total liabilities	119,524	56,690	176,214
Common Stock	4		4
Additional paid-in capital	18,984	(14,984)	4,000
Accumulated retained earnings (deficit)	23,318	(41,706)	(18,388)
Total stockholders' equity	42,306	(56,690)	(14,384)
<b>Condensed Consolidated Statement of Income for the three months ended 9/30/2012</b>			
Change in fair value of warrant liability	-	(41,706)	(41,706)
Net Income (loss)	\$ 9,842	\$ (41,706)	\$ (31,864)
Net income (loss) per common share, basic and diluted	\$ 0.27	\$ (1.14)	\$ (0.87)
<b>Condensed Consolidated Statement of Income for the nine months ended 9/30/2012</b>			
Change in fair value of warrant liability	-	(41,706)	(41,706)
Net income (loss)	\$ 30,631	\$ (41,706)	\$ (11,075)
Net income (loss) per common share, basic and diluted	\$ 0.91	\$ (1.24)	\$ (0.33)

183. As shown above, the Company's reported net income of \$9.8 million during the three months ended September 30, 2012 was, in reality, a loss of \$31.9 million. The magnitude of this overstatement is demonstrated by the impact on Tile Shop's reported liabilities and accumulated earnings at September 30, 2012. Originally, Tile Shop's reported assets of \$161.8 million exceeded its reported liabilities of \$119.5 million by \$42.3 million at September 30, 2012. In truth, however, the Company's liabilities of \$176.2 million at September 30, 2012 were understated by nearly 33%, and exceeded its assets by \$14.4 million. Moreover, the correction of these financial misstatements was sufficient to eclipse the entirety of the Company's reported \$23.3 million of undistributed earnings, accumulated from its inception through September 30, 2012, by \$18.4 million.

184. The restatements required Tile Shop to file an amended Form 10-Q with the SEC on March 18, 2013, for the quarter ended September 30, 2012.

185. Immediately prior to and during the Class Period, Tile Shop utilized *three* different outside auditors. For example, on April 15, 2013, Tile Shop reported that it had terminated Deloitte as its outside auditor as of April 9, 2013, and had engaged E&Y. According to the Company's Form 8-K, filed with the SEC that day:

On Form 10-K for the fiscal year ended December 31, 2011, the Company reported the existence of a material weakness in its internal control over financial reporting relating to deficiencies in the financial statement close process. Specifically, the Company lacked sufficient personnel with requisite competencies within its finance function for a company of its size and complexity and did not maintain financial close processes, procedures, and reporting systems that were adequately designed to support the accurate and timely reporting of its financial results. The Company reported the remediation of this material weakness in Item 9A of its Annual Report on Form 10-K for the fiscal year ended December 31, 2012.

On a Form 8-K dated February 18, 2013, the Company reported that its previously-issued financial statements for the three and nine months ended September 30, 2012 contained a misstatement relating to its accounting for outstanding common stock purchase warrants, and on a Form 10-Q/A filed March 18, 2013 restated such financial statements. As a result of the restatement, on Form 10-K for the fiscal year ended December 31, 2012 the Company reported the existence of a material weakness in its internal control over financial reporting relating to its identification and analysis of the complex accounting and financial reporting attributes associated with certain non-routine transactions such as the Company's common stock purchase warrant agreements, including not utilizing qualified external experts to supplement internal resources. The Company plans to implement additional procedures to remediate this material weakness.

186. Tile Shop's engagement of multiple auditors, coupled with its restatements, provides further support for a finding that the Company and the Officer Defendants consciously or recklessly disregarded the need to disclose the related-party relationships and transactions at issue.

187. Finally, in proceedings relating to his divorce, Rucker fraudulently manipulated, and then presented to a court, false information regarding Tile Shop's operations for the purpose of advancing his own interests. In this case, Tile Shop knowingly and/or recklessly failed to disclose the related-party transactions and relationships at issue. It should come as no surprise that Rucker would once again distort material information regarding the Company's business and operations to serve his own interests and those of his constituents.

#### **CLASS ACTION ALLEGATIONS**

188. Plaintiffs bring this action as a class action on behalf of all purchasers of Tile Shop common stock: (i) pursuant and/or traceable to the Registration Statements issued in connection with the Offerings, seeking to pursue remedies under the 1933 Act (the "1933 Act Class"); and (ii) during

the Class Period, seeking to pursue remedies under the 1934 Act (the “1934 Act Class”) (collectively, the “Classes”).

189. Excluded from the Classes are defendants and their families, the officers and directors and affiliates of defendants, at all relevant times, members of their immediate families and their legal representatives, heirs, successors or assigns, and any entity in which defendants have or had a controlling interest.

190. The members of the Classes are so numerous that joinder is impracticable. While the exact number of members is unknown to Plaintiffs at this time and can only be ascertained through appropriate discovery, Plaintiffs believe that there are hundreds of members in the proposed Classes. Record owners and other members of the Classes may be identified from records maintained by Tile Shop or its transfer agent and may be notified of the pendency of this action by mail, using the form of notice similar to that customarily used in securities class actions.

191. Plaintiffs’ claims are typical of the claims of the members of the Classes as all members are similarly affected by defendants’ wrongful conduct in violation of federal law.

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

193. Common questions of law and fact exist as to all members of the Classes and predominate over any questions solely affecting individual members of the Classes.

194. Among the questions of law and fact common to the 1933 Act Class are:

- (a) whether defendants violated the 1933 Act;
- (b) whether statements made in the Registration Statements omitted and/or misrepresented material facts; and
- (c) to what extent the members of the 1933 Act Class have sustained damages and the proper measure of damages.

195. Among the questions of law and fact common to the 1934 Act Class are:
- (a) whether all defendants (other than the Underwriter Defendants) violated the 1934 Act;
  - (b) whether statements made by these defendants to the investing public omitted and/or misrepresented material facts about the business and operations of Tile Shop;
  - (c) whether these defendants knew or deliberately disregarded that their statements were false and misleading; and
  - (d) to what extent the members of the 1934 Act Class have sustained damages and the proper measure of damages.

196. 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 members may be relatively small, the expense and burden of individual litigation make it impossible for members of the Classes to individually redress the wrongs done to them. There will be no difficulty in the management of this action as a class action.

#### **FRAUD ON THE MARKET PRESUMPTION OF RELIANCE**

197. At all relevant times, the market for Tile Shop common stock was an efficient market for the following reasons, among others:

- (a) Tile Shop common stock met the requirements for listing, and was listed and actively traded on the NASDAQ, a highly efficient, electronic stock market;
- (b) as a regulated issuer, the Company filed periodic public reports with the SEC and the NASDAQ;
- (c) Tile Shop regularly communicated with public investors via established market communication mechanisms, including regular disseminations of



press releases on the national circuits of major newswire services and other wide-ranging public disclosures, such as communications with the financial press and other similar reporting services; and

- (d) Tile Shop 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.

198. As a result of the foregoing, the market for Tile Shop common stock promptly digested current information regarding the Company from publicly available sources and reflected such information in the price of the stock. Under these circumstances, all purchasers of Tile Shop common stock during the Class Period suffered similar injury through their purchase of such stock at artificially inflated prices and a presumption of reliance applies.

#### **LOSS CAUSATION/ECONOMIC LOSS**

199. During the Class Period, defendants made false and misleading statements that misrepresented the Company's business and business relationships and artificially inflated the price of Tile Shop common stock. Later, when their misrepresentations became known to the market, the price of Tile Shop common stock fell precipitously as the artificial inflation came out of the price. As a result of their purchases of Tile Shop common stock during the Class Period, Plaintiffs and other members of the Class suffered economic loss, i.e., damages, under the federal securities laws.

#### **NO SAFE HARBOR**

200. Defendants are liable for any forward-looking statement because they knew that the statement was false or misleading when made. Moreover, any such statement was authorized and/or approved by an executive officer of Tile Shop, who knew that the statement was false or misleading

when made. None of the historic or present tense statements made by defendants were assumptions underlying or relating to any plan, projection or statement of future economic performance.

## COUNT I

### **For Violation of Section 11 of the 1933 Act Against Tile Shop, the Individual Defendants and the Underwriter Defendants**

201. For the purposes of this Count, Plaintiffs incorporate by reference those allegations concerning the parties, the former employees, the Registration Statements, and the 1933 Act Class only. Any allegations of fraud are hereby expressly disclaimed and not incorporated by reference in this Count.

202. This Count is brought pursuant to Section 11 of the 1933 Act, 15 U.S.C. §77k, against Tile Shop, the Individual Defendants and the Underwriter Defendants.

203. For the purposes of this Count, Plaintiffs do not allege that any of these defendants had scienter, which is not an element of a Section 11 claim.

204. The Registration Statements for the Offerings were inaccurate and misleading, contained untrue statements of material facts, omitted to state other facts necessary in order to make the statements made not misleading, and omitted to state material facts required to be stated therein.

205. Tile Shop is the registrant for the Offerings. The defendants named in this Count were responsible for the contents and dissemination of the Registration Statements.

206. As issuer of the shares, Tile Shop is strictly liable to Plaintiffs and the 1933 Act Class for any misstatements and omissions.

207. By reason of the conduct herein alleged, each defendant named in this Count violated Section 11 of the 1933 Act.

208. Plaintiffs acquired Tile Shop shares pursuant and/or traceable to the Registration Statements for the Offerings, and, at the time of their purchases, Plaintiffs and other members of the 1933 Act Class were unaware of the facts concerning the wrongful conduct alleged herein.

209. Plaintiffs and the 1933 Act Class have sustained damages. The value of Tile Shop common stock has declined substantially subsequent to and due to these defendants' violations.

## COUNT II

### **For Violation of Section 12(a)(2) of the 1933 Act Against Tile Shop, the Officer Defendants, TSI, JWTS, Inc. and the Underwriter Defendants**

210. For the purposes of this Count, Plaintiffs incorporate by reference those allegations concerning the parties, the former employees, the Registration Statements, and the 1933 Act Class only, consisting of those allegations contained and incorporated in Count I. Any allegations of fraud are hereby expressly disclaimed and not incorporated by reference in this Count.

211. This Count is brought pursuant to Section 12(a)(2) of the 1933 Act against Tile Shop, the Officer Defendants, TSI, JWTS, Inc. and the Underwriter Defendants.

212. For the purposes of this Count, Plaintiffs do not allege that any of these defendants had scienter, which is not an element of a Section 12(a)(2) claim.

213. By means of the defective Prospectuses, Tile Shop, the Officer Defendants, TSI, JWTS, Inc. and the Underwriter Defendants promoted and sold Tile Shop stock to Plaintiffs and other members of the 1933 Act Class.

214. The Prospectuses contained untrue statements of material fact, and concealed and failed to disclose material facts, as detailed above. Defendants Tile Shop, TSI and JWTS, Inc., the Officer Defendants, and the Underwriter Defendants owed Plaintiffs and the other members of the 1933 Act Class who purchased Tile Shop common stock pursuant to the Prospectuses the duty to make a reasonable and diligent investigation into the statements contained in the Prospectuses to

ensure that such statements were true and that there was no omission to state a material fact required to be stated in order to make the statements contained therein not misleading. These defendants, in the exercise of reasonable care, knew or should have known of the misstatements and omissions contained in the Prospectuses as set forth above.

215. Plaintiffs did not know, nor in the exercise of reasonable diligence could have known, of the untruths and omissions contained in the Prospectuses at the time Plaintiffs acquired Tile Shop common stock.

216. By reason of the conduct alleged herein, Tile Shop, the Officer Defendants, TSI, JWTS, Inc. and the Underwriter Defendants violated Section 12(a)(2) of the 1933 Act. As a direct and proximate result of such violations, Plaintiffs and the other members of the 1933 Act Class who purchased Tile Shop common stock pursuant to the Prospectuses sustained substantial damages in connection with their purchases of the stock.

217. Accordingly, Plaintiffs and the other members of the 1933 Act Class who hold the common stock issued pursuant to the Prospectuses have the right to rescind and recover the consideration paid for their shares, and hereby tender their common stock to the defendants sued in this Court. 1933 Act Class members who have sold their common stock seek damages to the extent permitted by law.

### **COUNT III**

#### **For Violation of Section 15 of the 1933 Act Against TSI, JWTS, Inc. and the Individual Defendants**

218. Plaintiffs incorporate by reference the allegations concerning the background of the defendants named in this Count, as well as the allegations concerning the preparation, signing and dissemination of the Registration Statements and the allegations set forth in Counts I and II, above.

219. This Count is brought pursuant to Section 15 of the 1933 Act, against TSI, JWTS, Inc. and the Individual Defendants.

220. As alleged herein, a primary violation of the 1933 Act occurred, in that certain of the defendants engaged in conduct in violation of Section 11 of the 1933 Act.

221. The Individual Defendants named in this Count were each control persons of Tile Shop by virtue of their positions as directors and/or senior officers of Tile Shop. The Individual Defendants named in this Count each had a series of direct and/or indirect business and/or personal relationships with other directors and/or officers and/or major shareholders of Tile Shop. By virtue of being wholly-owned by Rucker and Jacullo, respectively, and their ownership of Tile Shop stock, TSI and JWTS, Inc. both controlled Tile Shop.

222. The defendants named in this Count participated in violating Sections 11 and 12(a)(2) of the 1933 Act by signing or authorizing the signing of the Registration Statements and/or otherwise participating in the process that allowed the Offerings to be successfully completed.

223. Accordingly, Plaintiffs and the 1933 Act Class have sustained damages. The value of Tile Shop common stock has declined substantially subsequent to and due to these defendants' violations.

#### **COUNT IV**

##### **For Violation of Section 10(b) of the 1934 Act and Rule 10b-5 Against Tile Shop and the Officer Defendants**

224. Plaintiffs incorporate by reference all of the allegations set forth above, except those that disclaim the intentional or fraudulent nature of the conduct alleged herein.

225. During the Class Period, Tile Shop and the Officer Defendants disseminated or approved the false statements specified above, which they knew or deliberately disregarded 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, as detailed above.

226. The defendants named in this Count violated Section 10(b) of the 1934 Act and Rule 10b-5 in that they:

(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 the 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 Plaintiffs and others similarly situated in connection with their purchases of Tile Shop common stock during the Class Period.

227. Accordingly, Plaintiffs and the 1934 Act Class have suffered damages in that, in reliance on the integrity of the market, they paid artificially inflated prices for Tile Shop common stock. Plaintiffs and the 1934 Act Class would not have purchased Tile Shop common 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 these defendants' misleading statements.

## COUNT V

### **For Violation of Section 20(a) of the 1934 Act Against the Individual Defendants, TSI and JWTS**

228. Plaintiffs incorporate by reference all of the allegations set forth above, including those that would establish the culpable participation, in any primary violation of the 1934 Act, of the defendants named in this Count, to the extent necessary.

229. As alleged herein, a primary violation of the 1934 Act occurred, in that certain of the defendants engaged in conduct in violation of Section 10(b) of the 1934 Act and Rule 10b-5 promulgated thereunder.

230. The Individual Defendants, TSI and JWTS acted as controlling persons of Tile Shop within the meaning of Section 20(a) of the 1934 Act. By reason of the Individual Defendants' positions with the Company, and the Individual Defendants', TSI's and JWTS's ownership of Tile Shop common stock, the Individual Defendants, TSI and JWTS had the power and authority to cause Tile Shop to engage in the wrongful conduct complained of herein.

231. Accordingly, by reason of such conduct, these defendants are liable pursuant to Section 20(a) of the 1934 Act.

#### **PRAYER FOR RELIEF**

WHEREFORE, Plaintiffs pray for judgment as follows:

- A. Determining that this action is a proper class action, certifying Plaintiffs as class representatives under Rule 23 of the Federal Rules of Civil Procedure, and appointing Lead Counsel as Class Counsel;
- B. Awarding Plaintiffs and the members of the Classes damages, including interest;
- C. Awarding Plaintiffs' reasonable costs and attorneys' fees;
- D. Awarding rescission or a rescissory measure of damages; and
- E. Awarding such other, further or different relief as the Court deems just and proper.

#### **JURY TRIAL DEMAND**

Plaintiffs demand a trial by jury.

DATED: May 23, 2014

CHESTNUT CAMBRONNE PA

*/s/ Karl L. Cambronne*

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KARL L. CAMBRONNE (#14321)

JEFFREY D. BORES (#227699)  
17 Washington Avenue North, Suite 300  
Minneapolis, MN 55401-2048  
Telephone: 612/339-7300  
612/336-2940 (fax)  
kcambronne@chestnutcambronne.com  
jbores@chestnutcambronne.com

*Liaison Counsel for Plaintiffs*

ROBBINS GELLER RUDMAN  
& DOWD LLP  
SAMUEL H. RUDMAN  
JOSEPH RUSSELLO (admitted *pro hac vice*)  
EDWARD Y. KROUB (admitted *pro hac vice*)  
58 South Service Road, Suite 200  
Melville, NY 11747  
Telephone: 631/367-7100  
631/367-1173 (fax)  
srudman@rgrdlaw.com  
jrussello@rgrdlaw.com  
ekroub@rgrdlaw.com

*Co-Lead Counsel for Plaintiffs*

KESSLER TOPAZ MELTZER  
& CHECK, LLP  
KIMBERLY A. JUSTICE (admitted *pro hac vice*)  
MATTHEW MUSTOKOFF (admitted *pro hac vice*)  
MARGARET E. ONASCH (admitted *pro hac vice*)  
280 King of Prussia Road  
Radnor, PA 19087  
Telephone: 610/667-7706  
610/667-7056 (fax)  
kjustice@ktmc.com  
mmustokoff@ktmc.com  
monasch@ktmc.com

*Co-Lead Counsel for Plaintiffs*