IN THE COURT OF CHANCERY OF THE STATE OF DELAWARE

DRIVETRAIN, LLC, as Litigation Trustee of the Adeptus Litigation Trust,

Plaintiff,

v

THOMAS S. HALL, TIMOTHY L. FIELDING, GRAHAM B. CHERRINGTON, DANIEL W. ROSENBERG, DANIEL J. HOSLER, RICHARD COVERT, STEVEN M. TASLITZ; MERRICK M. ELFMAN; DOUGLAS L. BECKER; ERIC D. BECKER; CHRISTOPHER HOEHNSARIC; SCP III AIV THREE-FCER CONDUIT, L.P.; SCP III AIV THREE-FCER, L.P.; SC PARTNERS III, L.P.; STERLING FUND MANAGEMENT, LLC; STERLING CAPITAL PARTNERS III, LLC; and COVERT FAMILY LIMITED PARTNERSHIP,

Defendants.

C. A. No. 2019-0365-JTL

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Chancery Courtroom No. 12B
Leonard L. Williams Justice Center
500 North King Street
Wilmington, Delaware
Monday, January 21, 2020
11:00 a.m.

- - -

BEFORE: HON. J. TRAVIS LASTER, Vice Chancellor

- - -

ORAL ARGUMENT and RULINGS OF THE COURT ON DEFENDANTS' MOTIONS TO DISMISS

CHANCERY COURT REPORTERS
Leonard L. Williams Justice Center
500 North King Street - Suite 11400
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1 APPEARANCES:

2 MATTHEW E. FISCHER, ESQ.
MATTHEW F. DAVIS, ESQ.
3 Potter, Anderson & Corroon LLP
-and-
4 MICHAEL J. YODER, ESQ.
WILLIAM T. REID IV, ESQ.
5 ERIC D. MADDEN, ESQ.
BRANDON V. LEWIS, ESQ.
6 of the Texas Bar
Reid Collins & Tsai LLP
7 for Plaintiff

8 JOHN D. HENDERSHOT, ESQ.
ANDREW L. MILAM, ESQ.
9 Richards, Layton & Finger, P.A.
for SCP III AIV Three-FCER Conduit, L.P., SCP
10 III AIV Three-FCER, L.P., SC Partners III,
L.P., Sterling Fund Management, LLC, Sterling
11 Capital Partners III, LLC, Steven M. Taslitz,
Merrick M. Elfman, Douglas L. Becker, Eric D.
12 Becker, and Christopher Hoehn-Saric

13 S. MARK HURD, ESQ.
ALEXANDRA M. CUMINGS, ESQ.
14 Morris, Nichols, Arsht & Tunnell LLP
for Defendants Thomas S. Hall, Timothy L.
15 Fielding, Graham R. Cherrington, Daniel W.
Rosenberg, Daniel J. Hosler, Richard Covert,
16 and Covert Family Limited Partnership
-and-
17 JASON M. RUDD, ESQ.
of the Texas Bar
18 Wick Phillips
for Defendant Covert Family Limited
19 Partnership
-and-
20 MICHAEL J. BILES, ESQ.
of the Texas Bar
21 King & Spalding LLP
for Thomas S. Hall, Timothy L. Fielding, and
22 Graham R. Cherrington

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1 THE COURT: Welcome, everyone.
2 MR. HENDERSHOT: Good morning, Your
3 Honor.
4 MR. FISCHER: Good morning, Your
5 Honor. Matt Fischer, Potter Anderson, for the
6 plaintiff. I'll do a couple brief introductions.
7 From Reid Collins, Michael Yoder.
8 MR. YODER: Good morning, Your Honor.
9 MR. FISCHER: Bill Reid.
10 MR. REID: Good morning, Your Honor.
11 MR. FISCHER: Eric Madden, Brandon
12 Lewis.
13 MR. LEWIS: Good morning.
14 MR. FISCHER: And Your Honor knows
15 Mr. Davis.
16 MR. DAVIS: Good morning.
17 MR. FISCHER: Mr. Yoder will be
18 presenting on behalf of the plaintiff this morning.
19 THE COURT: Great. Thank you all for
20 being here. I appreciate it.
21 MR. HURD: Good morning, Your Honor.
22 I rise out of turn just to do a couple quick
23 introductions as well. Seated with me at counsel
24 table is Jason Rudd of Wick Phillips.

1 MR. RUDD: Good morning.
2 MR. HURD: Mr. Rudd has been admitted
3 pro hac vice. He represents the Covert Family Limited
4 Partnership and will present any argument on behalf of
5 it.
6 Also at counsel table is Mike Biles of
7 King & Spalding. He represents Messrs. Hall,
8 Fielding, and Cherrington. And I believe Your Honor
9 knows my colleague, Ms. Cumings.
10 THE COURT: I do. Thank you all for
11 being here as well.
12 MR. HENDERSHOT: Good morning, Your
13 Honor. Quick introduction before we begin. My
14 colleague, Andrew Milam.
15 MR. MILAM: Good morning, Your Honor.
16 MR. HENDERSHOT: With us just after
17 clerking for Justice Vaughn. And also, in the back is
18 Avi Epstein from the Sterling Partners.
19 THE COURT: Great. Thank you all.
20 MR. HENDERSHOT: Your Honor, I believe
21 Mr. Hurd will have a few remarks after I finish.
22 There's a lot going on and a number of issues and not
23 a lot of time. So with the Court's indulgence, I'll
24 stand on the papers for some of the subsidiary issues

1 like unjust enrichment and aiding and abetting. As to
2 the five Sterling principals, I think that's pretty
3 well set out, unless Your Honor has questions.
4 There's no statutory basis to haul them in here or go
5 after their assets personally.
6 The three big issues that I'd like to
7 cover today are the allegation of a bad-faith business
8 strategy -- that's in some ways the easiest claim, and
9 it deals with the background -- and then turn to the
10 argument that the partially synthetic secondary
11 offering structure requires entire fairness review,
12 and then, finally, circle back to the *Brophy* claim.
13 So as to the claim that some set of
14 the defendants adopted a growth strategy in bad faith,
15 let's preliminarily note that that's pled only against
16 the so-called insiders. Those are Mr. Hurd's clients,
17 Mr. Hall, Fielding, Cherrington, Rosenberg, and
18 Hosler. It's a minority of the board. Only three of
19 those individuals were on the board, so we're talking
20 about alleged disloyal, bad-faith conduct that only a
21 minority of the board was responsible for.
22 But the theory doesn't come anywhere
23 close to overcoming the presumption of the business
24 judgment rule. As stated in places like paragraph 313

1 of the complaint, the idea is that the insiders caused
2 the company to build additional facilities in poor
3 locations, despite knowing that patient volumes were
4 already declining at preexisting facilities and a
5 number of other things along those lines.
6 Obviously, it's not self-dealing in
7 the classic sense. Choices about where to put new
8 facilities or to what degree to pursue growth
9 strategy, rather than something else, classically
10 those are business judgments. The law presumes those
11 are undertaken in good faith on an informed basis, in
12 the honest believe that the decisions will promote the
13 welfare of the corporation and its stockholders, and a
14 plaintiff doesn't overcome that presumption by
15 asserting that it's bad faith or that the results were
16 bad.
17 So the core problem with the theory is
18 plaintiffs asking the Court to infer subjective ill
19 motivation from the fact that the board accepted known
20 risks that didn't pan out well enough. The paragraph
21 that says the facility sites were selected "in the
22 face of known risks posed by over-saturating the
23 market" -- that's paragraph 189 -- is an example of
24 what shows up in the complaint numerous times.

1 And the problem is that accepting
2 known risks is the directors' job. That's what
3 they're supposed to do. It's not bad faith. One
4 thinks of Chancellor Allen's classic discussion of
5 that in *Gagliardi v. TriFoods International*. It's in
6 everyone's interest -- the corporation, the
7 stockholders, the directors, the officers -- that
8 human fiduciaries face essentially zero risk of
9 liability for making disinterested business judgments
10 that turn out poorly. So proceeding in the face of
11 known risks is not a bad-faith claim. Our law is
12 actually more concerned if the directors don't
13 understand the risks or don't consider them carefully.
14 That gets toward gross negligence, but it's still not
15 bad faith.
16 And that's all that happened here. As
17 the complaint itself alleges, the company's strategy
18 during the relevant period is to enter joint ventures
19 with locally prominent healthcare companies, build a
20 bunch of new free-standing emergency rooms in big,
21 metro areas, and accept the tradeoffs that came with
22 that strategy. Building those facilities, staffing
23 them, equipping them, that's costly. Building public
24 awareness is costly. The facilities have ramp-up

1 periods.
2 The so-called cash flow hole that
3 shows up in the complaint is a temporal hole. It's
4 you invest now and hopefully get a return later,
5 that's the hole. And then, once the facility is
6 built, fixed costs are relatively high, but the
7 marginal cost of treating the next patient to walk in
8 the door is relatively low.
9 So if one come to the view that the
10 market for emergency medical care is underserved --
11 which, you know, if I sat in the ER for six hours
12 waiting to be treated recently, I might reasonably
13 think -- then it possibly makes sense to invest in
14 building out the treatment capacity, building the
15 awareness, and accepting the tradeoffs that come with
16 that, including lower per-patient revenue or eroding
17 payer mix caused by accepting Medicaid or Medicare or
18 Tricare patients, as opposed to just people with just
19 commercial insurance; accepting that some of the new
20 facilities are going to take patients from some of the
21 existing facilities, and accepting all over that in
22 exchange for, hopefully, more patients and more
23 revenue overall, and in an effort to capture
24 first-mover advantage.

1 Ex ante, is that a good tradeoff or a
2 bad one? I don't know. But that's not the call that
3 the Court has to make. The call the Court has to
4 make, under *Orchard*, is if it's one logical approach
5 to the corporation's objectives, then it's not bad
6 faith.
7 There's nothing in this complaint that
8 says the directors, or any of the defendants, knew
9 that a collapse was coming. We see claims that risks
10 had materialized or risks had been realized. What
11 that means is there are metrics that show that the
12 tradeoffs were happening more or less the way they
13 were expected to happen. Not bad faith.
14 There's no claim that the so-called
15 growth narrative was false. The company in fact did
16 go from a dozen facilities to nearly 100 in a matter
17 of about four years. There's no claim that any of the
18 disclosures, any particular statement, any particular
19 earnings report, were false or misleading. And it's
20 really backwards to say, "You defendants only grew the
21 company so that you could tell the market that the
22 company was growing so that the stock price would go
23 up so that you could cash out." Growing the company
24 means growing the pot of future cash flows, hopefully,

1 and promoting shareholders wealth. That's a
2 good-faith strategy, not a bad-faith strategy.
3 So I'll turn then to the claim about
4 the alleged self-dealing and the *Molycorp* case. This
5 is our friends' headline legal argument. And to our
6 minds, it doesn't really make a lot of sense. I take
7 it we are in agreement that insiders generally are
8 allowed to sell, and I take it we're in agreement that
9 the registration rights agreement was a valid, binding
10 contract. And I think we're also factually in
11 agreement that the net financial effect of the
12 conventional secondary offering versus the synthetic
13 secondary offering was identical.
14 In both of those structures, whether
15 the offering is synthetic, conventional, or, as
16 happened here, a mixture of the two each time, the
17 public buyers wind up with Class A shares, the sellers
18 wind up with cash, and the company doesn't wind up out
19 anything other than the administrative costs that the
20 registration rights agreement obliges it to bear.
21 So if the sellers don't gain anything
22 from the partially synthetic structure relative to
23 what they would have gained from the conventional
24 structure contemplated in the registration rights

1 agreement and the company also didn't suffer anything
2 from the partially synthetic structure, relative to
3 the conventional, then we don't see that there's any
4 reason to look at that from an equitable perspective
5 any more than there would be to look at it from an
6 equitable perspective if this were a purely
7 conventional offering.
8 It's not actionable self-dealing to
9 say, well, that's not quite what the contract said,
10 but it gets you to exactly the same place and nobody
11 can articulate why it's better for anybody or worse
12 for anybody. It's a formal distinction without a real
13 difference. And I think our friends do agree with us
14 that if the transactions here had been entirely
15 conventional secondary offerings, then the *Molycorp*
16 decision would control and we would not have fiduciary
17 duty claims.
18 I'll note parenthetically, *Molycorp*
19 assumed, without deciding, that the private equity
20 sellers there were a control group. So while we don't
21 agree that Sterling was a controller in any meaningful
22 sense for these transactions, under *Molycorp*, it
23 doesn't matter. The exercise of contractual
24 registration sale rights just is not actionable

1 self-dealing, regardless of whether it's done by a
2 controller or anybody else, because it's not dealing
3 with the company. The company is not really a party.
4 The money passes through the company's bank account
5 for a moment, but the company doesn't gain anything or
6 lose anything as a result.
7 And our friends' response to that line
8 of argument is, well, Sterling must have had some kind
9 of self-interested reason for choosing a partially
10 synthetic structure, and any deviation from what's
11 strictly laid out in the registration rights agreement
12 takes us outside the realm of *Molycorp*. Again, it's
13 an appeal to form without regard to substance. And
14 our friends can't explain what the board could or
15 should have done differently that would have resulted
16 in a different result for anyone or a better result
17 for the company or a worse result for any of the
18 sellers.
19 If the hypothesis is that the company
20 should have said, nope, we're not going to do a
21 synthetic secondary offering, then the next day,
22 Sterling says, all right, fine. We'd like to exchange
23 our units and our B shares for A shares, do so
24 contingent upon completion of the sale of those A

1 shares in a secondary offering that will be
2 underwritten. And under Section 3.6(f) of the LLC
3 agreement, they had every right to do that.
4 So if there's no self-dealing relative
5 to what the registration rights agreement granted
6 Sterling, what they had a specifically enforceable
7 right to get, and *Molycorp* says that what they had the
8 right to get isn't subject to entire fairness review,
9 then an exercise of entire fairness review here is
10 basically going to be futile.
11 There's no claim that the board could
12 have engaged in an efficient breach and made it stick.
13 There's no allegation that there's any ministerial
14 step they could have done that would have made any
15 difference at all.
16 Now, our friends do stick, in their
17 papers, with the claim that Sterling didn't have a
18 right to do a demand registration in July of 2015. I
19 think I'll stick with the papers on that one. It was
20 not a demand registration. It was a shelf takedown.
21 The papers for the offering itself make that clear,
22 and the complaint even, I think, admits that, in
23 paragraph 111. The consent that the board signed was
24 for a shelf takedown, and there's no dispute that

1 Sterling did have the right to do a shelf takedown in
2 July 2015, once the initial mandatory shelf
3 registration statement was filed.
4 So unless the Court has questions on
5 any of that, I'll turn to the *Brophy* claim. I think
6 we're generally in agreement that insiders are allowed
7 to sell their interests. That's the law, even though
8 insiders frequently, usually, have more information
9 and better insight into the corporation's prospects
10 than analysts or the general investing public.
11 Plaintiffs trying to plead a *Brophy*
12 claim have to meet a significant pleading bar. In the
13 *Oracle* case, it was described as showing a likelihood
14 that the company would outperform or underperform its
15 projections in some markedly unexpected manner. So
16 that's pretty close, in this context, I would suggest,
17 to saying somebody knew a bankruptcy was coming and
18 they didn't say it. Well, there's no allegation that
19 they knew that or had any way of knowing that at the
20 time of these offerings.
21 And, also, the normal rule of our law
22 is that an insider who possesses material inside
23 information is still allowed to trade, once that
24 information becomes public. If it's no longer inside

1 information, if it's public information, then once
2 that disclosure happens, the insider can't be engaging
3 in improper trading under *Brophy* because the
4 information is public. It's no longer the property of
5 the company that's being abused.
6 And I'd also point out that the timing
7 that's alleged here is, at least presumptively, likely
8 innocent. Each of the three offerings took place --
9 when the offering went out to the market, each of the
10 three of them took place within a day or two or three
11 after either a quarterly earnings report or an update
12 to earnings guidance. And, of course, they were also
13 accompanied by a prospectus supplement each time.
14 So there's a big volume of new and
15 updated information that goes out to the market
16 contemporaneously with or shortly before these
17 offerings happen. That suggests that -- it's pretty
18 hard to imagine anybody thinking that, oh, I've got
19 some secret information that I'm going to keep secret
20 for the month or so that it takes to get this
21 transaction done, to get this secondary offering
22 papered and done. And it's going to remain secret,
23 and I'm going to gain -- you know, I'm going to be
24 able to exploit that vis-a-vis the market.

1 And, again, it's really kind of
2 remarkable. There's no effort in this complaint to
3 identify a false or misleading statement that the
4 company made. The word "misleading" shows up,
5 according to my PDF search function, shows up 19 times
6 in that complaint. But every single instance is
7 rhetoric. There's not a single statement in the
8 complaint that the complaint says, "All right. Here's
9 what the company said. It was misleading for the
10 following reasons." There's sort of rhetorical
11 statements that, "Oh, overall it's kind of
12 misleading," but nothing that says, "Well, here is the
13 false statement that they made, or here's the
14 statement that might be true, but it's misleading for
15 the following reasons."
16 And that's a key point of distinction
17 as against the *Fitbit* decision, which I think is the
18 leading case saying that *Brophy* has application in the
19 context of an offering by the company, whether it's an
20 IPO or a secondary. There were both in *Fitbit*.
21 The allegations there were that
22 everybody on the inside of that company knew that the
23 technology underlying the primary product didn't work
24 accurately. There were directives going around to

1 cover up studies showing that the tech didn't work.
2 There had been multiple projects trying to fix the
3 tech, and those didn't work.
4 Nobody knew how to fix this product.
5 Nobody wanted to disclose it, either. And the
6 prospectus for the IPO, and then the prospectus for
7 the secondary, said, well, actually, our competitive
8 advantage over our rivals is our technology is very
9 accurate; it's more accurate than theirs. Assuming
10 that that's all true, as alleged in the complaint in
11 *Fitbit*, that's a lie. That was the problem there.
12 That's just straight-out false information. There's
13 nothing like that here.
14 What we read in our friends' answering
15 brief, instead, is that the disclosure issue here
16 is -- and I'm quoting from page 45 of their brief --
17 "[an] asymmetry between Sterling's knowledge and the
18 total mix of information in the market; a wide
19 informational chasm may exist due to non-disclosure
20 even absent affirmatively false statements." No
21 citation, no precedent, just an assertion that that's
22 enough.
23 And then later on the same page, they
24 say it again. "[W]hat matters is what Sterling knew

1 that the market didn't, and facility-level and
2 market-level patient volume data it had ... provided
3 key, non-public insights." Again, no citation to
4 anything in the complaint, no citation to a precedent,
5 and no allegation that Sterling or anybody else
6 actually realized these supposed insights in real
7 time.
8 It's really the same res ipsa loquitur
9 theory. Again, it's the company filed for bankruptcy
10 in April of 2017. Therefore, please infer that people
11 who had access to facility-level or market-level
12 patient data in 2015 or 2016 knew that a Chapter 11
13 filing was coming, even though we can't allege that.
14 And even though the plaintiff here
15 stands in the company's shoes, has the company's
16 documents, they chose not to put forward anything
17 suggesting that the board or the managers recognized
18 that figures like same-store patient-volume growth
19 data year over year or quarter over quarter were
20 anything more than data points. They didn't -- they
21 were not necessarily indicative of trends. Nobody
22 conceptualized them as such. Nobody knew that they
23 were such.
24 And our friends' line of reasoning,

1 you know, taken to its logical conclusion, means
2 insiders can never sell. It means Sterling can never
3 sell. It means directors and officers can never sell
4 because they always know more than the market does.
5 What's a wide enough informational chasm to state a
6 claim? It's a real departure from the way that *Oracle*
7 and similar precedents have treated the *Brophy*
8 analysis.
9 And it also leads to a real lack of a
10 compliance roadmap in the claim. If the standard is,
11 is there a wide enough informational chasm between
12 what the public knows as a result of prospectus
13 supplements and the like and what the insiders know,
14 well, how big is too big? What needs to go in those
15 disclosures now? How do we even think about that?
16 And for the reasons discussed in the *Oracle* decision,
17 that's not necessarily a positive direction for our
18 law to go.
19 And then, finally, let me come back
20 to -- it's really important to remember that the test
21 for reliability under *Brophy* turns on unauthorized use
22 of corporate information. The claim is the
23 corporation owns something, it owns information. And
24 the selling investor or the buying investor, the

1 trading investor, takes that information and uses it
2 for private profit without the company allowing that
3 to happen.
4 There may not have to be quantifiable
5 harm to the company to state a claim, but there does
6 have to be an improper gain by the trading fiduciary,
7 trading employee, whatever it is. There has to be
8 misuse of information that belongs to the company, not
9 authorized use.
10 And our friends chose not to challenge
11 the validity of the registration rights agreement or
12 the stockholder agreement. Adeptus agreed, before the
13 IPO, that Sterling would have the right to register
14 its shares and to sell those shares in an underwritten
15 secondary offering subject to the limited constraints
16 set forth in the registration rights agreement, and
17 the company agreed Sterling would have access to
18 detailed up-to-date information almost in real time,
19 in some cases. And the company undertook to be
20 responsible for making the necessary disclosures and
21 to indemnify the sellers if those disclosures wind up
22 coming short. That's essentially a promise to put
23 Sterling in the position to be able to sell.
24 Given that contractual backdrop, with

1 the company retaining a right to delay but not veto a
2 request for registration and sale by Sterling, you
3 know, we're not saying that there can't be a *Brophy*
4 violation here, but in this context, where the company
5 makes those promises to the trading investor, I think
6 *Brophy* has to require a plaintiff to explain what
7 knowing conduct the sellers engaged in that prevented
8 Adeptus's disclosure from being proper. Because it's
9 Adeptus's responsibility to put out those disclosures
10 if it should be attributed -- if the defects in those
11 disclosures, whatever they are -- and the complaint
12 doesn't identify them -- but if the defects are to be
13 attributed to somebody other than the company, then
14 there needs to be a pleading about why those defects
15 should be attributed to somebody other than the
16 company. And it's certainly not pled that Sterling
17 had anything to do with it.
18 So if there isn't some indication that
19 the sellers deliberately caused the disclosures to be
20 inadequate, or at least knew that the disclosures were
21 inadequate and allowed them to go out and trade
22 anyway, then there shouldn't be a viable *Brophy* claim.
23 Unless Your Honor has questions, I'll
24 yield the floor.

1 THE COURT: Thank you.
2 MR. HENDERSHOT: Thank you.
3 MR. HURD: Good morning, Your Honor.
4 Mr. Hendershot has pretty clearly covered the
5 waterfront. I also don't plan to spend any time on
6 the unjust enrichment claim. I think, for the reasons
7 we've articulated in the briefing, that's purely
8 duplicative of other claims and should be dismissed
9 for that reason.
10 I also would start with Count V, I
11 guess, because it's the logical starting place of
12 plaintiff's theory of the case. And in addition to
13 the points my colleague's already made, I would note,
14 just specifically with respect to my clients, that
15 Mr. Hosler ceased to be a director on May 29th of
16 2015. So there's no theory that he could be held
17 liable for subsequent events after he ceased to be a
18 director. To the extent the theory is based on a duty
19 owed to Adeptus LLC, as we noted in the briefing, the
20 amended complaint fails to plead any intentional
21 misconduct which would be required to state a claim
22 under the LLC agreement.
23 And, Your Honor, I was thinking about
24 analogies of a growth -- a growth platform and things

1 that you and I may have seen and why that really just
2 can't be subjective bad faith. And I've got to say,
3 certainly I've traveled in major metropolitan areas,
4 and I've seen Starbucks on every corner. And I
5 thought to myself, gee, I wonder why there's one on
6 this block and another one on that block. And, you
7 know, it's a very successful enterprise. They figured
8 out that there is a reason to do that.
9 And even closer to home, on Concord
10 Pike, we now have two pretty, brand-new Wawas within
11 less than two miles. Clearly, people think that there
12 is value to the growth model. And as Mr. Hendershot
13 noted, growing the top line is clearly a great
14 business strategy. It may be, as plaintiff alleges
15 with the benefit of hindsight, it didn't work out.
16 But that is not subjective bad faith, and that's what
17 they needed to plead.
18 As to Count II, which is the *Brophy*
19 claim, that claim is, as to my clients, asserted only
20 against Messrs. Rosenberg and Hosler. And in addition
21 to the reasons that have already been articulated,
22 which we also endorse, I would point out that the
23 language in both *Oracle* and *Toll Brothers* requires
24 proof in making a *Brophy* claim, that "(1) the

1 corporate fiduciary possessed material, nonpublic
2 information; and (2) the corporate fiduciary used that
3 information improperly by making trades because she
4 was motivated, in whole or in part, by the substance
5 of that information." And there's no allegation that
6 either Mr. Hosler or Mr. Rosenberg actually traded.
7 Finally, as to Count I, which I think
8 is appropriately called the headline count, again, I
9 would note that Mr. Hosler ceased to be a director on
10 May 29, 2015, and there's no suggestion that he could
11 be liable for any conduct that occurred after he
12 ceased to be a director.
13 The essence -- I think Mr. Hendershot
14 referred to it as kind of a futile demand -- or entire
15 fairness analysis. And that's what I really struggle
16 with here, too, Your Honor. And I recognize that our
17 law says damages is not necessarily an element of a
18 breach of fiduciary duty claim. But I think that's in
19 large part because there are this panoply of equitable
20 remedies including injunctive relief that the Court
21 can order.
22 Here, the company is no longer a going
23 concern. We have a litigation trustee whose sole
24 desire is to, you know, get money for the benefit of

1 the trust. And it can't be when, as we pointed out in
2 the briefing, proceeding under the registration rights
3 agreement with a purely secondary offering leaves both
4 the company and the sellers in precisely the same
5 position as a combined secondary and synthetic
6 offering, that there's -- that there's any purpose for
7 proceeding with a theory of a case that has no
8 ultimate damages remedy to it.
9 And unless Your Honor has any
10 questions, I'll sit down.
11 THE COURT: Thank you.
12 MR. RUDD: Jason Rudd for Covert
13 Family Limited Partnership. Your Honor, thank you for
14 allowing me to appear here today.
15 Your Honor, the primary request from
16 Covert Family LP is that it be dismissed for lack of
17 personal jurisdiction, as set forth in our pleadings.
18 I won't repeat what's there, but I would point out
19 that Covert FLP, the only ties it has to any of the
20 counts the plaintiffs have alleged is Mr. Covert, who
21 was a board member at the time. I believe plaintiffs
22 will announce a settlement with Mr. Covert, where he
23 is going to be dismissed from this action.
24 So in addition to the arguments that

1 are in our pleadings showing the FLP doesn't have
2 personal jurisdiction, the fact that Mr. Covert is
3 going to be dismissed from the action would further
4 undermine any jurisdiction this Court would have over
5 the FLP. So we would ask that it be dismissed on that
6 grounds.
7 Happy to answer any questions Your
8 Honor may have.
9 THE COURT: Thank you.
10 MR. RUDD: Thank you.
11 MR. YODER: Your Honor, just to
12 address a matter of housekeeping. I apologize for the
13 late notice, but we reached a settlement with
14 Mr. Covert last night, so we will, in fact -- assuming
15 that settlement is consummated -- be dismissing
16 Mr. Covert as an individual director. We also, within
17 the last week or so, have reached a settlement with
18 Mr. Fielding, so he will also be dismissed from this
19 action. And on the Covert Family Limited Partnership
20 jurisdictional argument, we would just refer to the
21 briefing on that.
22 So if Your Honor doesn't mind, I think
23 I'll go a little bit out of order from what Sterling
24 and the individual defendants did and start with the

1 entire fairness claim in Count I, which is the duty of
2 loyalty claim.
3 And from our standpoint, the facts of
4 this case are -- what actually happened are in
5 dispute. The defendants did not sell their interest
6 to third parties in accordance with contractual
7 rights. Instead, Adeptus purchased their LLC units
8 directly from a controlling stockholder, and from at
9 least half of its directors, in each of the offerings,
10 for cash.
11 Now, Adeptus had no contractual
12 obligation to purchase those LLC units, and Adeptus
13 had no contractual obligation to fund those purchases
14 with the proceeds of a primary offering. But it did
15 so anyway because Sterling was in a position, and
16 actually did completely dominate and control those
17 transactions throughout, as alleged in detail in the
18 complaint in paragraphs 97 to 127.
19 In particular, what we find
20 particularly troubling here is the circumstances in
21 the lead-up to each of these offerings. Sterling
22 itself decided, as we allege in paragraphs 102 to 116,
23 when the board would be first made aware of these
24 transactions. Sterling controlled the information

1 flow to the board, when Adeptus's general counsel
2 would even let the board know that these transactions
3 were on the table. Sterling couched its demands under
4 the RRA, even though it didn't actually follow that
5 agreement. It dictated the timing of each of the
6 offerings. It dictated how many shares would be sold.
7 And the board was presented with the
8 resolutions that authorized these transactions at the
9 last possible minute, with no time for deliberation.
10 And, in fact, the board offered no resistance. There
11 was no deliberation. There was no substantive
12 discussion. And they basically just rubber-stamped
13 the resolutions placed before them at the last minute,
14 as we allege in paragraphs 99, 127, and 130.
15 In fact, the only input the board
16 decided -- or provided in these transactions was to
17 determine how much they themselves wanted to sell to
18 the company and to occasionally voice displeasure when
19 they were asked to provide signature pages on
20 documents that they hadn't even seen yet, as we allege
21 in paragraphs 126 to 127.
22 Now, many of these same facts reveal
23 transactions that were the result of a grossly unfair
24 process, as we fleshed out in more detail in

1 paragraphs 128 to 141. The bottom line is no one
2 looked out for Adeptus. There was no attempt to see
3 if there was any approximation of a third-party arm's
4 length transaction. There was no special committee.
5 There was no independent financial advisor. There was
6 no -- not even independent counsel. Sterling
7 completely controlled both Adeptus's in-house counsel
8 and the company's nominal outside counsel. There was
9 no independent legal advice.
10 And, again, no substantive
11 deliberations whatsoever. No consideration of
12 alternatives. No considerations of trying to extract
13 a concession from Sterling if Sterling was going to
14 ask them to do this favor by this extra-contractual
15 demand, and no questioning of Sterling's assertions.
16 And the other -- I think another key
17 point is there is no discussion or no true disclosure
18 of all facts to the board regarding the company's
19 financial condition. And that, I think -- this isn't
20 just a situation where the company was a healthy
21 company and this is purely substance over form.
22 Sterling received a 10X windfall here of over
23 $500 million from a company that was bankrupt within
24 three years of going public. And as we allege in the

1 complaint, there's not an intervening causal change of
2 why this company has stock trading at 105 in July of
3 2015 and is bankrupt less than two years later, has
4 stock trading at $8.60 in November 2016, when some of
5 the facts come to light.
6 So that, I think, on the process
7 standpoint, the lack of disclosure, the lack of
8 deliberation of what requirements Adeptus needed to
9 meet its own capital needs, is a very troublesome
10 fact. Now, defendants have not meaningfully addressed
11 any of the fair process allegations in the briefing or
12 here this morning. And because entire fairness is, of
13 course, a unitary test, failure to address fair
14 process in and of itself precludes them from carrying
15 their burden on a motion to dismiss on entire
16 fairness.
17 And that's really the first of four
18 fundamental flaws with Sterling's economic equivalency
19 argument. And that is, at the end of the day, that is
20 just really a fair price argument. Any time a
21 fiduciary sells a piece of property, such as the LLC
22 units here, to a company, there's always going to be a
23 discussion of what that fiduciary could have gotten
24 from a third party. And that may be a relevant

1 argument to establish whether or not the price is
2 fair, but just because there's a fair price argument
3 that has been raised, that does not preclude entire
4 fairness from being the appropriate standard of
5 review.
6 And, of course, again, a defendant
7 cannot carry their burden on establishing entire
8 fairness on fair price alone when the process is as
9 grossly unfair as alleged in our complaint. And, of
10 course, the complaint also alleges unfair price in
11 paragraphs 142 to 156. Again, the theory there is
12 from a before and after standpoint, Sterling had LLC
13 units. Yes, there are contractual rights associated
14 with them, but there is not a perfect equivalency
15 between the bundle of rights represented by the LLC
16 unit versus a liquid Class A share. And then Sterling
17 also received -- and the selling defendants received a
18 windfall because of the fact that the stock was
19 inflated in the first place for all of the allegations
20 that I'll get to in a minute related to good faith and
21 *Brophy*.
22 So that gets to the second fundamental
23 problem with the economic equivalency argument, and
24 that is it goes beyond the pleadings and asks the

1 Court to presume in this hypothetical world where
2 Sterling had actually made a demand the exact same
3 thing would have occurred. The exact same time, exact
4 same price, exact same number of shares. But the
5 problem is, Sterling, in doing so, is essentially
6 asking for the benefit of the presumption that the
7 board would have been equally corrupted and equally
8 acted as doormats.
9 And to be clear, the board had ample
10 opportunity to push back here. They could have
11 delayed the offerings. They could have participated.
12 They could have conducted their own primary offering.
13 And there are any number of one of those circumstances
14 in which it's conceivable that Sterling could have
15 either had to sell fewer shares or at a less favorable
16 time or at a less favorable price.
17 So it's inappropriate on a motion to
18 dismiss to assume, in this counterfactual
19 hypothetical, that the board would have been -- done
20 exactly what they did here, given that the board, as
21 we allege, did not employ any sort of procedural
22 protections whatsoever.
23 And it's only natural, in this sort of
24 controlling stockholder context, that if the board had

1 been independent, if it had independent counsel, they
2 at least would -- there would have at least been some
3 tension, there would have been some pushback, as to
4 what would have happened. And to the extent there is
5 any uncertainty as to what would have happened in this
6 alternative hypothetical world, Sterling created that
7 uncertainty by choosing the transactions here. And
8 they shouldn't have the benefit of creating
9 uncertainty by not following the agreement and then
10 asking for a factual finding on a motion to dismiss as
11 to what would have occurred and suggest that we need
12 to plead around some counterfactual hypothetical.
13 So on that note, we are not in
14 agreement with the idea that there is no economic
15 difference here. We think -- we think there would
16 have been.
17 And also, I would note, the source of
18 cash really shouldn't matter for entire fairness
19 purposes. This company incurred a massive amount of
20 debt, as we allege in the complaint. Now, they did
21 the offerings to pay Sterling while they're choosing
22 debt on the other hand. They very easily could have
23 incurred debt to pay Sterling and used equity
24 offerings to fund the business. And in that case,

1 this notion of economic equivalency would -- I mean, I
2 don't think they could even credibly argue that had
3 this company flipped the capital structure around,
4 that entire fairness wouldn't apply.
5 And on that note, it's also worth
6 noting that in this hypothetical world, *Molycorp*
7 itself is not broad enough to completely preclude the
8 board from doing anything. As Vice Chancellor Noble
9 noted on page 10, it's conceivable that the directors
10 had a duty -- or could have had a duty to conduct a
11 company registration, or to interfere, if the facts
12 had supported it in that case. The problem in that
13 case is not -- the case doesn't go so far as to say a
14 board, when presented with a demand on their
15 registration agreement, has its hands tied and can do
16 absolutely nothing. Just on the facts of that case,
17 there were not allegations to support it.
18 So the third fundamental problem with
19 Sterling's economic equivalency argument is that it
20 essentially allows the defendants to avoid the
21 consequences of their decision to pursue the Up-C.
22 Now, as we allege in the complaint, paragraph 63 to
23 73, the Up-C was pursued in order to obtain certain
24 future tax benefits. Now, those tax benefits are the

1 outgrowth of a bifurcated ownership structure between
2 LLC units in Adeptus LLC and Class A shares in Adeptus
3 Inc. So without that bifurcated separation of
4 economic units, there would be no tax benefits, there
5 would have been no reason to do the Up-C and get the
6 pearl in the oyster shell, so to speak.
7 Now, the problem for Sterling and the
8 defendants was that Up-C sweetener of tax payments on
9 the back end came with consequences. And that is LLC
10 units and Class B shares are inherently less liquid
11 than the Class A shares that are publicly traded.
12 Now, yes, Sterling could have theoretically exchanged
13 them, but any sort of exchange would have been a
14 restricted security subject to Rule 144's
15 restrictions.
16 Now, 144 obviously is a safe harbor --
17 provides a safe harbor and exemption to underwriting
18 requirements, but to comply with the 144 exemption,
19 there are certain requirements and conditions, such as
20 the 144(d) holding period requirement, the Rule 144(e)
21 volume limitation, Rule 144(f) manner of sale
22 restrictions. And as the Delaware Supreme Court
23 recognized in *Oberly*, 144 imposes significant enough
24 liquidity constraints that a substantial discount

1 would be awarded.
2 Now, that's where the registration
3 rights agreement comes in at the big picture here,
4 because to a certain extent, it allows some of those
5 restrictions to be gone. That's why there is a
6 registration rights agreement here, because of the
7 inherent problems in these LLC units. But it's not a
8 perfect cure. And I think that's the bottom line,
9 Your Honor, is that at the end of the day, the bundle
10 of rights is different. And Sterling is asking the
11 Court to completely ignore the consequences, which is
12 especially inappropriate where Sterling drove the
13 transaction in question and did not follow the RRA.
14 And on that note, the final problem
15 with Sterling's economic equivalence argument relates
16 to this July 2015 offering. We do vehemently dispute
17 that this transaction was a valid shelf takedown. As
18 we allege in paragraphs 108 to 111, Sterling made a
19 demand notice. We provided the Court with a copy of
20 that demand notice. That was under Rule -- Section
21 2(a) of the registration rights agreement, and that
22 section provides that Sterling cannot do a demand --
23 more than one demand within any 180-day period. So
24 starting from that standpoint alone, it's a false

1 premise to say that this alternative secondary -- or
2 conventional secondary was on the table for the July
3 2015 offering.
4 Now, Sterling suggests that a footnote
5 on a prospectus supplement suggests otherwise, but,
6 first of all, that contradicts the complaint. And,
7 second, there's no evidence in the record to suggest
8 that Sterling actually complied with the requirements
9 to do a valid takedown under Rule 4(c). To have a
10 valid ability to do a takedown, you have to first of
11 all register the -- provide notice to the company to
12 include the shares in the shelf registration statement
13 under 3(a). There's no evidence Sterling ever did
14 that. And, second, Sterling would have to provide
15 notice in accordance with 4(c) to do a takedown
16 notice. There's no evidence they did that.
17 So I don't think the Court can ignore
18 the well-pleaded allegations of the complaint and
19 assume facts that are beyond the record that somehow
20 Sterling changed their mind and did a 4(c) instead
21 when there is a demand notice, as we allege in the
22 complaint.
23 So ultimately, Your Honor, the entire
24 fairness -- the duty of loyalty claim in Count I comes

1 down to the entire assumption, again, of what is
2 really a fair price argument, that fair price
3 precludes review. Again, we don't think there is fair
4 price. We allege otherwise, and that's a fact issue
5 that's inappropriate for a motion to dismiss.
6 But in any event, it doesn't change
7 the standard of review, regardless of what the price
8 is. And from our position, the defendants' argument
9 on Count I collapses entirely unless the Court is
10 going to ignore Adeptus's actual role in these
11 transactions.
12 So unless Your Honor has any
13 questions, I'll move on to the next claim.
14 On the *Brophy* claim, I think a
15 sensible starting point is the notion that they
16 were -- that Sterling was contractually entitled to
17 sell by the shareholders agreement in the registration
18 rights agreement. Now, there are a few problems with
19 that theory. First of all, parties cannot
20 contractually exculpate themselves for duty of loyalty
21 breaches under 102(b)(7). But the bigger problem is
22 the agreement doesn't actually say what Sterling
23 implies.
24 In particular, I would refer the Court

1 to Section 6(p) of the registration rights agreement,
2 which provides that defendants -- or any seller can
3 get all the information they want upon reasonable
4 request. But it gives them the ability to disclose
5 that information, to the extent they need to correct
6 any disclosure in the registration statement or
7 prospectus. And, lastly, it concludes that "no such
8 information shall be used by such person as the basis
9 for any market transactions in securities of the
10 company in violation of the law."
11 So in other words, 6(p) basically
12 precludes -- it doesn't authorize them to sell as they
13 see fit. It precludes them from using confidential
14 information to make improper market transactions.
15 I'd also note under -- the notion that
16 all of the responsibilities had been referred to
17 Adeptus is also not supported by the agreement. Not
18 only does 6(p) give Sterling the ability to review
19 documents and correct disclosures; 6(a) also gives
20 Sterling the ability to go back and confer with
21 counsel, or confer and provide input and review
22 registration statements ex ante before they're filed.
23 And the key point here, again, is
24 Adeptus's purported counsel took direction from

1 Sterling, and not Adeptus. So it's a little bit
2 disingenuous to completely control Adeptus with
3 respect to these -- to these transactions, take
4 control of counsel so that Adeptus doesn't even have
5 independent counsel, and then, for Sterling, to
6 then -- as we allege in paragraphs 122 and 132, and
7 then to say, oh, well, because counsel we were
8 controlling didn't fix it, it's somehow your fault,
9 Adeptus, because of the registration rights agreement.
10 And taking a step back from the bigger
11 picture, the registration rights agreement says
12 nothing about the timing of the decision to sell,
13 either. It only comes into play after a decision to
14 sell has already been made. And that's really what
15 *Brophy* is fundamentally about. It's about accounting
16 for profits from abusing a position of trust owed to
17 the fiduciaries. It's not misappropriation in the
18 sense of I'm taking your confidential information and
19 I'm giving it to someone else. It's benefiting from
20 confidential information you have. So it's really
21 about unjustly profiting from it.
22 And, in fact, the *Latesco* case they
23 cite in the -- Sterling cites in their reply brief
24 drops a note to the third Restatement of Agency that

1 basically makes that point, that an agent has a duty
2 not to use or communicate confidential information for
3 the agent's own purpose or for those of a third party.
4 So turning to more of the merits of
5 the claim, I think the key that's lost in this -- and
6 I think it addresses the parade of horribles that, of
7 course, insiders have more information than anyone
8 else, so they can never sell. That's the reason why
9 the courts draw a line in materiality. That's the
10 whole purpose of the materiality exception, is to
11 draw -- or the requirement, is to draw that line.
12 Now, here, based on the nature of this
13 business, this is a fixed-cost business that depends
14 on patient volume. That is the key operating metric.
15 As the company discloses in its filings, as we allege
16 in paragraph 258, the company identifies patient
17 volume as one of the key operating metrics.
18 In paragraph 190 we allege, as the
19 company described in its filings, that too much -- or
20 declines in patient volume from oversaturation were a
21 material risk. So there's no question that patient
22 volume, in and of itself, is the single-most important
23 driver of this company's ability. It's the most
24 important driver of how the company assesses what it's

1 doing. And that fact is evident by the fact that
2 there are, as we allege in the complaint, there are
3 daily patient volume reports. Management in Sterling
4 is reviewing this information is real time.
5 And those patient volume reports, as
6 we allege in paragraphs 264 to 279, are really kind of
7 the key on the basis of the knowledge. Because this
8 is not -- this is not a situation where, you know, a
9 lot of the *Brophy* cases deal with, well, the directors
10 should have known because they're directors. That's
11 not the case here at all. This is they have actual
12 real-time access to the key operating metric for the
13 entire company that is the key to the entire business
14 model.
15 And the juxtaposition between what
16 that data was showing and the representations to the
17 market are striking, in particular with respect to the
18 June -- July 2015 offering and the June 2016 offering.
19 So the July 2015 offering, the company reports
20 guidance on July 23, 2015, which is just days before
21 the offering itself. They raise guidance based on the
22 so-called continued success of the growth plan in
23 their earning report.
24 But as we allege in paragraphs 264 to

1 267, the patient volume reports at the time were
2 showing -- telling a completely opposite story. It
3 got worse from April to May to June. So as they're
4 growing, their patient volumes are getting worse.
5 It's -- they're significantly down, both relative to
6 the previous month, but also year over year, and
7 they're significantly below budget.
8 So you have real-time information of
9 the most important operational metric there is of this
10 company that shows that growth is not working, and yet
11 they're raising earnings and going to the market
12 predicated on, you know, continued success of the
13 growth plan.
14 Let's then fast-forward to the June
15 2016 offering. Again, April 20, 2016, as we allege in
16 paragraph 177, where Adeptus reported earnings. The
17 CEO, Defendant Hall, was quoted as saying he's
18 "pleased" with the Q1 results; they were "in line with
19 expectations" and "demonstrate continued process in
20 executing our growth plan."
21 So, again, they're -- they're
22 aggressively touting how well growth is going. But in
23 reality -- and at the same time, they report a
24 top-line growth figure of 8 percent same-store volume

1 across all stores.
2 But as we allege in the complaint, in
3 paragraphs 269 to 275, the opposite is actually
4 happening, because growth is -- or the patient volumes
5 are tanking in five of six markets, five of their six
6 markets. And the only reason there is any growth
7 whatsoever is because of the few laggard hospitals --
8 or few laggard facilities in Dallas when they opened
9 the facilities to lower-paying patients. So there is
10 a very clear delta between what the information in
11 real time is showing them and what they're
12 representing to the market.
13 And, again, I think the emphasis on
14 growth is a factor, both for materiality and scienter,
15 because this company fundamentally was touted as a
16 growth company. That was the investment thesis for
17 the company. As we allege in the complaint, in the
18 filings themselves, the very second sentence of the
19 company's own reviews say, "We have achieved growth."
20 It's so important to their narrative, it's the second
21 sentence they tell everyone about what their company
22 is.
23 And they repeat the same sentence
24 throughout the filings. They emphasize the robust

1 pipeline. They emphasize the robust growth, et
2 cetera. And they do this in the prospectus, they do
3 it in the 10-Ks, all the earnings they highlighted, et
4 cetera.
5 So, obviously, whether or not growth
6 is working is a highly material issue, because it's
7 the whole investment thesis for the company. It was
8 not a very profitable company, if at all. In fact, it
9 was losing money. And, instead, you have stock that's
10 going to the moon because it's being valued as a
11 growth stock even though the insiders are seeing
12 information in real time that shows that the growth
13 is -- is tanking the patient volumes and, in turn,
14 profitability.
15 Now, at this point we're not
16 saying -- the complaint does not allege "should have
17 known." It is a "must have known," actual-knowledge
18 allegation. And I direct the Court to paragraph 267,
19 for example, where we allege "Based on the wide-spread
20 underperformance and declining patient volumes across
21 all markets as reflected in the Patient Volume
22 Reports, Sterling and the Insiders knew that their
23 various growth-related initiatives were not working."
24 There are similar allegations in 60, 163, 164, 241.

1 In particular, they were aware of major problems which
2 motivated them to dump their holdings and gloss over
3 the problems.
4 So there are allegations of actual
5 knowledge, and I think the complaint alleges in some
6 detail how they knew it. So you have the patient
7 volume reports. Pre-IPO, we allege, Sterling was
8 involved directly in preparing the company's financial
9 models and knew the import of patient volume and how
10 it drove profitability. So that's alleged at
11 paragraph 56.
12 We also allege that Sterling had
13 direct access to all information through the
14 stockholders agreement. They had an open backchannel
15 to Hall and Fielding, as we allege in 242 to 248.
16 And, again, they had real-time access to all the key
17 operating metrics at the company. So I think those
18 facts support a reasonable inference for our specific
19 averments of actual knowledge.
20 It's difficult -- as this -- as the
21 Court held in *Pfeiffer v. Toll*, when you have this
22 sort of core operational metric and they have their
23 fingers -- their hands on it on a daily basis, the
24 defendants should not be entitled to a 12(b)(6)

1 inference that they didn't know.
2 And on that note, as the Court has
3 previously found, *Brophy* claims are not subject to
4 9(b) specificity requirements. They're treated under
5 a 12(b)(6) standard on just the normal 12(b)(6) rules.
6 And as the Court found in *Tesla*,
7 there's no requirement to plead a smoking gun. And
8 that's essentially what a lot of the argument comes
9 down to, is we don't allege -- we have not yet had
10 access to Sterling's internal documents, so we don't
11 have a Sterling document where Sterling says XYZ. We
12 just have allegations that support knowledge based on
13 all the information to them, which I think it's fair
14 to reasonably infer that they had to have known.
15 The other -- one of the other facts
16 that really supports the materiality of the
17 information here is the collapse of the stock price
18 after the fact. As we allege in paragraphs 17 and
19 155, the company disclosed some information on
20 November 1, 2016, that partially disclosed the
21 problems; I don't think it went into all of it. But
22 the stock price tanked 71 percent over two days, down
23 to $8.60. And then, in March 2017, they disclosed
24 some of the problems with the joint venture, and then

1 there's a 57 percent decline down to $2.79.
2 So, again, that kind of goes back to
3 the growth narrative of the company was sold. The
4 company was not being priced on its actual operating
5 results; it was being priced on future growth. And
6 when you have actual knowledge of facts showing that
7 the oversaturation risk was being materialized, that
8 obviously creates a problem.
9 And, finally, I think the timing --
10 defendants argue that the timing supports an innocent
11 inference, and we actually think it's the opposite.
12 As we allege in paragraph 120, all of Sterling's
13 decisions, the movement on when they started
14 initiating these offerings, were done within days of
15 earnings reports, within days of joint venture
16 announcements; so their timing -- trying to time these
17 offerings at a time to get as much as they possibly
18 can, when the stock is going to be -- even though they
19 know at the same time that the growth is not actually
20 there.
21 And, really, I think the materiality
22 issue, again, comes down to the total mix of
23 information in the market. *Oracle*, I think even in
24 that case itself, then-Vice Chancellor Strine

1 references to a certain extent, the characterization
2 of soft versus hard information isn't what it's really
3 about, because to even make a future prediction,
4 you're going to have to base that on other data.
5 So the fundamental difference is in
6 that case you're deal with a future earning estimate.
7 That's the bad fact that happened. This isn't a
8 failure of a future prediction. We're not saying that
9 they said they were going to hit X and they didn't hit
10 X. Our position is real-time knowledge that the
11 entire investment thesis for the company is broken.
12 And that is a very different -- that has a very
13 different impact on the total mix of information in
14 the market than mere earnings news.
15 And in some ways -- turning to good
16 faith. I think the good faith claim -- or the bad
17 faith claim and the *Brophy* claim really do dovetail.
18 Because the typical *Brophy* case, there is some
19 material negative event that occurs. The insiders
20 learn about it before the market and they trade on it,
21 and that's the nature of the claim.
22 This is a little bit different,
23 because here, the insiders are creating the bad
24 decision through their "growth for growth's sake"

1 narrative. And, again, we allege that they knew the
2 growth was counterproductive based on the information
3 before them. It's not a hindsight claim. It's a
4 claim based on real-time actual knowledge of what they
5 knew.
6 And, ultimately, I think the -- two
7 ships passed in the night a little bit on the briefing
8 here, because the defendants frame the question of bad
9 faith in terms of the reasonableness of this decision
10 to grow or reasonableness of the decision of joint
11 ventures, et cetera. And we're not saying had they
12 subjectively believed that those decisions were
13 appropriate, that there would be a problem there. I
14 think we would have conceded those. If you had proper
15 motives and the subjective belief that those sorts of
16 decisions were in the company's best interests, then
17 there wouldn't be a bad faith claim.
18 Our claim is very different. Our
19 claim is you did these things -- even though it could
20 be rational in some circumstances, you did it knowing
21 that it was not in the best interests of the company
22 so you could dump your shares; and the fact that there
23 is clearly a motive to do that, as evidenced by the
24 fact they did, in fact, dump their shares.

1 And that's where a lot of the
2 other -- the other facts surrounding -- you know, the
3 accounting issues, the lease accounting, those things,
4 they're not -- the lease accounting isn't necessarily,
5 itself, actionable. The point of that is you have a
6 company who's focused on financial-statement window
7 dressing, even if it's compliant with GAAP. But when
8 you have a CFO saying it's vitally important to our
9 strategy that we get this sort of accounting treatment
10 that makes not a darned bit of difference for cash
11 flow, I think that supports the inference that these
12 guys are really focused on the short-term stock price,
13 not the long-term benefit to the company, because they
14 don't really care what happens once they're cashed
15 out.
16 Ultimately, I think our position is
17 very simple, and it is that good faith requires
18 subjective belief that you were acting in the best
19 interests of the company for the long-term benefit of
20 its shareholders. Anything other than that is not
21 good faith. And in our view, they did not have the
22 required subjective belief here. And because they
23 didn't have the required subjective belief here, based
24 on their knowledge, based on these other facts,

1 they're not entitled -- it both rebuts the presumption
2 of good faith under *Disney* and it states a claim.
3 Unless Your Honor has any other
4 questions, I think I'll rest and refer to the
5 briefing.
6 THE COURT: Could you focus in a
7 little bit on the Hosler issue of his departure from
8 the board. Mr. Hurd raised that several times.
9 MR. YODER: Oh. Yes, Your Honor. We
10 do not -- we do not intend to hold him liable for any
11 transactions that occurred after he left the board.
12 So it's an imprecise pleading, perhaps, in how we
13 captioned the claims, but --
14 THE COURT: And could you also
15 elaborate a little bit on the issue of Hosler and
16 Rosenberg's exposure on the *Brophy* claim?
17 MR. YODER: So I think in the *Fitbit*
18 case, the Court said it can't be in Delaware law that
19 someone is off the hook merely because it was a third
20 party that did the selling. Now, in that case the
21 facts were a little bit different because the
22 fiduciaries in issue were a little bit higher up than
23 what Rosenberg and Hosler were here.
24 But, ultimately, our position is that

1 the duty of loyalty -- the duty of loyalty, as I was
2 saying earlier, requires you to account for profits
3 for the benefit of your fiduciaries. So if you are
4 passing information on to Sterling, as Rosenberg and
5 Hosler did, if you're passing information on to them,
6 they are then making trades resulting in $240 million
7 coming in, and you -- the fiduciaries are having
8 enhanced personal compensation as a result of that,
9 you're still benefiting from your position as a
10 fiduciary of Adeptus, even if you yourself are not
11 doing the trading.
12 THE COURT: All right. Thank you.
13 MR. HENDERSHOT: Good morning again,
14 Your Honor.
15 A couple of points on reply. I
16 thought I heard my friend say early on in his
17 presentation that there was no disclosure to the board
18 of the company's true financial condition at the times
19 of the offerings. That's not alleged anywhere in the
20 complaint. Our friends stand in the shoes of the
21 company. They have the company's documents, they have
22 books, board consents, all that stuff. They chose not
23 to put anything like that in the complaint or in front
24 of the Court.

1 I heard my friends say that they do
2 dispute that there could have been some economic
3 difference between the economics of a fully
4 conventional secondary, a fully synthetic secondary,
5 or a mix of the two. Again, that's speculation.
6 That's not pled anywhere in the complaint.
7 I heard my friends say that there's no
8 evidence that Sterling sent a shelf takedown notice
9 for what became the July 2015 offering. Again, they
10 chose not to put that in front of the Court. They've
11 got the documents. They chose not to put it in front
12 of the Court. And they don't say this wasn't the
13 shelf takedown, this was done via a demand
14 registration.
15 They never say that the board elected
16 to waive the 180-day period. That's what the
17 registration rights agreement says, is that Sterling
18 can't do a second demand registration within 180 days
19 of a prior one unless the board -- I forget if it's
20 phrased as waived or consent, but the board has to
21 act. There's no allegation that the board took such
22 an action. Again, that's a choice of pleading that
23 our friends made. They should be stuck with it.
24 On the *Brophy* claim, the discussion of

1 Section 6(p) of the registration rights agreement,
2 yes, it says that Sterling can't do illegal trades.
3 We didn't. There's no claim that we made trades that
4 were unlawful.
5 Finally, my friend talked a little bit
6 about what people knew, and there is a series of
7 allegations in the 260s and 270s of the complaint,
8 around that part. It's worthwhile to read that
9 section of the complaint carefully because they keep
10 switching metrics, and they keep switching -- they
11 keep asking for inferences that don't really make
12 sense based on metrics in isolation.
13 For example, paragraph 267 talks about
14 a decline in average patient volume per facility on a
15 year-over-year basis. And the time frame on that is
16 early 2015. So we're talking about what happened in
17 2014 versus what happened in 2013, average patient
18 volume per facility year over year is in bad shape, is
19 declining.
20 Well, that's a period when the company
21 is opening new facilities very rapidly, according to
22 the public disclosures and also according to the
23 complaint. And if I have three facilities in a city
24 in 2014, and then I build seven more, so I have ten in

1 2015, it's not exactly a shock or a red flag if the
2 ten facilities in that city have lower average numbers
3 of patients, facility by facility, year over year,
4 than the three did the preceding year, because the
5 existing facilities are going to subsidize the new
6 ones; there's a ramp-up period. All these things are
7 part of the strategy, or at least they could be, and
8 that goes to whether this is a rational approach to
9 shareholder value.
10 Then the very next paragraph,
11 paragraph 268, the complaint switches to same-store
12 patient volume year over year. And this one is
13 comparing first quarter 2016 to first quarter 2015, so
14 comparable quarter, year over year. But, again,
15 expected tradeoff of the business strategy of growth
16 is some of the patients who a year ago would have gone
17 to one of my three old facilities might now go to one
18 of my seven new facilities. So they bleed off from
19 the three old ones and go to one of the seven new
20 ones.
21 So that reduces patient volume at
22 these stores that are included in the year-over-year
23 metric, because those are the ones that existed at the
24 beginning of the year. Again, that's at least

1 consistent with being a known and accepted tradeoff,
2 rather than an indication that this business is headed
3 for bankruptcy.
4 Then, paragraph 270, we switch over to
5 same-store patient volumes, but now it's quarter
6 against quarter, comparing first quarter 2016 to
7 fourth quarter of 2015. It's a business that exhibits
8 seasonal variation. That's disclosed in all the
9 10-Qs, all the prospectuses. The seasonality is
10 disclosed. Q4 is the big quarter. There's lots of
11 reasons why that might be the case -- people get hurt
12 more easily in the fall and early winter, or get the
13 flu in December more than they do in February. A lot
14 of theories about that, but Q4 empirically is the big
15 quarter. So a decline in patient volume from Q4 to Q1
16 doesn't necessarily mean anything.
17 And, finally, when we get down to
18 paragraph 278 -- the complaint actually says this --
19 it's true, we get an admission, really, that general
20 growth and overall volume provides -- or provided no
21 information by itself as to the profitability of the
22 business. All these volume numbers could have
23 indicated trends, but maybe not. Running a public
24 company with hundreds of millions of dollars in annual

1 revenue is complicated, and plaintiff doesn't get
2 anywhere close to bad faith by saying, look, here's
3 some numbers that, in hindsight, could have been
4 indicative of a trend. It just doesn't work that way.
5 And, again, they've got board decks,
6 they've got board presentations, they've got board
7 minutes. They've got internal emails on the Adeptus
8 side. They put some of those emails in their
9 complaint, put them in front of the Court. If there
10 is, you know, a smoking gun, if there is a realization
11 that, gosh, we have a real problem here, the strategy
12 isn't working, we need to revise our strategy, where
13 is it? It's not there.
14 Unless Your Honor has questions for
15 me, I'll sit down.
16 THE COURT: Thank you.
17 MR. HURD: Just briefly, Your Honor.
18 Your Honor asked a question about the *Brophy* claim
19 against Messrs. Hosler and Rosenberg. And opposing
20 counsel conceded that facts matter and this case is
21 not like *Fitbit*, and then talked about passing on
22 information to get a benefit for doing that, passing
23 on information to Sterling.
24 There's a couple problems with that.

1 First of all, those allegations don't appear in the
2 complaint. And then, secondly, it does ignore the
3 fact that -- which is acknowledged in the complaint --
4 that Sterling had contractual rights to information.
5 So it wasn't as if my clients had to pass on some
6 information to Sterling that Sterling didn't already
7 have a right to. And I think counsel has conceded
8 that there's really no allegation of a personal
9 benefit to either of them.
10 With that, I'll sit down, Your Honor.
11 THE COURT: Thank you.
12 Anything else?
13 All right. Let's take 15 minutes,
14 until 20 after, and then I'll let you-all know where
15 we stand.
16 (A recess was taken, 12:05 to 12:20 p.m.)
17 THE COURT: Welcome back, everyone.
18 Please be seated.
19 We're here on the motions to dismiss
20 in Drivetrain v. Hall, which is Civil Action No.
21 2019-0365-JTL. It is a pleading-stage motion to
22 dismiss that challenges a quite hefty complaint. The
23 complaint weighs in at 142 pages, with 315 paragraphs.
24 It's brought on behalf of a litigation trust that is

1 representing the company, which was forced to file for
2 bankruptcy.
3 This is the type of lengthy, detailed
4 complaint where the Court of Chancery often takes on
5 the task of writing the equivalent of a post-trial
6 decision or summary judgment ruling at the pleading
7 stage based on the allegations of the complaint. I,
8 unfortunately, don't have the bandwidth right now to
9 do that because I have actual post-trial rulings,
10 several of them, that are in the queue. So I'm going
11 to tell you where I would come out on this, were I to
12 write such a lengthy opinion, and you-all can move on
13 from there.
14 The complaint is detailed and
15 specific. It describes what can be characterized in
16 somewhat inflammatory fashion, but I think aptly, as a
17 sophisticated pump-and-dump scheme in which a
18 controlling stockholder leads a company on a plan of
19 rapid growth where the business metrics really didn't
20 support it. But the high-growth path did enable the
21 controller and other insiders to cash out to the tune
22 of millions of dollars while the company itself ended
23 up in bankruptcy.
24 The defendants' motions to dismiss

1 largely ask the Court to speculate about different
2 possible causes for the company's demise and to draw
3 inferences in their favor. I'm largely denying the
4 motion for the reasons stated in the answering brief.
5 As the parties did today, I won't cover all the issues
6 or arguments, but I will dilate on several points.
7 I'm going to start with Count I, which
8 alleges that the controlling stockholder breached its
9 fiduciary duties and the other defendants breached
10 their fiduciary duties by extracting cash from the
11 company through inside sales. The defendants largely
12 respond that these were part of partial secondary
13 offerings which they claim had the same economic
14 substance as a secondary offering, and hence, under a
15 registration rights agreement and the rights it
16 provides, should not give rise to a claim because
17 ultimately it's the same result, which is either
18 entirely fair to the company or would result in no
19 damages.
20 That defense makes some sense to me,
21 and it ultimately may prevail. But it's something
22 where, at the pleading stage, I don't think I can draw
23 the defense-friendly inference that these complex
24 transactions have the same economic substance as a

1 true contractually based secondary. People do Up-C
2 IPOs and follow them with synthetic secondaries to get
3 tax benefits. It's logical that there would be a
4 trade-off such that up-front benefits would result in
5 you giving something up on the back end.
6 I'm hesitant to make another broad,
7 pleading-stage assertion about economic substance. We
8 have several of these in Delaware law. One is that,
9 for example, options that directors own always align
10 their interests with that of the stockholders in a
11 merger. That's the type of high-level, first-order,
12 simplistic concept that makes sense if you don't think
13 about it too hard. But when you think about the fact
14 that there is acceleration going on in the stock
15 option plans, and when you think about the fact that
16 there's ongoing risk of forfeiture if the company
17 remains independent, it becomes apparent that there is
18 more that's in play than just that headline claim.
19 Another broad claim we've made is the
20 idea that a contingent fee for an investment banker
21 always aligns its interests with those of the
22 stockholders in the company. That's another issue
23 where, again, if you just say that fast and don't
24 think too hard about it, it sounds good. But, in

1 fact, there is a difference in terms of both the
2 independent decision on remaining versus a sale, and
3 there's different incentives that manifest as the
4 contingently compensated professional gets closer and
5 closer to the end stage of a deal.
6 Yet another one where I think we have
7 blundered too quickly into pleading-stage assertions
8 of equivalence is the idea that preferred stock can
9 have the same economics, in terms of upside, as common
10 stock, particularly when it's fully convertible. That
11 can be true, but preferred stock dynamics and
12 investment profiles are usually much more complex than
13 that.
14 I've tried, in my writings, to be
15 mindful of these nuances and not automatically adopt
16 these relatively high-level simplistic equivalencies,
17 which, while they may be generally true, mask a lot of
18 details that could be highly significant in a given
19 case.
20 The plaintiffs have pointed to
21 sufficient differences between the manner in which
22 these offerings were conducted and the insider sales
23 were conducted and how a true secondary would take
24 place, that I am not going to make a determination at

1 the pleading stage about whether these are
2 fundamentally equivalent from an economic standpoint.
3 In addition to the risks of glossing
4 over what may be meaningful differences -- as I say,
5 it's logical to me that there would be some -- this is
6 a flip of the doctrine of independent legal
7 significance. It would effectively be a "heads we
8 win, tails you lose," for the defendants. When form
9 dictated a result, they could rely on form. When
10 substance dictated a result, they could rely on
11 substance. At least at the pleading stage, I'm not
12 going to embrace that.
13 I do think that the points that the
14 plaintiffs have made about the transaction structure
15 and the provisions in the investor rights agreement
16 are sufficient to distinguish *Molycorp* and similar
17 cases. And so I'm not willing to grant the motion to
18 dismiss at the pleading stage.
19 I also think that the complaint easily
20 pleads that Sterling was a controlling stockholder,
21 based on a combination of factual allegations,
22 including its equity ownership, its contract rights,
23 and the human relationships that were involved here,
24 not only with particular individuals, but given

1 Sterling's long-standing role as a sponsor of this
2 company. So I am denying the motion to dismiss Count
3 I.
4 I am also denying the motion to
5 dismiss Count II. Here, too, the defendants have
6 tried a divide-and-conquer strategy of taking apart
7 the complaint and addressing individual aspects and
8 saying they're okay on their own. But I think the
9 complaint has to be read as a whole, and it tells a
10 story. The complaint supports inferences of material
11 nonpublic information, particularly involving the
12 patient volume counts. It also supports a reasonable
13 inference of scienter. Certainly, other explanations
14 are possible. Other inferences are possible. I don't
15 deny that for a moment. But at this stage, all the
16 plaintiffs have to do is plead a reasonable inference.
17 I don't believe that the registration
18 rights agreement provides pleading-stage insulation
19 against the plaintiff's claim. It does mean that
20 perhaps the defendants will have some type of claim
21 for indemnification against the company. Given that
22 the company is bankrupt, that's probably cold comfort
23 to them. But I don't think that it follows from the
24 possible existence of a claim that the company's

1 obligations under the registration rights agreement
2 insulate the defendants, at least at this stage of the
3 proceeding.
4 I am going to grant the motion to
5 dismiss Count II as to Rosenberg and Hosler. I think
6 the allegations about them are scant as to the passing
7 along of information. This is necessarily an
8 interlocutory ruling, so while they're being
9 dismissed, should the discovery record later show that
10 they in fact had a greater degree of involvement, then
11 the plaintiffs can seek to modify this ruling for good
12 cause shown.
13 In terms of Count III and Count IV,
14 these are really fallback claims and pled as
15 alternatives to Count I. Count III pleads a claim of
16 unjust enrichment, and the idea there is that if you
17 can't get to the beneficiaries who actually ultimately
18 got the money on any other theory, then unjust
19 enrichment would come into play. Count IV is a way of
20 arguing in the alternative that if any of the Sterling
21 entities weren't controllers, then there would be a
22 way to get them on grounds of aiding and abetting. I
23 think both of those are well pled.
24 This, finally, brings me to Count V,

1 which is where the defendants started their
2 presentations. Count V attempts to plead an
3 overarching claim for action not in good faith and a
4 breach of the duty of loyalty. Here again, I think
5 it's critical to read the allegations that support
6 this count in the context of the complaint as a whole,
7 and particularly in the context of the allegations
8 that support the *Brophy* claim to the effect that the
9 data really was not supporting the company's continued
10 claims about its growth strategy and the allegations
11 in Count I, which argue that, really, this was all a
12 setup for Sterling to cash out when the stock price
13 was high.
14 I do agree with Mr. Hendershot and
15 Mr. Hurd that if all the plaintiffs had done was come
16 in and say that this was some type of reckless growth
17 strategy for growth's sake, then that would be the
18 type of claim that the business judgment rule would
19 protect. Here, though, the growth strategy and the
20 allegations about a lack of good faith are part of an
21 overall account that is tied in with, again, what is
22 argued to be a very sophisticated pump-and-dump scheme
23 where, instead of being carried out over a couple
24 weeks by some boiler room in New Jersey or New York,

1 this involved a longer con that was carried out by a
2 highly sophisticated investment firm.
3 And I think, when viewed in the
4 context of that backdrop and that overarching theory,
5 Count V, at least at the pleading stage, survives.
6 Once again, I say that understanding that growth can
7 be a viable strategy, that accelerated growth can be a
8 viable goal, and that opening stores that cause have
9 some cannibalization can be a viable strategy. I am
10 not rejecting any of that as a matter of law. All I
11 am saying is that when you fairly read the complaint
12 as a whole, I think it supports a claim in this
13 context.
14 I think that the plaintiff's Section
15 109 argument after *Hazout* is sound. This is something
16 that I believed when I first read *Hazout*, and I
17 continue to believe it. I don't see an entity-based
18 distinction between the 3114 analysis in *Hazout* and
19 the Section 109 analysis that would apply here in this
20 case.
21 And as to Covert FLP, I will allow
22 jurisdictional discovery. That discovery is largely
23 going to be coextensive with the merits discovery,
24 since the claim here is scheme-based. It sounds to me

1 that, given the agreement on a settlement, there may
2 be something that can be done to resolve that. But at
3 least for today, I'm going to permit jurisdictional
4 discovery, and Covert FLP can certainly renew its
5 jurisdictional arguments later.
6 I'm going to stress what I've
7 attempted to note throughout: This is not a
8 post-trial ruling or a liability determination,
9 notwithstanding the defendants' efforts to turn this
10 into the type of argument that would happen at a later
11 procedural stage. It's simply a determination that,
12 at the pleading stage, the complaint supports
13 reasonable inferences sufficient to enable the
14 plaintiff to get past the motion to dismiss and start
15 conducting of discovery.
16 Thank you all for coming in today. We
17 ended up going about five minutes longer than the
18 segment. I apologize for keeping you-all away from
19 your lunch for that additional time, but I'm grateful
20 for everyone who came, and I'm particularly grateful
21 for those of you who traveled from out of town. I
22 wish you a safe trip back to your homes, wherever it
23 is you're from, and I hope everyone has a good rest of
24 the day.

1 We stand in recess.
2 (Court adjourned at 12:37 p.m.)
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1
2 CERTIFICATE
3
4 I, JULIANNE LABADIA, Official Court
5 Reporter for the Court of Chancery of the State of
6 Delaware, Registered Diplomate Reporter, Certified
7 Realtime Reporter, and Delaware Notary Public, do
8 hereby certify that the foregoing pages numbered 3
9 through 70 contain a true and correct transcription of
10 the proceedings as stenographically reported by me at
11 the hearing in the above cause before the Vice
12 Chancellor of the State of Delaware, on the date
13 therein indicated, except for the rulings, which were
14 revised by the Vice Chancellor.
15 IN WITNESS WHEREOF I have hereunto set
16 my hand at Wilmington, this 23rd day of January, 2020.
17
18 /s/ Julianne LaBadia
----
19 Julianne LaBadia
Official Court Reporter
20 Registered Diplomate Reporter
Certified Realtime Reporter
21 Delaware Notary Public
22
23
24