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IN THE SUPREME COURT OF THE STATE OF DELAWARE

IN RE SMILEDIRECTCLUB, INC. DERIVATIVE LITIGATION	No. 205, 2021 Court Below: Court of Chancery of the State of Delaware, C.A. No. 2019-0940-MTZ

APPELLANTS' REPLY BRIEF

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INTRODUCTION

Plaintiffs-Appellants ("Plaintiffs"), stockholders of nominal defendant SmileDirectClub, Inc. ("SDC" or the "Company"), submit this Reply Brief in support of their Appeal. Plaintiffs' claims relate to purchases by the Company of almost $700 million of units ("LLC Units") in SDC Financial LLC ("SDC Financial"), a subsidiary owning SDC's underlying business, $630 million of which were purchased from corporate insiders (the "Insider Transactions"), occurring after the closing of SDC's initial public offering ("IPO" or the "Offering") and three days after Plaintiffs became SDC stockholders. The Insider Transactions provided a massive financial windfall to the corporate insiders, as the Company paid $21.85 for each of the LLC Units on the same day that SDC common stock, which was the economic equivalent of an LLC Unit, traded between $17.81 and $19.00 per share and closed at $18.90 per share. The lack of fairness of the Insider Transactions to SDC was further evidenced by the subsequent decline of SDC's stock price to $8.74 per share as additional adverse facts which were known to SDC insiders but were undisclosed at the time of the Insider Transactions were publicly disclosed.

The central issue in this appeal is whether the Court of Chancery incorrectly held that Plaintiffs failed to meet their burden of demonstrating standing under 8 *Del. C.* §327 ("Section 327" or the "Statute"). Section 327 governs standing in stockholder derivative actions by requiring a plaintiff to have been "a stockholder of

the corporation ***at the time of the transaction*** of which such stockholder complains." 8 *Del. C.* §327 (emphasis added). The "time of the transaction" about which Plaintiffs are complaining is the Defendants' decision to pay $21.85 for each of the LLC Units for a total of $630 million in the Insider Transactions, even though the Company was not obligated to do so. That decision necessarily took place after the time Plaintiffs became stockholders of SDC upon completion of the IPO, and Defendants' wrongdoing occurred at that time because they ignored their unremitting fiduciary duty not to proceed with a transaction which was unfair to the Company where there existed no binding legal agreement to do so. Instead, the IPO prospectus (the "Prospectus") upon which Defendants base their arguments stated that the Company had an ***intention*** to proceed with the Insider Transactions ***that was subject to change***, rather than an obligation to do so.

However, even if Defendants' contention that the "time of the transaction" for purposes of Section 327 is when the terms of the transaction became definite rather than legally binding is correct – and it clearly is not – it would not change the outcome of this case. Specifically, the Prospectus stating that the terms of any purchases of LLC Units the Company intended to do were "***subject to change***" defeats Defendants' contention that the terms had become definite prior to the IPO.

Therefore, and as discussed below in greater detail, Plaintiffs respectfully submit that the Chancery Court's judgment dismissing this action should be reversed and this action remanded to the Chancery Court for further proceedings.

ARGUMENT

I. PLAINTIFFS HAVE STANDING TO SUE BECAUSE THEY WERE SDC STOCKHOLDERS AT THE TIME OF THE INSIDER TRANSACTIONS

Defendants contend that Plaintiffs lack standing to sue because: (a) to determine the "time of the transaction" within the meaning of Section 327 "it does not matter when a transaction becomes certain to occur; what matters is when its terms become definite." AB at 29 (citing *7547 Partners v. Beck*, 682 A.2d 160, 162 (Del. 1996)); and (b) the terms of the Insider Transactions became definite before the time of the IPO. Defendants are in error with respect to both of their arguments.

A. The "Time of the Transaction" Occurs When the Wrongful Acts Complained Are Susceptible to Being Remedied Which in This Case Was After Plaintiffs Acquired SDC Stock

Beck contains no statement or rule of law that, as Defendants contend, the time of a transaction for purposes of Section 327 is when "the terms [of a transaction] become definite." AB at 29. Instead, *Beck* defines the "time of the transaction" as used in Section 327 according to the plain meaning of that term "by identifying the 'wrongful acts which [the plaintiff] want[s] remedied and which are susceptible of being remedied in a legal tribunal.'" 682 A.2d at 162 (quoting *Newkirk v. W.J. Rainey, Inc.*, 31 Del. Ch. 433, 76 A.2d 121, 123 (1950)).

Beck did not look to the time the private placement was completed because, there, the plaintiff was "challenging the 'terms of the [Private Placement] rather than the technicality of its consummation.'" 682 A.2d at 163 (citation omitted).

Accordingly, "***the wrongs alleged*** … occurred at the time ***the decision was made*** to sell the directors stock … in the Private Placement" and it was an "uncontestable fact" that the decision "must have been made prior to the date on which the Prospectus was issued, since the fact that ***there would be a Private Placement*** and the terms thereof were disclosed in the Prospectus." *Id.* at 163 (emphasis added).

Beck, however, did not dispense with the need for there to be a binding agreement for a "transaction" to have taken place for purposes of Section 327. Aside from the issue not being relevant to the claims as plead by the plaintiff, *Beck* was a case in which a binding agreement existed even absent the final signing of a private placement agreement because "[a] contract need not be in writing to be valid" where (1) the parties have made a bargain with 'sufficiently definite' terms; and (2) the parties have manifested mutual assent to be bound by that bargain." *Sarissa Cap. Domestic Fund LP v. Innoviva, Inc.,* 2017 WL 6209597, at *21 & n.225 (Del. Ch. Dec. 8, 2017) (citing *Osborn ex rel. Osborn v. Kemp*, 991 A.2d 1153, 1158 (Del. 2010)). Specifically, there was an "uncontestable fact" that the "time of the decision" was prior to the public offering notwithstanding the uncertainty as to the precise time when the private placement agreement was formally executed. *Beck,* 682 A.2d at 163.

Here, in contrast, Plaintiffs are, in fact, challenging the consummation of the Insider Transactions on the grounds that SDC was not obligated to proceed with that

overpriced purchase of LLC Units when Plaintiffs acquired SDC stock. *See, e.g.,* ¶6 (A17). Rather, Plaintiffs alleged in the Complaint that the decision to proceed with the Insider Transactions only took place ***after the IPO***. *See* ¶¶40, 50-52 (A50-51, A52-53). Indeed, Defendants fail to point to any statement in the Prospectus or other record facts demonstrating that such final approval of "definite terms" occurred before the IPO and, instead, acknowledge that the Court of Chancery did ***not*** make a factual determination, like that in *Beck*, that final Board approval to proceed with the Insider Transactions took place before the IPO. AB at 32.

In addition, any argument that SDC was legally bound to proceed with the Insider Transactions and, more specifically, to pay $21.85 for each of the LLC Units purchased, would be specious. Absent such a binding agreement, Defendants had an "unremitting fiduciary obligation to adjust [] strategy as circumstances unfold if [directors] believes in good faith that the change is in the best interest of the corporation and its stockholders." *Firefighters' Pension Sys. of City of Kansas City, Missouri Tr. v. Presidio, Inc.*, 251 A.3d 212, 271 (Del. Ch. 2021). That fiduciary duty was breached *after* Plaintiffs became stockholders, when SDC obtained the net proceeds from the IPO and entered into the Insider Transactions, ignoring that the price being paid for the LLC Units far exceeded their market value and true value. *See, e.g.,* ¶6 (A17).

Specifically, the LLC Agreement contains provisions governing the Company's purchases of LLC Units (A449-55) but is completely silent as to the Insider Transactions and did not require SDC to make any purchases after the IPO or to consummate the Insider Transactions, let alone at the specific price of $21.85 per share. Indeed, Defendants do not even bother to claim that the LLC Agreement required SDC to proceed with the Insider Transactions.

Instead, Defendants pivot their arguments on the Prospectus. However, those arguments fail because the Prospectus does not contain any statements demonstrating a binding commitment with respect to proceeding with the Insider Transactions, and certainly not for $21.85 per LLC Unit. Instead, the Prospectus states that the Company "***intend***[s] to use ... the net proceeds from this offering ... to purchase [LLC Units and Common Stock]." *See* Prospectus at cover, 13, 16-17, 55, 62-63, 65, 152-53 (A142, A161, A164-65, A203, A210-211, A213, A300-301) (using the word "intend" at least eleven separate times as it relates to purchase of the LLC Units and Common Stock, and never suggesting the existence of a binding agreement).[1]

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[1] *See* e.g., Prospectus at p.13 (A161) ("[w]e ***intend*** to use substantially all of the net proceeds we receive from this offering … to purchase a number of newly issued LLC Units from SDC Financial … In addition, we ***intend*** to use a portion of the net proceeds to purchase shares of Class A common stock from the Blocker Shareholders at" $21.85 per share); *id*. at 16-17 (A164-65) ("We ***intend*** to use such proceeds as follows…"); *id*. at 62-65 (A210-13) ("We ***intend*** to use substantially all

The term "intend" has a well understood meaning as a clearly formulated or planned determination to act in a certain way. *See* https://www.merriam-webster.com/dictionary/intent; *see also Delmarva Power & Light Co. v. First S. Util. Const., Inc.*, 2007 WL 2758777, at *2 (Del. Super. Ct. Sept. 18, 2007), *vacated*, 2007 WL 3105112 (Del. Super. Ct. Oct. 11, 2007) (quoting Bryan A. Garner, A Dictionary of Modern Legal Usage 457 (2d ed. 1995) ("defining 'intend' to mean 'to desire that a consequence will follow from one's conduct.'")). The use of the word "intend" in the Prospectus therefore explicitly signified a plan that was "subject to change based on various important factors, some of which are beyond [SDC's] control[,]" (Prospectus at 58 (A206)), and ***not*** a binding commitment to conduct the transaction at the $21.85 price. Driving home this point is the fact that the Prospectus explicitly stated that SDC's actions "could differ materially" from the intentions expressed therein. Prospectus at 59 (A207). *See also* A149, A206-07 (disclaiming that the pricing of the Insider Transactions was "set" before the IPO by warning that the Prospectus must be read as a whole, considering its "Cautionary Statement

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of the net proceeds we receive from this offering … to purchase a number of newly issued LLC Units from SDC Financial…. We ***intend*** to cause SDC Financial to use a portion of the net proceeds it receives from the sale of LLC Units to us to purchase and cancel LLC Units from Pre-IPO Investors" for $21.85 per share); *id*. at 152-153 (A300-01) ("We ***intend*** to use approximately $616.3 million… the net proceeds we receive from this offering to purchase and cancel LLC Units from Pre-IPO Investors and shares of Class A common stock from the Blocker Shareholders at a price per LLC Unit and share of Class A common stock" for $21.85 per share).

Regarding Forward-Looking Statements[,]" explaining statements qualified by word like "intends" are not guarantees, and explaining that SDC's actions "could differ materially from those expressed in [forward-looking] statements").

Lavine v. Gulf Coast Leaseholds, Inc., 122 A.2d 550 (Del. Ch. 1956), further demonstrates that Defendants' reading of *Beck* is incorrect. *See* OB at 11. Defendants' attempt to cabin *Lavine* as a unique rule of standing applicable only to situations in which stockholder approval is required (AB at 21-22) is unavailing. *Lavine* was not based upon any unique aspect of stockholder approval but, instead, on the fact that "***the transaction*** of which plaintiff complains ***was not completed*** before plaintiff became a stockholder." *Id.* at 552 (emphasis added). Thus, in *Desimone v. Barrows*, one of the cases cited by Defendants in their effort to limit *Lavine*, then-Vice Chancellor Strine instead described *Lavine* as a case in which "the agreement had no effect until approved." 924 A.2d 908, 925 n.40 (Del. Ch. 2007).[2]

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[2] The other cases Defendants cite do not change this analysis. *Kaufman v. Albin*, 447 A.2d 761 (Del. Ch. 1982), distinguished *Lavine* as involving a majority vote of stockholders, while *Kaufman* involved a tender offer but with respect to the relevant issue of finality of a transaction, followed *Lavine* in holding that until a majority of the shares registered their approval through the tendering of those shares, "the transaction was subject to extinction." *Id.* at 764. *Levine v. Sinclair Oil Corp.*, 261 A.2d 911 (Del. Ch. 1969), held that the underlying transaction which constituted a usurpation of corporate opportunity had been legally completed before the plaintiff became a stockholder, constituting the relevant date for determining Section 327 standing even though the damages had not manifested themselves yet. *Brown v. Automated Mktg. Sys., Inc.*, 1982 WL 8782, at *2 (Del. Ch. Mar. 22, 1982), upon which Defendants rely, correctly states the governing law as being "when unfairness

Defendants' effort to distinguish *Leung v. Schuler,* 2000 WL 264328 (Del. Ch. Feb. 29, 2000), is similarly infirm because although the facts themselves may be different, the underlying principle of law remains unchanged: a stockholder has standing to sue if it holds stock before a company is obligated to undertake otherwise wrongful conduct. In *Leung*, the wrongful conduct arose when the shares were issued, much the same way that the Insider Transactions only became binding upon SDC when Defendants plowed ahead with them despite having no obligation to do so.

Defendants' attempt to distinguish *Maclary v. Pleasant Hills, Inc.*, 109 A.2d 830 (Del. Ch. 1954), is also unsuccessful. Although *Maclary* admittedly represents a unique set of facts – as does this case – the actual holding is not, as Defendants claim, premised on a lack of disclosure but, instead, on the transaction not having been deemed complete prior to the plaintiff having purchased stock in the company. *See* OB at 13 (quoting *Maclary*, 109 A.2d at 833-34).

Defendants' effort to distinguish *In re Nine Systems Corp. Stockholder Litigation*, 2013 WL 771897 (Del. Ch. Feb. 28, 2013), is similarly unavailing. *Nine Systems* unquestionably focused on when the terms of the transaction had become

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is alleged, 'it is not the merger itself that constitutes the wrongful act of which plaintiff complains, but rather it is the fixing of the terms of the transaction which will be finalized by the consummation of the merger which provides the foundation for the suit.'" (AB at 22 n.4).

legally binding to the extent the Court was willing to look past the date when, based upon the statute, a reverse stock split transaction had been legally completed because subsequent events called into question whether all the terms of that reverse stock split had truly fully and finally been set on that date.

B. In Any Event, Defendants Have Failed to Demonstrate That the Terms of the Insider Transactions Became Definite Prior to the IPO

Even if Defendants were correct and the key moment in time for determining standing was when the terms of the Insider Transactions became "definite" (rather than legally obligatory) – which finds no support in *Beck* or the body of Delaware precedent interpreting Section 327 – Plaintiffs should still prevail because it is at least reasonably conceivable (if not absolutely certain) that the terms of the Insider Transactions were ***not*** definite at the time of the IPO. Rather, the Prospectus explicitly stated that the Board's "intended" use of the IPO proceeds was "***subject to change***[,]" that the Board retained "***broad discretion***" in the use of those proceeds, and that SDC's actions "***could differ materially***" from the intentions expressed therein. Prospectus at 13, 16-17, 55, 58-59, 64-65, 152-53 (A162-163, A201, A204, A207, A210-211, A298-299). Simply stated, anything that "can differ materially" because it is "subject to change" and to "broad discretion" is ***not definite***.

"Definite" is defined as "free of all ambiguity, uncertainty, or obscurity[.]" *See* https://www.merriam-webster.com/dictionary/definite; *see also Eagle Force*

Holdings, LLC v. Campbell, 187 A.3d 1209, 1213 (Del. 2018) (holding that the agreement was not sufficiently definite due to a lack of agreement on certain material terms, primarily the consideration to be exchanged). It is impossible to reasonably conclude that the terms of the Insider Transactions, which the Prospectus explicitly stated "could differ materially[,]" were merely "intended[,]" and were "subject to change" and to the Board's "broad discretion[,]" were "free of all ambiguity or uncertainty[.]" Indeed, when something is subject to change or to discretion, it is obviously ambiguous and uncertain. That is precisely what "subject to change" means, and that is precisely what "broad discretion" permits.

Moreover, the specific use of the word "intends" concerning the Insider Transactions in the Prospectus contrasts significantly with other language therein. Specifically, the Prospectus described the purchase of the Blocker shares in far more definitive terms, stating that the Company "will" purchase the Blocker shares. *See* A159; *see also* ¶¶31-39 (A25-29) (discussing the permissive and mandatory language used by the Prospectus). This key difference in language between "intends" and "will" makes it appear very likely (and, at minimum, reasonably conceivable) that a binding contract covered the purchase of the Blocker shares but did not exist with respect to the purchase of the LLC Units. *See* ¶43 (A50); Prospectus at 17-18 (A165-66).

The Court of Chancery also sought to avoid the implications of the Prospectus plainly referring to the Insider Transactions as being finalized by finding that the only contingency relating to completing the Insider Transactions was that they were "dependent on raising capital[.]" Opinion at 31. Plaintiffs respectfully submit, however, this finding is at odds with the well-pled complaint and the language of the Prospectus and, at best, reflects a generous (and impermissible) drawing of inferences in Defendants' favor contrary to the requirements of Rule 12(b)(6).

Rather, there are no record facts showing that the only contingency to proceeding with the Insider Transactions on the terms of paying $21.85 for each LLC Unit was raising the necessary capital in the IPO. No such statement is made in the Prospectus which, instead, as previously discussed, only expresses an ***intent*** to proceed with the Insider Transactions at a price that, as explicitly stated in the Prospectus, was "subject to change" and "broad discretion". *E.g.*, ¶35 (A27-28); Prospectus at 58-59 (A206-07).

Therefore, and as noted above, the actions of the Board, as fiduciaries of SDC, were subject to change absent a legally binding agreement. *See Presidio, supra*. Here, since there was no such binding agreement – and neither Defendants nor the Chancery Court contend otherwise – the terms of the Insider Transactions could not have been definite until they occurred at which time SDC fiduciaries were obligated to exercise their fiduciary duties to ensure the fairness of the terms of the Insider

Transactions based upon the information in their possession at that time. *Presidio*, 251 A.3d at 271.

II. PUBLIC POLICY CONSIDERATIONS ALSO FAVOR REVERSING THE COURT OF CHANCERY'S DECISION

Defendants initially contend that this Court may not address issues of public policy in resolving this Appeal because Plaintiffs failed to raise the argument in opposing Defendants' motion to dismiss. However, in making that argument, Defendants ignore that the Chancery Court premised its decision, in part, on policy grounds when it held that its holding "does not mean that Plaintiffs are without recourse." Opinion at 33. In addition, Defendants ignore that they opened the door to policy issues by contending for the first time[3] during oral argument before Chancery Court that Plaintiffs had engaged in claims purchasing. *See* Tr. at 9, 21, 23, 31, 32 (A913, A925, A927, A935-36). Plaintiffs responded to that contention in their argument before Chancery Court. *See* Tr. at 38-39 (A942-43). Accordingly, the question was also fairly presented to the Chancery Court. *See, e.g.*, *Watkins v. Beatrice Companies, Inc.*, 560 A.2d 1016, 1020 (Del. 1989) ("In determining whether an issue has been fairly presented to the trial court, this Court has held that the mere raising of the issue is sufficient to preserve it for appeal…. In a case where the trial court noted in passing that it finds an argument unpersuasive, such issue was

[3] Defendants raised the public policy arguments for the first time at oral argument before the Court of Chancery after failing to raise such arguments in their motion to dismiss.

deemed to have been fairly raised for the purpose of Supreme Court Rule 8.") (citations omitted).

On the merits, the policy purpose of Section 327 is to prevent people from purchasing stock with the express aim of bringing claims, *i.e.*, claims purchasing. *See, e.g.*, *In re Beatrice Companies, Inc. Litig.*, 522 A.2d 865 (Del. 1987) (collecting cases supporting the proposition that the "purpose of [Section 327] is to prevent potential plaintiffs from purchasing stock in order to maintain a derivative action attacking a transaction which occurred prior to the purchase of the stock."). Plaintiffs, as previously explained did not and, indeed, could not have known, that Defendants would be breaching their fiduciary duties through the Insider Transactions. OB at 23. Plaintiffs, notwithstanding the Prospectus disclosing an "intent" to engage in the Insider Transactions did not know, nor could they have known, that by the time of the Insider Transactions the price of SDC common stock would decline from the $23.00 offering price to between $17.81 and $19.00 only days later when the Insider Transactions took place. ¶49 (A52).

Defendants' stated concern about opening the floodgates to claim buying has no merit. The facts in this case are in many ways *sui generis* with the Company having discretion whether and, if so, on what terms to proceed with the Insider Transactions combined with the highly unusual precipitous drop in the price of the common stock so soon after the offering which so obviously required Defendants to

exercise their unremitting fiduciary duties in declining to proceed with the Insider Transactions.

In addition, any analysis based upon "intentions" invites mischief, because determining which "intentions" can qualify as a "transaction" for Section 327 purposes is fraught with subjective interpretations. For this reason, allowing the Opinion below to stand would defeat key policy goals of Delaware law: certainty, predictability, and uniformity. *See, e.g., Salzberg v. Sciabacucchi*, 227 A.3d 102, 137 (Del. 2020) (citations and footnotes omitted); *Broz v. Cellular Info. Sys., Inc.*, 673 A.2d 148, 159 (Del. 1996) (noting that "certainty and predictability are values to be promoted in our corporation law."). This point is emphatically demonstrated by the Court of Chancery's Opinion here, which impermissibly drew inferences in Defendants' favor contrary to the requirements of Rule 12(b)(6). *See* OB at 19-23.

CONCLUSION

For the reasons stated above, Plaintiffs respectfully submit that the Court of Chancery's judgment dismissing this action should be reversed and this action remanded for further proceedings.

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