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IN THE SUPREME COURT OF THE STATE OF DELAWARE

IN RE ZIMMER BIOMET HOLDINGS, INC. DERIVATIVE LITIGATION	No. 304, 2021 Court Below: Court of Chancery of the State of Delaware, Consolidated C.A. No. 2019-0455-LWW

APPELLANTS' CORRECTED OPENING BRIEF

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NATURE OF PROCEEDINGS

This is an appeal from the dismissal on demand futility grounds of a stockholder derivative action on behalf of nominal defendant Zimmer Biomet Holdings, Inc. ("Zimmer" or "the Company"), a Delaware corporation headquartered in Warsaw, Indiana that makes medical devices. Zimmer was created through a nearly $15 billion merger between Zimmer Holdings, Inc. and another medical device company located in Warsaw, Biomet, Inc. ("Biomet"), that closed on June 24, 2015 (the "Merger"). The Merger was touted as a key strategic transaction that could help strengthen Zimmer's medical device businesses, diversify its portfolio, and generate cross-selling opportunities to accelerate organic revenue growth, a key financial metric.

On November 22, 2016, following a nearly two-month "for cause" inspection of a Zimmer manufacturing facility in Warsaw (the "North Campus"), the U.S. Food & Drug Administration ("FDA") issued a scathing fifty-seven page inspection report detailing a broad range of quality control violations. ¶¶116-119; A819-876.[1] Those violations so endangered public safety that on September 29, 2016, in the middle of the inspection, after the FDA issued five separate holds on Zimmer's products, the Company shut down North Campus

[1] ¶_ refers to the Verified Consolidated Stockholder Derivative Complaint (A62).

production to prevent the sale of adulterated medical products. ¶¶114-115. The shutdown lasted approximately one month with product holds continuing into Zimmer's fourth quarter, severely impacting financial results due to lost shipments and at least $300 million in unplanned remediation costs.

In a December 21, 2016 letter to the FDA regarding the North Campus inspection, Zimmer admitted it already knew about wide-ranging "systemic" problems at the facility for months before the inspection, as it had conducted three internal compliance audits of North Campus beginning in early 2016. Those audits uncovered dozens of FDA compliance deficiencies, many of which were self-described as either critical or major violations.

Non-public materials from Zimmer's Board of Directors (the "Board"), obtained by Plaintiffs pursuant to 8 *Del. C*. § 220, confirm that Zimmer's directors had *actual contemporaneous knowledge* of these North Campus internal compliance results no later than May 3, 2016 and that they were fully informed about systemic problems at *multiple other* manufacturing facilities throughout 2015 and 2016. However, rather than disclose these adverse conditions and the massive remediation expenses necessary to address them, Zimmer's management and the Board *concealed* these facts from stockholders in an attempt to falsely project Zimmer's continued post-Merger success.

While these problems remained secret, the Board approved large and unusual secondary stock offerings by four groups of private equity funds affiliated with Kohlberg Kravis Roberts & Co. L.P. ("KKR"), The Blackstone Group L.P. ("Blackstone"), TPG Global, LLC ("TPG"), and Goldman Sachs Capital Partners ("Goldman") (collectively "PE Defendants")—the former owners of Biomet who received Zimmer shares in the Merger. As Zimmer's stock price soared from approximately $91 per share to over $130 in response to positive, post-Merger statements by Zimmer and its fiduciaries (¶14), the PE Defendants promptly sold all their stock.

The offerings were conducted in February, June, and August 2016 pursuant to offering documents approved, authorized, and signed by Zimmer's directors and pursuant to which the PE Defendants sold 100% of their holdings for over *$3.3 billion*—exiting their investments in just six months as Zimmer's compliance problems remained hidden. After these sales, as the truth about the Company's non-compliance with federal regulations hit the market in late 2016, the stock price plummeted, closing at a low of approximately $98 per share on November 11, 2016, down from a high of over $130 just a few weeks earlier. ¶25.

Significantly, pursuant to a 2014 Stockholders Agreement with the Company, the PE Defendants placed two directors on the Zimmer Board to represent their interests and obtain confidential information. These directors,

defendants Michael W. Michelson and Jeffrey K. Rhodes, were senior members of KKR and TPG, respectively, but served as the director designees for *all* the PE Defendants. These designees were specifically authorized under the agreement to share material non-public information with the PE Defendants regarding Zimmer's compliance problems. The PE Defendants, armed with this material non-public information, sold all their Zimmer shares before the truth was revealed.

Defendants include current and former officers and directors of Zimmer. Under established Delaware precedents, Plaintiffs allege claims for breach of fiduciary duty arising out of their failure to disclose the truth about Zimmer when communicating with shareholders. Plaintiffs further allege these breaches by the Board furthered the unlawful sale of the PE Defendants' stock at inflated prices, including by defendants Michelson and Rhodes through the KKR and TPG funds they personally represented.

On demand futility, Plaintiffs argued that eight directors (the "Director Defendants"), constituting a majority of the Zimmer Board (eight of eleven), faced a substantial likelihood of liability for violating the fiduciary duty of disclosure, and for knowingly facilitating unlawful stock sales of Michelson and Rhodes, through the PE Defendants, excusing demand under then governing precedents. *Rales v. Blasband*, 634 A.2d 927 (Del. 1993), now superseded by *United Food and Com.*

Workers Union and Participating Food Indus. Emps. Tri-State Pension Fund v. Zuckerberg, et al., 2021 WL 4344361 (Del. Sept. 23, 2021). The Court granted Defendants' motions to dismiss pursuant to Del. Ch. Ct. Rule 23.1 ("Rule 23.1"), improperly extending pleading inferences in favor of Defendants, and not exclusively in favor of Plaintiffs, as required.

For example, the Court rejected allegations that the Board was in possession of material non-public information that it was obligated to disclose, notwithstanding Plaintiffs' citation to Board materials showing the Board was informed in 2015 and 2016 of systemic compliance issues across Zimmer's manufacturing facilities, including results from the North Campus audits. The Court rejected allegations that such information was material on the unfounded basis that its future impact on Zimmer's "financial performance" was unknown to the Board. The Court rejected allegations that the Director Defendants were responsible for false SEC offering documents they approved for the insider sales. And the Court rejected the inference that insiders profited by sharing adverse information with the PE Defendants, notwithstanding their senior positions with two of the funds and the suspicious timing and coordinated nature of the sales.

The Court's reasoning conflicts with Delaware law. The Court drew all critical inferences in favor of Defendants, producing an anomalous result which

sets impossible pleading burdens for stockholder plaintiffs. Notably, the Court's analysis directly contradicts the treatment of the same core facts in *Shah v. Zimmer Biomet Holdings, Inc.*, 348 F. Supp. 3d 821 (N.D. Ind. 2018), a federal securities class action against Zimmer filed by defrauded stock purchasers (the "Class Action"). Applying heightened federal pleading standards for securities fraud, the federal court held that beginning no later than June 7, 2016, "there was a duty to disclose" the North Campus audit results "and their likely consequences," including in the same offering documents signed by the directors. That court described North Campus as "the proverbial ticking time bomb" and noted that "it is not a stretch to think that absent full-remediation a product hold was inevitable." *Shah,* 348 F. Supp. 3d at 827, 840. Despite stronger more particularized allegations pled here, based on Board-level documentary evidence that was not available to plaintiffs in the Class Action, the Court failed to extend the same inferences.

The Court's reasoning was erroneous and prevented meritorious claims from proceeding into discovery. The Opinion should be reversed.

SUMMARY OF ARGUMENT

1. Plaintiffs alleged with particularity that demand was excused because a Board majority (eight of eleven) faced a substantial likelihood of liability for non-exculpated breaches of fiduciary duty. The Director Defendants made false statements to stockholders that omitted disclosure of systemic FDA compliance violations at Zimmer's manufacturing facilities. The Court erroneously held the omitted information was not material and failed to apply Delaware law holding directors accountable for their misstatements.

2. Plaintiffs alleged with particularity that demand was excused because a Board majority (eight of eleven) faced a substantial likelihood of liability for enabling illegal insider trading by private equity funds affiliated with two Zimmer directors. The Court's reasoning immunized those two directors from liability for insider trading under *Brophy v. Cities Serv. Co.*, 70 A.2d 5 (Del. Ch. 1949) and shielded other directors who enabled these breaches of the duty of loyalty.

STATEMENT OF FACTS

A. The Merger.

Zimmer manufactures and sells medical equipment. ¶2. Zimmer was created by the June 2015 Merger with privately-held Biomet. ¶3. Prior to the Merger, Biomet was owned by the PE Defendants. ¶¶4, 48-63. Upon completion of the Merger, Biomet stockholders owned approximately 15% of the new company. ¶4. Stockholders were told that combining the two companies would generate millions of dollars in synergies through leveraging the companies' complementary sales channels to generate cross-selling opportunities. ¶6.

After the Merger closed on June 24, 2015, both companies' primary manufacturing facilities in Warsaw, Indiana remained open, tasked with manufacturing legacy Zimmer's and Biomet's respective products. ¶¶9, 12, 126. These facilities included the legacy Zimmer "West Campus" facility and the Biomet "North Campus" facility, the latter responsible for manufacturing crucial products that were necessary to achieve the revenue growth and cross-selling synergies touted in connection with the Merger. *Id.*

Because product quality and safety were critical to Zimmer's reputation and its ability to sell products, compliance with FDA manufacturing regulations was "mission critical" to Zimmer's operations. ¶8. Accordingly, Zimmer's Board was

tasked with monitoring the "risk-related issues pertaining to laws and regulations enforced by the [FDA]." *Id.* Each Director Defendant received "detailed regular reports […] that include[d] discussions of the risks and exposures," and were "routinely informed of developments that could affect [Zimmer's] risk profile." *Id.*

B. Board Materials Confirm Its Knowledge of Systemic Deficiencies.

Before and after the Merger, legacy Zimmer's and Biomet's manufacturing facilities were experiencing serious FDA compliance problems. ¶¶ 9-13, 105-112. Problems at Biomet's North Campus became apparent immediately after the Merger. This is confirmed by Robin Barney ("Barney"), Zimmer's Senior VP of Global Operations and Logistics, who filed a wrongful termination lawsuit against Zimmer following the September 2016 North Campus FDA inspection. In an email dated October 28, 2016, while the inspection was ongoing, Barney wrote about systemic problems at the Biomet facilities, including North Campus:

> It is clear that the Biomet quality systems and therefore process controls have lagged current best practices.
>
> ***
>
> Biomet systems and processes and their maturity, or lack thereof, in comparison to Zimmer, became clear to senior management ***soon after close*** when the extent and scope of Trident was learned. These gaps were further understood and documented via several audits over the last 12 months.

(Emphasis added.) *See Barney v. Zimmer Biomet Holdings, Inc.*, Case No. 3:17-cv-00616 (N.D. Ind. 2017) (Dkt. No. 131 p.8); A878.

Barney's concerns are confirmed by the Board record. Zimmer conducted a series of audits at many of its manufacturing facilities, including of serious non-compliance with federal regulations at North Campus. ¶¶108-110, 120-131, 137-138, 159-161; A544-548, A563-A578, A606-609, A629-630, A658-660. Further confirming the scope of the problems were letters the Company sent to the FDA in December 2015 and again in December 2016 in which Zimmer *admitted* these systemic unremediated quality problems. ¶108.

By February 2016, when the PE Defendants began selling their shares and Zimmer issued its 2015 Form 10-K (A879), the Director Defendants were in possession of at least the following material adverse non-public information:

- Due to ongoing quality problems across Zimmer's facilities, including problems identified at North Campus shortly after the Merger, Zimmer commenced a sweeping internal audit of North Campus and other facilities (¶¶9-13, 105-111, 120-157, 159-161; A536-553, A563-A578, A595-609, A618-630, A788-790);
- Zimmer's West Campus facility had repeatedly failed to implement adequate FDA compliance protocols and in November 2015 was hit with a Form 483

with ten negative observations, nine of which were repeats going back as far as 2011 (¶¶105-110, 143; A597, A602-604, A620, A624-625);[2]

- In a letter to the FDA dated December 21, 2015 concerning the West Campus, Zimmer acknowledged the need to address "systemic issues" (¶108);
- In November 2015, Zimmer's Puerto Rico facility received a Form 483 with four negative observations, three of which were repeats which Zimmer advised the FDA would not be fully remedied before June 2017 (¶¶109-110, 143-144; A597, A600-601, A620, A623);
- The West Campus and Puerto Rico Form 483 observations spawned a company-wide internal audit beginning in late 2015 (¶¶154; A629);
- As of January 2016, Zimmer was confronting compliance violations related to eight separate FDA inspections including an FDA Warning Letter (¶111-112; A620);
- As of September 2015, Zimmer's Project Trident remediation program, which included the West Campus and Puerto Rico facilities (among others), had cost the Company nearly *$250 million*—and yet still could not prevent the

[2] A Form 483 inspection report reflects significant deviations from applicable standards and may lead to serious sanctions. ¶¶91-104.

disastrous FDA inspection results at those facilities in November 2015 (¶¶128, 136-139; A544-548, A574-578);

- North Campus had at least two outstanding FDA findings that went unremediated since its 2014 biennial inspection, and third-party auditors hired in October 2014 confirmed the facility badly needed remediation, finding eleven major and seven minor deficiencies requiring ten "action records," *six of which remained unremediated as of the July 2015 Board meeting* (¶131; A553, A809-814); and
- North Campus was due at any time for its 2016 biennial FDA inspection which was all but certain to uncover the same, repeat findings (¶¶93, 175).

The Director Defendants' knowledge of Zimmer's systemic quality problems only grew from there. In early 2016, Zimmer uncovered dozens of manufacturing deficiencies considered either "critical" or "major." ¶¶159-161; A658. As the Company later admitted to the FDA, three early-2016 audits pertaining to North Campus were particularly egregious. *Id.*; A788-790.

These audits identified major compliance problems related to design controls, sterile packaging, complaint handling, nonconforming material, and [corrective and preventative actions ("CAPAs")]. ¶122; A788-790. The last audit was completed by June 2016, and the major findings had been presented to the Board no later than May

2016—a full month before the PE Defendants' June 2016 offering. ¶¶123-125, 147& n.15, 158-164; A658, A788-790.

In the first North Campus audit report (the "Corporate Complaints Process Audit"), dated March 31, 2016, Zimmer identified six major and two minor deficiencies as reported to the Board. ¶¶124-125, 159-161; A658, A789. The second audit report (the "Corporate Design Controls Audit), dated April 13, 2016, identified an additional four critical and fifteen major deficiencies. *Id.* In the third audit (the "Corporate General QMS Audit"), dated June 7, 2016,[3] Zimmer identified fifteen major and five minor deficiencies in the North Campus quality management system. *Id.* In total, from just the three audits alone, the Board possessed unequivocal knowledge of four "critical" and thirty-six "major" compliance violations at a single facility, which it learned about no later than May 3, 2016. *Id.*

Importantly, the North Campus audits disclosed in Zimmer's December 21, 2016 letter to the FDA were the same ones presented to the Board on May 3, 2016. *Id*. In Zimmer's December 2016 letter to the FDA, Zimmer identified the audits by their names and dates: (1) "Corporate Complaints Process Audit," dated March 31, 2016; (2) "Corporate Design Controls Audit," dated April 13, 2016; and (3)

[3] Though the final report for this audit was published in June 2016, it was presented to the Board on May 3, 2016 with the report then "in draft." ¶¶159-161; A658.

"Corporate General QMS Audit," dated June 7, 2016. ¶¶124-125; A789. This information closely matches three of the internal audits presented to the Board on May 3, 2016: (1) "EtQ Complaints Enterprise Audit," dated March 31, 2016; (2) "Biomet Warsaw North (Design & Package)," dated April 13, 2016; and (3) "Corporate Audit Process," with the report then "in draft." ¶¶159-161; A658.

The Company used slightly different nomenclature internally than it did with the FDA, but the audits are the same upon close inspection. The titles of the first two audits are similar, emphasizing the words "complaints" and "design," respectively, and no other audits on the slide were dated March 31 or April 13. *Cf.* A658 and A789. As to the third audit, no other audits on the slide were dated after mid-April, and no other audits on the slide match the same number and severity of findings (fifteen major and five minor). *Id.* Furthermore, Zimmer disclosed to the FDA who conducted each audit. The first audit was conducted by Zimmer's Corporate Audit Team; the second by Parexel and King & Spalding; and the third by Dohmen Life Science Services. A789. The corresponding "entity" information shared with the Board was: (1) "ZBQC"; (2) "Parexel" and "K&S"; and (3) "DLSS." A658.

By the time of the June and August 2016 offerings, the Director Defendants possessed the following *additional* material adverse non-public information concerning Zimmer's systemic quality problems:

- Zimmer's internal audits detailed "systemic network issues" similar to those uncovered during FDA inspections (¶¶108-112, 159-161; A658-660);
- North Campus was a serious problem for Zimmer with three separate audits uncovering four critical, thirty-six major, and seven minor findings, presented to the Board at latest on May 3, 2016 (¶¶124-125, 159-161; A658, A789);
- Remediation of North Campus would be a long and costly process, initially forecasted to stretch into 2017 and later extended to the end of 2018 (¶¶160-161, 166-167; A660, A695);
- A multi-year remediation project to bring Zimmer's facilities into compliance would cost hundreds of millions of dollars (*Id.*; ¶¶211-212); and
- Zimmer could not satisfy demand for its products or accelerate organic revenue growth—key promises made to stockholders—while simultaneously remediating these extensive quality problems (¶266, 269).

Thus, from shortly after the Merger through September 2016, when the North Campus FDA investigation began, the Director Defendants had actual knowledge of extensive FDA compliance problems across Zimmer's facilities, including the critical North Campus, and understood the inevitable consequences of them. ¶¶266, 299-310.

C. The North Campus FDA Inspection Confirmed What the Board Already Knew About Systemic Quality Problems There.

On September 12, 2016, the FDA commenced a "for cause" inspection of North Campus. ¶¶18, 113, 175-176; A719. Consistent with the Company's internal audits, the FDA found serious violations at the facility, including repeats from a prior inspection. ¶¶18-20, 113-120, 175-176, 185-186; A759-763, A788-798, A819-876. Within days, the FDA imposed constraints on North Campus including shipment holds, quarantined products, halting of cleaning operations, and other containment actions. *Id*. Approximately three weeks later, Zimmer shut down North Campus to prevent the sale of adulterated products. *Id*.

On November 22, 2016, the FDA issued a Form 483 describing *fourteen* violations involving health, safety, and manufacturing issues at North Campus. ¶¶116-119; A819-876. Two violations were identical to ones found during a previous 2014 inspection. *Id*. Other violations were similar to ones discovered at other facilities, including West Campus. *Cf.* ¶¶106, 138. Repeat violations are significant because they can serve as a basis for more severe enforcement actions. ¶¶102-104.

That the North Campus FDA inspection was "for cause" is important. Though the facility was due for a regular biennial inspection, the FDA was responding to *actual complaints* about substandard products manufactured at North Campus. ¶175;

A719. Zimmer's extensive quality problems went to core operations and threatened to endanger patients and diminish Zimmer's reputation with doctors, risking material impacts to its business. Due to reports it received concerning previous audit results, discussed above, the Board knew about these abject conditions and knew exactly the results to expect from an FDA inspection—an inspection they knew was imminent.

Zimmer's sophisticated Board also knew the FDA's standard enforcement actions and thus fully grasped exactly what kinds of adverse consequences would follow from Zimmer's years-long FDA compliance failures. ¶¶102-104, 162; A655.

Despite the shutdown of Zimmer's flagship North Campus and hundreds of millions of dollars in lost sales, the Director Defendants still concealed the truth. On October 31, 2016, the Company issued a materially misleading press release describing its third-quarter 2016 results. ¶¶217-219. This announcement was pre-cleared by members of the Audit Committee in an October 24, 2016 meeting during which a discussion ensued about the then-ongoing FDA inspection. ¶¶181-183; A800-801. The Audit Committee "expressed no objections to the contents of the draft earnings release." *Id*.

Zimmer reported lowered revenue guidance and lowered expected organic revenue growth for Q4 2016. ¶217. The release omitted mention of the North Campus shutdown and obfuscated the Company's poor financial performance with

vague language about "variable" sales caused by "unanticipated supply constraints related to our transitioning supply chain infrastructure." ¶218.

The deception held up for approximately a week until, on November 8, 2016, a securities analyst reported partial information about the in-progress North Campus inspection, including the manufacturing shutdown and product holds. ¶¶220-223.[4] Combined, the October 31 and November 8 disclosures wiped out approximately $4 billion of market value in mere days. *Id.*

The Company later disclosed additional supply shortages and production delays, and that ongoing remediation would continue to cause shortages and severe financial consequences into 2017 and beyond. ¶237. By May 2017, Zimmer determined internally that remediation of North Campus alone would cost upwards of *$300 million* and extend through 2018. ¶190.

D. Defendants Omitted Material Information in SEC Filings.

Zimmer's February, June, and August 2016 offering materials and other SEC filings, including those made a part thereof or incorporated by reference, omitted material information concerning the Company's systemic quality and compliance problems. ¶¶259-266; A487-533, A879-1104. The Board had knowledge of these undisclosed adverse facts at the time the disputed statements were made:

[4] The full extent of the problems remained hidden until December. ¶¶228-230.

- Eight Director Defendants attended Board meetings held during 2015 and 2016 where they discussed seven critical and sixty-two major quality system violations uncovered in internal audits that began in 2013, including of North Campus, in addition to systemic problems impacting Zimmer's entire network of facilities (¶¶126-164, 306-309; A534-677);
- Eight Director Defendants approved the $3.3 billion in stock sales by the PE Defendants, facilitated by misleading offering documents they approved and omitted material adverse non-public information and were approved by the same eight directors (¶¶35-42, 251, 306, 313-318; A487-533, A964-1104);
- Eight Director Defendants reviewed, signed, approved, and issued Zimmer's misleading 2015 Form 10-K (¶¶35-42, 306; A879-963); and
- Members of the Audit Committee reviewed and approved Form 10-Qs and financial press releases that concealed the systemic manufacturing violations (¶¶35, 36, 38, 40, 181-183, 213-215, 221, 306).

Thus, a majority of the Board (eight of eleven) faces a substantial likelihood of personal liability for breaching their duty of loyalty and are personally interested in the subject matter of this action. ¶¶35-42, 306-310.

E. The Stockholders Agreement Enabled the PE Defendants to Sell Their Stock Only With Board Approval and Participation.

A majority of the Board also facilitated insider trading by Michelson, Rhodes, and the PE Defendants. Pursuant to the Stockholders Agreement between the PE Defendants and Zimmer, the PE Defendants were authorized to and did designate two members of the Board: Michelson and Rhodes. ¶¶5, 85-90, 252-258; A431-437. Michelson and Rhodes represented the interests of *all* the PE Defendants and shared with them Zimmer's confidential business and financial information. *Id*.

Section 1.6 of the Stockholders Agreement granted "Information Rights" to the PE Defendants to non-public information from multiple sources inside the Company. ¶¶86, 255-257; A435-437. In addition, in the event the PE Defendants exercised their registration rights, they would be given "a reasonable opportunity to participate in the preparation of such registration statement and each prospectus included therein and such other opportunities to conduct a reasonable investigation . . . , including reasonable access to the Company's books and records, officers, accountants and other advisors." A452.

Defendants Michelson and Rhodes had long served as Biomet directors and brought with them extensive knowledge of quality problems at Biomet, including North Campus. ¶¶42, 45, 87, 254. More than anyone on the Board, they were keenly aware of the "ticking time bomb" nature of these problems, and they used that

knowledge—including the results of the Company's internal audits—to tip the PE Defendants before it inevitably became public. ¶¶88-90, 252-258, 270.

As their designees, Michelson and Rhodes acted as agents of the PE Defendants, and their knowledge may be imputed to the funds. ¶¶88-89, 252. The PE Defendants opportunistically exercised their rights and collectively sold over $3.3 billion of Zimmer stock in three offerings. ¶¶14-15, 259-265. These sales were motivated in whole or in part by material adverse non-public information shared with the PE Defendants by Michelson and Rhodes. ¶¶134, 141, 152, 157, 164, 171, 255-258; A534-677.

In total, KKR Biomet sold over $919 million in Zimmer stock, the Blackstone Defendants over $705 million, the TPG Defendants over $898 million, and the Goldman Defendants over $779 million. ¶¶48-63; 259-265.

F. The Class Action.

In the Class Action, based on the same core facts, U.S. District Judge Philip P. Simon sustained most of the plaintiffs' claims under rigorous federal pleading standards for securities fraud, holding that "[Plaintiff's] allegations paint a convincing story that, if proven true, would constitute fraud in violation of the securities laws." *Shah*, 348 F. Supp. 3d at 826. Judge Simon sustained allegations

that the Director Defendants issued false and misleading statements in the June and August 2016 secondary offering materials.

Importantly, in this case, Plaintiffs obtained Board-level records which the Class Action plaintiffs did not possess, and which confirm contemporaneous Board knowledge of systemic, undisclosed compliance problems plaguing the Company. These records provide the necessary link between Zimmer's Board and the false and misleading statements in its public filings (as described by Judge Simon)—a connection that the Court here ignored. Judge Simon made the following observations in finding actionable securities violations:

- "These systemic issues were not speculation, but were confirmed through the company's own audits of North Campus, concealed from the investing public, and all the while, Zimmer continued to make its optimistic statements regarding its operations and revenues." *Id.* at 839.
- "Even a few days of quarantine [in the final days of the quarter] could have an adverse material effect on ZBH's bottom line. And given that the issues at the North Campus were alleged to be known and systemic in nature, it is not a stretch to think that absent full-remediation a product hold was inevitable." *Id.* at 840.
- Zimmer "was alleged to have known the specific facts relating to the quality

system issues at its major North Campus plant which would inevitably be a regulatory disaster." *Id.* at 842.

Notably, the allegations supporting Plaintiffs' disclosure claims here are substantially stronger than those Judge Simon found sufficient.

ARGUMENT

I. THE DIRECTOR DEFENDANTS FACE A SUBSTANTIAL LIKELIHOOD OF LIABILITY FOR BREACHING THE FIDUCIARY DUTY OF DISCLOSURE, EXCUSING DEMAND.

A. Question Presented.

Whether pre-suit demand is excused under *United Food and Commercial Workers Union and Participating Food Industry Employers Tri-State Pension Fund v. Zuckerberg, et al.*, 2021 WL 4344361 (Del. Sept. 23, 2021) ("*Zuckerberg*"), where a majority of the directors face a substantial likelihood of liability for breaching the fiduciary duty of loyalty. This issue was preserved for appeal (A254-269, 379-393).

B. Scope of Review.

The Court's review of decisions under Rule 23.1 is *de novo*. *Brehm v. Eisner*, 746 A.2d 244, 253-54 (Del. 2000).

C. Merits of Argument.

In *Zuckerberg*, this Court modified the analysis for evaluating allegations of demand futility in a derivative action. As this Court noted, "[t]he purpose of the demand-futility analysis is to assess whether the board should be deprived of its decision-making authority because there is reason to doubt that the directors would be able to bring their impartial business judgment to bear on a litigation demand." *Zuckerberg*, 2021 WL 4344361, at *16. The "refined test 'refocuses the inquiry on the decision regarding the litigation demand.'" *Id.* The new approach focuses on the

central concern that the directors on the demand board "cannot be considered proper persons to conduct litigation on behalf of the corporation" when they "are under an influence which sterilizes their discretion." *Id.* The demand futility test now requires the following "questions" to be asked:

> (i) whether the director received a material personal benefit from the alleged misconduct that is the subject of the litigation demand; (ii) whether the director faces a substantial likelihood of liability on any of the claims that would be the subject of the litigation demand; and (iii) whether the director lacks independence from someone who received a material personal benefit from the alleged misconduct that would be the subject of the litigation demand or who would face a substantial likelihood of liability on any of the claims that are the subject of the litigation demand. If the answer to any of the questions is "yes" for at least half of the members of the demand board, then demand is excused as futile. *Id.* at 17.

This Court further observed that the modified test is "consistent" with long-time precedent including *Rales*, the standard the Court below applied for demand futility. *Id.* at *2. If "the directors face a 'substantial likelihood' of personal liability, their ability to consider a demand impartially is compromised under *Rales,* excusing demand." Op. 26. As such, while the Court below may have identified the proper inquiry on demand futility, it plainly erred in its application. Notable throughout the Opinion is the Court's failure at every step to extend reasonable inferences solely in favor of Plaintiffs. Under Rule 23.1, "Plaintiffs are entitled to all reasonable factual inferences that logically flow from the

particularized facts alleged." *Brehm*, 746 A.2d at 255. Plaintiffs are "not required to plead evidence" and the Court must draw all reasonable inferences in Plaintiffs' favor. *Id.* This is true even if the Court believes an inference in favor of defendants is more likely. *La. Mun. Police Emps.' Ret. Sys. v. Pyott*, 46 A.3d 313, 351 (Del. Ch. 2012), *rev'd on other grounds*, 74 A.3d 612 (Del. 2013).

The particularity requirement under Rule 23.1 "does not entitle a trial court to discredit or weigh the persuasiveness of well-pled allegations." *In re China Agritech Inc.,* 2013 WL 2181514, at *4 (Del Ch. May 21, 2013). And "it is important that the trial court consider all the particularized facts pled by plaintiffs . . . in their totality and not in isolation from each other." *Del. Cnty. Empls.' Ret. Fund v. Sanchez*, 124 A.3d 1017, 1019 (Del. 2014). A derivative complaint should not be dismissed at the pleading stage if any set of facts can be discerned showing demand futility. *Grobow v. Perot*, 539 A.2d 180, 188 (Del. 1988).

The Court's analysis also cannot be reconciled with the threshold question of whether a *reasonable doubt* has been alleged as to interestedness. *Brehm*, 746 A.2d at 268. "Reasonable doubt" means there is a "doubt based upon reason and common sense which . . . intelligent, reasonable and impartial people may honestly entertain." *Mills v. State*, 732 A.2d 845, 851 (Del. 1999). "Reasonable doubt" is "akin to the concept that the stockholder has a reasonable belief that the board lacks

independence or that the transaction was not protected by the business judgment rule"—an "objective test." *In re Ezcorp Inc. Consulting Agreement Deriv. Litig*., 2016 WL 301245, at *108 (Del. Ch. Jan. 25, 2016). Plaintiffs need not win the case on the pleadings, but only make a "threshold showing, through the allegation of particularized facts, that their claims have some merit." *Rales*, 634 A.2d at 934; *Grobow*, 539 A.2d at 186 ("Reasonable doubt must be decided by the trial court on a case-by-case basis employing an objective analysis").

Here, Plaintiffs established a detailed chronology of what the Director Defendants knew and when they knew it, based on a careful examination and presentation of internal records showing that the Board was fully aware of material undisclosed adverse facts that ultimately caused substantial stockholder losses, and that they enabled massive insider trading. But as explained below, the Court resolved factual issues in favor of Defendants rather than Plaintiffs and set an untenable bar for reasonable doubt that far exceeds what is required under Delaware law.

1. Demand Is Excused Because the Directors Omitted Material Information in Statements to Shareholders.

"[D]irectors have the statutory power and responsibility to direct and oversee the business and affairs of the corporation." *Pfeiffer v. Toll,* 989 A.2d 683, 693 (Del. Ch. 2010), *abrogated on other grounds by Kahn v. Kolberg Kravis Roberts & Co.,* 23 A.3d 831 (Del. 2011); 8 Del. C. § 141(a) ("The business and affairs of every

corporation . . . shall be managed by or under the direction of a board of directors"). Directors may be held accountable for "corporate traumas," such as "regulatory sanctions, criminal or civil fines," "misconduct by officers or employees, massive business losses, and innumerable other potential calamities." *Pyott,* 46 A.3d at 340 (2012) (noting "[t]he list of corporate traumas . . . is long and ever expanding").

When directors communicate with shareholders about corporate affairs, they have a fiduciary duty to exercise due care, good faith and loyalty. *Malone v. Brincat*, 722 A.2d 5, 10 (Del. 1998); *see also id*. at 14 (when directors are "deliberately misinforming shareholders about the business of the corporation, either directly or by a public statement, there is a violation of fiduciary duty. That violation may result in a derivative claim on behalf of the corporation."); *In re Wayport, Inc. Litig.*, 76 A.3d 296, 315 (Del. Ch. 2013) ("[D]irectors owe a duty to stockholders not to speak falsely.").

"Communications that depart from this expectation . . . violate the fiduciary duties that protect shareholders. Such violations are sufficient to subject directors to liability in a derivative claim." *In re InfoUSA*, *Inc., S'holders Litig.*, 953 A.2d 963, 990 (Del. Ch. 2007); *see also Malone*, 722 A.2d at 9 ("[D]irectors who knowingly disseminate false information that results in corporate injury ... violate their fiduciary duty, and may be held accountable in a manner appropriate to the circumstance.").

Thus, directors who knowingly issue false statements "may be considered to be interested for purposes of demand." *InfoUSA,* 953 A.2d at 991.

Plaintiffs' allegations meet this standard. Plaintiffs allege that Zimmer's directors: (a) touted the purported ongoing success of the integration of Zimmer and Biomet; (b) failed to disclose known systemic quality system and quality control problems; (c) failed to disclose the Company's FDA regulatory deficiencies; and (d) failed to disclose the massive remediation efforts that were necessary to bring Zimmer into compliance with FDA regulations and that would adversely impact production and distribution of key products. These undisclosed material facts rendered Zimmer's SEC filings and public statements misleading and eventually led to FDA-mandated shipment delays which made it impossible for Zimmer to achieve the accelerated organic revenue growth it touted. ¶266.

Further, Plaintiffs specifically allege the nature of the misconduct for each of the Director Defendants. In particular, Plaintiffs allege that the February, June and August 2016 offering documents and the 2015 Form 10-K were false and misleading because of their omissions. ¶¶33-42, 266. The Director Defendants possessed *actual knowledge* of ongoing serious violations of the FDA's manufacturing and safety requirements at the Company's facilities and concealed those systemic violations from the Company's stockholders in those SEC filings, for which they had personal

responsibility. In this way, they acted disloyally by abdicating their responsibilities to act in the best interests of the Company at all times. *See*, *e.g.*, *In re Am. Int'l Grp., Inc., Consol. Deriv. Litig.*, 976 A.2d 872, 889 n.48 (Del. Ch. 2009) ("[O]ne cannot act loyally as a corporate director by causing the corporation to violate the positive laws it is obliged to obey."), *aff'd sub nom. Tchrs' Ret. Sys. of La. v. Gen. Re Corp.*, 11 A.3d 228 (Del. 2010).

2. The Court Misapplied the Elements Of Disclosure Liability.

In reasoning that Plaintiffs failed to state non-exculpated disclosure claims, the Court misapprehended Plaintiffs' allegations and applicable law. On the first page of the Opinion, the Court summarized the Complaint's allegations as follows:

> The primary theory behind the plaintiffs' claims is that Zimmer's officers and directors knew in 2015 and 2016 that Zimmer was facing serious regulatory compliance challenges but concealed them from the market while facilitating sales of Zimmer stock by private equity funds in possession of that material non-public information. Opinion ("Op.") at 1.

But in conducting its analysis, the Court created an alternate narrative premised on the erroneous assumption that the case centered on compliance failures at North Campus ***only***. However, the Complaint is replete with allegations of systemic quality control and manufacturing problems across *many* of Zimmer's facilities – problems

that Zimmer's Board knew about for approximately a year before the FDA inspection.

As such, allegations regarding compliance failures *solely* at North Campus (as the Court below found) are not the *sine qua non* of the Complaint. Rather, the Complaint asserts that the Director Defendants failed to disclose company-wide violations of FDA regulations and compliance failures that existed for well over a year and were well-known to the Board, beginning at least as early as mid-2015. And those regulatory violations led inevitably to the manufacturing shutdown at North Campus and Zimmer's cratering financial results in late 2016.

The Court's unwarranted narrowing of the scope of the case in Defendants' favor was compounded by its misapplication of the elements for stating a disclosure claim. To state a claim for breach by omission of the duty of disclosure under Delaware law, a plaintiff must plead facts identifying material, reasonably available information that was omitted from the disclosure. *Oliver v. Boston Univ.*, 2000 Del. Ch. LEXIS 104, at **24-25 (Del. Ch. July 18, 2000). The Court erred applying each element.

First, the undisclosed information was material. Information is material when there is "a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix'

of information made available." *Rosenblatt v. Getty Oil Co.*, 493 A.2d 929, 944 (Del. 1985) ("An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote.") (quoting *TSC Indus, Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976)). The *TSC* standard for materiality under Delaware law is "consistent with the definition of materiality under the federal securities laws." *Morrison v. Berry*, 191 A.3d 268, 283 n.63 (Del. 2017). Materiality is "fact-sensitive" and ordinarily not appropriate for resolution on the pleadings. *Alessi v. Beracha*, 849 A.2d 939, 949 n. 68 (Del. Ch. May 11, 2014).

To begin with, the Court wrote off altogether Plaintiffs' allegations that the Director Defendants were aware of systemic compliance problems at the Company's facilities dating back to 2015, failing to even consider them. For the narrow band of allegations that it *did* evaluate, the Court held that the non-public information about North Campus presented to the Board in 2016 was not material because there was no allegation the Board knew these problems would "ripen into negative financial consequences." Op. at 36. The Court also reasoned that the Board was not "told" a ship hold "would occur." Op. at 45. This analysis was error.

The Court's reasoning fails to correctly apply the law on materiality. The Court's grafting of a requirement that Plaintiffs must allege that the Director

Defendants knew that undisclosed information would have specific "financial consequences" is unfounded, and the precise argument was rejected by Judge Simon in the Class Action applying the universal pleading rule on materiality:

> It would be inappropriate to find that the quality systems issues identified at North Campus, which were eventually subject to the FDA's inspection, and the product hold were not material. Defendants argue that plaintiffs cannot definitively say that the revenue hit created by the product hold (which occurred near the final days of the third quarter) and other snafues at North Campus were the sole cause of the revenue miss and attendant stock fall. But defendants seek to hold plaintiff to too high a standard in this instance—plaintiffs need not allege that defendants' misconduct was responsible for the entirety of the revenue miss and stock price decline. The materiality standard is not so rigid, especially at the pleading stage. And given the intense investor analyst focus and large dip in ZBH's stock once news relating to North Campus's quality systems issues hit the market, even before the FDA had released its formal Form 483 letter, I would look askance at a claim that this information was immaterial as a matter of law. *Shah*, 348 F. Supp. 3d at 840-41.

The same reasoning applies here to *all* of Plaintiffs' particularized allegations about systemic compliance problems across all facilities. The vulnerability of major production facilities to regulatory enforcement that inevitably led to negative financial consequences (a risk well-known to the Board) is plainly material to shareholders in the total mix of information.

There is no requirement to allege the Board's knowledge of the precise financial impact that the undisclosed adverse information might have. *See In re*

Fitbit, Inc., 2018 Del. Ch. LEXIS 571, at **27-30 (Del. Ch. December 14, 2018) (internal reports that corporation's core technology had major design flaws sufficed to allege material adverse information in support of breach of fiduciary duty claims, as confirmed by ruling denying motion to dismiss on the same core facts in related federal securities class action); *Silverberg v. Gold*, 2013 WL 6859282, at *11 (Del. Ch. Dec. 31, 2013) ("I am convinced that disclosure of physician reluctance to prescribe Provenge, or the risk of such reluctance, would have 'significantly altered the total mix of information in the marketplace,' and thus, that information was material under Delaware law.")

The Court relied primarily on *In re Truecar, Inc.*, 2020 Del. Ch. LEXIS 303 (Del. Ch. Nov. 3, 2021) in formulating its materiality standard, but *Truecar* is easily distinguishable. That case involved allegations that the Truecar board knew that changes to a third party website would hurt the company's sales and failed to disclose these issues in a March 2017 Form 10-K. But that court ruled that the board did not learn about the website changes until September 2017, after the changes had already occurred, and only then did they learn that these changes contributed to the company's losses – and so had no reason to expect any negative consequences in advance. *Truecar*, 2020 Del. Ch. LEXIS 303 at **45-48. But here, prior to the disputed statements, the Director Defendants were fully apprised at Board meetings

early on that Zimmer's flagship facilities were replete with FDA compliance violations, which could (and did) necessarily impair production capabilities that unsurprisingly led to poor financial results.

Finally, the Court held that "plainly, every negative observation from all of Zimmer's facilities would not have been important information to investors." Op. at 37. That is not what Plaintiffs argue needed to be disclosed. Instead, Plaintiffs allege that, in addition to the North Campus problems identified by the 2016 audits, there was an obligation to disclose that there was a state of systemic compliance failures across the Company's facilities requiring costly remediation.

Second, the information was known to the Director Defendants. Internal records show that the Director Defendants were regularly briefed on material facts at Board meetings by management and compliance consultants. And the allegations reflect that the Board's knowledge dates back to 2015 – well before any of the insider sales. With respect to the North Campus allegations in particular, the May 3, 2016 Board materials show that the internal audits were discussed there – *the same internal audits the Company later disclosed had identified the very problems that caused the shutdown*. That is compelling evidence of knowledge at the pleading stage, prior to discovery. The Court erred when it rejected the inference of knowledge because Plaintiffs did not allege that the Board actually "received a copy

of the audit reports or a description of the compliance issues they addressed." Op. at 15. To the contrary, Plaintiffs specifically allege that the Director Defendants received the information from those audits at Board meetings and knew it – and that is enough for an inference at the pleading stage. Del. Ch. Ct. Rule 9(b) (for claims requiring particularized pleading, knowledge "may be averred generally"); *Prairie Cap. III, L.P. v. Double E Holding Corp.*, 132 A.3d 35, 62 (Del. Ch. 2015). These are matters to be addressed in discovery, not the on the pleadings.

Third, the information was omitted by the Director Defendants in their disclosures. The Director Defendants had personal responsibility for the contents of key SEC filings, which omitted material facts regarding systemic compliance problems at Zimmer, including but not limited to the North Campus problems. The Court improperly rejected Plaintiffs' allegations that the Director Defendants were responsible for these filings, even the offering documents, reasoning there was a lack of information about "Board-level involvement" in them. This was plain error. In so reasoning, the Court disregarded established Delaware law and policy as announced by this Court in *Salzberg v. Sciabacucchi*, 227 A.3d 102 (Del. 2020):

> The drafting, reviewing, and filing of registration statements by a corporation and its directors is an important aspect of a corporation's management of its business and affairs and of its relationship with its stockholders. This Court has viewed the overlap of federal and

> state law in the disclosure area as "historic," "compatible," and "complimentary." *Salzberg*, 227 A.3d at 114.

See also Kandell v. Niv., 2017 WL 4334149, at *17 (Del. Ch. Sept. 29, 2017) (where directors signed Form 10-K, court rejected argument that "the directors were unaware of this legal prohibition against limitation of customer loss, given the disclosures in the Company's Form 10-Ks."); *In re Hansen Med., Inc. Stockholders Litig.*, 2018 Del. Ch. LEXIS 197, at **25-28 (Del. Ch. June 18, 2018) (where complaint alleged false statements in a proxy, plaintiffs stated "reasonably conceivable non-exculpated claim for breach of fiduciary duties against the Director Defendants due to material misstatements and omissions").

The Court improperly denied Plaintiffs the reasonable inference that the Director Defendants were responsible for the omissions of material facts in the offering documents that were issued under a single registration statement they each signed, or in any SEC filing they signed or approved during the relevant period. In this regard, the Court observed that "having reviewed the prospectuses issued in connection with the February, June and August Offerings, none appear to bear the signature of any Director Defendants." Op. at 39. But this misapprehends the offering process, by which prospectuses are issued under and a part of the underlying registration statement (which was signed by all of the Director Defendants). *See*

A106, A1050, A1091 (February, June and August 2016 prospectuses each a "part of" the underlying registration statement). The Court's flawed reasoning immunizing the Director Defendants for disclosure violations is directly contrary to the "historic," "compatible" and "complimentary" overlap of state and federal disclosure law this Court identified in *Salzberg*.

The cases relied upon by the Court on this issue are not even remotely analogous. In *Ellis v. Gonzalez*, 2018 WL 3360816, (Del. Ch. July 10, 2018), plaintiffs sought to tie directors to certain regulatory filings they did not sign. In *In re Citigroup Inc. S'holder Deriv. Litig.*, 964 A.2d 106 (Del. Ch. 2009), plaintiffs sought to tie directors to alleged subprime accounting violations in the company's financial statements and to corporate press releases. And in *In re China Auto Sys. Inc. Deriv. Litig.*, 2013 WL 4672059 (Del. Ch. Aug. 30, 2013), the Court rejected allegations that directors signed false and misleading SEC filings, but (unlike the instant case) there was no allegation that the directors "knew the statements were wrong." Here, Plaintiffs present highly particularized allegations of Board knowledge based on a trove of internal Board-level documents, and specifically identify the documents the Director Defendants signed.

In sum, the Director Defendants had a duty to disclose the disputed information in the Company's publicly filed documents. By failing to do so, they are

subject to a substantial likelihood of liability for non-exculpated claims for breach of the duty of loyalty. As such, demand is futile for each Director Defendant who signed or approved the materially false and misleading SEC filings.

II. THE DIRECTORS FACE A SUBSTANTIAL LIKELIHOOD OF LIABILITY FOR APPROVING ILLEGAL INSIDER TRADING BY THE PE DEFENDANTS, EXCUSING DEMAND.

A. Question Presented.

Whether pre-suit demand is excused under *Zuckerberg* where a majority of the directors faces a substantial likelihood of liability for knowingly facilitating unlawful sales of the Company's stock by directors and their affiliates. This issue was preserved for appeal. (A269-271, 379).

B. Scope of Review.

The Court's review of decisions under Rule 23.1 is *de novo*. *Brehm*, 746 A.2d at 253-54.

C. Merits of Argument.

This case arises in part from unlawful insider trading on a truly massive scale. The Director Defendants' disclosure violations were a necessary element of the PE Defendants' stock sales while Zimmer's share price was artificially inflated. Plaintiffs allege that the PE Defendants, armed with material non-public information provided to them by their designees, Michelson and Rhodes, fortuitously liquidated all of their shares, selling the last $1 billion of their shares in August 2016, just weeks before Zimmer's disastrous internally known, but undisclosed, systemic regulatory problems became known to the market.

Unlike many insider trading cases where a fiduciary sells stock in a private transaction, these sales, effectuated pursuant to registered offerings made by the Company, *would not have been possible but for the participation and approval of the Board*. The Court erred by failing to extend all reasonable inferences to Plaintiffs regarding the incriminating stock sales and the Board's approval thereof, in contravention of Delaware law and policy.

1. The PE Defendants Sold Stock Motivated in Whole or in Part by Material Adverse Non-Public Information.

The Court's first error was its failure to extend to Plaintiffs the reasonable inferences that Michelson and Rhodes engaged in actionable insider trading under *Brophy* through the funds they controlled. The Court concluded that there were "no particularized allegations that Michelson or Rhodes actually shared any information with the PE Funds." Op. at 56. This reasoning ignores the designated roles on the Board played by Michelson and Rhodes as the PE Defendants' representatives and agents with respect to their multi-billion dollar investments.

By cabining Michelson and Rhodes from their funds at the pleading stage, the Court created an untenable result that impairs the remedial purposes of *Brophy*, a result rejected by the Court in very similar circumstances in *Fitbit*. There, the Court faced the issue of whether stock sales by investment entities affiliated with the directors (not by the directors personally) were attributable to the directors for the

purpose of stating a *Brophy* claim. The Court noted that the directors were senior principals in their respective investment companies that held the investment:

> [T]he Selling Defendants seek a ruling that would permit a director to trade on inside material information without consequence just because the director did not trade personally but rather passed the information to an entity with which he is affiliated (and over which he exercised control) to do the trading. *That is not and cannot be our law.* Indeed, to allow these directors, through their controlled funds, to profit from inside information without recourse would be inconsistent with the policy of "extinguish[ing] all possibility of profit flowing from a breach of the confidence imposed by the fiduciary relation" that undergirds Delaware's insider trading law. [emphasis supplied]. *Fitbit*, 2018 Del. Ch. LEXIS 571, at **32-33.

Indeed, Delaware law serves to "extinguish[] all possibility of profit flowing from a breach of the confidence imposed by the fiduciary relation." *Guth v. Loft*, 5 A.2d 503, 510 (Del. 1939). This exact reasoning applies here, but the Court failed to apply these familiar principles of Delaware law.

As senior principals in KKR and TPG, KKR Biomet's trades are attributable to Michelson and the TPG Defendants' trades are attributable to Rhodes for *Brophy* purposes. As the Court in *Fitbit* reiterated in a decision refusing certification of the issue for an interlocutory appeal: "[I] am satisfied that it is not particularly novel or controversial as a matter of Delaware law to declare that a fiduciary may not share inside information with a fund he controls so that the fund, in turn, can trade on that

inside information as a means to avoid *Brophy* liability." *In re Fitbit, Inc.*, 2019 Del. Ch. LEXIS 14, at *10 (Del. Ch. Jan. 14, 2019).

Any argument to the contrary defies the very purpose of the Stockholders Agreement, which provided all of the funds' consents to sharing information with and among all signatories. "[T]he practical reality [is] that director representatives . . . routinely share confidential corporate information with colleagues on their affiliated investment funds. The managing directors of these funds regularly meet to monitor their investments, and they routinely receive reports from their director designees on the performance of their portfolio companies." J. Travis Laster and John Mark Zeberkiewicz, *The Rights and Duties of Blockholder Directors*, 70 Bus. Law 33, 55 (Winter 2014-2015) (citing *In re Trados Inc. S'holder Litig.*, No. 1512–VCL, 2013 WL 4511262, at **4-5 (Del. Ch. Aug. 16, 2013)). The Court failed to acknowledge the "practical reality" recognized by Vice Chancellor Laster and explicitly bargained for in the Stockholders Agreement. That such information was shared with the PE Defendants is the only reasonable inference at the pleading stage.

The Complaint pleads additional facts from which the Court may reasonably infer improper trading. Zimmer's business model following the Merger was severely threatened by its regulatory problems, of which the entire Board was intimately aware. Michelson and Rhodes in particular, as Biomet directors, knew that Zimmer's

ability to produce the rosy results promised following the Merger was seriously in doubt, and that the situation was far worse than outsiders could divine.

In this regard, the nature, timing and size of the stock sales support the reasonable inference of scienter. The PE Defendants sold 100% of their Zimmer stock in the offerings, cashing out just in time. *Zimmerman v. Braddock*, 2005 WL 2266566 at *8 (Del. Ch. Sept. 8, 2005) ("approximately $248 million" in sales supported *Brophy* claim); *Fitbit*, 2018 Del. Ch. LEXIS 571, at *3 (timely sales by private funds affiliated with directors in registered offerings showed scienter).

Instead of applying these familiar pleading principles, the Court imposed impossible pleading burdens contrary to the closely analogous *Fitbit* case that, if allowed to stand, would shield fiduciaries from discovery and undermine *Brophy*. Significantly, the Court in *Fitbit* did not impose a requirement that plaintiff plead the date and time of information sharing between the director and the entity that did the trading. The Court's reasoning defies common sense in light of the purpose of the Stockholders Agreement and the nature and timing of the trades. Accordingly, Plaintiffs have adequately pled a *Brophy* claim against Michelson and Rhodes.

2. Plaintiffs State Non-Exculpated Claims for Breach of the Duty of Loyalty Against Directors Who Approved the Illegal Stock Sales.

The Court also failed to extend reasonable inferences that the directors played a *central role* in the sales. Even where a director does "not personally benefit from

[an] unfair transaction," if the director "actively assist[s] [another] in carrying out" a self-dealing transaction and thus "act[s] to further [the beneficiary's] interests in [the] transaction" rather than the company's interests, the director faces a substantial risk of liability for a breach of the duty of loyalty. *In re Emerging Commc'ns, Inc. S'holders Litig.*, 2004 Del. Ch. LEXIS 70, **140-41 (Del. Ch. May 3, 2004) (director who facilitated breach of fiduciary duty by fellow director held liable); *Ryan v. Gifford*, 918 A.2d 341, 356 (Del. Ch. 2007) (allegations that some directors "approved" improper option grants while others "accepted" them "are sufficient . . . to raise a reason to doubt the disinterestedness of the current board").

Tyson Foods, *Inc. Consol. S'holder Litig.*, 919 A.2d 563 (Del. Ch. 2007) is instructive. There, directors approved so-called "spring-loaded options"—options granted before the release of positive disclosures which enable recipients to profit when those disclosures occur. The court held such options "clearly involve[] a deception" and implicate a "duty of loyalty" not only for the recipients of the options but also for directors who approve them, because directors approving the options "intentionally use[] inside knowledge not available to shareholders in order to enrich" the options recipients. *Tyson Foods*, 919 A.2d at 592-93. Although *Tyson Foods* concerned "spring-loaded" options timed to take advantage of forthcoming positive disclosures, the court noted the same breach would occur with respect to so-

called "bullet-dodging" transactions that enable insiders to avoid losses from forthcoming negative disclosures. *Id.*

In *Fitbit*, the court similarly held that a director who approved suspicious secondary offerings of stock pursuant to which insiders sold their shares faced a substantial likelihood of liability for breach of fiduciary duty, *even though he did not personally make any sales or profit from them*. The court held that the director "knowingly facilitated" the trading when he voted to approve a lock-up waiver which permitted the insiders to sell their stock. *Fitbit,* 2018 Del. Ch. LEXIS 571, at **43-44. Similar director action (and more) is alleged here – each of the Director Defendants approved the offerings. Again, the Court failed to apply *Fitbit* and ignored that the Director Defendants' actions in withholding information from stockholders regarding the Company's systemic regulatory problems was necessary for Michelson and Rhodes to profit based on the material non-public information.

Plaintiffs' allegations are amplified by Zimmer's misrepresentations to shareholders, which facilitated the sales before the stock price declined, as it was bound to do (and did) when the bad news emerged. Given the Director Defendants' approval of the Merger and the potential fallout (including personal liability) if the material non-public information was disclosed, there was ample motivation for them to keep it under wraps. This misconduct further supports the Board's potential

liability for breach of their non-exculpable duties of loyalty and good faith by enabling the insider sales. *See In re Dole Food Co. S'holder Litig.*, 2015 Del. Ch. LEXIS 223, at **129-34 (Del. Ch. Aug. 27, 2015) (director breached duty of good faith by misrepresentations that drove down stock price and enabled other director's opportunistic transaction while stock price artificially depressed); *Ryan*, 918 A.2d at 355-56 (director faces substantial likelihood of liability for breach of duty of loyalty for facilitating improper option grants through misrepresentations).

Contrary to its obligation to extend all reasonable inferences to Plaintiffs, the Court concluded (Op. at 56) that the Complaint "lacks any basis to infer that the rest of the Board had knowledge" regarding "information sharing" between Michelson and Rhodes and the PE Defendants, even though the fortuitously timed offerings were conducted by the Board at the request of the PE Defendants for the sole purpose of allowing them to sell their stock as Zimmer's compliance problems worsened. Again, this reasoning sets impossible pleading standards for stockholders challenging disloyal conduct by fiduciaries and ignores that Plaintiffs are entitled to the benefit of all reasonable inferences. The Director Defendants cannot bury their heads in the sand. They can claim ignorance of the *Brophy* violations later in the case.

CONCLUSION

The Opinion granting Nominal Defendant-Appellee Zimmer's motion to dismiss should be reversed.

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