EFiled: Dec 26 2024 02:46PM EST
Filing ID 75312980
Case Number 446,2024

IN THE SUPREME COURT OF THE STATE OF DELAWARE

RHONDA SCHERTZ, Derivatively on Behalf of CARVANA CO., Plaintiff Below, Appellant, v. ERNEST GARCIA II, Defendant Below, Appellee, -and- CARVANA CO., a Delaware corporation, Nominal Defendant Below, Appellee.	No. 446, 2024 On appeal from the Court of Chancery of the State of Delaware, C.A. No. 2023-0600-KSJM **PUBLIC VERSION FILED: DECEMBER 26, 2024**

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Dated: December 10, 2024

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NATURE OF PROCEEDINGS

This is a stockholder derivative suit brought on behalf of Nominal Defendant Below, Appellee Carvana Co. ("**Carvana**" or the "**Company**").

Informed by her review of the Company's books and records obtained pursuant to 8 *Del. C.* § 220, Plaintiff Below, Appellant Rhonda Schertz ("**Plaintiff**"), filed her Verified Amended Stockholder Derivative Complaint (the "**Complaint**") asserting claims for breaches of fiduciary duties and unjust enrichment against Carvana's officers and directors and the Company's controller, Defendant Below, Appellee Ernest Garcia II ("**Garcia Senior**"). (A0037, A0212-0218).

Defendants moved to dismiss the Complaint under Chancery Court Rules 12(b)(6) and 23.1, or alternatively to stay the case in favor of a related securities fraud class action. (A0326). Plaintiff opposed and the Court of Chancery heard oral argument. (*Id.*, A0717 *et seq.*).

The Court of Chancery dismissed the Complaint under Rule 12(b)(6) in its Telephonic Bench Ruling dated September 25, 2024. *Schertz v. Garcia et al.*, C.A. No. 2023-0600-KSJM (Del. Ch. September 25, 2024) (Exhibit A, the "**Ruling**").

Plaintiff appeals from the Ruling to the extent that it dismissed her claim against Garcia Senior for insider trading under Chancery Court Rule 12(b)(6).

INTRODUCTION

Carvana became one of the country's largest used car dealers by leveraging the power of the Internet. (A0039, A0041, ¶¶4, 9). Unlike brick-and-mortar car dealers whose business is limited to a discrete geographic area, Carvana offered its customers the ability to choose a car from a nationwide inventory through its web platform. (*Id.*).

Greatly complicating this was the fact that all 50 states have different laws governing the issuance or transfer of a motor vehicle title and registration ("**T&R**"). (A0064-66, ¶¶62-66). The T&R laws that apply to a given car sale are a function of where the purchaser is located. (*Id.*). Carvana concedes that "offering a nationwide inventory to expand the customers' choices" makes it more complicated to comply with the numerous applicable T&R laws. (A0504). For example, the Company acknowledges that:

> if a customer in Arizona purchases a vehicle that Carvana itself has acquired from a customer in North Carolina, that involves changing the license plates and changing the registration and moving that [car] from… State A, where the car has been… to State B. And these states [all] have different laws[.]

(*Id.*). A car dealer's failure to comply with state T&R laws may cause a number of problems for the buyer, such as being unable to legally drive the car on a public road; obtain insurance; or produce proof of ownership. (A0068-73, A0109-124, ¶¶71-75,

146-168). Sometimes it leads to encounters with law enforcement, such as drivers being pulled over for expired temporary plates or arrested for being unable to produce a registration. (*Id.*).

A confluence of events – the Covid-19 pandemic, car factories and brick-and-mortar car dealers temporarily closing, rising demand for used cars, and Carvana's introduction of touchless delivery and pickup – led to explosive growth in Carvana's sales and footprint. (A0039, ¶5). By the end of 2022, Carvana was operating in 33 states and its sales (over 425,000 cars annually) were up almost 240% from 2019. (*Id.*).

Carvana could not keep up with the increasingly heavy burden of timely complying with state T&R laws, leading to growing customer dissatisfaction and scrutiny by state regulators. (A0125-134, ¶¶171, 177, 180, 183, 184). Starting in July 2020, the Company's Board of Directors (the "**Board**") was informed of Carvana's escalating T&R problems several times and tried, without success, to fix things. (*Id.*). Nevertheless, Carvana's increasing difficulty in complying with state T&R laws was not disclosed to the market and its stock price increased. (A0160, ¶227).

Garcia Senior was no rookie used car dealer. He has over three decades of experience in the business; co-founded Carvana; installed a Board that is beholden

to him; installed his son as the Company's President and CEO; controls 84% of Carvana's stock voting power; and received over $1.5 billion from related party transactions with Carvana which the Company acknowledges are "not negotiated at arm's length." (A0045-62, ¶¶19, 33-34, 39, 45-47, 55-57).

Recognizing the danger that Carvana's inability to comply with state T&R laws posed to its business, Garcia Senior began to unload his Carvana stock while it traded at record heights. By February 25, 2021 – when Carvana filed its 2020 annual report disclosing that failing to comply with state laws "could" hypothetically have a material adverse effect on its business – Garcia Senior had dumped over $1.28 billion worth of Carvana stock after amending his 10b5-1 trading plan twice in six months to increase his daily sales limit, as well as over $478 million worth of Carvana stock outside his 10b5-1 trading plan. (A0144, A0159-160, ¶¶202, 226-227; A0224-255).

Through August 2021 – when local media first reported that a state regulator acted in response to Carvana's failure to comply with T&R laws – Garcia Senior sold over $3.6 billion worth of Carvana stock. (A0045, A0101, A0156, ¶¶18, 135, 219; A0224-0298). The extent of Carvana's systematic failure to comply with its legal obligations under state T&R laws began coming to light when *Barron's*

published its exposé titled *Carvana Sought to Disrupt Auto Sales. It Delivered Undriveable Cars* after the market closed on June 24, 2022. (A0067-76, A0160, ¶¶71-77 (summarizing exposé, 227).

Carvana was fined and/or had its dealer license suspended in at least 10 of the 33 states where it operates, an extreme punishment which it concedes caused "incalculable and irreparable" harm to its "business operations and goodwill." (A0090-109 A0194-195 ¶¶110-145, 290). One state even charged Carvana's General Counsel, the officer responsible for ensuring Carvana's compliance with T&R laws, with 74 *criminal* counts for this corporate malfeasance. (A0091-92, ¶¶112-114). Carvana's stock price collapsed by 96% when the full extent of its failure to comply with state T&R laws was finally disclosed. (A0043, ¶14).

Plaintiff adequately pleads facts from which the Court may reasonably infer that Carvana's systematic failure to ensure adequate compliance with state T&R laws, the resulting adverse effects on the Company, and its inability to remedy this, was material, non-public information ("**MNPI**") during the period of Garcia Senior's sales; that Garcia Senior knew this MNPI; and that Garcia Senior was motivated to sell by the substance of this MNPI. Plaintiff respectfully requests this

Court to reverse the Court of Chancery's Ruling dismissing her claim against Garcia Senior for insider trading, and remand this matter for further proceedings.

SUMMARY OF ARGUMENT

1. Dismissing Plaintiff's *Brophy* claim against Garcia Senior was not warranted under Chancery Court Rule 12(b)(6) because she sufficiently pleads all the elements of the claim.

a. Plaintiff pleads sufficient facts to reasonably infer that between October 30, 2020, and August 23, 2021, *i*) Carvana's systematic failure to ensure adequate compliance with state title and registration laws, *ii*) its adverse effect on the Company, and *iii*) the Company's inability to fix the problem, was MNPI.

b. Plaintiff pleads sufficient facts to reasonably infer that Garcia Senior knew the foregoing MNPI.

c. Plaintiff pleads sufficient facts to reasonably infer that Garcia Senior's sales of Carvana stock between October 30, 2020, and August 23, 2021, or any part thereof, was at least partially motivated by the substance of the foregoing MNPI.

STATEMENT OF FACTS

Plaintiff incorporates by reference the facts in the Introduction above. Additional facts relevant to Plaintiff's argument are discussed in the Merits of the Argument below.

I. The Garcias Dominate Carvana

A. Garcia Senior's History of Shady Business Practices

Garcia Senior began his career as an Arizona real estate developer. (A0049, ¶32). In 1990, he pled guilty to federal felony fraud charges arising from his role in the S&L Crisis. (A0049, ¶¶32-33). The U.S. Attorney General observed that Garcia Senior's "scheme [was] of particular concern because it [was] designed to conceal the true nature of the financial transactions involved…. In the process, federal regulators [were] deceived, the [banking] institution [was] defrauded and the taxpayers [were] left to foot the bill." (A0049, ¶33). As a result of his felony plea, Garcia Senior was, among other things, banned for life from serving as an employee, officer, or director of any NYSE-listed company. (A0050, ¶34).

In 1991, Garcia Senior bought a rental car chain called Ugly Duckling and built it into a network of used-car dealerships that "charged high interest rates to buyers with bad credit and was quick to repossess cars from delinquent borrowers."

(*Id*.). In 1996, Garcia Senior took Ugly Duckling public on the Nasdaq while maintaining 56% ownership. (A0050, ¶35).

The next few years were rocky and scandal-filled. Ugly Duckling stockholders accused Garcia Senior of "feathering his own nest with Ugly Duckling's assets" by looting the company through unfair related party transactions (A0051, ¶37). In 2002, Garcia Senior took advantage of Ugly Duckling's depressed stock price to take the company private through a rock-bottom tender offer. (*Id.*). He then renamed the company DriveTime and installed as its CEO a crony, who like Garcia Senior had pled guilty to a felony in connection with the S&L Crisis. (A0050-52, ¶¶36-37).

Although the company's name changed, its business model did not. As *The Wall Street Journal* reported, "DriveTime's secret sauce was selling cars to risky borrowers and quickly repossessing the vehicles if they fell behind on their loan payments…. [A]round 45% of the company's loans were delinquent at any given time." (*Id.*). DriveTime eventually ran into trouble with regulators for its predatory business practices, leading to an $8 million fine and increased federal oversight. (A0053, ¶40).

B. Garcia Junior Joins the Family Business

Around the time that Ugly Duckling went private and changed its name to DriveTime, Garcia Senior's son – Defendant Below, Ernest Garcia III ("**Garcia Junior**") – joined the family business. (A0052, ¶38). Garcia Senior and Garcia Junior (together, the "**Garcias**") are exceptionally close and share an impenetrable web of business interests, described by *The Wall Street Journal* as "a convoluted tangle of interrelated companies and related party transactions [that are] very difficult to understand or pull apart." (A0052-53, A0058, ¶¶39 n.18, 48). For example, Garcia Junior – who lives next door to his father – "is the sole beneficiary of a trust that owns 11.31% of DriveTime and two other [Garcia Senior-controlled] companies supplying services to Carvana…. With his children, [Garcia Junior] is the beneficiary of a second trust owning another 11.31% of the companies…. [Garcia Senior] has sole control of one trust and shares control of the other." (A0058, ¶¶48).

C. Garcia Senior Co-Founds Carvana as a Controlled Company

In 2012, Garcia Senior, his son, and two of Garcia Junior's associates co-founded Carvana Group LLC as a wholly owned subsidiary of DriveTime. (A0052-

53, ¶39). Garcia Senior installed Garcia Junior as the company's President and CEO (A0045, ¶19).

Carvana relied heavily on DriveTime from the start. *Forbes* reported that Carvana bought "most of its used car inventory from its parent, which purchased Carvana's loans and supplied it with other financial support and technological assistance." (A0052-53, ¶39). Garcia Junior concedes that "[w]e were able to build Carvana into a stronger company much quicker than we likely would have been able to do without [having] the benefits [that] we had early in our company's history from being able to use the backbone" of his father's company, Drivetime. (*Id.*). As one of Carvana's creditors observed, "As long as Ernie Sr. is involved in DriveTime, he's directly involved in Carvana." (A0064, ¶61).

In 2017, the Garcias took Carvana public on the NYSE. (A0054-56, ¶¶43-46). As Garcia Senior is banned for life from the NYSE on account of his felony plea, his involvement with the Company must necessarily be from behind the scenes. Garcia Senior thus installed his longtime cronies, Defendants Below, Ira Platt ("**Platt**") and Gregory Sullivan ("**Sullivan"**) as directors. (A0046, A0056-57, A0195-211, ¶¶22, 24, 46, 293-316). Based on the same facts as alleged in the Complaint, the Court of Chancery found in a prior action that Platt and Sullivan both

lack independence from Garcia Senior. *In re Carvana Co. Stockholders Litigation*, 2022 WL 2352457, at *13-14 (Del. Ch. June 30, 2022). Garcia Senior also installed Garcia Junior (already the Company's President and CEO) as a director. (A0045, A0056-57, ¶¶19, 46). Garcia Senior thus ensured that at least half of Carvana's six-member Board was beholden to him. (A0056-57, A0195-211, ¶46, 291-316).

D. Carvana's Capital Structure Cements the Garcias' Control

Not much changed for the Garcias as a result of the IPO. Carvana's dual-class ownership structure provides that any share owned by Garcia Senior, Garcia Junior, and their affiliates (the "**Garcia Parties**") is entitled to ten votes per share, compared to one vote per share held by the public. (A0057, ¶47). A Wharton professor observed that this corporate structure, which is untethered from the Garcias' economic interest in Carvana, lets the Garcias "run this $60 billion public company as if it's a family firm and for the family's benefit… It's amazing." (A0063, ¶58).

Garcia Senior is Carvana's largest stockholder with approximately 84% of its stock voting power. (A0056, ¶45). Together, the Garcias control 97% of Carvana's stock voting power. (A0054, ¶43). The Company disclosed in a prospectus that:

> the Garcia Parties have the ability to elect all of the members of our Board and thereby control our policies and operations, including the appointment of management, future issuances of our Class A common stock or other securities, the payment of

> dividends, if any, on our Class A common stock, the incurrence of debt by us, amendments to our amended and restated certificate of incorporation and amended and restated bylaws, and the entering into of extraordinary transactions.

(A0063, ¶59). The Court of Chancery acknowledged in a prior action that the Garcias "collectively control Carvana[.]" *In re Carvana*, 2022 WL 2352457, at *1.

E. Carvana's Related Party Transactions with the Garcias are Not Negotiated at Arm's Length

The Garcias' grip on Carvana is evidenced through their numerous related party transactions. *The Wall Street Journal* notes that the Garcias' companies "are [as] intertwined as the Garcia men." (A0062, ¶56). Among other things, Carvana has bought tens of millions of dollars' worth of used cars from DriveTime. (A0054, ¶42). One of the Garcias' companies provides the extended warranties that Carvana sells to its customers, responsible for 12% of Carvana's profits. (A0059-60, ¶50). Another has built a $10 billion portfolio by financing most of the cars sold by Carvana. (A0060, ¶51). Garcia Senior's real estate company, Verde Investments, developed Carvana's office campus. (A0060, ¶¶52). Another handles Carvana's collections on customer car loans. (A0061, ¶53). Another sells insurance to Carvana customers. (A0062, ¶56). Carvana concedes in its SEC filings that its related-party transactions with the Garcias' companies are "not negotiated at arm's length." (A0057, ¶47).

This cornucopia of sweetheart deals has been tremendously lucrative for Garcia Senior. In 2021 and 2022 alone, Carvana paid Garcia Senior's companies over $418 million through at least six income streams, and he personally received $1.1 billion from Carvana as the largest beneficiary of its tax receivable agreement. (A0062, ¶¶55, 57).

II. The Board Knew of Carvana's Failure to Adequately Comply with State T&R Laws

The Company's books and records evidence that the Board knew about Carvana's systematic failure to comply with state T&R laws; the resulting adverse effects on the Company; and Carvana's inability to fix the problem.

At the July 2020 Board meeting attended by Garcia Junior, Platt, and Sullivan (among others), the Board reviewed a presentation that referenced "registration delays" as a reason for declining NPS. (A0125, A0127-128, ¶¶171, 175). NPS – an acronym for "Net Promoter Score" – is a customer satisfaction metric which the Board uses to track the Company's compliance with state T&R laws. (A0125-126, ¶172). *See also* Ruling at 21-22 ("Management that consistently receives T&R compliance information [via NPS] has implemented a reporting system, even if it's not a great one…. [T]he NPS system captured concrete data on customer experiences

with vehicle registration and titling and kept the Board… informed of the relevant risks.").

Although the minutes of the July 2020 Board meeting are almost completely redacted after the topic of NPS is introduced, they note that reversing Carvana's declining NPS is a "Key Focus" and that Carvana "[r]e-launched [its] Top-5 Initiative to reduce registration delays." (A0127-128, ¶¶174-175).

The Board's corrective measures were unsuccessful. At the October 2020 Board meeting attended by Garcia Junior, Platt, and Sullivan (among others), the Board reviewed a presentation acknowledging that "Registration Delays" are among the "Four key drivers" of declining NPS. (A0127-130, ¶¶177-178). The presentation and accompanying minutes are otherwise almost completely redacted. (*Id.*).

Carvana's NPS continued to falter. At the February 2021 Board meeting attended by Garcia Junior, Platt, and Sullivan (among others), the Board reviewed a presentation noting that "Registration Delays" are among the "Four variables [that] are consistently the root cause(s) of poor NPS," which was at its lowest level since January 2019. (A0130-132, ¶¶179-180). The rest of the presentation is almost completely redacted. (A0131-132, ¶180).

At the July 2021 Board meeting attended by Garcia Junior and Platt (among others; Sullivan was absent), "registration challenges" were listed among the principal factors harming NPS and "the Company's short and long-term tactics and strategies to respond to the same" were mentioned. (A0133-134, ¶183). The rest of the presentation is almost completely redacted. (*Id.*).

Carvana's tactics and strategies to improve its compliance with state T&R laws were ineffective. At the October 2021 Board meeting attended by Garcia Junior, Platt, and Sullivan (among others), the Board reviewed a presentation yet again acknowledging that "Registration" is among the "key drivers of NPS" and that the Company is "zeroing in on projects" to "address" it. (A0134-136, ¶¶184-185). The minutes reflect the Board's discussion of how "customer comments [are] impacting NPS and how the registration process is affected by varying DMV requirements." (A0135-136, ¶185). Both the minutes and presentation are heavily redacted. (A0134-136, ¶¶184-185).

III. Carvana Did Not Disclose this Information to the Public

The Board knew that Carvana was unable to ensure adequate compliance with its legal obligations under state T&R laws, that this caused adverse effects for the Company, and that its remedial efforts were ineffective. But Carvana never disclosed

this to the public and its disclosures concerning compliance with state T&R laws were highly circumscribed.

On May 6, 2020, Carvana filed its Form 10-Q for the quarter ended March 31, 2020. (A0138, ¶190). The filing stated in relevant part that "[t]here have been no material changes to the risk factors disclosed… in our most recent Annual Report on Form 10-K" filed on February 26, 2020 (the "**2020 Annual Report**"). (A0139, ¶192). The relevant risk factor disclosures in the 2020 Annual Report stated:

> We operate in several highly regulated industries and are subject to a wide range of federal, state, and local laws and regulations. Changes in these laws and regulations, or our failure to comply, ***could*** have a material adverse effect on our business… We are subject to a wide range of evolving federal, state, and local laws and regulations, many of which may have limited to no interpretation precedent as it relates to our business model. Our sale and purchase of used vehicles and related activities, including the sale of complementary products and services, are subject to state and local licensing requirements, state laws related to title and registration, [and others].

(A0139, ¶192, emphasis changed). The 2020 Annual Report did not disclose that Carvana was already facing severe difficulties in adequately complying with state T&R laws.

On August 5, 2020, Carvana filed its Form 10-Q for the quarter ended June 2020. (A0141, ¶194). Garcia Junior stated during an earnings call later that day that

holding title for too long creates problems with the Federal Trade Commission, noting that if clients "would like to sell you their car and it takes longer for you to hold the people and longer to get their title cleared, et cetera, that's not a great experience on the FTC side." (A0141, ¶196).

On February 25, 2021, the Company filed its annual report on Form 10-K for the year ended December 31, 2020 (the "**2021 Annual Report**"). (A0143, ¶199). Discussing regulatory risks, the 2021 Annual Report again stated that Carvana's failure to comply with state laws "***could***" have a material adverse effect on the Company's business and made similar risk disclosures as in the 2020 Annual Report (A0144-146, ¶¶202, 204, emphasis added).

On August 5, 2021, Carvana filed a Form 8-K after the market closed announcing its financial results for the quarter ended June 30, 2021. (A0146-147, ¶206). During the earnings call later that day, Garcia Junior stated that one of the possible constraints to Carvana's business "***could*** show up in registration delays." (*Id.*, emphasis added).

On August 10, 2021, ABC 11 Eyewitness News in Raleigh-Durham, North Carolina reported that Carvana's dealer license for its Raleigh facility was suspended for six months because Carvana had "failed to deliver titles to the DMV, sold motor

vehicles without a state inspection, and issued out-of-state temporary tags and plates for vehicles sold to customers in North Carolina" in violation of North Carolina T&R laws (A0101-102, ¶135).

Although this was the first *public report* of a state regulator taking action against Carvana, North Carolina was *not* the first state regulator that had acted. In February 2021, Michigan had placed Carvana on probation for 18 months for violating its state T&R laws. (A0094, ¶120).[1] On August 3, 2021, Carvana settled a civil action brought by the Los Angeles, San Diego, Santa Clara, and Ventura County District Attorneys for operating in California without a dealer's license between 2015 and 2019. (A0100, ¶132). Carvana did not publicly disclose the actions by Michigan or California, and they were not picked up by the media at the time.

On August 11, 2021, management was asked about the North Carolina suspension during the Company's presentation at the J.P. Morgan 2021 Auto Conference. (A0147-149, ¶207). Carvana's CFO, Defendant Below, Mark Jenkins ("**Jenkins**"), stated "I think ***we had quite a small fraction of customers that were***

[1] The following year, Michigan suspended Carvana's dealer license for its suburban Detroit facility after Carvana violated its probation 127 times, including "***committing fraudulent acts*** in connection with selling or otherwise dealing in vehicles." (A0094-95, ¶121, emphasis added).

impacted by title and registration delays, but it did happen in the state of North Carolina." (*Id.*, emphasis added). When asked if he was "comfortable that this is a very North Carolina specific issue and not something [Carvana] might need to investigate" in other states, Jenkins replied "[O]ur understanding is that ***this is quite unprecedented.*** But having said that, our goal is to provide the best customer experiences possible[.]" (*Id.*, emphasis added). When Jenkins's microphone cut off, Carvana's Vice President of Investor Relations jumped in and stated that North Carolina "***was a relatively unusual action, but is also pretty small in scope***, relatively speaking." (*Id.*, emphasis added).

IV. Garcia Senior Suspiciously Sells Over $3.6 Billion of Carvana Stock Before the Company's Problems Were Publicly Disclosed

From October 30, 2020, through August 23, 2021 – at the same time as Carvana faced mounting problems with its T&R compliance efforts – Garcia Senior sold Carvana stock every single trading day for a total of 2,500 transactions worth over $3.67 billion. (A0156, ¶219). Starting by selling 30,000 shares a day under his 10b5-1 trading plan filed in June 2020, Garcia Senior modified the plan in November 2021 to raise his daily sales limit to 50,000 shares. (A0158, ¶224). He modified the plan again in May 2021 to raise his daily sales limit to 60,000 shares. (*Id.*). The facts

supporting a reasonable inference that Garcia Senior traded on Carvana's inside information are discussed in the Argument below.

ARGUMENT

The Chancellor Erred in Dismissing Plaintiff's *Brophy* Claim Against Garcia Senior Under Rule 12(b)(6)

A. Question Presented

Did Plaintiff plead the elements of a claim for insider trading against Garcia Senior? This issue was preserved below in Plaintiff's brief in opposition to defendants' motion to dismiss and at oral argument (A0395-399, A0784-786).

B. Standard of Review

"This Court reviews *de novo* a decision to grant a motion to dismiss under Court of Chancery Rule 12(b)(6). The Court will grant a motion to dismiss under Rule 12(b)(6) only if the plaintiff could not recover under any reasonably conceivable set of circumstances susceptible of proof. "When considering such a motion, the Court must accept all well-pleaded factual allegations in the Complaint as true and draw all reasonable inferences in favor of the plaintiff." *City of Fort Meyers General Employees' Pension Fund v. Haley*, 235 A.3d 702, 716 (Del. 2020) (cleaned up).[2]

[2] Unless otherwise noted, all emphasis in quotations is added and all internal quotation marks and internal citations are omitted.

The pleading standards under Chancery Rule 12(b)(6) "are minimal." *Central Mortg. Co. v. Morgan Stanley Mortg. Capital Hldgs. LLC*, 27 A.3d 531, 536 (Del. 2011). "[E]ven vague allegations are 'well pleaded' if they give the opposing party notice of the claim." *In re General Motors (Hughes) Shareholder Litigation*, 897 A.2d 162, 168 (Del. 2006). "This standard is based on the 'notice pleading' requirement established in [Chancery Court Rule] 8(e) and is 'less stringent than the standard applied when evaluating whether a pre-suit demand has been excused in a stockholder derivative suit pursuant to Chancery [Court] Rule 23.1.'" *Malpiede v. Townson*, 780 A.2d 1075, 1083 (Del. 2001).

Moreover, "[u]nder [Court of Chancery] Rule 9(b), state of mind may be pled generally. That is because it [is] virtually impossible for a party plaintiff to sufficiently and adequately describe the defendant's state of mind at the pleadings stage." *Desert Equities, Inc. v. Morgan Stanley Leveraged Equity Fund, II, L.P.*, 624 A.2d 1199, 1208 (Del. 1993). Thus, pleading a claim for "breach of fiduciary duty that has at its core the charge that the defendant knew something, there must, at least, be sufficient well-pleaded facts from which it can reasonably be inferred that this 'something' was knowable and that the defendant was in a position to know it." *Albert v. Alex. Brown Management Services, Inc.*, 2005 WL 2130607, at *11 (Del.

Ch. Aug. 26, 2005). "[O]n the question of pleading knowledge… [Chancery Court Rules 12(b)(6) and 9(b)] are very sympathetic to plaintiffs." *Wells Fargo & Co. v. First Interstate Bancorp,* 1996 WL 32169, at *11 (Del. Ch. Jan. 18, 1996).

Demand futility is not at issue in this appeal. The Court thus "evaluate[s] the *Brophy* allegations under the plaintiff-friendly Rule 12(b)(6) standard, [and] not a particularity standard." *Pfeiffer v. Toll*, 989 A.2d 683, 692 (Del. Ch. 2010), abrog. in part on other grounds, *Kahn v. Kolberg Kravis Roberts & Co.*, *L.P.*, 23 A.3d 831(Del. 2011).

"Accordingly, for purposes of a motion to dismiss under Rule 12(b)(6), [Plaintiff] need only plead facts supporting a reasonable inference of [Garcia Senior's] knowledge" of MNPI and his motivation to sell over $3.6 billion of stock based on the substance thereof. *Electric Last Mile Solutions, Inc. Stockholder Litigation*, 2024 WL 223195, at *3 (Del. Ch. Jan. 22, 2024).

C. Merits of Argument

"[A] shareholder owes a fiduciary duty… if [he] owns a majority interest in or exercises control over the business affairs of the corporation." *Kahn v. Lynch Commc'n Sys., Inc.*, 638 A.2d 1110, 1113 (Del. 1994) (emphasis omitted). Garcia

Senior owns approximately 84% of the Company's stock voting power. (A0056, ¶45).

Plaintiff also alleges sufficient facts to reasonably infer that Garcia Senior controls Carvana. *See* Statement of Facts, Point I (The Garcias Dominate Carvana), *supra*. Indeed, Carvana publicly acknowledged in a prospectus that the Garcias "control our policies and operations, [and] have the ability to elect all of the members of our Board and thereby control our policies and operations, including the appointment of management[.]" (A0063, ¶59). Regardless, Garcia Senior's supermajority of Carvana's stock voting power makes him a fiduciary to the Company.

Brophy v. Cities Service Co. allows the Company to recover from its fiduciaries who traded company stock based on the company's confidential information. 70 A.2d 5, 7 (Del. Ch. 1949). This is meant to "extinguish[] all possibility of profit flowing from a breach of the confidence imposed by the fiduciary relation." *Guth v. Loft, Inc.*, 5 A.2d 503, 510 (Del. 1939).

Pleading a *Brophy* claim against Garcia Senior requires Plaintiff to allege facts sufficient for the Court to infer 1) that Garcia Senior had knowledge of MNPI, and 2) that Garcia was motivated to sell his Carvana stock by the substance of the MNPI.

Kahn v. KKR, 23 A.3d at 838. For purposes of this appeal, Plaintiff's allegations are assessed under the forgiving pleading standard under Chancery Court Rules 8, 9(e), and 12(b)(6). *Supra.*

1. Carvana's Difficulties in Adequately Complying with State T&R Laws Constitutes MNPI

Delaware has long followed the federal standard for materiality. Information is material if there is a "substantial likelihood that, under all the circumstances, [it] would have assumed actual significance in the deliberations" of a reasonable shareholder deciding whether to trade stock. *Rosenblatt v. Getty Oil Co.*, 493 A.2d 929, 944 (Del. 1985).

Material information need not rise to the level of a trade secret. *Triton Constr. Co. v. E. Shore Elec. Servs., Inc.*, 2009 WL 1387115, at *11 (Del. Ch. May 18, 2009). Nor need it rise to the level requiring prompt disclosure to the market. *Goldstein v. Denner*, 2022 WL 1797224, at *8 (Del. Ch. June 2, 2022). Indeed, *Brophy* "did not speak in terms of *material* information in the sense of facts the corporation was obligated to disclose; it spoke in terms of *confidential* information[.]" *Id.* (emphasis original), citing *Brophy,* 70 A.2d at 7. Confidential information is material for purposes of *Brophy* if it would "significantly alter[] the 'total mix' of information in

the marketplace." *In re Oracle Corp. Deriv. Litig.*, 867 A.2d 904, 934 (Del. Ch. 2004), quoting *Rosenblatt*, 493 A.2d 929.

The Board knew the importance (and hence materiality) of complying with state title and registration laws. (A0130-131, A0136-137, ¶¶179, 186-187) (Board materials recognizing that "Licensing and Title/Reg Processing" are among Carvana's "Major Regulated Activities"). As such, the Board was required to rigorously oversee this corporate function. *See, e.g., In re Clovis Oncology, Inc. Deriv. Litig*., 2019 WL 4850188, at *13 (Del. Ch. Oct. 1, 2019). This underscores the importance of adequately complying with state T&R laws to Carvana's business.

The Board was repeatedly informed that Carvana's efforts to ensure adequate compliance with state T&R laws were falling short, and that this deficiency was a principal driver of the Company's low NPS. *See* Statement of Facts, Point II (The Board Knew of Carvana's Failure to Adequately Comply with State T&R Laws), *supra*.

Yet none of this was publicly disclosed. Some of Carvana's disclosures were anodyne statements that T&R compliance involved many different laws novel to Carvana's business model, (A0139, ¶192), and that customers are unhappy when it takes a long time for their vehicle title to clear. (A0141-142, ¶196). Other disclosures

stated that failing to adequately comply with state T&R laws "***could***" – in other words, hypothetically – have a material adverse effect on Carvana's business, but did not disclose that Carvana was already being materially affected. (A0139, A0144-147, ¶¶192, 202, 204, 206).

Still other disclosures by Carvana were demonstrably misleading. (A0147-149, ¶207) (management stating that "quite a small fraction of customers… were impacted by title and registration delays" and implying that Carvana's problems with state regulators were limited to North Carolina, despite actions already taken by California and Michigan). *See* Statement of Facts, Point III (Carvana Did Not Disclose this Information to the Public), *supra.*

This is quite different than *Camping World*, where the company "was upfront about the reality" that it might not be able to execute on its plan to operate 70 stores and that "its plans were subject to change." *In re Camping World Holdings, Inc. Stockholder Derivative Litigation,* 2022 WL 288152, at *10 (Del. Ch. Jan. 31, 2022). Unlike Carvana, the company in *Camping World* was making regular, contemporaneous, and fulsome disclosures about its changing business plans. *Id.* at *9.

The Court of Chancery was thus factually mistaken in ruling that "Carvana told the market almost the exact same information at almost the exact time." Ruling at 28, 30, citing *In re TrueCar, Inc., Stockholder Derivative Litigation,* 2020 WL 5816761 (Del. Ch. Del. Ch. Sept. 30, 2020).

The Board learned of Carvana's difficulty in ensuring adequate compliance with state T&R laws and the damage that this was causing to its NPS in July 2020. (A0125, A0127-129, ¶¶171, 174-175). In August 2020, Garcia Junior said during an earnings call that customers dislike delays in clearing title – an utterly banal observation. (A0141-142, ¶196). In October 2020, the Board was informed that "Registration Delays" were a key driver of faltering NPS. (A0129-130, ¶¶177-178).

Garcia Senior began selling his Carvana stock at the end of October 2020. (A0156, ¶219). In February 2021, the Board was informed that "Registration Delays" continued to drive low NPS. (A0130-132, ¶¶179-180). By the time the Company made its next disclosure a few days after the February 2021 Board meeting – that failure to adequately comply with state T&R laws "***could***" hypothetically have an adverse effect on the business – Garcia Senior had already sold over $1.7 billion worth of Carvana stock after amending his 10b5-1 trading plan to increase his daily

sales limit. (A0144, A0160, ¶¶202, 227, emphasis added). *See* Complaint Ex. A (stock sales table).

The only other disclosures before Garcia Senior stopped selling on August 23, 2021, were *i*) during the August 5, 2021 earnings call when Garcia Junior repeated that failing to comply with state T&R laws "***could***" – in other words, hypothetically – have an adverse effect on Carvana's business, and *ii*) during the J.P. Morgan 2021 Auto Conference on August 11, 2021 when Carvana's CFO misleadingly implied that North Carolina was the only state where Carvana faced a regulatory issue. (A0141-142, A0147-149, ¶¶196, 206-207). By then, Garcia Senior had almost finished his sales. Accordingly, the Court of Chancery misapprehended the facts in ruling that Carvana had publicly disclosed the MNPI at issue at or near the time that it was disclosed to the Board.

At the pleading stage, it is reasonable to infer that confidential information concerning Carvana's failure to ensure adequate compliance with state T&R laws, that this was a principal driver of customer dissatisfaction, and that its efforts to fix the problem were unsuccessful, would be material to a reasonable investor. Carvana's self-described business model is to offer customers a "nationwide inventory." (A0504). Adequately complying with state T&R laws is critical for

interstate car sales. Persistent problems with this central corporate function undermined Carvana's business model. For purposes of Chancery Court Rule 12(b)(6), this confidential information could thus fairly be deemed to have "assumed actual significance in the deliberations" of someone deciding whether to trade Carvana stock. *Rosenblatt*, 493 A.2d at 944.

Moreover, the materiality of this information is confirmed by the market reaction when it was finally disclosed to the public. *Pfeiffer*, 989 A.2d at 694; *SEB Investment Management AB v. Endo International PLC*, 351 F. Supp. 3d 874, 904 (E.D. Pa. 2018) ("The substantial fall in [the] stock price upon each revelation… demonstrate that the [concealed facts] were material. The market's reaction shows that an investor would want to know [these facts].").

Barron's published its *Undriveable Cars* exposé after the market closed on June 24, 2022, reporting the extent of Carvana's failure to adequately comply with state T&R laws. (A0067-76, A0186-187, ¶¶71-77 (summarizing exposé), 272). Carvana's stock price *fell by more than 30%* over the next five trading days. (*Id.*). On October 7, 2022, the Michigan Secretary of State suspended Carvana's dealer license because of "imminent harm to the public." (A0187, ¶273). On this news, the Company's stock fell by 13.8% over two trading days. (*Id.*). The Complaint lists

numerous other examples of Carvana's stock price falling after public disclosures of Carvana's failure to adequately comply with state T&R laws. (A0180-0186, ¶¶ 263-271).

2. It is Reasonable to Infer that Garcia Senior Knew and Was Motivated to Sell Based on this MNPI

Whether Plaintiff adequately pled that Garcia Senior knew Carvana's confidential information (*i.e.,* Carvana's persistent failure to adequately comply with state T&R laws, its negative effect on customer satisfaction, and the Company's inability to fix the problem), and was motivated to sell his Carvana stock by the substance of that information, is effectively the same scienter analysis. As noted in the Standard of Review above, Plaintiff's allegations are examined under a forgiving notice pleading standard and not under the more stringent particularity standard.

Courts recognize that "by necessity, a *Brophy* claim usually rests on circumstantial facts" at the pleading stage. *In re TrueCar, Inc. Sec. Litig.*, 2020 WL 5816761, at *24 (Del. Ch. Sept. 30, 2020). Plaintiff is "not required to uncover and plead the smoking scienter gun" for a successful *Brophy* claim…. [A]t this stage, it is enough [to] plead a series of… facts that would support a reasonable inference of knowledge, and resulting scienter, on the part of the insider trader[]." *In re Fitbit,*

Inc. Stockholder Deriv. Litig., 2018 WL 6587159, at *15 (Del. Ch. Dec. 14, 2018).[3] This typically includes facts about the timing and size of the trades. *Clovis*, 2019 WL 4850188, at *15; *Guttman v. Huang*, 823 A.2d 492, 504 (Del. Ch. 2003).[4] The relevant factors are considered in their totality. *Grabski on behalf of Coinbase Glob., Inc. v. Andreesen,* 2024 WL 390890, at *10 (Del. Ch. Feb. 1, 2024).

There are ample facts supporting the reasonable inference that Garcia Senior was motivated by his knowledge of Carvana's confidential information when he sold ***over $3.67 billion*** worth of Carvana stock. Garcia Senior changed his 10b5-1 trading plan to sell more shares not once, but twice in only six months to double his daily sales limit. (A0158, A0160, ¶¶224, 227). Garcia Senior's 10b5-1 trading plan adopted on June 15, 2020, let him sell up to 30,000 shares daily. (*Id.*) On November

[3] The allegations in *Fitbit* were evaluated under a particularity standard because demand futility was at issue. Because that is not the case here, Plaintiff's allegations must be evaluated "under the plaintiff-friendly Rule 12(b)(6) standard, [and] not a particularity standard." *Pfeiffer*, 989 A.2d at 692.

[4] Another factor that is frequently considered is the percentage of the insider seller's holdings that was sold. *Id.* Between October 30, 2020 and August 23, 2021, Garcia Senior sold 16.74% of his Carvana stock for proceeds of $3.67 billion. (A0156 ¶219). "[W]here, as here, stock sales result in a truly astronomical figure, less weight should be given to the fact that they may represent a small portion of the defendant's holdings." *Nursing Home Pension Fund, Loc. 144 v. Oracle Corp.*, 380 F.3d 1226, 1232 (9th Cir. 2004) (sales supported scienter in a "novel situation: few others could sell $900 million worth of stock and sell only 2.1% of their holdings").

4, 2020 – five months later – Garcia Senior turbocharged his 10b5-1 trading plan to increase his daily trading limit to 50,000 shares. (*Id.*). On May 21, 2021 – six months later – Garcia Senior changed his plan to increase his daily trading limit to 60,000 shares (*Id.*). Notably, the latter modification came as Carvana's stock price climbed to record highs shortly after Carvana was placed on probation in Michigan – a fact that was not disclosed to the public. (A0160, ¶227).

A University of Pennsylvania professor and head of the Forensic Analytics Lab at Wharton told *The Wall Street Journal*, "Historically, frequent modification of these plans has been concerning for regulators because it raises the chance that their owners are reacting to inside information. I've studied 20,000 10b5-1 plans. I can't recall another of this size where there are modifications every six months." (A0161, ¶228). A Stanford Graduate School of Business professor concurred, noting that "[t]he active modification of a 10b5-1 plan raises the question of whether someone is trying to rebalance their portfolio, time the market, or is in possession of [MNPI]." (A0160, ¶227). Garcia Senior modifying his 10b5-1 trading plan every six months resulting in his daily trading limit doubling supports a reasonable inference of scienter. On top of the suspicious modifications to his 10b5-1 trading plan, Garcia

Senior also sold 2 million shares of Carvana stock on December 2, 2020, outside his 10b5-1 trading plan for proceeds of over $478 million. (A0159, ¶226).

Also suspicious is that Garcia Senior made substantially all his stock sales *before* August 10, 2021. *See* Complaint Ex. A and B (table and charts of stock sales). That is the date of the first media report that Carvana was having difficulty in adequately complying with state T&R laws – the report by North Carolina television that Carvana's dealer license was suspended, which Carvana management was asked about at an auto conference the next day. (A0101-102, A0147-149, ¶¶ 135, 207).

Garcia Senior sold at the top of the market and stopped selling less than two weeks news of Carvana's suspension in North Carolina was first reported. *See* Complaint Ex. A and B. "[T]roubling is the fact that the stocks were sold… near the stock's peak… and just prior to the stock's decline… and subsequent plunge[.]" *No. 84 Emp.-Teamster Joint Council Pension Tr. Fund v. Am. W. Holding Corp.,* 320 F.3d 920, 939 (9th Cir. 2003). This further supports a reasonable inference of scienter.

Further supporting a reasonable inference of scienter are the Form 4s filed by Garcia Senior, showing that his most recent sale of Carvana stock prior to the start of his selling spree was on June 11, 2019 – more than 15 months earlier. (A0158-

159 ¶225). In fact, Garcia Senior's Form 4s reflect that, between June 11, 2019 (the date of Garcia Senior's last prior sale), and October 30, 2020 (the date of Garcia Senior's first sale at issue), he purchased 555,556 shares of Carvana stock at a below-market private sale which boosted the number of Carvana's outstanding public shares by 26% and diluted everyone except the Garcias. (*Id.*).

This purchase was through a private offering where the Court of Chancery noted in a prior case that the Garcias worked to engineer the sale for their own personal benefit. *In re Carvana*, 2022 WL 2352457, at *4. Specifically, "Garcia Senior participated behind the scenes in the planning and execution of the very abbreviated process" leading to the sale, which included back-and-forth emails between the Garcias about the details of the transaction. (A0157-158, ¶223, quoting *id.*). For example, "Garcia Junior forwarded the stock issuance allocations list to Garcia Senior, referring to the list as 'Pretty solid' and stating that they had to 'figure out [the] plan on your money.'" (A0064, ¶60, quoting *id.*).

This is not a case resting on conclusory allegations that Garcia Senior "must have known" of Carvana's confidential information by virtue of his position. Ruling at 27. Garcia Senior controls over 84% of the Company's stock voting power, and his son controls another 13%. (A0054-56, ¶¶43, 45). Garcia Senior used his

dominance over Carvana to install a Board that lacks independence and his son sits at the Company's helm. (A0056-57, ¶46). The Company acknowledged that the Garcias:

> have the ability to elect all of the members of our Board and thereby control our policies and operations, including the appointment of management, future issuances of our Class A common stock or other securities, the payment of dividends, if any, on our Class A common stock, the incurrence of debt by us, amendments to our amended and restated certificate of incorporation and amended and restated bylaws, and the entering into of extraordinary transactions.

(A0063, ¶59). The Garcias use their control to run Carvana "as if it's a family firm and for the family's benefit." (A0063, ¶58). There has been over $1.5 billion worth of related party transactions between the Garcias and Carvana, deals which the Company acknowledges were "not negotiated at arm's length." (A0057, 0062, ¶¶47, 55-57).

Under the circumstances, it is reasonable to infer the Garcias talk about the Company – particularly matters affecting its business. Garcia Senior's longtime and extensive close personal and professional ties to Platt and Sullivan support the same inference. (A0195-0209, ¶¶293-316). With over three decades in the used car business, (A0050, ¶34), Garcia Senior recognizes the significance of confidential information that Carvana's compliance with state T&R laws was inadequate. Garcia

Senior thus had motive and opportunity to learn and act upon Carvana's confidential information that would negatively affect the value of his substantial holdings in the Company when it inevitably came out.

Accordingly, Plaintiff alleges sufficient facts, under the lenient pleading standards of Chancery Court Rules 8, 9, and 12(b)(6), to infer that Carvana's undisclosed systematic failure to ensure adequate compliance with state T&R laws, its negative effect on customer satisfaction, and the Company's inability to fix the problem constitutes MNPI, and that Garcia Senior was motivated to sell over $3.67 billion worth of his Carvana stock by the substance of this information.

CONCLUSION

Plaintiff respectfully requests the Court reverse the Court of Chancery's ruling dismissing her *Brophy* claims against Garcia Senior under Rule 12(b)(6) and direct further proceedings consistent therewith.

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Dated: December 10, 2024
Public Version: December 26, 2024