



IN THE COURT OF CHANCERY OF THE STATE OF DELAWARE

THE CITY OF CAMBRIDGE)
RETIREMENT SYSTEM,)
)
 Plaintiff,)
) C.A. No. 2017-0322-SG
 v.)
)
 UNIVERSAL HEALTH SERVICES, INC.,)
)
 Defendant.)
 _____)

**DEFENDANT'S OPENING BRIEF
ON THE INCORPORATION CONDITION**

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INTRODUCTION

The Court asked the parties to brief the narrow (and likely dispositive) legal issue that triggered this books-and-records action pursuant to 8 *Del. C.* § 220. Defendant Universal Health Services, Inc. (“UHS”) asked Plaintiff The City Of Cambridge Retirement System (“Cambridge”) to agree that any derivative complaint Cambridge might file based on its Section 220 inspection be deemed to incorporate by reference the documents Cambridge inspects (an “Incorporation Condition” or “Condition”). This Court approved and imposed such an Incorporation Condition in *Amalgamated Bank v. Yahoo! Inc.* (“*Yahoo*”).¹ The two other UHS stockholders that have made books-and-records demands like Cambridge’s have agreed to it, and obtained UHS’s substantial production of requested documents. But Cambridge refused, and opted to challenge *Yahoo* and its Incorporation Condition. This Court should reject that challenge and impose the Condition.

Parting ways with *Yahoo* and the other UHS stockholders, Cambridge maintains that it is entitled to inspect UHS’s books and records with no Incorporation Condition whatsoever.² Cambridge’s objection is unfounded. The

¹ 132 A.3d 752, 796–99 (Del. Ch. 2016).

² Verified Complaint Pursuant to 8 *Del. C.* § 220 to Compel Inspection of Books and Records, filed April 26, 2017 (Dkt. No. 1, Tr. ID 60490251, “Complaint”) ¶ 26.

Incorporation Condition—as this Court held in *Yahoo*—merely ensures that, should a plaintiff take inspected documents out of context in a future complaint, a court may consider the context. It does not alter the pleading standard on that future complaint. Cambridge asserts, however, that it has the right to force a court to consider only those inspected documents it picks and chooses to cite. Cambridge thus departs not only from *Yahoo*, but also from the established law and practice on which *Yahoo* relied. Worse, Cambridge would require the judiciary to let a future derivative case proceed even if Cambridge had inspected books and records rendering its allegations unsupportable.

This Court should not indulge such an affront to judicial efficiency. UHS reasonably insisted on an Incorporation Condition here, and the Court should enter partial judgment imposing that Condition. Once the Court rules on the Incorporation Condition, UHS will produce the documents it has already agreed to provide for Cambridge’s inspection. Cambridge has not identified any specific issues with the scope of that proposed production. UHS thus anticipates that the parties can resolve any further issues without the Court’s intervention. If not, however, then UHS reserves its previously stated objections to the purpose and scope of Cambridge’s inspection demand,³ as discussed with the Court on May 8, 2017.

³ See Complaint Ex. 3.

BACKGROUND

In December 2016, a web site called “BuzzFeed” published a story alleging misconduct at behavioral health facilities affiliated with UHS.⁴ UHS promptly disputed and denied those allegations. Among other things, UHS released a substantial amount of information rebutting BuzzFeed’s claims at www.uhsthefacts.com.⁵ Although UHS’s stock price fell temporarily after the BuzzFeed story,⁶ it quickly returned to pre-BuzzFeed levels.⁷

The BuzzFeed story nevertheless precipitated legal action. Based on the story, a securities class action⁸ and a derivative action⁹ were filed. In addition, three stockholders (including Cambridge) have requested to inspect UHS’s books and records pursuant to 8 *Del. C.* § 220.

The books-and-records requests from the two stockholders other than Cambridge are proceeding smoothly. Both stockholders agreed to confidentiality

⁴ See Complaint Ex. 1 at 2-5.

⁵ Complaint Ex. 3 at 2.

⁶ Complaint Ex. 1 at 6.

⁷ Complaint Ex. 3 at 2.

⁸ *Heed v. Universal Health Servs., Inc.*, No. 16-cv-9499 (C.D. Cal.).

⁹ *Heed v. Miller*, No. 17-cv-1476 (E.D. Pa.).

agreements containing an Incorporation Condition like the one this Court approved in *Yahoo*.¹⁰

Things have gone less smoothly with Cambridge. Unlike the other two stockholders, Cambridge refused to sign any agreement with UHS with an Incorporation Condition. UHS tried to accommodate Cambridge's concerns. In emails and a teleconference, UHS's counsel explained the basis for the Incorporation Condition, and offered to expressly limit it to the terms set forth in *Yahoo*.¹¹ On April 26, however, Cambridge filed the Complaint, alleging that "[c]onditioning the production of documents on a stockholder's acceptance of an Incorporation [Condition] is improper."¹²

¹⁰ See *Amalgamated Bank v. Yahoo! Inc.*, 132 A.3d 752, 796–99 (Del. Ch. 2016).

¹¹ See Complaint ¶ 24.

¹² Complaint ¶ 26; see *id.* ¶¶ 9-12, 23-25, 27, 38.

NATURE AND STAGE OF THE PROCEEDINGS

On April 26, 2017, Cambridge filed its Complaint to compel inspection of books and records pursuant to 8 *Del. C.* § 220. It simultaneously filed a motion to expedite this case. Regarding that motion, the Court held a teleconference on May 8, 2017. On that teleconference, the Court agreed to resolve the Incorporation Condition issue on opening and answering briefs submitted by the parties on May 15 and May 24, respectively. The Court further set a hearing for July 17, 2017, to address any remaining issues, including UHS's reserved objections to the purpose and scope of Cambridge's inspection demand.¹³

¹³ See Complaint Ex. 3. As the Court explained during its May 8, 2017 teleconference with counsel:

You can brief it any way you like, but I'm going to decide the legal issue first and then we are going to go to a hearing on scope if we need to. So if you will set a briefing schedule, I will be happy to look at this quickly and decide whether I need to get you back on the phone for any more assistance. Otherwise, I'll give you my decision on that issue and then you can decide what's left for a hearing.

Transcript of May 8, 2017 teleconference, Appendix ("App"), Tab 1, at p. 8.

ARGUMENT

I. THE COURT MAY IMPOSE AN INCORPORATION CONDITION ON THE INSPECTION

Section 220 provides that this “Court may, in its discretion, prescribe any limitations or conditions with reference to” a books-and-records inspection.¹⁴ This grant of authority is—as the Supreme Court recently recognized—“broad.”¹⁵ “[N]othing in the text of § 220 itself or Delaware case law in interpreting it limits the Court of Chancery’s authority to restrict the use of material from an inspection when” “the legitimate interests of Delaware corporations” “are threatened.”¹⁶ Accordingly, “Delaware courts have repeatedly ‘placed reasonable restrictions on shareholders’ inspection rights in the context of suit brought under 8 *Del. C.* § 220.’”¹⁷

Imposing an Incorporation Condition on Cambridge’s inspection of books and records is well within the authority that Section 220 grants. Indeed, this Court so held in *Yahoo*. It recognized that “the Incorporation Condition protects the legitimate interests of both [the defendant] and the judiciary by ensuring that any [derivative] complaint that [the plaintiff] files will not be based on cherry-picked

¹⁴ 8 *Del. C.* § 220(c).

¹⁵ *United Techs. Corp. v. Treppel*, 109 A.3d 553, 557 (Del. 2014).

¹⁶ *Id.* at 559 (emphasis added).

¹⁷ *Disney v. Walt Disney Co.*, C.A. No. 234-N, 2005 WL 1538336, at *1 (Del. Ch. June 20, 2005) (quoting *Stroud v. Grace*, 606 A.2d 75, 89 (Del. 1992)); see also *United Techs.*, 109 A.3d at 558 & n.30.

documents.”¹⁸ Moreover, as explained below, the Incorporation Condition merely “build[s] on” existing law permitting courts to consider documents integral to a complaint.¹⁹ Because the Incorporation Condition thus “protect[s] the corporation’s legitimate interests and [prevents] possible abuse of the shareholder’s right of inspection,” it is within the Court’s authority to impose.²⁰

II. THE COURT SHOULD IMPOSE AN INCORPORATION CONDITION ON THE INSPECTION

A. The Incorporation Condition Is Proper

The Complaint is a frontal assault on this Court’s holding in *Yahoo*.²¹ The Court cannot give Cambridge what it seeks without rejecting the sound reasoning of *Yahoo* and opening a rift in Delaware law. Cambridge does not and cannot justify such a drastic step.

Yahoo was much like this case. The plaintiff “suspect[ed] wrongdoing” and, to investigate, filed a books-and-records action pursuant to Section 220.²² Either by agreement or order, the defendant provided some (but not all) of the requested

¹⁸ *Yahoo*, 132 A.3d at 797.

¹⁹ *Id.*

²⁰ *CM&M Grp., Inc. v. Carroll*, 453 A.2d 788, 793–94 (Del. 1982); *see Yahoo*, 132 A.3d at 796–97.

²¹ 132 A.3d at 796–99. Appeals were taken from *Yahoo*, but the case was dismissed with prejudice before the appeals reached the merits. Stipulation of Dismissal, *Amalgamated Bank v. Yahoo! Inc.*, C.A. No. 10774-VCL (Del. Ch. June 13, 2016).

²² *Yahoo*, 132 A.3d at 778.

documents, but sought an Incorporation Condition requiring that the inspected documents be deemed “incorporat[ed] by reference into any derivative action complaint that [the plaintiff] files.”²³

The *Yahoo* Court imposed the Incorporation Condition.²⁴ “[T]he only effect of the Incorporation Condition,” the Court reasoned, “will be to ensure that the plaintiff cannot seize on a document, take it out of context, and insist on an unreasonable inference that the court could not draw if it considered related documents.”²⁵ This “protects the legitimate interests of both [the defendant] and the judiciary by ensuring that any complaint that [the plaintiff] files will not be based on cherry-picked documents.”²⁶

With such a limited and laudable effect, the arguments against an Incorporation Condition are unpersuasive. Plaintiffs should not have the right to “[p]lay[] games with virtual ellipses,”²⁷ forcing courts to make inferences from

²³ *Id.* at 774–75, 796.

²⁴ *Id.* at 796.

²⁵ *Id.* at 798.

²⁶ *Id.* at 797; *accord id.* at 798 (“Imposing the condition helps balance Yahoo’s rights against those of the plaintiff by recognizing that the production as a whole should provide the basis for any follow-on complaint, not just a handful of isolated documents or emails.”).

²⁷ *See In re Synthes, Inc. S’holder Litig.*, 50 A.3d 1022, 1026 (Del. Ch. 2012).

documents that are flatly contradicted by other documents the plaintiff has. And, of course, parties have no right to mislead the Court.²⁸

As the *Yahoo* Court explained, moreover, imposing an Incorporation Condition is fully consistent with established law. For example, courts may, on motions to dismiss, consider any documents “integral” to or “incorporated by reference into” the complaint.²⁹ This rule, like the Incorporation Condition, rests on the public policy that “allegations largely predicated upon documents not presented to the Court in the pleadings should not escape the Court’s review under Rule 12(b)(6) by the plaintiff’s merely alleging selected and misleading portions of those documents.”³⁰ Similarly, courts ruling on motions for preliminary injunctions may consider evidence outside the complaint on which plaintiffs have relied.³¹

The reasoning of *Yahoo* applies with equal force here. Indeed, Cambridge has offered no basis for distinguishing this case from *Yahoo*. Because *Yahoo* is persuasive—and because departing from *Yahoo* would make this Court’s law

²⁸ *E.g.*, Del. R. of Prof’l Conduct 3.3(a) (providing, inter alia, that “[a] lawyer shall not knowingly . . . make a false statement of fact or law to a tribunal”).

²⁹ *Winshall v. Viacom Int’l, Inc.*, 76 A.3d 808, 817 (Del. 2013); *see Yahoo*, 132 A.3d at 797.

³⁰ *In re Gardner Denver, Inc.*, C.A. No. 8505-VCN, 2014 WL 715705, at *2 (Del. Ch. Feb. 21, 2014) (quotation marks omitted).

³¹ *In re Morton’s Rest. Grp., Inc. S’holders Litig.*, 74 A.3d 656, 658–59 n. 3 (Del. Ch. 2013) (Strine, C.); *see Yahoo*, 132 A.3d at 798.

inconsistent—the Court should enter partial judgment imposing an Incorporation Condition on Cambridge’s inspection.

B. Cambridge’s Arguments Against The Incorporation Condition Are Meritless

Cambridge’s Complaint alleges various reasons why the Court should depart from *Yahoo* and compel UHS to proceed with the inspection, subject to its objections, without an Incorporation Condition. None persuades.

1. Cambridge first objects that nothing in 8 *Del. C.* § 220 *requires* the Incorporation Condition.³² That is hardly surprising. Not every books-and-records demand is made to investigate alleged wrongdoing and prepare a derivative complaint. An Incorporation Condition might well be superfluous when books-and-records demands are made for other purposes. But it makes perfect sense in cases like this case—and *Yahoo*—where the plaintiff’s object is to investigate a potential derivative complaint.

Delaware courts routinely impose (and so parties routinely agree to) sensible conditions not required by statute. Section 220 does not impose a confidentiality requirement, for instance. But, “[a]lthough once novel, now there is a presumption that the production of books and records pursuant to section 220 should be conditioned upon a reasonable confidentiality order.”³³ Likewise, courts may

³² Complaint ¶ 26(a).

³³ *Yahoo*, 132 A.3d at 796–97 (quotation marks omitted).

require that any derivative suit based on the inspected documents be filed in Delaware.³⁴ Courts' authority to impose such conditions is beyond dispute.³⁵

Since *Yahoo*, the Incorporation Condition has joined the ranks of commonly imposed conditions. As noted above, two other UHS stockholders have agreed to it. So have plaintiffs in at least three other books-and-records cases brought in this Court.³⁶

2. Cambridge next notes that “an Incorporation [Condition] is not part of the standard form confidentiality order recommended by the Court of Chancery.”³⁷ But that standard form has nothing to do with this case. It is designed for discovery in plenary proceedings, not books-and-records inspections.³⁸ In plenary proceedings, discovery typically comes *after* motions to dismiss the substantive complaint, when an Incorporation Condition would serve no purpose.

³⁴ *United Techs. Corp. v. Treppel*, 109 A.3d at 558–59.

³⁵ *See* 8 Del. C. § 220(c); *Yahoo*, 132 A.3d at 796.

³⁶ *See* App. at Tab 2, Plaintiffs' Post-Trial Brief at 16-18, *In re Plains All Am. Pipeline, L.P. Unitholders Books & Records Litig.*, C.A. No. 11954-VCMR (Del. Ch. Mar. 9, 2017); App. at Tab 3, Defendants' Reply Brief In Support Of Motion To Dismiss at 12-13 n. 24, *H&N Mgmt. Grp., Inc. v. Couch*, C.A. No. 12847-VCMR (Del. Ch. Mar. 3, 2017); App. at Tab 4, Defendants' Opening Brief In Support Of Their Motions To Dismiss at 12 n. 4, *IRA Trust FBO Bobbie Ahmed v. Crane*, C.A. No. 12742-CB (Del. Ch. Dec. 29, 2016).

³⁷ Complaint ¶ 26(b).

³⁸ *See* http://courts.delaware.gov/chancery/docs/Sample_Confidentiality_Stipulation.pdf.

3. Cambridge further contends that the Incorporation Condition would, “for all practical purposes, improperly alter[] the pleading standards applicable to any derivative claim that may result from the stockholder’s 220 investigation.”³⁹

Yahoo squarely rejected this contention. As the Court explained, “The Incorporation Condition *does not change the pleading standard* that governs a motion to dismiss. For purposes of a Rule 12(b)(6) motion, all well-pleaded factual allegations still will be accepted as true. If there are factual conflicts . . . , and if the plaintiff makes a well-pleaded factual allegation, then the allegation will be credited.”⁴⁰

In other words, with or without the Incorporation Condition, courts are required to view “competing inferences or a factual dispute”⁴¹ “in a light most favorable to the plaintiff.”⁴² The Condition would only keep plaintiffs from “insist[ing] on an unreasonable inference that the court could not draw if it considered related documents.”⁴³

³⁹ Complaint ¶ 26(d).

⁴⁰ *Yahoo*, 132 A.3d at 798 (emphasis in original; quotation marks and citation omitted).

⁴¹ See Complaint ¶ 26(d).

⁴² *McMullin v. Beran*, 765 A.2d 910, 916 (Del. 2000).

⁴³ *Yahoo*, 132 A.3d at 798; see also *Gantler v. Stephens*, 965 A.2d 695, 704 (Del. 2009) (holding that, on a motion to dismiss, courts may not “draw unreasonable inferences in the plaintiffs’ favor”).

In any event, the rationale for limiting what a court may consider on a motion to dismiss a derivative action does not undermine the Incorporation Condition. As then-Chancellor Strine has explained, “Generally, the harm of considering any materials not attached” to the complaint on a motion to dismiss “is the lack of notice that the material may be considered.”⁴⁴ The Incorporation Condition threatens no such harm. The plaintiff and the defendant each would have—and each would know that the Court could consider—all of the documents subject to the Condition.

4. Relatedly, Cambridge objects that the Incorporation Condition lets a company frame any future derivative complaint by “cherry-picking the documents it produces.”⁴⁵ That is wrong for two reasons. First, it is the plaintiff, not the defendant, that chooses what to allege and what inferences it wants drawn from documents referred to in the complaint. The defendant, on a motion to dismiss, may respond only to the plaintiff’s allegations and contest unreasonable inferences.

Second, as explained above, the Incorporation Condition does not alter any pleading standards. It does not permit the defendant to lob in its own evidence in the hope of creating factual disputes and prevailing on them. In assessing the sufficiency of a pleading, the plaintiff still must prevail in any factual dispute on

⁴⁴ *Morton’s*, 74 A.3d at 658 n.3 (quotation marks omitted); *see also Gardner Denver*, 2014 WL 715705, at *2 & n. 13.

⁴⁵ Complaint ¶ 26(c).

which reasonable minds could differ. The Incorporation Condition allows the defendant only to provide the full picture if the plaintiff “seize[s] on a document and take[s] it out of context.”⁴⁶

5. Cambridge next argues that the Incorporation Condition is unnecessary in light of this Court’s Rule 11.⁴⁷ But *Yahoo* correctly rejected this argument as well. As the Court explained, “invoking Rule 11 is strong medicine,” best suited to outright falsehoods.⁴⁸ The Incorporation Condition “enables a court to deal with” unreasonable inferences “in more measured fashion.”⁴⁹ By analogy, when plaintiffs have distorted individual documents in their complaints, this Court has credited the documents rather than imposing Rule 11 sanctions.⁵⁰ An Incorporation Condition merely authorizes the same approach if a plaintiff distorts the body of the books and records it has inspected.

⁴⁶ *Yahoo*, 132 A.3d at 797.

⁴⁷ Complaint ¶ 26(e) (“If a defendant board believes the stockholder is being disingenuous or making statements that are false and inconsistent with the evidence, the board has appropriate remedies, including under Rule 11.”).

⁴⁸ *Yahoo*, 132 A.3d at 799.

⁴⁹ *Id.*

⁵⁰ *E.g., In re BioClinica, Inc. S’holder Litig.*, C.A. No. 8272-VCG, 2013 WL 5631233, at *7 (Del. Ch. Oct. 16, 2013) (crediting the document, not the plaintiffs’ allegation, where the allegation “selectively ignore[d] the predicate of the *same sentence*” (emphasis in original)).

6. Finally, Cambridge claims that *Frederick Hsu Living Trust v. ODN Holding Corp.*⁵¹ “makes clear that a stockholder is *not* required to accept an incorporation by reference provision in order to exercise inspection rights under Section 220.”⁵² But *Frederick Hsu* says no such thing. That opinion concerned a plenary action filed *after* a books-and-records action had already concluded.⁵³ The defendant asked the Court to incorporate books and records into the complaint after the fact. The Court declined, however, because the authority for imposing an Incorporation Condition (Section 220) does not apply to plenary actions.⁵⁴ All *Frederick Hsu* holds, therefore, is that the time to impose an Incorporation Condition is *during* the books-and-records action—that is, now.

III. A DECISION WHETHER TO IMPOSE AN INCORPORATION CONDITION COULD END THIS ACTION

The Court stated during its May 8 teleconference with the parties that it intended to enter partial judgment regarding the Incorporation Condition before addressing any other issues that this action might present.⁵⁵ It authorized UHS to

⁵¹ C.A. No. 12108-VCL, 2017 WL 1437308 (Del. Ch. Apr. 25, 2017).

⁵² Plaintiff’s Reply In Support Of Motion To Expedite at 3 (May 3, 2017) (Dkt. No. 11, Tr. ID 60551100).

⁵³ *Frederick Hsu Living Trust v. ODN Holding Corp.*, C.A. No. 12108-VCL, 2017 WL 1437308, at *1-*2 (Del. Ch. Apr. 25, 2017).

⁵⁴ *Id.* at *2-*3 (distinguishing *Yahoo*).

⁵⁵ *See* App. Tab 1 at p. 8 (indicating that the Court would determine the Incorporation Condition issue first, “and then you can decide what’s left for a hearing”).

reserve its rights on its objections to the demand's purpose and scope⁵⁶ at this time. That approach was prudent, because resolving the Incorporation Condition question should end this action and obviate the need to address any further issues.

The parties already have a meaningful starting point for resolving any residual issues without the Court's intervention. UHS has already agreed, subject to its objections about purpose and scope, to produce a plethora of responsive books and records.⁵⁷ Since UHS proposed that inspection, on April 3, Cambridge has not objected to its scope or asked to meet and confer about it. In the meantime, Cambridge's April 26 Complaint focused almost entirely on the Incorporation Condition, and mentioned UHS's proposed production only in passing. UHS is hopeful that, with the Incorporation Condition resolved, the parties will be able to reach agreement on any remaining issues without further judicial intervention.

⁵⁶ See Complaint Ex. 3.

⁵⁷ Complaint Ex. 3; Complaint ¶ 23.

CONCLUSION

The Court should enter partial judgment directing that any inspection of books and records shall be conditioned on the inspected books and records being deemed incorporated by reference into any complaint Cambridge files relating to the subject matter of its demand.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I, Joseph C. Schoell, do hereby certify that on May 15, 2017, a copy of each of the following documents: 1) Defendant's Opening Brief on the Incorporation Condition; 2) Certificate of Compliance with Typeface Requirement and Type-Volume Limitation; 3) Appendix to Defendant's Opening Brief on the Incorporation Condition; and 4) Compendium of Key Cases to Defendant's Opening Brief on the Incorporation Condition was served upon the following counsel of record via File and ServeXpress:

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