NATURE OF THE ACTION

1. This is a securities fraud class action brought on behalf of a class consisting of all persons, other than defendants and persons and entities related to them, who purchased or otherwise acquired the common stock of Sun Healthcare Group, Inc. ("Sun" or the "Company") from June 2, 1998, through the close of trading on February 1, 1999 (the "Class Period").

2. Sun purports to be one of the largest full-service, long-term healthcare providers in the United States. The Company owns and operates an international network of hospitals, nursing centers and contract-service providers in 46 states and 4 foreign countries. The Company reported more than $3 billion in 1998 revenues, employing a work force in excess of 50,000 people. A substantial amount of Sun's revenues are derived from Medicare patients. As health costs soared during the 1990's, Congress debated at length a Medicare payment plan that would cut Medicare expenditures by billions of dollars.

3. As a result of this debate, legislation was passed in the form of the Balanced Budget Act of 1997 ("BBA"), and thereafter, on May 12, 1998, the Health Care Financing Administration ("HCFA") published for all post-hospital extended-care services – principally skilled nursing facilities ("SNFs") – new reimbursement rates, known collectively as the Prospective Payment System ("PPS" or "SNF-PPS"). It did this under §4432 of the BBA, which mandated phasing in the SNF-PPS and affected Sun materially and adversely in several respects:

   (a) The BBA's new per-diem flat rate replaced the previous reimbursement system under which Medicare paid separately, for covered SNF patients, for "reasonable-care," routine-care, capital, and ancillary-service costs. The Medicare per-diem established a single flat payment that was markedly below the previous total of the separate payments. Medicare reimbursement per-day/per-patient went from an average figure of $500 in 1998 to $325 in 1999.

   (b) A major part of Sun's core business consists of its own network of SNFs (i.e., affiliated" facilities), which was one of the largest in the country, and one that was expanding. Revenue from long-term and subacute-care services, including ancillary services to affiliated facilities, was $1,237,746,000 in 1997. Whereas nursing homes overall draw only about 12% of their revenues from Medicare, with the rest coming mainly from state/federal Medicaid or out-of-
pocket, Sun's SNFs drew a much higher percentage of revenue — 24%-30% — from Medicare. This had made Sun more profitable than other nursing-home chains in the past — when Medicaid, but not Medicare, had been tightly constrained — but the BBA made the Company highly vulnerable to the diminished payments under the new Medicare SNF-PPS reimbursement system. That was because Sun treats a greater percentage of higher-acuity patients than many other nursing homes, and the SNF-PPS calculations most adversely affect such higher-acuity patient providers. The reimbursement reduction for Medicare patients of SNFs directly reduced Sun's revenues.

(c) Sun operated an extensive network of contract service providers of ancillary services, including physical, speech and respiration rehabilitation therapy, and pharmaceutical services, under contracts that provided these services to SNFs not part of Sun itself, that is, "unaffiliated" SNFs. Sun also was one of the largest providers of temporary — therapy staffing to unaffiliated hospitals and nursing homes. Revenue in 1997 from therapy services to nonaffiliates was $301,301,000; from pharmaceutical services to nonaffiliates, $123,411,000; and from temporary — therapy-staffing services to nonaffiliates, $138,556,000. These services had been a profitable part of Sun's business in previous years because separate Medicare payment for ancillary services to SNF patients had been fast-growing and high-volume. But the per-diem SNF-PPS adversely changed that. With the unaffiliated SNFs not able to arrange reimbursement by Medicare for ancillary services separate from the overall flat per-diem, the unaffiliated SNFs reduced their contract service arrangements with Sun by terminating the contracts, reducing the volume of services purchased or negotiating lower payment rates.

(d) Besides the SNF-PPS, which curbed spending by Medicare Part A on therapy services, BBA §4641 also curbed spending by Medicare Part B on therapy services. Even though patients received therapy services through Medicare Part B in some circumstances, beginning in 1999 the BBA imposed an annual per-beneficiary cap of $1,500 for total Part B outpatient physical, speech and occupational-rehabilitation therapy. These caps produced an overall market glut of therapy services and further increased the occurrence of unaffiliated purchasers of contract-therapy services reducing payments to Sun by terminating the contracts or by reducing the volume of services purchased in favor of obtaining the services in other ways or by negotiating lower rates.
(e) Sun's announced marketing approach of selling a more comprehensive array of contract-therapy services than its competitors — through its SunSolutions division — did not reverse the BBA's adverse effect on Sun. The Company's marketing strategy was little more than avoiding — only temporarily — public acknowledgment of the problems;

(f) The BBA also curbed payments for other parts of Sun's business, including its chain of rehabilitation hospitals. The BBA §§4411, 4412, 4414, 4415, 4416, and 4419 imposed a series of measures curbing Medicare reimbursement of rehabilitation hospitals, including reducing capital payments, ceasing annual updates in reimbursement rates, caps on limits, reduced bonuses, and ending favorable exemptions and other terms for some providers. These measures produced falling rates and a glut of rehabilitation hospital beds.

4. Despite the certainty that the BBA and PPS reimbursement schedule would cause staggering declines in revenues, Sun's public statements, both before and during the Class Period, led the investing public to falsely believe that the SNF-PPS and other Medicare reimbursement policies, (which had historically accounted for almost 30% of Sun's annual revenue) would not have a material impact on the Company's operating results.

5. In order to at least temporarily off-set the revenue declines Sun was going to suffer under the BBA, Sun's strategy was to continue its expansion in the nursing-care industry. The growth-by-acquisition strategy was dependent upon and achieved almost entirely by acquiring for stock and cash nursing-care facilities throughout the world. In furtherance of this plan, which was dependent upon Sun maintaining a high stock price, Sun acquired Regency Health Services, Inc. ("Regency") in 1997, which dramatically increased the size of Sun's business. Primarily as a result of this acquisition, Sun's total assets increased from $1.2 billion at December 31, 1996, to more than $2.5 billion at December 31, 1997. Sun's debt also increased dramatically — to $1.5 billion — as a result of the acquisition. Thereafter, in June 1998, Sun acquired Retirement Care Associates ("RCA"), an operator of 98 skilled-nursing facilities and assisted-living centers in the Southeast United States. This acquisition, which had been in negotiations for 20 months, was designed to increase Sun's revenues and to gain entry into the Southeast U.S. market, particularly in Florida. As part of the RCA purchase, Sun also acquired Contour Medical, Inc. ("Contour"), which was a
subsidiary of RCA. Sun paid for RCA with 7.6 million shares of its stock. The number of shares paid was dependent on the value of Sun's stock for the 20 trading days prior to the closing. Thus, the higher the price of Sun's stock, the fewer shares Sun had to pay.

6. Under the BBA, healthcare providers were scheduled to switch to the PPS per-diem reimbursement plan at varying times. RCA converted on July 1, 1998, and Sun converted on January 1, 1999. The Company knew, however, even before the PPS reimbursement plan was actually implemented, that Sun could not profitably operate under the new rules. Sun knew of the adverse impact BBA would have on its existing operations and profitability due to the knowledge they obtained from Sun's Northwest Region, which, under the directorship of Vice President Colleen Bittner, had operated under a similar per-diem payment schedule from at least 1995. Bittner repeatedly explained to defendant Andrew Turner and Regional Vice Presidents Gary McGuire, Connie Gray, and Tom Mack, that the per-diem system of Medicare reimbursement provided Sun with insufficient funds to profitably operate. Despite reorganization and cost-cutting efforts, the Northwest Region consistently under-performed compared with Sun's other regions and lost money. Thus, defendants knew or should have known of the material, adverse impact that the BBA would have on the Company's future results. However, to prevent the complete collapse of Sun's stock price, defendants publicly, but falsely, proclaimed throughout the Class Period that Sun was well prepared to meet the challenges of the BBA and better suited than its competitors to address the changing Medicare environment.

7. Defendants took advantage of Sun's artificially inflated stock price by negotiating and consummating several critical acquisitions utilizing Sun's common stock as currency. The buyouts of RCA and Contour were critical to Sun's future success because various avenues of previous growth would be cut off almost entirely under the new Medicare reimbursement system. Thus, defendants believed that the only way to meet outstanding short-term growth estimates was through acquisitions as opposed to "internal" growth. Consequently, they were motivated to conceal the adverse impact the Medicare PPS would have on the Company until after the RCA and Contour acquisitions were completed. Defendants were further motivated to conceal the true impact of the BBA on Sun's operations for a substantial period of time after the acquisitions were completed so
as not to subject themselves and the Company to litigation from former shareholders of RCA or Contour who had given up their shares in those companies in exchange for Sun's common stock. Ultimately, however, after the truth of Sun's business was revealed, RCA did sue Sun for, *inter alia*, securities fraud.

8. Despite Sun's knowledge that it would suffer materially lower revenues under the PPS and that its Northwest Region had earlier failed to profitably operate under a similar reimbursement system, the defendants asserted that Sun was well positioned for the new regulations, that its SunSolution product would offset much of the revenue decreases expected from the PPS, and that Sun was on track to earn $0.90+ and $1.00+ per share in 1998 and 1999, respectively. For example:

   (a) On August 11, 1998, Sun's Chairman and CEO, defendant Andrew L. Turner ("Turner"), stated that "while the industry's transition to Medicare PPS continues to present challenges and uncertainties, Sun continues to demonstrate both its leadership and its preparedness for the new operating environment."

   (b) On October 8, 1998, defendant Mark G. Wimer ("Wimer"), the Company's Chief Operating Officer, was quoted in the *Albuquerque Tribune* as follows:

   "I think that any type of environmental change as significant as the conversion of the Medicare program from a cost basis to a fixed-fee system creates turmoil. Every time we have one of these waves of change, there are many more opportunities to acquire facilities."

   "People say 'I am fed up with change. I've been running my nursing home for 15 years, and this is the last straw. I'm selling out.'"

   "Anytime there's turmoil, there's opportunity."

   (c) On October 29, 1998, in connection with Sun's 1998 third quarter earnings announcement, Turner continued to falsely imply that Sun was prepared to deal with the implementation of the PPS:

   We continue to believe that the new prospective payment system will make our industry more efficient, providing benefit to both our resident population and the government. We also continue to believe that PPS will favor Sun's operating model of controlling all of the ancillary services required by long-term care residents. That view is already being borne out by the early marketing success of our SunSolution product.
(d) In an article published in *Modern Healthcare*, on November 9, 1998, Turner once again falsely implied that the new Medicare PPS standards would be of benefit to Sun and its shareholders by stating that the Company was benefitting from Medicare's new long-term care PPS thanks to "early and intensive preparation."

(e) Defendants made these statements during the Class Period even though the Company participated in efforts by the healthcare industry to have Congress "carve-out" or separate payment for ancillary services — because of PPS's large-scale adverse effects. Well before it adjourned in October 1998, Congress had decided not to make the requested "carve-out" which Sun desperately needed, making it doubly misleading for defendants to publicly embrace the changes as a positive for Sun.

9. On February 2, 1999, after months of these positive statements, which were repeated by securities analysts who urged investors to "buy" Sun's stock, the Company stunned the investing public by announcing that its fourth quarter 1998 results would show a staggering loss of $761 million due to Medicare payment changes and a declining demand for its therapy services.

10. This announcement, which starkly contradicted defendants' representations throughout the Class Period, caused Sun's common stock price to fall by 57%, from $4-3/4 to $2-1/16 per share, far below its Class Period high of $17 per share, on trading volume of 16.2 million shares, 26 times its three-month daily average. Shortly after the announcement, several security analysts who were following the Company slashed their ratings. As Sun has continued to disclose additional problems, including mounting losses of hundreds of millions of dollars and possible bankruptcy, its stock price declined to as low as $1-3/16 and presently does not trade. As a result, thousands of investors who purchased Sun's stock during the Class Period have lost tens of millions of dollars.

**JURISDICTION AND VENUE**

11. The claims asserted herein arise under and pursuant to §§10(b) and 20 of the Securities Exchange Act of 1934 (the "Exchange Act") [15 U.S.C. §§78j(b) and 78t(a)] and Rule 10b-5 promulgated thereunder by the SEC [17 C.F.R. §240.10b-5].
12. This Court has jurisdiction over the claims asserted in this Complaint pursuant to §27 of the Exchange Act, as amended [15 U.S.C. §78aa], and 28 U.S.C. §§1331 and 1337.

13. Venue is proper in this judicial district pursuant §27 of the Exchange Act. Certain acts and conduct complained of herein, including the dissemination of materially false and misleading information to the investing public, occurred in the District of New Mexico. Sun maintains its corporate headquarters and principal place of business in this District and did so at all relevant times.

14. In connection with the acts and conduct alleged in this Complaint, defendants, directly or indirectly, used the means and instrumentalities of interstate commerce, including, but not limited to, the mails, interstate telephone communications and the facilities of the New York Stock Exchange ("NYSE"), a national securities exchange.

PARTIES

15. (a) On July 12, 1999, the Court appointed Joel Shpigel, Marc Blatstein, and William Gabriel as Lead Plaintiffs pursuant to 15 U.S.C. §78u-4(a)(3)(B). Lead Plaintiffs Joel Shpigel, Marc Blatstein and William Gabriel each purchased shares of Sun's common stock during the Class Period and have suffered substantial damages as a result of defendants' wrongful acts as alleged herein.

(b) Plaintiffs Robert Rosenberg, Arnold Nelson Mahler and Roberta Jo Mahler Trustees of the Mahler Family Trust, Hung Sun, Inc., Bernard L. Beck, Glen Davis, Naomi Raphael, Kevin Maher, Elke Brueckner, Alan Gordon, Michael McGriff, Yosef Streicher, and William F. Driscoll purchased shares of Sun's common stock during the Class Period and have suffered substantial damages as a result of defendants' wrongful acts as alleged herein.

16. Defendant Sun purports to be one of the largest full-service, long-term healthcare providers in the United States. The Company owns and operates a national network of hospitals, nursing centers and contract-service providers in 46 states. Sun shares were listed on the NYSE, but no longer trade under the symbol "SHG." Sun maintains its executive offices at 101 Sun Avenue N.E., Albuquerque, New Mexico, 87109.
17. Defendant Andrew L. Turner ("Turner") was, at all times during the Class Period, Chairman of the Board and Chief Executive Officer of Sun. As CEO, Turner has oversight responsibility for all aspects of Sun's operations. He made or approved the making of several materially false and misleading statements or omissions during the Class Period, which were contained in press releases, interviews, statements to analysts, and Sun's SEC filings.

18. Defendant Mark G. Wimer ("Wimer") held the positions of President and Chief Operating Officer of Sun at all times during the Class Period. Wimer made or approved the making of several materially false and misleading statements or omissions during the Class Period, which were contained in press releases, interviews, statements to analysts, and Sun's SEC filings.

19. Defendant Robert D. Woltil ("Woltil") held the position of Chief Financial Officer during the Class Period. Woltil approved the making of several materially false and misleading statements or omissions during the Class Period, which were contained in press releases, interviews, statements to analysts and SEC filings. In addition, he signed materially false and misleading Reports on Form 10-Q filed by Sun containing its financial results for the first, second and third quarters of 1998. While in possession of material, adverse, non-public facts about Sun Healthcare and its business, Woltil sold 15,677 shares of Sun Healthcare for proceeds of over $90,000.

20. Collectively, defendants Turner, Wimer and Woltil, are referred to herein as the "Individual Defendants."

21. During the Class Period, the Individual Defendants each occupied positions in the Company that made them privy to material adverse non-public information. Because of their senior-level positions and/or positions on the Board of Directors of the Company, they each had access to such internal information. The Individual Defendants knew or recklessly disregarded that the adverse facts specified herein were being concealed from the public.

22. Each of the Individual Defendants, by virtue of their management and/or directorship positions, had the duty to exercise due care and diligence and the duty of full and candid disclosure of all material facts related thereto. They were required to exercise reasonable care and prudent supervision over the dissemination of information concerning the business, operations, and financial reporting of Sun. By virtue of such duties, these officers and directors were required to, inter alia,
supervise the preparation of Sun's SEC filings and approve any reports concerning the financial condition of Sun, and supervise and monitor press releases, public statements, and other information disseminated to the investing public by representatives of Sun.

23. The Individual Defendants were control persons of Sun within the meaning of §20 of the Exchange Act by reason of their own involvement in the daily business of Sun and/or their positions on Sun's Board of Directors, and/or as senior executives of Sun. The Individual Defendants, at the time they held positions with Sun, were able to and did exercise substantial control over the operations of Sun, including control of the materially false and misleading statements, omissions, and course of conduct complained of herein.

24. It is appropriate to treat the Individual Defendants as a group for pleading purposes and to presume that the false and misleading information conveyed in Sun's public filings, press releases, interviews, and other publications as alleged herein are the collective actions of the narrowly defined group of Individual Defendants identified above.

25. As officers, directors and/or controlling persons of a publicly held company under the federal securities laws, the Individual Defendants had a duty to (a) disseminate promptly complete, accurate, and truthful information with respect to Sun; (b) correct any previously issued statements that had become materially misleading or untrue; and (c) disclose any trends that would materially affect earnings and the operating results of Sun, so that the market price of Sun's publicly traded securities would be based upon truthful and accurate information. The Individual Defendants failed to adequately discharge these duties.

**SCIENTER ALLEGATIONS**

26. Defendants acted with scienter in that the Individual Defendants knew or recklessly disregarded that the statements they made, referenced herein, were materially false and misleading. Defendants knew that statements would be issued or disseminated to the investing public and knowingly or recklessly participated or acquiesced in the issuance of such statements. By virtue of their receipt of information reflecting the true facts regarding Sun, their control over, and/or receipt and/or modification of Sun's materially misleading misstatements and/or their associations with Sun,
which made them privy to confidential, proprietary information concerning Sun, defendants participated in the fraudulent scheme alleged herein.

27. Defendants took advantage of Sun's artificially inflated stock price by negotiating and consummating the acquisition of RCA/Contour by utilizing Sun's common stock as currency in funding the acquisitions and defendant Woltil sold 15,677 shares of his Sun stock for proceeds over $90,000.

28. Defendants' purpose in artificially inflating the stock was to meet publicly reported growth projections through acquisitions as opposed to "internal" growth. Consequently, defendants were motivated to conceal the expected impact that the PPS would have on the Company until after the RCA/Contour acquisition was completed. Defendants were further motivated to conceal the true impact of the BBA on Sun's operations for a substantial period of time after the RCA/Contour acquisition was completed so as not to subject themselves and the Company to litigation from the selling shareholders of RCA or Contour who had given up their shares in those companies in exchange for Sun's common stock.

29. The top executives of Sun, including the Individual Defendants, also knew that the PPS would not work, because the State of Oregon had already caused Sun to operate under a similar program. In 1995 or early 1996, Health Care Financing Administration ("HCFA") Regional Intermediaries Northwest implemented changes to the Medicare reimbursement system for nursing homes in the region. As a result, those nursing homes, including the Company's SunRise Nursing Home facilities, operated under a reimbursement system that was virtually identical to PPS. During 1995 and after, during senior corporate management meetings, Colleen Bittner, formerly SunRise Clinical Director, who was promoted to Vice President of SunRise Northwest Region, repeatedly explained to Turner and Senior VP, Rehabilitation Services, Bob Levin, then head of Sun's Ancillary Services Division, what was happening in the Northwest Region relating to the Medicare reimbursement changes and why she was unable to achieve profitable results for her region under that system. Also in attendance at these meetings were Gary McGuire, SunRise Sr. Vice President – Western region; Connie Gray, SunRise Sr. Vice President – Central Region; and Tom Mack, SunRise Sr. Vice President – Eastern Region.
30. At their senior management meetings, as well as at monthly mid-level management meeting, Bittner repeatedly explained to Turner and Levin that all SunRise facilities would, in the future, be required to operate under a system similar to the one her region was then under. She told them that "the future is here" and that it was where Sun was headed — the Northwest Region just happened to be the first.

31. Bittner explained to Turner and Levin in detail why the Northwest Region was not able to achieve profitability. Their response was "deal with it." In response to Turner's and Levin's comments, Bittner tried to deal with the changes by letting employees go and by staff reorganizing. Despite her efforts, she was unable to operate the region profitability. Bittner was eventually transferred to Dallas to work directly for David Kniess, President of SunDance — Sun's rehabilitation-therapy division.

32. Even though Turner and Levin understood that the situation in the Northwest Region was Sun's future, there was little or no discussion about what to do in order to prepare for it. Instead, there was a lot of talk about which lawyers to talk with and which politicians in Washington to meet with to fight the pending PPS reimbursement-plan proposals.

33. As part of Sun's efforts, Turner and other senior managers traveled to Washington, D.C. before the PPS went into effect to learn how the new PPS would negatively impact Sun's business and to lobby against PPS. Defendants learned what they already knew from Sun's Northwest Region's experience — PPS would adversely impact Sun's operations and profitability for many months, if not years. Despite this knowledge, they repeatedly told the public that Sun would actually prosper under the PPS and was better positioned than others to do so.

34. The undisclosed adverse information concealed by defendants during the Class Period is the type of information which, because of SEC regulations, rules of the national stock exchanges, and customary business practice, is expected by investors and securities analysts to be disclosed to the investing public. This information is known by corporate officials and their legal and financial advisors to be the type of information which is expected to be and must be disclosed. For example, under Item 303 of Regulation S-K, promulgated by the SEC under the Exchange Act, there is a duty to disclose in periodic reports filed with the SEC "known trends or any known demands,
commitments, events or uncertainties" that are reasonably likely to have a material impact on a company's sales revenues, income or liquidity, or cause previously reported financial information not to be indicative of future operating results. 17 C.F.R. §229.303(a)(1)-(3) and Instruction 3. In addition to the periodic reports required under the Exchange Act, management of a public company has a duty "to make full and prompt announcements of material facts regarding the company's financial condition." SEC Release No. 34-8995, 3 Fed. Sec. L. Rep. (CCH) ¶23,120A, at 17,095, 17 C.F.R. §241.8995 (October 15, 1970). The SEC regulates companies "that can reasonably be expected to reach investors and the trading markets, whoever the intended primary audience." SEC Release No. 33-6504, 3 Fed. Sec. L. Rep. (CCH) ¶23,120, at 17,095-3, 17 C.F.R. §241.20560 (January 13, 1984). The SEC has emphasized that "[i]nvestors have legitimate expectations that public companies are making, and will continue to make, prompt disclosure of significant corporate developments." SEC Release No. 18271, [1981-1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶83,049, at 84,618 (November 19, 1981).

PLAINTIFFS' CLASS ACTION ALLEGATIONS

35. Plaintiffs bring this lawsuit pursuant to Rule 23(a) and (b)(3) of the Federal Rules of Civil Procedure, on behalf of themselves and a class of persons who purchased shares of Sun's common stock from June 2, 1998, through February 1, 1999, inclusive (the "Class"). Excluded from the Class are defendants herein, members of the immediate families of the defendants, any person, firm, trust, corporation, officer, director or other individual or entity in which any defendant has or had a controlling interest or which is related to or affiliated with any of the defendants, and the legal representatives, agents, affiliates, heirs, successors-in-interest or assigns of any such excluded party.

36. This action is properly maintainable as a class action for the following reasons:

(a) The Class of investors for whose benefit this action is brought is so numerous that joinder of all Class members is impracticable. During the Class Period, Sun had over 60 million common shares outstanding, held by thousands of stockholders. Members of the Class are scattered throughout the United States.
There are questions of law and fact which are common to members of the Class and which predominate over any questions affecting only individual members. The common questions include, *inter alia*, the following:

(i) Whether the federal securities laws were violated by defendants' acts as alleged herein;

(ii) Whether defendants participated in and pursued the common course of conduct complained of herein;

(iii) Whether documents, press releases and other statements disseminated to the investing public and Sun's shareholders during the Class Period misrepresented material facts about the business, management, revenues, earnings, transactions, markets, financial condition, risk and business prospects of Sun;

(iv) Whether statements made by defendants to the investing public during the Class Period misrepresented material facts about the business and finances of Sun;

(v) Whether the market price of Sun's common stock during the Class Period was artificially inflated due to the material misrepresentations and failure to correct the material misrepresentations complained of herein; and

(vi) To what extent the members of the Class have sustained damages and the proper measure of damages.

Plaintiffs' claims are typical of the claims of other members of the Class and plaintiffs have no interests that are adverse or antagonistic to the interests of the Class.

Plaintiffs are committed to the vigorous prosecution of this action and have retained competent counsel experienced in litigation of this nature. Accordingly, plaintiffs are adequate representatives of the Class and will fairly and adequately protect the interests of the Class.

Plaintiffs anticipate that there will not be any difficulty in the management of this litigation as a class action.

For the reasons stated herein, a class action is superior to other available methods for the fair and efficient adjudication of this action and the claims asserted herein. Because of the size
of the individual Class members' claims, few, if any, Class members could afford to seek legal redress individually for the wrongs complained of herein.

BACKGROUND

38. By the beginning of 1998, Sun was recognized as a worldwide leader in providing long-term healthcare solutions. Sun operates long-term and post-acute care facilities in the United States, United Kingdom, Spain, Germany and Australia. The Company's subsidiaries provide therapy and pharmacy services, fulfill the medical supply needs of nursing homes, and offer a comprehensive array of ancillary services for the healthcare industry.

39. Revenues from Sun's operations rose dramatically prior to the Class Period due to the Company's very rapid debt and equity-financed expansion. Sun's growth strategy relied heavily on the acquisition of long-term and sub-acute care facilities.

40. In the fourth quarter of 1997, in furtherance of this strategy, Sun acquired Regency, which dramatically increased the size of Sun's business. Primarily as a result of this acquisition, Sun's total assets increased from $1.2 billion at December 31, 1996, to more than $2.5 billion at December 31, 1997. Almost all of Sun's growth was generated through acquisitions and Sun's executives sought to acquire RCA both to increase Sun's revenues and to gain entry into the Southeast U.S. market, particularly in Florida.

41. The Company relies heavily on third-party payors for revenue, with payments from Medicare alone representing almost 30% of the Company's revenue. Despite the dramatic changes in the Medicare reimbursement system enacted by Congress, the Company falsely indicated to the investing public that it was well prepared to combat the changes.

42. For example, on February 25, 1998, in connection with Sun's announcement of earnings for fourth quarter 1997, Turner indicated that "[o]ur operations [from 1997] continued to return strong results, and we ended the year well prepared for the impending changes in Medicare reimbursement."

43. On April 27, 1998, Sun announced earnings of $0.37 per diluted share for first quarter 1998, "the strongest earnings ever reported by the company for a first-quarter." The press release also stated: "The company's first-quarter results were the product of solid performance in all of Sun's
core operating divisions, as well as its acquisition of Regency Health Services," said Andrew L.
Turner, Sun's chairman and chief executive officer. "Sun's therapy services division, in particular,
had an exceptional quarter, due largely to the company's rapid integration of Regency," Mr. Turner
noted."

44. Subsequent to the release of its first quarter 1998 results, Sun held a telephonic
conference call for securities analysts, money and portfolio managers, institutional investors, large
Sun shareholders, brokers, and stock traders to discuss Sun's first quarter results, its business, and
its prospects. During the call, Turner and Wimer made presentations and answered questions.
During the call — and in follow-up conversations with participants — they directly disseminated
important information to the market by stating:

• The acquisition of RCA was proceeding on plan and was not expected to negatively
affect Sun's 1999 results.
• Sun would be one of the best-positioned nursing-home companies after the
acquisition of RCA.
• Occupancy rates were increasing, which would positively impact future earnings.
• Sun was enjoying many synergies with Regency that would lead to improved
earnings in future quarters and years.
• Sun had imposed operating margins at Regency's South Coast rehabilitation
subsidiary which would benefit company-wide margins.
• Sun was well prepared for the new PPS and would be able to report earnings in line
with expectations.
• Sun was on track to report EPS of $1.60-$1.67 and $1.85-$1.90 in 1998 and 1999,
respectively.

45. On May 12, 1998, the HCFA published new reimbursement rates for PPS, which
imposed a per-diem flat rate for all post-hospital extended-care services. The services included
ancillary services such as therapy and pharmacy services. Changes in the Medicare reimbursement
system resulted in a one-third reduction in per-day/per-patient Medicare reimbursements from
approximately $500 in 1998 to $325 in 1999.
46. In May 1998, Sun raised $345 million from the issuance of convertible-trust preferred securities and $150 million from the issuance of 9-3/8% senior-subordinated notes.

47. On May 22, 1998, Sun filed its 1997 Form 10-K, which stated:

Under the current Medicare reimbursement system, ancillary services, such as rehabilitation and respiratory therapy services and pharmaceutical services, have significantly higher operating margins than the margins associated with the provision of routine services to patients at long-term and subacute care facilities and accordingly have provided more than half of the Company's operating profits. The higher operating margins from the provision of ancillary services are primarily attributable to more favorable reimbursement rates. In addition, a substantial portion of the Company's consolidated interest expense was attributable to the Company's long-term and sub-acute services and its foreign operations due to the capital intensive nature of these businesses and to related acquisitions. The Company believes that when Medicare implements a prospective payment system ("PPS") for long-term and subacute care services it may be better able than some of its competitors to respond to the new PPS environment because it provides more types of ancillary services in-house and to nonaffiliated facilities than many of its competitors. There can be no assurance that the Company will be able to maintain its margins or that its margins will decrease and that PPS will not have a material adverse effect on the Company's financial condition or results of operations. See "Effects from Changes in Reimbursement."

(Emphasis added.).

48. Therefore, prior to the start of the Class Period, Sun represented that it was thoroughly prepared for industry-wide conversion to PPS and prepared for the integration of its operations with RCA.

FALSE AND MISLEADING STATEMENTS DURING THE CLASS PERIOD

49. The Class Period begins on June 2, 1998, when Sun filed an amendment to its Form S-4 Registration Statement/Prospectus ("Prospectus") with the SEC, which falsely indicated that Sun was "unsure" what effect the new PPS would have on its operating results. By this time almost an entire year had passed since the enactment of the BBA, and during this time period defendants had conducted numerous internal analyses reflecting the adverse impact that the BBA would have on Sun's future operations, and had experienced disastrous results in profitability after applying a virtually identical per-diem reimbursement system enacted in its Northwest Region. Furthermore, through the sheer silence of the Prospectus regarding RCA's preparedness for the BBA, defendants implied that RCA was similarly equipped to adapt to the new PPS.
50. On June 2, 1998, Sun and RCA filed a Form S-4 Joint Proxy Statement/Prospectus/Information Statement (the "Joint Proxy") with the SEC which, likewise, deceptively indicated that Sun was unsure whether PPS would have an adverse impact on the Company:

There can be no assurance that payments under governmental or private payor programs will remain at levels comparable to present levels or will be adequate to cover the costs of providing services to patients eligible for assistance under such programs. Significant decreases in utilization and limits on reimbursement could have a material adverse effect on Sun's financial condition and results of operations, including possible impairment of certain assets. Most recently, in the BBA, Congress amended the reimbursement provisions applicable to exempt hospitals services, skilled nursing, therapy and other ancillary services.

* * *

RISKS RELATED TO PROSPECTIVE PAYMENT SYSTEM

In the BBA, Congress passed numerous changes to the reimbursement policies applicable to exempt hospital services, skilled nursing, therapy and other ancillary services. The BBA provides for a phase-in of a PPS for skilled nursing facilities over a four-year period, effective for Sun's facilities on January 1, 1999. Under PPS, Medicare will pay skilled nursing facilities a fixed fee per patient day based on the acuity level of the patient to cover all pos-hospital extended care routine service costs (i.e., Medicare Part A patients), including ancillary and capital related costs for beneficiaries received skilled services. The per diem rate will also cover substantial all items and services furnished during a covered stay for which reimbursement was formerly made separately under Medicare. During the phase-in, payments will be based on a blend of the facility's historical costs and a federally established per diem rate. Interim final regulations, including the federal per diem rates, were published on May 12, 1998. It is unclear what the impact of PPS will be on Sun. There can be no assurance that the imposition of PPS will not have a material adverse effect on the results of operations and financial condition of Sun.

Sun's revenues from its impatient facilities will be significantly affected by the size of the federally established per diem rate. There can be no assurance that the per diem rate will not be less than the amount Sun's inpatient facilities currently receive for treating the patients currently in its care. Moreover, since Sun treats a greater percentage of higher acuity patients than many nursing home, Sun may also be adversely impacted if the federal per diem rates for higher acuity patients doesn't adequately compensate Sun for the additional expenses and risks for caring for such patients. As a result, there can be no assurance that Sun's financial condition and results of operations will not be materially and adversely affected. [Emphasis added]

51. The section of the Joint Proxy discussing the integration of RCA did not indicate that Sun anticipated any unique problems associated with the conversion of RCA facilities to PPS. The Joint Proxy stated:
Sun plans to integrate promptly the operations, facilities and personnel of Sun and RCA following the RCA Merger. The general result will be to combine administrative organizations with a reduced headcount and overhead structure and to eliminate duplicative or unnecessary corporate functions. Sun will assume management of all RCA operations upon completion of the RCA Merger. None of the directors or executive officers of RCA is expected to continue in the management of the combined operations. Sun expects to incur a charge of approximately $30 million in connection with the Mergers, consisting of transaction costs and integration expenses, including elimination of redundant corporate functions, severance costs related to headcount reductions, the write-off of certain intangibles and property and equipment and the settlement of certain class action lawsuits. In addition, there can be no assurance that Sun will not incur additional charges in subsequent quarters to reflect costs associated with the Mergers. See "Risk Factors — Risk Factors Concerning the Mergers — Difficulty of Integrating Acquired Operations," "The RCA Merger — Operations Following the RCA Merger" and "Unaudited Pro Forma Combined Financial Statements."

52. The Joint Proxy also contained an entire section called "DIFFICULTY OF INTEGRATING ACQUIRED OPERATIONS," which failed to indicate that the conversion of RCA to PPS posed any unique issues:

DIFFICULTY OF INTEGRATING ACQUIRED OPERATIONS.

The integration of operations of RCA and Contour following the RCA Merger and/or the Contour Merger (either or both of such transactions being referred to herein as the "Mergers") will require the dedication of management resources that will detract attention from Sun's day-to-day business. The difficulties of integration may be increased by the necessity of coordinating geographically separated organizations, integrating personnel with disparate business backgrounds and combining different corporate cultures. As part of the Mergers, Sun is expected to seek to reduce expenses by eliminating duplicative or unnecessary personnel, corporate functions and other expenses. There can be no assurance that Sun will be able to reduce expenses in this fashion or that there will not be high costs associated with such activities or that there will not be other material adverse effects of such activities. Such events could materially and adversely affect Sun's financial condition and results of operations. There can be no assurance that Sun will be able to successfully integrate acquired operations, including the operations of RCA and Contour, or to successfully manage any growth; failure to do so effectively and on a timely basis could have a material adverse effect upon Sun's financial condition and results of operations.

(Emphasis added.)
53. The Joint Proxy also indicated that Sun was intimately familiar with the operations of RCA, because the Company had been providing ancillary and management services to RCA since their agreement in principle to merge in February of 1997:

Since the execution of the RCA Merger Agreement on February 17, 1997, Sun has been providing, on an arm's-length basis, pharmacy products and services, therapy and supplies ("Ancillary Services"), and other management consulting and advisory services, to certain facilities owned, leased or managed by RCA, its affiliates and affiliates of the shareholders of RCA party to the RCA Stock Option Agreement (the "RCA Facilities"). In connection with Amendment No. 3, RCA agreed to take all reasonable action, including terminating existing contracts with other providers of Ancillary Services in accordance with the terms thereof, to cause all remaining RCA Facilities to begin receiving all of their required Ancillary Services from Sun or Sun's affiliates as soon as practicable after November 25, 1997. See "The RCA Merger-Ancillary Services Agreements." As of March 31, 1998, Sun was providing Ancillary Services to RCA Facilities in six states. Revenues from the provision of such Ancillary Services, and from the provision of such other Management Consulting and Advising Services, to RCA Facilities totaled $11.0 million and $12.4 million, or 1.5% and 0.6% of Sun's net revenues, for the three months ended March 31, 1998 and for the year ended December 31, 1997, respectively, substantially all of which remained unpaid as of March 31, 1998. Sun and RCA have also entered into a management agreement on an arm's-length basis, dated as of July 15, 1997 (the "Management Agreement"), pursuant to which Sun has agreed to provide management, consulting and advisory services with respect to all 16 RCA Facilities in Virginia and North Carolina.

(Emphasis added). Based on these disclosures, the market did not expect that the transition of RCA to PPS would be any more difficult than the transition of the rest of Sun's businesses to PPS.

54. On May 21, 1998, Sun filed its Form 10-Q for the quarter ended March 31, 1998. The Form 10-Q failed to disclose that Sun knew that its margins would be adversely impacted by PPS. Instead, the Form 10-Q contained only boilerplate warnings indicating that it was unclear what impact PPS would have on Sun:

There can be no assurance that payments under governmental or private payor programs will remain at levels comparable to present levels or will be adequate to cover the costs of providing services to patients eligible for assistance under such programs. Significant decreases in utilization, changes in reimbursement, including salary equivalency and PPS, could have a material adverse effect on the Company's financial condition and results of operations, including the possible impairment of certain assets.

In the Balanced Budget Act of 1997 (the "BBA"), Congress passed numerous changes to the reimbursement policies applicable to exempt hospital services, skilled nursing, therapy and other ancillary services. The BBA generally provides for a phase-in of a prospective payment system for skilled nursing facilities over a four year period, effective for the Company's facilities on January 1, 1999. Under PPS, Medicare will pay skilled nursing facilities a fixed fee per patient day based on the acuity level of the patient to cover all post-hospital extended care routine service
costs (i.e., Medicare Part A patients), including ancillary and capital related costs for beneficiaries receiving skilled services. The per diem rate will also cover substantially all items and services furnished during a covered stay for which reimbursement is currently made separately under Medicare. Such services are currently reimbursed on a "pass through" basis. During the phase-in, payments will be based on a blend of the facility's historical costs and a federally established per diem rate. Interim final regulations, including the federal per diem rate, were published on May 12, 1998. It is unclear what impact PPS will have on the Company. There can be no assurance that PPS will not have a material adverse effect on the results of operations and financial condition of the Company.

(Emphasis added.)

55. In addition to the use of SEC filings to disseminate The Company's misleading statements, Sun and the other defendants regularly communicated with securities analysts, knowing that the analysts could and would repeat to the public what management told them. On June 22, 1998, in furtherance of their strategy and plans, Sun's management (Turner and Wimer) spoke to Bear Stearns analysts A.J. Rice and T. Gallucci about Sun's operations and prospects. Based on Sun management's statements, Bear Stearns issued a report on June 23, 1998, written by Rice and Gallucci, which forecasted 1998 and 1999 EPS of $1.62 and $1.86, respectively, rated Sun "a buy," and which stated in part:

Sun Healthcare shares have drifted over the last few weeks, along with the healthcare services sector in general. We checked in with management for a quick update regarding current operating trends. Management reports operating results are essentially tracking expectations, and there has been no change in the company's "guidance" for the current quarter or for all of 1998.

* * *

In other news, a shareholder vote relating to the Retirement Care Associates acquisition is scheduled for June 30. The operating performance of RCA, on a stand alone basis, continues to fall short of expectations (proxy material suggests that, if pooled, RCA would require a $0.10 downward restatement of Sun's first-quarter $0.37 EPS versus our previous estimate of $0.06-0.08). Management remains optimistic that Sun will be able to quickly improve the operating performance of RCA, once it is completely owned. Nevertheless, we continue to believe that, if the RCA deal closes, we will likely reduce our 1999 EPS estimate to $1.80.

56. On July 1, 1998, Sun announced that it had completed the stock-for-stock acquisition of RCA and Contour:

Sun will issue 0.505 shares of common stock in exchange for each outstanding share of RCA stock, for a total of approximately 7.6 million shares. Sun will also issue approximately 298,000 shares of its Series B convertible preferred stock in exchange for the outstanding shares of RCA Series F preferred stock, which is convertible into approximately 280,000 shares of Sun common stock.
Sun also acquired Contour Medical ... Sun will issue approximately 1.8 million shares of common stock in exchange for the remaining 35 percent of Contour Medical common stock, which is an exchange ratio of 0.524.

... Both acquisitions were approved by 90 percent of the votes cast by Sun shareholders.

57. On July 1, 1998, based on communications with Sun's management (Turner and Wimer), Robinson-Humphrey issued a report on Sun written by Jeff Villwock, which stated:

Sun and RCA shareholders approved their merger yesterday.... We believe that the closing of this transaction should help the stock.... Much of the financial benefit from the merger is in expanding ancillary services to RCA facilities.... We continue to think that SHG is well positioned going forward and that the stock will rally in the second half of 1998.... We believe that SHG is one of the best positioned to prosper under the prospective payment system.

58. On July 9, 1998, Legg Mason Wood Walker, Inc. ("Legg Mason") initiated coverage of Sun, but only after its analyst Kirsten Jensen spoke with Sun management (Turner/Wimer). On July 9, 1998, Legg Mason issued a favorable report on Sun written by Jensen, which was based on information provided to Jensen by Turner and Wimer. Legg Mason's report forecast 1998 and 1999 EPS of $1.59 and $1.85, respectively, and stated in part:

* We are initiating coverage on Sun Healthcare Group, Inc. with Buy/Above-Average Risk ratings and a 12-month target price of $22. Estimated 1998 and 1999 earnings per share are $1.59 and $1.85, respectively.

* Sun shares have a compelling valuation trading at 8.5x our 1999 earnings estimates with several catalysts contributing to upside.

* SunSolutions, a product designed to maximize margins in a fixed-payment reimbursement environment, has broad market appeal to smaller nursing home providers.

* The acquisition of Retirement Care Associates, a troubled operation that has significant geographic overlap while opening several new markets, provides opportunities for Sun to turnaround existing operations and increase Medicare participation, a positive under prospective payment for facilities that have not traditionally operated in that environment.

* The "graying of the world" leads to international growth opportunities for Sun as a leading long-term care provider.

59. On July 13, 1998, Bear Stearns issued a report on Sun written by Rice and Galucci which stated:

We are reiterating our BUY recommendation on the shares of Sun Healthcare.... After meeting with a number of members of the Sun management team this week, the company seems relatively confident that it will
be able to deliver EPS in $1.80 range for all of 1999. For our part, we also believe it is highly unlikely that the company's earnings power would drop to the level currently being discounted in the public markets. On the other hand, we believe any enhanced confidence in the company's ability to deliver 1999 earnings anywhere near our $1.80 estimate would propel the shares substantially higher.

(Emphasis added).

60. On July 16, 1998, Turner was interviewed by Karen Gibbs of the Cavuto Business Report. The interview, published that same day; included the following colloquy:

GIBBS: Now, many critics charge that this may make a decision now for the companies between patient care and profits. How do you respond to that?

TURNER: Well, I believe that there's a reasonable balance that can always be achieved between our obligation to deliver excellent patient care to our patients, and also, to meet the needs of the constituency of our shareholders, as well. And it's our obligation, as the managers of the company, to achieve that balance.

GIBBS: Now you, the company, has completed some acquisitions. Contour Medical as well as Retirement Care Associates (URL: N/A). What does that do to the stable of services that you provide now?

TURNER: Well, Retirement Care Associates is a group of nursing homes located largely in the Southeast part of the United States. Sun is doing business coast-to-coast throughout America. So, that simply enhances our, or complements our geographic spread in that particular arena.

Contour Medical, on the other hand, is a very strategic element in that we offer at Sun a wide array of all of the ancillary services that a geriatric patient might require in a nursing home.

* * *

GIBBS: How can you offer a [comprehensive] package, like this, at a fixed cost and make money?

TURNER: Well, there's only one answer to that question, and that's to reduce our costs to a level that allows us to do so. And that is the intention of the new perspective payment system. So, our obligation at this juncture is to figure out how to deliver desired outcomes with respect to the clinical care of our patients, but to do so with their unit costs that is not as high as it's been in the past.

GIBBS: And with the demographic shifting, so that we are going to have more elderly in elder care, will you be able to benefit from that?

TURNER: Oh, no question. I mean, the fundamental reason that companies like Sun Healthcare have such a bright future is the fact that the demography favors us. More people are living longer. They're enjoying a quality of life for a longer period of time. And that benefits our organization.
61. Defendants’ statements detailed above at ¶¶49-60 were materially false and misleading at the time they were issued because they knew the following information, all of which was concealed from shareholders:

   (a) Under the new SNF-PPS, profit margins for the Company's own SNFs were substantially lower, and the claim that "it provides more types of ancillary services in-house than many of its competitors" was of no benefit because its response to a flat per-diem system entailed reducing what it provided for such services;

   (b) Under the new SNF-PPS, Sun's previous reliance on revenues from providing ancillary services by contract with unaffiliated facilities and temporary-therapist staffing for unaffiliated facilities — far from rendering it "better able than some of its competitors to respond to the new PPS environment because it provides more types of ancillary services ... to nonaffiliated facilities than many of its competitors" — produced a dramatic loss of revenue, because unaffiliated facilities reduced their own costs by terminating their Sun contracts, which reduced the volume of services purchased or temporary staff used, and they were able to negotiate lower rates;

   (c) Sun was worse off than its competitors, not better, because it paid the heavy costs of providing an array of ancillary services to SNFs in a market that, due to other BBA provisions as well as the SNF-PPS, was both shrinking and glutted. And it was also worse off than its competitors, not better, because the BBA, simultaneously with enacting the PPS for long-term and subacute-care services, included other provisions adversely affecting Sun's chain of rehabilitation hospitals;

   (d) Sun was acquiring extremely troubled operations from RCA in an effort to gain market share — a move which would cost millions to bring RCA's facilities up to date and into compliance with federal regulations;

   (e) Sun's primary reliance on revenues resulting from the provision of ancillary services exacerbated the materially adverse effect of the new PPS program on the Company's financial results due to the fixed-fee per-patient rate impose under the PPS;

   (f) Sun's reported financial results were materially overstated and presented in violation of GAAP, as detailed in ¶¶107-123;
(g) By the beginning of the Class Period, as a result of reduced reimbursement rates under the PPS, the goodwill of Sun's domestic facilities had become impaired in a reasonably ascertainable amount, thereby requiring the Company under GAAP to write down such goodwill;

(h) Through due diligence performed by Sun in connection with the acquisition of RCA, defendants knew or should have known that RCA was totally unprepared for reimbursement changes under the new PPS and should have immediately reserved for this eventuality upon acquiring RCA; and

(i) Through Bittner and Sun's Northwest Division, defendants knew the per-diem based medicare reimbursement schedule would cause revenues to drop and result in losses;

(j) Due to the above factors, there was no reasonable basis for Sun's forecasted 1998 and 1999 EPS disseminated during the Class Period, which could not and would not be achieved.

62. On August 11, 1998, Sun issued its earnings announcement for second quarter 1998, including, EPS of $0.38 before pooling and merger charges. The press release also stated:

"Excluding RCA and several anticipated charges, Sun's operating results for the quarter were among the best in the industry, particularly in terms of our performance under salary equivalency," said Andrew L. Turner, Sun's chairman and chief executive officer. "Apart from our operating performance, we also completed the acquisition of RCA, received word that the OIG investigation had been suspended, and rolled out our SunSolution product to a very anxious and receptive base of potential customers," Mr. Turner noted. "While the industry's transition to Medicare PPS continues to present both challenges and uncertainties, Sun continues to demonstrate both its leadership and its preparedness for the new operating environment."

63. On August 11, 1998, after the release of its second quarter 1998 results, Sun held a conference call for analysts, money and portfolio managers, institutional investors, and large Sun shareholders to discuss Sun's second quarter results, its business and its prospects. During the call – and in follow-up conversations with analysts – Turner and Wimer stated:

- Although the quarter had been adversely affected by United Kingdom operations, Sun was still on track to have 1998 and 1999 EPS of $1.33+ and $1.80-$1.85, respectively.
- Sun's U.S. operations continued to show improving margins and profitability.
• Sun expected some reduction in revenues due to the new PPS, but expected these to be at least partly offset by improved operating efficiencies.

• Implementation of the PPS would be neutral to Sun's future results.

• Sales of SunSolution would offset much of the negative revenue impact of the PPS.

64. On August 11, 1998, Robinson-Humphrey issued a report on Sun written by Jeff Villwock, which was based on communications with Sun management, and stated:

Regarding the implementation of the Prospective Payment System (PPS), SHG announced that 1999 revenues will likely be penalized by an estimated $60 million, but that should be more than offset by an expected $62 million in cost savings due to changes related to the implementation of PPS. The net effect should be slightly accretive to earnings in 1999. Under a worse case scenario, we expect PPS to be earnings neutral in 1999.... We continue to believe that SHG is positioned to prosper under PPS.... We believe that SHG is one of the best positioned to prosper under the pending prospective payment system.

65. On August 12, 1998, Bear Stearns issued a report on Sun written by Rice and Simpson which was based on communications with Sun's management and stated:

Management estimates that the implementation of PPS will likely be neutral and could even be modestly accretive, as a projected $60 million revenue decline is offset by $62 million in annual cost savings, potentially creating a pre-tax net gain of $2 million.

66. On August 19, 1998, Sun filed its Form 10-Q for the second quarter ended June 30, 1998, which described the impact of the transition to PPS on Sun as follows:

There can be no assurance that payments under governmental or private payor programs will remain at levels comparable to present levels or will be adequate to cover the costs of providing services to patients eligible for assistance under such programs. Significant decreases in utilization, changes in reimbursement, including salary equivalency and PPS, could have a material adverse effect on the Company's financial condition and results of operations, including the possible impairment of certain assets.

In the Balanced Budget Act of 1997 (the "BBA"), Congress passed numerous changes to the reimbursement policies applicable to exempt hospital services, skilled nursing, therapy and other ancillary services. The BBA generally provides for a phase-in of a prospective payment system for skilled nursing facilities over a four year period. PPS will become effective for the Company's facilities on January 1, 1999, other than the facilities acquired with RCA for which PPS became effective July 1, 1998. Under PPS, Medicare will pay skilled nursing facilities a fixed fee per patient day based on the acuity level of the patient to cover all post-hospital extended care routine service costs (i.e., Medicare Part A patients), including ancillary and capital related costs for beneficiaries receiving skilled services. The per diem rate will also cover substantially all items and services furnished during a covered stay for which reimbursement is currently made separately under Medicare. Such services are currently reimbursed on a "pass through" basis. During the phase-
in, payments will be based on a blend of the facility's historical costs and a federally established per diem rate. Interim final regulations, including the federal per diem rate, were published on May 12, 1998. **It is unclear what impact PPS will have on the Company. There can be no assurance** that PPS will not have a material adverse effect on the results of operations and financial condition of the Company.

The Company's revenues from its inpatient facilities will be significantly affected by the size of the federally established per diem rate. **There can be no assurance** that the per diem rate will not be less than the amount the Company's inpatient facilities currently receive for treating the patients currently in its care. Moreover, since the Company treats a greater percentage of higher acuity patients that many nursing homes, the Company may also be adversely impacted if the federal per diem rates for higher acuity patients does not adequately compensate the Company for the additional expenses and risks for caring for such patients. **As a result, there can be no assurance that the Company's financial condition and results of operations will not be materially and adversely affected.**

(Emphasis added.)

67. The Form 10-Q for the second quarter was materially false and misleading for the reasons described in ¶61(a)-(j) above. The Form 10-Q deceptively indicated that PPS could have an adverse impact upon the Company, when the defendants knew that PPS was certain to reduce margins substantially and ruin Sun's financial condition. Although the Form 10-Q did indicate that RCA had been converted to PPS as of July 1, 1998, the defendants once again failed to disclose that (a) Sun had not had an opportunity to adequately prepare RCA for the retroactive conversion; and (b) third and fourth quarter earnings would be adversely impacted because Sun had been unable to adequately train staff and institute new record-keeping and compliance systems in advance of its acquisition of RCA.

68. On September 22, 1998, Bear, Stearns & Co. Inc. issued a report on Sun written by Rice and Simpson which stated:

*We have checked in with Sun management, who says that its third party contract therapy business has tracked expectations thus far in the quarter. In addition, Sun reportedly remains upbeat about hitting its target of putting in **place 100 new SunSolution full service ancillary contracts by the end of 1998** (up from an original target of 75 set earlier this year). The company is continuing to seek to improve, the operating performance of Retirement Care Associates (RCA), but the business quicker than anticipated conversion to Medicare PPS (RCA converted to PPS on July 1, 1998) hurt performance early in the third-quarter.*

(Emphasis added).

69. On September 25, 1998, Schroder & Co. Inc. issued a report on Sun written by Charles Lynch, which stated:
Following SHG's acquisition of Retirement Care Associates on June 30 of this year, SHG had anticipated that RCA's 74 skilled nursing facilities, which had historically operated under a June fiscal year, would shift to a December fiscal year and therefore would transition to a Medicare prospective payment system (PPS) in January 1999 with the majority of SHG's homes. However, in mid-July SHG was informed by the Health Care Financing Administration that those facilities had indeed been shifted to PPS reimbursement on July 1. As a result of this shift, for which the company had not yet prepared those facilities' resident assessment reporting, the facilities recorded poor financial performance... in the early part of July.

(Emphasis added).

70. In this same report, Schroder & Co. classified this event as a "Hiccup," but noted that "This Development Actually Has Positive Ramifications Going Forward." Schroder & Co. reported that "[t]he company indicated that it may be able to recoup in 4Q:98 any lost Medicare revenues from the period in question .... Importantly, though, this issue has no negative implications for the remainder of this year or for 1999. Profitability at the RCA facilities has improved dramatically and management expects that 4Q:98 EPS will easily exceed those of 3Q:98." "[W]e view this near-term bump as having positive long-term ramifications in the form of improved PPS payments to RCA facilities in 1999. We continue to view SHG as one of the most attractively valued issues in the group and believe the SHG is positioned to achieve strong earnings growth over the coming several years." (Emphasis added)

71. On September 28, 1998, Sun reported that it had completed a preliminary review of its financial results in third quarter 1998, and determined that its results would be lower than expected, in the range of $.20 to $.24 per diluted share. The September 28, 1998 release reported that:

The lower-than-expected earnings relate primarily to the effects of a Health Care Financing Administration decision in late July 1998 to convert the company's RCA facilities to PPS retroactive to July 1, 1998. The retroactive conversion determination precluded the company from adequately training staff and instituting new record keeping and compliance systems in advance of the June 30 closing. This disruption, which also contributed to lower-than-expected PPS rates for the RCA facilities, resulted in the earnings shortfall.

72. In an effort to reassure the market and avoid a free fall in the price of Sun's common stock, defendants deceptively represented to investors that the Company did not anticipate that
similar operational issues would arise with respect to the conversion of the balance of Sun's facilities to PPS on January 1, 1999. The September 28, 1998 press release also stated:

The company expects the adverse impact of the early conversion to lessen significantly during the fourth quarter of 1998, and in the first quarter of 1999 when RCA facilities are expected to be eligible for more favorable PPS rates. Sun does not anticipate similar operational issues when the company's remaining inpatient facilities transition to PPS on Jan 1, 1999, as scheduled.

(Emphasis added.)

73. Moreover, the September 28, 1999 press release also falsely indicated that Sun already had in place operational changes that would "neutralize" the impact on earnings of the transition to PPS:

The company noted that it expects both total revenues and pre-tax margins from contract therapy services to be unchanged or improved during the quarter. As previously reported, Sun has continued to reduce its cost of operations in therapy services and instituted new operational procedures to neutralize the earnings impact of changes in demand and reimbursement resulting from the industry's transition to salary equivalency and the prospective payment system (PPS).

(Emphasis added).

74. The above-referenced statements in ¶62-66 and 68-73 were materially false and misleading when made due to Sun's knowledge that the RCA facilities were on a June 30 cost year and therefore, would automatically be subject to PPS restrictions as of July 1. To the extent that the Company believed that a waiver of the effective date was possible, such belief could not have been based upon any reasonable expectation, as granting such a waiver would directly conflict with the underlying purpose and rationale of the BBA.

75. On September 28, 1998, Robinson-Humphrey issued a report on Sun written by Villwock, which stated: "We expect the SHG transition to PPS to be smoother than the RCA transition. SHG facilities have a longer period of time to adjust to PPS." Despite downgrading the stock, Robinson-Humphrey once again wrote on September 29, 1998, that "We believe that SHG is one of the best positioned companies to prosper under the pending prospective payment system. ... We are convinced that PPS can be accretive to earning for SHG over the long-term."
On September 29, 1999, Francoise Giacalone, an analyst at Credit Lyonnais, echoed the sentiments of Robinson-Humphrey when Giacalone despite poor third quarter 1998 numbers, "[o]n the positive side, we continue to believe that Sun is the best positioned among long-term care providers to benefit from PPS: the SunSolution bundled ancillary product is being well received and could exceed the target of 100 contracts for 1998."

On October 8, 1998, the *Albuquerque Tribune* published an article that quoted Wimer as follows:

"We would like to go to the market and sell some stock and use the proceeds to pay down some debt and become a little less leveraged. *But given the condition of stock prices in the sector today, there is no way we are going to sell stock for $6 and $7 dollars, when we know it's worth $25.*"

(Emphasis added.) One month later, on November 11, 1998, Woltil sold 15,677 shares (or over 25% of his personal holdings) of Sun's stock at $5.75 per share.

In this same article, Wimer falsely implied that Sun was positioned to take advantage of the turmoil in the industry that was created by the PPS:

"I think that any type of environmental change as significant as the conversion of the Medicare program from a cost basis to a fixed-fee system creates turmoil. Every time we have one of these waves of change, there are more opportunities to acquire facilities."

"People say 'I am fed up with change. I've been running my nursing home for 15 years, and this is the last straw. I'm selling out.'"

"Anytime there's turmoil, there's opportunity."

On October 15, 1998, Furman Selz LLC issued a report on Sun written by Leslie Henshaw, which even after seeing how PPS affected the recently-acquired RCA facilities, the Company continued to tout its ancillary services division as a key to future profitability, stated:

[W]e expect investors to seek signs of health within SHG's core businesses, particularly its ancillary rehabilitation services division, which management stressed is performing in line with prior guidance (including the execution of 100 full-service contracts by year-end 1998).

On October 15, 1998, Johnson Rice analyst Courtney LeClercq also viewed SunSolution as an effective remedy for any PPS problems the Company might have:

[S]ales of the SunSolution product have already exceeded the revised goal of 100, with the majority of the new clients signing up for the full bundle of products. As
a result, management stated that their target for PPS performance next year will be exceeded and should be more than $0.02-0.03 accretive.

81. On October 16, 1998, in a Company press release, Wimer stated that Sun was capable of "expanding" revenues under the PPS:

"The creation of a single ancillary services division, and the elimination of separate pharmacy and rehabilitation divisions, will promote an integrated approach to the provision of ancillary services. It will also improve Sun's ability to succeed in marketing SunSolution, an all-inclusive service product that is our primary strategy for expanding our revenue under PPS."

(Emphasis added.)

82. The October 16, 1998 press release was materially false and misleading because the defendants knew that Sun would not be "expanding" revenues under PPS. The federal reimbursement rate was available to Sun as of May 12, 1998. Therefore, the defendants knew that revenues and operating margins were expected to materially decline — after not expand — the implementation of the PPS. Changes in the Medicare reimbursement rate resulted in a one-third reduction in per-patient medicare reimbursements from approximately $500 in 1998 to $325 in 1999.

83. After speaking with Ken Noonan, President of SunSolution, LeClercq authored an October 21, 1998 research report on Sun, which reiterated her "accumulative" rating, and once again touted the SunSolution product:

Overall, interest and reception have been favorable, particularly among regional chains .... [W]e reiterate that Sun Healthcare is taking a proactive approach towards PPS with offering of SunSolution, and sales of the product appear to be on track.

84. On October 29, 1998, Credit Lyonnais analyst Francoise Giacalone also viewed the SunSolution product positively — as a means of combating PPS — noting in a research report that:

[W]e believe SHG is prepared for PPS ... [t]o Sun's credit, the higher-margin SunSolution product is the only fully developed bundled offering on the market that we are aware of. We think it will give the company a unique competitive advantage.

85. On October 29, 1998, defendants announced diluted net earnings of $.20 per share for third quarter 1998, on revenues of $826.7 million, compared to net revenues of $555.2 million for third quarter 1997.

86. Statements made by Turner on October 29, 1998 continued to falsely imply that Sun was prepared to deal with the implementation of the PPS:
"We continue to believe that the new prospective payment system will make our industry more efficient, providing benefit to both our resident population and the government. **We also continue to believe that PPS will favor Sun's operating model of controlling all of the ancillary services required by long-term care residents.** That view is already being borne out by the early marketing success of our SunSolution product."

(Emphasis added.)

87. Subsequent to the release of its third quarter 1998 results, Sun held a conference call for analysts, money and portfolio managers, institutional investors, and large Sun shareholders to discuss Sun's results, its business and its prospects. During the call – and in follow up conversations with analysts, – Turner and Wimer stated:

- Sun was successfully marketing its SunSolution product, which sales would benefit from the new PPS rules.
- Sun was well positioned to thrive under the new PPS.
- The new PPS would benefit Sun's operating model because the Company controlled all of the ancillary services required by long-term residents.
- Despite some uncertainty regarding the impact of PPS, Sun was still on track to have 1998 and 1999 EPS of $.91-$92 and $1.00-$1.40, respectively.

88. In the days following their conversations with Sun management, analysts issued reports on Sun that were based on and repeated information provided by Turner and Wimer. These reports projected 1998 and 1999 EPS and earnings growth for Sun as follows:

<table>
<thead>
<tr>
<th>Firm</th>
<th>Date</th>
<th>1998 EPS</th>
<th>1999 EPS</th>
<th>Growth Rate</th>
<th>Analyst</th>
</tr>
</thead>
<tbody>
<tr>
<td>Legg Mason</td>
<td>10/29/98</td>
<td>$0.91</td>
<td>$1.20</td>
<td></td>
<td>Jensen</td>
</tr>
<tr>
<td>Credit Lyonnais</td>
<td>10/29/98</td>
<td>$0.92</td>
<td>$1.40</td>
<td>15%</td>
<td>Giacalone</td>
</tr>
<tr>
<td>BT Alex. Brown</td>
<td>10/29/98</td>
<td>$0.92</td>
<td>$1.21</td>
<td>13%</td>
<td>Swenson</td>
</tr>
<tr>
<td>Robinson-Humphrey</td>
<td>10/30/98</td>
<td>$0.91</td>
<td>$1.00</td>
<td>18%</td>
<td>Villwock</td>
</tr>
</tbody>
</table>

89. The October 29, 1998 press release and related statements were materially false and misleading because defendants knew that the PPS would not benefit either the Company or the population that it serves because the PPS reimburses patients on a flat per-patient daily rate, which creates an incentive for providers to reduce the amount of ancillary services provided to each patient.
The press release and related statements were also false and misleading because despite Sun's efforts at expansion through its SunSolution product, consumer acceptance of SunSolutions was materially below the Company's expectations and far below the levels necessary to off-set the adverse consequences of PPS reimbursement expenses.

90. On October 30, 1998, Robinson-Humphrey analyst Villwock stated in a research report that despite a "weakening demand for contract therapy services," he maintained his rating on Sun:

[W]e are convinced that the benefit of PPS in SHG's owned nursing homes after this short transition, will more than make up for whatever detriment they show in other parts of the business. We are more convinced than ever that PPS will be a large positive for SHG .... Investors in the stock today should own it because they believe that SHG is well positioned to thrive under the new payment system. We share that view.... Investors should buy SHG because they believe that when it is obvious that SHG can complete the transition, the stock will already be significantly higher than current prices, and extraordinary returns are earned by acquiring stocks before the improvement is obvious.

(Emphasis added.).

91. On October 30, 1998, Schroder & Co., Inc. analyst Lynch once again opined that with the progress of SunSolution, Sun was well-prepared for PPS:

Based on our conversations with the company ... we believe that SHG has done an absolutely tremendous amount of work in preparing its facility staff and its operating systems and structure for the changes that PPS will bring about.

92. On November 2, 1998, Turner spoke at a Robinson-Humphrey conference in Atlanta. His comments were later reported by Bloomberg:

Sun Healthcare Group Inc. should see earnings grow about 30 percent next year as the No. 2 U.S. nursing-home operator benefits from revenue from recent purchases and lessens its dependence on Medicaid, its chairman said.

Sun, which operates 605 long-term facilities around the world, said it would slow its pace of acquisitions after buying more than 200 nursing homes in the past two years, and concentrate on improving its ancillary businesses, such as home health services.

"We'll probably grow 30 percent in 1999 if we do nothing else," Andrew Turner, Sun's chairman and chief executive, said at a Robinson-Humphrey Co. conference in Atlanta today. "We don't fee the need to hurt the balance sheet to a further degree to grow the company."

Most of the increase will come from its July acquisition of Retirement Care Associates Inc., which will add about $300 million in revenue next year, he said.
93. In an article published in *Modern Healthcare* on November 9, 1998, Turner once again made it sound like the new Medicare PPS standards would benefit Sun and its shareholders, by stating that the Company was benefitting from the PPS thanks to "early and intensive preparation."

94. On November 17, 1998, half-way into its 1998 fourth quarter, Sun filed its Form 10-Q for third quarter 1998, September 30, 1998, which reported the financial results as announced on October 29, 1998. The Form 10-Q deceptively stated that reimbursement rates would be "generally" less, while failing to disclose that margins would be substantially reduced. Moreover, the Form 10-Q deceptively reiterated the boilerplate statement that "[t]here can be no assurance that PPS will not have a material adverse effect on the results of operations and financial condition of the company," while failing to disclose that defendants knew that it would. The Form 10-Q stated:

*There can be no assurance* that payments under governmental or private payor programs will remain at levels comparable to present levels or will be adequate to cover the costs of providing services to patients eligible for assistance under such programs. Significant decreases in utilization, changes in reimbursement, including salary equivalency and PPS, could have a material adverse effect on the Company's financial condition and results of operations, including the *possible* impairment of certain assets.

*   *   *

Although it is unclear what the long-term impact of PPS will be, the transition to PPS for RCA facilities on July 1, 1998 negatively impacted the Company's earnings for the quarter ended September 30, 1998. There *can be no assurance* that PPS will not have a material adverse effect on the results of operations and financial condition of the Company.

The Company's revenues from its inpatient facilities will be significantly affected by the federally established per diem rate. The *new per diem rate will set limits on the amount of certain types of care the government will pay for per patient per day*. The Company expects that the per diem reimbursement rate will generally be less than the amount the Company's inpatient facilities currently receive on a daily basis under cost based reimbursement. In response, the Company intends to take various actions to reduce its costs, including the elimination of therapy positions. Moreover, since the Company treats a greater percentage of higher acuity patients than many nursing homes, the Company may also be adversely impacted if the federal per diem rates for higher acuity patients do not adequately compensate the Company for the additional expenses and risks for caring for such patients. As a result, there *can be no assurance* that the Company's financial condition and results of operations will not be materially and adversely affected by the implementation of PPS.

(Emphasis added.).
95. On February 2, 1999, despite the plethora of earlier positive statements, the Company stunned the investing public by announcing that Sun's fourth quarter 1998 results would show a loss due to Medicare payment changes and a declining demand for its therapy services. The reasons given for the expected loss focused primarily on changes in the Medicare reimbursement system, and a greater-than-expected decline in demand for certain Company services. Sun also announced that it expected to record a charge for the write-down of impaired goodwill for certain of its domestic inpatient facilities that have been affected by the Company's transition to the Medicare PPS. Turner stated that "[t]he continuing transition to PPS during the fourth quarter had a severe impact on our company."

96. Wall Street's reaction was fast and furious. Sun's stock plummeted 57%, from $4-3/4 per share on February 1, 1999, to close at $2-1/16 per share on February 2, 1999, in trading that was 26 times the average daily trading volume for the stock for the prior three months. As Sun has continued to disclose additional problems, its stock price declined to as low as $1-3/16 and currently does not trade.

POST-CLASS PERIOD DISCLOSURES

97. On April 9, 1999, Sun reported its 1998 year-end results, which included a loss for the fourth quarter totaling $761.7 million, or $13.34 per share, and a loss of $753.7 million, or $14.49 per share for the year. Discussing this bleak financial performance, Turner admitted that PPS, and its impact on the demand for ancillary services, had sent Sun into a "tailspin" and having a "severe impact on Sun, from which it will take some time to recover."

98. On April 9, 1999, Sun also reported that its independent auditor, Arthur Andersen LLP, would "include a statement expressing its concern about the company's ability to survive in its report on the company's 1998 results." Furthermore, Sun announced that it was slashing 10,000 positions and closing or consolidating regional and divisional units.

99. On April 10, 1999, the Orlando Sentinel published an article stating that because of Sun's wider-than-expected fourth quarter loss, the Company failed to meet some of the terms of its loan agreements. The article also stated that "[t]he company said it is working with creditors to renegotiate the agreements."
100. On April 12, 1999, *The Wall Street Journal* published an article outlining the impact of PPS on companies like Sun:

Industry analysts say its impact has been compounded for companies like Sun, which had set up units to provide various high-margin therapy services, under contract, to smaller operators, which themselves are now scrambling to cut costs.

Compared to the year-earlier period, Sun reported that quarterly revenue plunged 22% for its therapy-services business and 66% for its temporary therapy staffing services unit. Meanwhile, a company spokeswoman said that reimbursement for its Medicare patients has effectively been reduced to about $300 a day, from about $500.

101. On April 12, 1999, Alex. Brown analysts Jean Swenson and Noel Ashekian lowered their Sun 1999 EPS estimate to a loss of $1.21 per share. The report also stated:

In response to the unrelenting pricing pressures of PPS, SHG instituted a recovery plan during 4Q 1998 that is designed to return the company to profitability by the end of 1999. We remain skeptical.

102. On May 18, 1999, Sun announced its first quarter 1999 results, which it said continued to be impacted by PPS. Turner stated, "[a]s anticipated, and as we advised in our fourth quarter announcement, results for the first quarter continued to be impacted by the industry's transition to PPS."

103. On May 18, 1999, Alex. Brown analysts Swenson and Ashekian issued a report outlining Sun's first quarter 1999 results. Noting that the Company had announced a loss of $1.27 per share for first quarter 1999, the report stated: "[t]he horrendous results in 1Q 1999 were driven primarily by the impact of preparing for the transition to PPS and were further exacerbated by a weakening in Medicare census and a more rigid regulatory environment."

104. In its Form 10-Q for the period ending June 30, 1999, Sun announced that it had filed suit in the Superior Court of Fulton County, Georgia, against certain individuals who served as directors, officers or employees of RCA prior to Sun's acquisition of RCA, alleging breaches of fiduciary duties, breaches of contract and conversion. The lawsuit sought damages of $30 million. The Form 10-Q also disclosed that, in May 1999, certain defendants countersued Sun alleging, among other things, securities fraud, negligent misrepresentation, and breach of contract.

105. In a July 26, 1999 article published in *The Arizona Republic*, Sun admitted that the Company's financial plummet was the "result of cuts in federal Medicare payments."
106. On August 20, 1999, Sun announced its second quarter 1999 results, posting a loss of $588.6 million on a 20% drop in revenue, which resulted in a $10.06 loss per share. The results included a charge of $400 million for the write-down of impaired goodwill and other long-lived assets; $52 million for disposition of assets; $66 million for revenue adjustment and reserves, and $6 million for financial restructuring in response to its defaults under credit arrangements. Sun also warned that it may have to seek Chapter 11 bankruptcy protection unless it can renegotiate the terms on a defaulted credit facility. The Company announced that its second and third quarter 1998 results were restated because of an accounting charge related to its purchase of RCA.

SUN'S FALSE FINANCIAL REPORTING

107. In order to manipulate Sun's financial results, the Individual Defendants caused Sun to improperly account for uncollectible accounts receivable, fail to record operating and other expenses, improperly account for goodwill, and improperly account for the acquisition of RCA, thereby materially overstating its earnings in violation of GAAP. Sun has subsequently written off hundreds of millions of dollars of impaired goodwill and has restated its results to correct for this improper accounting and to report certain charges in the second and third quarters of 1998 which Sun had previously failed to report.

Sun's Failure to Record Expenses in the Quarters the Expenses Were Incurred

108. On August 11, 1998, Sun reported its second quarter 1998 results including EPS of $0.38, but excluding the pooling with RCA, certain charges, and extraordinary losses. On October 29, 1998, Sun reported its third quarter 1998 results, including EPS of $0.20 per share. On February 1, 1999, Sun announced preliminary results for the fourth quarter 1998, which included certain charges.

109. In fact, Sun had misstated its second and third quarter results and certain of the costs and expenses recorded in the fourth quarter 1998 should have been recorded in the second and third quarters. Sun had failed to properly accrue for uncollectible receivables, failed to report certain costs it had incurred in those quarters and failed to record a loss of the sale of assets which had occurred in the third quarter 1998. Sun's second quarter EPS, excluding RCA and extraordinary losses were actually only $0.02. Sun's third quarter EPS was actually a loss of $0.02. Moreover, Sun had
improperly accounted for its acquisition of RCA treating it as a pooling of interests rather than as a purchase as described below. The expense adjustments to Sun's previously reported results for the second and third quarters of 1998 were as follows:

<table>
<thead>
<tr>
<th></th>
<th>Second Quarter</th>
<th>Third Quarter</th>
</tr>
</thead>
<tbody>
<tr>
<td>Additional Operating Expenses</td>
<td>$3.588M</td>
<td>$ 802K</td>
</tr>
<tr>
<td>Additional G&amp;A Expenses</td>
<td>$590K</td>
<td>$1.295M</td>
</tr>
<tr>
<td>Provisions for Losses on</td>
<td>$4.810M</td>
<td>$3.827M</td>
</tr>
<tr>
<td>accounts receivable</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Loss on Sale of Assets</td>
<td></td>
<td>$2.185M</td>
</tr>
<tr>
<td>Legal &amp; Regulatory Expenses</td>
<td>$425K</td>
<td>$938K</td>
</tr>
<tr>
<td>Goodwill for RCA</td>
<td></td>
<td>$1.467M(^1)</td>
</tr>
<tr>
<td>Total Adjustments:</td>
<td>$9.413M</td>
<td>$10.514M</td>
</tr>
</tbody>
</table>

110. Sun's failure to take required write-downs of uncollectible receivables and to record certain losses and operating expenses when the losses and expenses were incurred in the second and third quarters of 1998, caused Sun to materially overstate its earnings before taxes in both of those quarters. Expenses are to be recorded in the period they are incurred or in the quarter it becomes evident that assets are expected to provide reduced or no further benefits. See FASB Statement of Concepts No. 5, ¶¶85-87. A loss should be recorded for uncollectible receivables when it is probable that a receivable or a portion of a group of receivables will not be collected. FASB Statement of Concepts No. 5, ¶23.

**Sun's Improper Accounting for Goodwill**

111. GAAP, as set forth in Statement of Financial Accounting Standards ("SFAS") 121, Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed of, and Accounting Principles Board Opinion ("APB") No. 17, ¶31, require the periodic evaluation of goodwill. Pursuant to SFAS 121, long-lived assets, including goodwill, are to be reviewed for impairment if events or changes in circumstances indicate that the carrying amount of the long-lived assets may not be fully recoverable. An asset is considered impaired if its carrying amount exceeds

\(^1\) This additional charge was the result of Sun changing the way it accounted for the acquisition of RCA, described below.
its expected undiscounted cash flows. SFAS 121, ¶6. An impairment loss is to be recorded by the
amount by which the asset's carrying amount exceeds its fair value. SFAS 121, ¶7.

112. In October 1997, Sun acquired the stock of Regency, whose assets included goodwill
of $422.6 million. As a result of the acquisition, Sun's goodwill increased from $566.4 million at
September 30, 1997, to $1.03 billion at December 31, 1997. By the beginning of the Class Period,
defendants were preparing for the new PPS, which, based on the reports and analyses provided to
the Individual Defendants, was going to dramatically decrease future revenues. Defendants were
aware that the economic benefit expected to be derived from the goodwill had been dramatically
reduced. Thus they knew that the goodwill on Sun's financial statements was impaired. But, in
order to avoid reporting the impairment and dramatically reducing the Company's reported earnings,
Sun failed to record the required loss for the impairment during the Class Period.

113. Ultimately, in fourth quarter 1998 the quarter which was audited by outside
accountants – Sun took a charge of nearly $700 million, more than half of which was to write off
impaired goodwill and uncollectible receivables.

Sun's Use of the Pooling-of-Interests Method in the Acquisition of RCA

114. On June 30, 1998, Sun had acquired RCA for approximately 7.6 million shares of
stock valued at $122 million (approximately $16 per share). The acquisition was accounted for as
a pooling of interests and the financial statements of Sun were restated to include the accounts and
operations of RCA for all periods prior to the merger.

115. Pursuant to GAAP, there are two principal methods of accounting for business
combinations: (1) pooling of interests; and (2) purchase method. GAAP, as set forth in APB No.
16, describes the requirements of each method. The purchase method requires the acquiring
company to record the difference between the purchase price and the value of the net assets acquired
as "goodwill" which is then amortized as an expense against earnings over several years after the
acquisition. The pooling-of-interests method, by contrast, records no goodwill and no subsequent
amortization expense against earnings. The pooling-of-interests method is an increasingly
disfavored method of accounting for mergers as it fails to account for the true cost of acquisitions.
116. There are strict requirements as to the use of the pooling-of-interests method and a list of several requirements, all of which must be met or the pooling-of-interests method may not be used. One such requirement is that the combined entity not intend to dispose of a significant part of the assets within two years of the acquisition. APB No. 16, ¶48c.

117. As a result of Sun's use of the pooling-of-interests method in the acquisition of RCA, no goodwill was recorded and hence no amortization expense was recorded in the quarter ended September 30, 1998, thereby overstating Sun's reported earnings before taxes in that quarter by $1.46 million. Within several months of the acquisition, Sun has disposed of a significant portion of the assets acquired from RCA. Hence, Sun has been forced to restate its results for the second and third quarters of 1998.

The Restatement of Sun's Results

118. The restatement of the Company's previously issued financial statements resulted in Sun converting its previously reported profit (before extraordinary losses) of $0.20 per share into a loss of $0.02. Revenue for third quarter 1998 was reduced by $12.248 million, and expenses were increased from what Sun originally reported by millions of dollars.

119. The fact that Sun has restated its financial statements is an admission that its previously issued financials were improperly reported based on information known at the time the financial statements were issued and that the misreporting was material. See APB Nos. 9 and 20. The Company's 1998 Form 10-K stated:

As announced on April 5, 1999, the Company determined that its acquisition of RCA should be accounted for as a purchase and not a pooling of interests, as previously reported. The basis for the determination was the Company's recent decision to dispose of general non-core businesses. In addition, the Company determined that certain fourth quarter charges should have been recorded in previous 1998 quarters. As a result, the Company has restated its previously reported financial results for the second and third quarters of the fiscal year ended December 31, 1998.
120. The Company's false-financial reporting during the Class Period painted a misleading picture of Sun's operations and prospects.

121. GAAP are those principles recognized by the accounting profession as the conventions, rules and procedures necessary to define accepted accounting practice at a particular time. SEC Regulation S-X (17 C.F.R. §210.4-01(a)(1)) states that financial statements filed with the SEC which are not prepared in compliance with GAAP are presumed to be misleading and inaccurate, despite footnote or other disclosure. Regulation S-X requires that interim financial statements must also comply with GAAP, with the exception that interim financial statements need not include disclosure which would be duplicative of disclosures accompanying annual financial statements. 17 C.F.R. §210.10-01(a).

122. Due to these accounting improprieties, the Company presented its financial results and statements in a manner which violated GAAP, including the following fundamental accounting principles:

(a) The principle that interim financial reporting should be based upon the same accounting principles and practices used to prepare annual financial statements (APB No. 28, ¶10);

(b) The principle that financial reporting should provide information that is useful to present and potential investors and creditors and other users in making rational investment, credit and similar decisions was violated (FASB Statement of Concepts No. 1, ¶34);

(c) The principle that financial reporting should provide information about the economic resources of an enterprise, the claims to those resources, and effects of transactions, events and circumstances that change resources and claims to those resources was violated (FASB Statement of Concepts No. 1, ¶40);

(d) The principle that financial reporting should provide information about how management of an enterprise has discharged its stewardship responsibility to owners (stockholders) for the use of enterprise resources entrusted to it was violated. To the extent that management offers securities of the enterprise to the public, it voluntarily accepts wider responsibilities for accountability to prospective investors and to the public in general (FASB Statement of Concepts No. 1, ¶50);
(e) The principle that financial reporting should provide information about an enterprise's financial performance during a period was violated. Investors and creditors often use information about the past to help in assessing the prospects of an enterprise. Thus, although investment and credit decisions reflect investors' expectations about future enterprise performance, those expectations are commonly based, at least partly, on evaluations of past enterprise performance (FASB Statement of Concepts No. 1, ¶42);

(f) The principle that financial reporting should be reliable in that it represents what it purports to represent was violated. That information should be reliable as well as relevant is a notion that is central to accounting (FASB Statement of Concepts No. 2, ¶¶58-59);

(g) The principle of completeness, which means that nothing is left out of the information that may be necessary to insure that it validly represents underlying events and conditions was violated (FASB Statement of Concepts No. 2, ¶79); and

(h) The principle that conservatism be used as a prudent reaction to uncertainty to try to ensure that uncertainties and risks inherent in business situations are adequately considered was violated. The best way to avoid injury to investors is to try to ensure that what is reported represents what it purports to represent (FASB Statement of Concepts No. 2, ¶¶95, 97).

123. Further, the undisclosed adverse information concealed by defendants during the Class Period is the type of information which, because of SEC regulations, regulations of the national stock exchanges and customary business practice, is expected by investors and securities analysts to be disclosed and is known by corporate officials and their legal and financial advisors to be the type of information which is expected to be and must be disclosed.

SAFE HARBOR

124. The safe harbor provided for forward-looking statements ("FLS") does not apply to the false FLS pleaded. The safe harbor does not apply to Sun's false-financial statements. None of the FLS pleaded herein were identified as "forward-looking statements" when made, it was not stated that actual results "could differ materially from those projected," nor did meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the FLS accompany those FLS. None of the particular oral FLS in Sun's conference calls or
other oral presentations pleaded were identified as required. The defendants are liable for the false FLS pleaded because, at the time each FLS was made, the speaker knew that the FLS was false and that the FLS was authorized and/or approved by an executive officer of Sun who knew that the FLS was false. None of the historic or present-tense statements made by defendants were assumptions underlying or relating to any plan, projection or statement of future economic performance, as they were not stated to be such assumptions underlying or relating to any projection or statement of future economic performance when made nor were any of the projections or forecasts made by defendants expressly related to or stated to be dependent on those historic or present-tense statements when made.

COUNT I
For Violation of Section 10(b) of the Exchange Act and Rule 10b-5 Promulgated Thereunder Against All Defendants

125. Plaintiffs repeat and reallege the allegations set forth above as though fully set forth herein.

126. This Count is brought by plaintiffs pursuant to §10(b) of the Exchange Act and Rule 10b-5 promulgated thereunder by the SEC against Sun and the Individual Defendants.

127. Throughout the Class Period, Sun and the Individual Defendants carried out a plan, scheme and course of conduct which allowed Sun to complete two critical acquisitions utilizing the Company's inflated stock as currency in negotiating and consummating the transactions. In furtherance of this unlawful scheme, plan and course of conduct, defendants, and each of them, took the actions set forth herein.

128. The defendants (a) employed devices, schemes, and artifices to defraud; (b) made untrue statements of material fact and/or omitted to state material facts necessary to make the statements made not misleading; and (c) engaged in acts, practices, and a course of business which operated as a fraud and deceit upon the purchasers of Sun's stock in an effort to maintain artificially high market prices for Sun's securities in violation of §10(b) of the Exchange Act and Rule 10b-5. Sun and the Individual Defendants are sued either as primary participants in the wrongful and illegal conduct charged herein or as controlling persons as alleged below.
129. In addition to the duties of full disclosure imposed on the Individual Defendants by their status as controlling persons of Sun, and as a result of their affirmative statements and reports, or participation in the making of affirmative statements and reports to the investing public, these defendants had a duty to promptly disseminate truthful information that would be material to investors in compliance with the integrated disclosure provisions of the SEC as embodied in SEC Regulation S-X (17 C.F.R. §§210.01, et seq.) and Regulation S-K (17 C.F.R. §§229.10, et seq.) and other SEC regulations, including accurate and truthful information with respect to Sun's operations, financial condition and earnings so that the market price of Sun's common stock would be based on truthful, complete and accurate information.

130. Sun and the Individual Defendants, individually and in concert, directly and indirectly, by the use of means or instrumentalities of interstate commerce and/or of the mails, engaged and participated in a continuous course of conduct to conceal adverse material information about the business, operations and future prospects of Sun as specified herein. The defendants employed devices, schemes and artifices to defraud while in possession of material adverse non-public information and engaged in acts, practices, and a course of conduct as alleged herein in an effort to assure investors of Sun's value and performance and continued substantial growth, which included the making of, or the participation in the making of, untrue statements of material facts and omitting to state material facts necessary in order to make the statements made about Sun and its business operations and future prospects, in light of the circumstances under which they were made, not misleading, as set forth more particularly herein, and engaged in transactions, practices and a course of business which operated as a fraud and deceit upon the purchasers of Sun securities during the Class Period.

131. The primary liability and controlling-person liability of the defendants named in this Count arises from the following facts: (i) each of the Individual Defendants was a high-level executive and/or director at Sun during the Class Period and was a member of Sun's management team; (ii) each of the Individual Defendants, by virtue of his responsibilities and activities as a senior officer and/or director of Sun, was aware of critical healthcare legislation affecting the Company; (iii) each of the Individual Defendants enjoyed significant personal contact and familiarity with the
other defendants and was advised of and had access to other members of Sun's management team, internal reports and other data and information about Sun's finances, operations, policies and practices at all relevant times; and (iv) each of the defendants was aware of Sun's dissemination of information to the investing public that they knew or recklessly disregarded was materially false and misleading.

132. By virtue of the foregoing, Sun and the Individual Defendants have violated §10(b) of the Exchange Act, and Rule 10b-5 promulgated thereunder.

133. As a direct and proximate result of the wrongful conduct of the defendants named in this Count, plaintiffs and the other members of the Class suffered damages in connection with their purchases of Sun's securities during the Class Period.

134. The undisclosed adverse information concealed by these defendants during the Class Period is the type of information which, because of SEC regulations, rules of the national stock exchanges and customary business practice, is expected by investors and securities analysts to be disclosed to the investing public. This information is known by corporate officials and their legal and financial advisors to be the type of information which is expected to be and must be disclosed.

COUNT II
For Violation of Section 20 of the Exchange Act Against the Individual Defendants and Sun

135. Plaintiffs repeat and reallege the allegations set forth above as if set forth fully herein. This Count is asserted by plaintiffs against the Individual Defendants and Sun.

136. The Individual Defendants acted as controlling persons of Sun within the meaning of §20 of the Exchange Act as alleged herein. By virtue of their high-level positions, substantial stock holdings, participation in and awareness of the Company's operations and intimate knowledge of the Company's internal financial condition, business practices, products, and the actual progress of its development and marketing efforts, these defendants had the power to influence and control and did influence and control, directly or indirectly, the decision-making of Sun, including the content and dissemination of the various statements that plaintiffs contend are false and misleading. Sun controlled each of the Individual Defendants and all of its employees. Each of the Individual
Defendants was provided with or had unlimited access to copies of Sun's internal reports, press releases, public filings and other statements alleged by plaintiffs to be misleading prior to and shortly after these statements were issued, and had the ability to prevent the issuance of the statements or cause the statements to be corrected.

137. In particular, each of the Individual Defendants had direct involvement in or intimate knowledge of the day-to-day operations of Sun and, therefore, is presumed to have had the power to control or influence the particular transactions giving rise to the securities violations as alleged herein, and exercised the same.

138. As set forth above, the Individual Defendants and Sun each violated §10(b) and Rule 10b-5 by their acts and omissions as alleged in this Complaint. By virtue of their positions as controlling persons, these defendants are liable pursuant to §20 of the Exchange Act.

139. As a direct and proximate result of the wrongful conduct of these defendants, plaintiffs and the other members of the Class suffered damages in connection with their purchases of the Company's securities during the Class Period.

BASIS OF ALLEGATIONS

140. Plaintiffs have alleged the foregoing based upon investigation of their counsel, which included a review of Sun's SEC filings, analyst reports, and advisories about the Company, press releases issued by the Company, media reports about the Company, and discussions with former employees and consultants, and believes that substantial additional evidentiary support will exist for the allegations set forth in ¶¶26, 28-33, 55-61, 74, 82 and 107-112, after a reasonable opportunity for discovery.

PRAYER FOR RELIEF

WHEREFORE, plaintiffs, on behalf of themselves and the Class, pray for judgment as follows:

A. Declaring this action to be a class action properly maintained pursuant to Rule 23 of the Federal Rules of Civil Procedure;

B. Awarding plaintiffs and other members of the Class damages together with interest thereon;
C. Awarding plaintiffs and other members of the Class their costs and expenses of this litigation, including reasonable attorneys' fees, accountants' fees, any experts' fees, and other costs and disbursements; and

D. Awarding plaintiffs and other members of the Class such other and further relief as may be just and proper under the circumstances.

JURY DEMAND

Plaintiffs demand a trial by jury.

DATED this 10th day of Sept., 1999.

FREEDMAN, BOYD, DANIELS, HOLLANDER, GOLDBERG & CLINE P.A.
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JOSEPH GOLDBERG

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DECLARATION OF SERVICE BY MAIL

I, the undersigned, declare:

1. That declarant is and was, at all times herein mentioned, a citizen of the United States and a resident of the County of San Diego, over the age of 18 years, and not a party to or interest in the within action; that declarant's business address is 600 West Broadway, Suite 1800, San Diego, California 92101.

2. That on September 10, 1999, declarant served the CONSOLIDATED AMENDED COMPLAINT FOR VIOLATION OF THE SECURITIES EXCHANGE ACT OF 1934 by depositing a true copy thereof in a United States mailbox at San Diego, California in a sealed envelope with postage thereon fully prepaid and addressed to the parties listed on the attached Service List.

3. That there is a regular communication by mail between the place of mailing and the places so addressed.

I declare under penalty of perjury that the foregoing is true and correct. Executed this 10th day of September, 1999, at San Diego, California.

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