IN THE COURT OF CHANCERY OF THE STATE OF DELAWARE

IN AND FOR NEW CASTLE COUNTY

STACEY FEINGLASS MANZO on behalf of herself and all others similarly situated, Plaintiff, v. RITE AID CORPORATION, a Delaware corporation, MARTIN L. GRASS, TIMOTHY J. NOONAN, FRANKLIN C. BROWN, NANCY A LIEBERMAN, LEONARD STERN, PRESTON R. TISCH, WILLIAM J. BRATTON, and KPMG LLP, Defendants.	)	C.A. No. 18451 -NC

MEMORANDUM OPINION

Date Submitted: September 6, 2002
Date Decided: December 19, 2002

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CHANDLER, Chancellor

Stacey Feinglass Manzo, shareholder of Rite Aid Corporation ("Rite Aid"), brings this purported class action on behalf of herself and other shareholders of Rite Aid who neither bought nor sold Rite Aid stock between March 1, 1997, and October 18, 1999. Ms. Manzo has been a shareholder of Rite Aid since the early 1970s.

Defendants are Rite Aid, a Delaware Corporation that owns and operates several thousand retail drug stores in thirty-eight states; Martin L. Grass, former Chairman of the Board and former CEO of Rite Aid; Timothy J. Noonan, a former officer and director; Franklin C. Brown, Vice Chairman of the Rite Aid board and a former officer (Grass, Noonan, and Brown are collectively "inside directors"); Nancy A. Leiberman, Leonard Stern, Preston R. Tisch, and William J. Bratton, all outside directors and audit committee members (Leiberman, Stern, Tisch, and Bratton are collectively "audit committee directors"); and KPMG, LLP, formerly Rite Aid's independent auditing firm.

Plaintiff brings claims of common law fraud and equitable fraud against all defendants; a claim for breach of fiduciary duty against all the inside directors and audit committee directors, and a claim for aiding and abetting breach of fiduciary duty against KPMG.

Defendants have moved to dismiss all claims under Court of Chancery Rule 12(b)(6) for failure to state a claim. Within the context of the motion to dismiss

under 12(b)(6), defendants assert that plaintiff has failed to state direct claims, as opposed to derivative ones, which raises issues of whether demand is required under Rule 23.1. Furthermore, defendants assert that, under Delaware law, no claim of fraud can be pursued as a class action. Defendants also raise several issues of inadequate pleading specificity as to the fraud claims.

I. FACTUAL BACKGROUND

The 145-page amended complaint alleges that Rite Aid, the inside directors, and the audit committee directors made material omissions and affirmative misrepresentations, falsely overstating earnings and the value of assets while understating expenses, in virtually every single piece of financial information released by Rite Aid for over three years, from March 1, 1997 to October 18, 1999.[1] Due to the alleged misstatements and misrepresentations, Rite Aid's earnings for the three years required downward restatement by about 50% or approximately $1.6 billion.

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[1] The amended complaint alleges material false and misleading statements and omissions in annual reports for the years 1997-99; SEC filings (10-Qs and 10-Ks) throughout the period; audit opinions and auditor's letters from this time period; press releases and interviews in trade journals; verbal statements by management at shareholders meetings; management statements to analysts; responses to SEC comment letters; statements made when reporting invoice "write-downs" to product suppliers; financial projections provided to banks; and other statements regarding financial information of Rite Aid.

It is also alleged, that because they served as outside auditors of Rite Aid, KPMG knew or should have known of these financial misrepresentations since they had access to documentation and records that would demonstrate the inaccuracies and underlying improprieties. In addition, KPMG had an obligation as Rite Aid's auditors to evaluate these materials and investigate any departures from Generally Accepted Accounting Principles ("GAAP"). Therefore, by issuing "clean" or unqualified audit opinions, KPMG assisted in the falsifications until at least early 1999.

The amended complaint further alleges that Rite Aid knowingly and deliberately engaged in a number of improper and illegal business practices that (1) skewed reported financial results; (2) exposed Rite Aid to severe legal liabilities; and (3) reduced consumer confidence. Specific examples include:

Cash registers at Rite Aid pharmacies were programmed to facilitate charging uninsured customers higher prices than insured customers for prescription drugs;

Rather than writing off outdated over-the-counter products (including pharmaceuticals for adults and children), Rite Aid sold these products to unwary customers;

Rite Aid used store managers to perform construction and other non-managerial work after hours, violating state employment laws, in order to reduce expenses related to store renovations; and

Stores were routinely understaffed-frequently there was no licensed pharmacist on duty during operating hours as required by state pharmacy board regulations.

One result of the alleged mismanagement and persistent overstatement of Rite Aid's financial picture was to artificially inflate the price at which Rite Aid stock traded. As of January 1999, the stock traded as high as $50.94 per share. Ultimately, in 1999, a series of events exposed the nature and scope of the wrongdoing, and Rite Aid's share price plummeted. The SEC announced an investigation into Rite Aid's accounting practices. The attorney general of Florida filed a $2 billion racketeering lawsuit against the company in connection with Rite Aid's practice of differential pricing of prescription drugs for insured and uninsured customers. Rite Aid restated its 1997-99 pre-tax earnings downward by $500 million. Grass resigned as Chairman and CEO of Rite Aid. KPMG resigned as Rite Aid's auditors. Following an audit by Deloitte & Touche LLP, Rite Aid again restated its 1997-99 earnings downward for a total reduction of $1.6 billion or approximately 50% less than originally reported. These, and other events and revelations about the management and practices of Rite Aid, were greeted by

plunging share prices. By the time the original complaint in this case was filed in October 2000, Rite Aid had been trading in the $2-3 per share range.

The amended complaint asserts that management bonuses were tied to the share price averaging above $49.50 per share over a thirty-day period, and this motivated the inside directors to falsely inflate earnings to drive up the price at which Rite Aid shares traded. In addition, Rite Aid had made a $1.5 billion acquisition of another large drugstore chain, PCS Health Systems, Inc. ("PCS"). This acquisition was financed by short-term debt with the intent of refinancing the debt through a secondary offering of Rite Aid stock. The need to refinance this acquisition placed additional pressure on the management and directors of Rite Aid to promote and maintain Rite Aid's inflated share price. In the wake of revelations throughout 1999 of Rite Aid's financial misdeeds, however, it appears that the secondary offering never occurred.

II. ANALYSIS

A. *Standard of Review*

In considering a motion to dismiss under Court of Chancery Rule 12(b)(6), the Court must assume the truthfulness of all well-pleaded facts contained in the complaint and view those facts and all reasonable inferences drawn from them in

the light most favorable to the plaintiff.[2] Conclusory allegations unsupported by facts contained in the complaint, however, will not be accepted as true.[3] Dismissal is appropriate under Rule 12(b)(6) only where it appears with a reasonable certainty that the plaintiff would not be entitled to the relief sought under any reasonable set of facts properly supported by the complaint.[4]

B. Common Law and Equitable Fraud Claims Against All Defendants

Plaintiffs fraud claims on behalf of the proposed class are dismissed with prejudice because individual issues of justifiable reliance predominate over issues comrnon to the members of the class. Plaintiffs fraud claims on behalf of herself as an individual are dismissed without prejudice because the amended complaint fails to adequately allege justifiable reliance and cognizable damages.

Plaintiff alleges that the various misrepresentations made by Rite Aid over the course of the three years in question constitute both common law and equitable fraud. The elements of common law fraud are: (1) a false representation of fact by the defendant; (2) the defendant knows or believes the

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[2] *See Grobow v. Perot, 539* A.2d 180, 187 (Del. 1988) (stating that "upon a motion to dismiss, only well-pleaded allegations of fact must be accepted as true" and that the Court "need not blindly accept as true all allegations, nor must it draw all inferences from them in plaintiffs' favor unless they are reasonable inferences").

[3] *Id.* (stating that "conclusionary allegations of fact or law not supported by allegations of specific fact may not be taken as true").

[4] *Rabkin v. Philip A. Hunt Chem. Corp., 498* A.2d 1099, 1104 (Del. 1985).

representation to be false or acts with reckless indifference to its truth or falsity; (3) the defendant intends to induce the plaintiff to rely on the representation; (4) the plaintiff actually and justifiably relies on the false representation; and (5) the plaintiff incurs damages as a result of such reliance.[5] For the purposes of ruling on this motion to dismiss, the only difference between common law and equitable fraud is that the second element, scienter, need not be proven to make out a claim of equitable fraud because "equity provides a remedy for negligent or innocent misrepresentations."[6] Because I find the pleadings are sufficient to constitute a well-pleaded allegation of scienter as to all defendants, the analyses of the common law fraud and equitable fraud claims are identical for the purposes of this ruling.

1. Making False Representations

As to the first element, plaintiff more than adequately alleges that false representations were made by the company, through the director defendants', and with the assistance of KPMG.

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[5] *Gaffin v. Teledyne, Inc.,* 611 A.2d 467,472 (Del. 1992).
[6] *Zim v. VLI Corp.,* 681 A.2d 1050, 1061 (Del. 1996).
[7] The audit committee directors assert that plaintiff failed sufficiently to allege that they "made" any of the misleading statements. The allegations are adequate to support an inference that the audit committee members' participation in the review and approval of the financial statements in question could constitute "making" such statements for the purposes of plaintiffs prima facie claim of fraud.

The audit committee directors also assert a defense of good faith reliance on the reports of corporate advisors and officers as permitted under 8 *Del.* C. § 141(e). As the complaint does not include allegations regarding the reports of experts (other than co-defendant KPMG-allegedly

2. Knowledge, Belief, or Reckless Disregard As to the Truth or Falsity

Plaintiffs amended complaint also adequately alleges scienter in that the magnitude and scope of the misrepresentations alleged support a reasonable inference that each and all of the defendants acted with at least reckless disregard for the truth or falsity of at least some of the various financial statements, press releases, and other public disclosures alleged to be materially false and misleading.

3. Intent That Plaintiff Rely

Plaintiff alleges that false and misleading disclosures were made in financial statements, annual reports, various SEC filings, public statements to analysts, to major shareholders, and to the press regarding the financial performance of the company and regarding the company's explanations for variations from anticipated financial performance. Due to the nature of these disclosures, the Court can draw the reasonable inference that plaintiff would be able to prove that Rite Aid, the director defendants, and KPMG intended that shareholders rely on their truth.

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an aider and abettor in the directors breaches of fiduciary duties), the protections of § 141(e) would constitute an affiative defense for which evidence may be brought at trial. It cannot affect the ruling on a motion to dismiss because at this stage, the plaintiffs allegations must be taken as true, notwithstanding any defenses that may be raised in a trial on the merits.

4. Actual and Reasonable Reliance

The requirement that plaintiff plead and prove actual and reasonable reliance on the false representations made by the defendants is fatal to a class action claim of either common law or equitable fraud. Delaware law is clear that neither equitable nor common law fraud claims may be maintained as class actions because (1) certification of a class requires that "questions of law or fact common to the members of the class predominate over any questions affecting only individual members"[8] and (2) in a common law or equitable fraud case the individual question of "justifiable reliance[] will inevitably predominate over common questions."[9] Plaintiff cannot rely on a presumption of reliance based on a type of "fraud on the market" theory because the Supreme Court has determined that Delaware does not recognize such a claim.[10]

Plaintiff points out that *Gaffin* proscribes class certification only "in a *purely* common law or equitable fraud case."[11] Plaintiff asserts that the class may be certified in this case because they have also stated a claim for breach of fiduciary duty. This argument is unavailing because, as discussed below, the breach of fiduciary duty claim is dismissed on other grounds.

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[8] Court of Chancery Rule 23(b)(3).
[9] *Gaffin*, 611 A.2d at 474.
[10] *See Malone v. Brincat, 722* A.2d 5, 12-13 (Del. 1998).
[11] Pl.'s Answering Br. at 50 (emphasis in original) (quoting *Gaffin*, 611 A.2d at 474).

Finally, plaintiff contends that class certification issues need not be decided at this stage in the proceedings. It is true that the Court need not reach all the issues relevant to class certification on this motion to dismiss. Nonetheless, where the claim stated cannot *by its nature* form the basis of a class action, no class could be entitled to relief under any set of facts and it is appropriate to dismiss the claim as to the purported class under Rule 12(b)(6).

The inability to certify a class for a fraud claim, however, is not dispositive of defendants' liability to plaintiff as an individual for frauds alleged. Thus it is necessary to examine whether plaintiff adequately pleads that *she* actually and justifiably relied on misrepresentations by defendants. The amended complaint fails to allege reliance except in the most conclusory fashion.[12] Only one factual statement from the amended complaint is relevant to an evaluation of whether plaintiff did in fact rely on defendants' misrepresentations when deciding to hold her stock in Rite Aid. The amended complaint states, "Plaintiff Stacey Feinglass Manzo has owned Rite Aid stock since the early 1970's and continues to own it today."[13] This assertion is made in the context of establishing standing to

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[12] Pl.'s Am. Compl. ¶ 2 (stating that plaintiffs injuries resulted from the "defendants' wrongful conduct (and, to the extent required, plaintiffs and class members' reliance on that conduct)"), ***id.*** ¶ 274 (stating that plaintiff and class members "received and relied" on various communications of the company), ***id.* ¶ *279 (same),***

[13] Pl.'s Am. Compl. ¶ 6.

bring this claim. Nonetheless, the fact that plaintiff has decided to hold her Rite Aid stock continuously over some thirty years undercuts, to some extent, any later assertions that between March 1, 1997, and October 18, 1999, that decision was based on the inaccurately positive picture presented in the company's financial disclosures. Perhaps plaintiff did rely on defendants' misrepresentations, but so far she has failed to allege any facts to support such an inference.

5. Damages

Similarly, plaintiffs fraud claims are dismissed without prejudice because she has failed to allege legally cognizable damages suffered as a result of reliance on any false representations. In order to survive a motion to dismiss a fraud claim, plaintiff must allege damages.[14] Plaintiff makes two attempts to articulate a damages theory; neither is successful.

Plaintiff alleges "investment opportunity losses," yet fails to cite a single case to support such a theory of damages. Under this theory, the Court is asked to presume that plaintiffs investment in Rite Aid stock would have been deployed in other more successful investments had plaintiff been privy to accurate information concerning Rite Aid's financial performance. First, this presupposes reliance by plaintiff upon false representations about Rite Aid's financial condition, which, as

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[14] *See Gaffin*, 611 A.2d at 472.

discussed above, is unsupported in the amended complaint. Second, awarding money damages to compensate plaintiff for the return she *could* have earned had she invested elsewhere-as she was free to do, but didn't do-amounts to speculation founded upon uncertainty. As plaintiff has failed to direct this Court to any precedent or policy to support such an award, plaintiffs assertion of "investment opportunity losses" does not, in my opinion, state a cognizable injury.

In addition, plaintiff asserts that she is entitled to "benefit of the bargain damages." The amended complaint fails to articulate any specific bargain from which these benefits purportedly flow and, therefore, does not state a cognizable injury.[15]

C. Breach of Loyalty Claim Against Director Defendants

Plaintiffs breach of fiduciary duty claims are dismissed with prejudice because they are derivative in nature, and plaintiff has (1) failed to make demand on the board of directors, (2) failed to allege facts to support excusing demand under Court of Chancery Rule 23.1, and (3) disavowed in the amended complaint any intention to bring a derivative action. *Malone* contemplates that intentional

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[15] The Plaintiffs Answering Brief in Opposition to Defendants' Motion to Dismiss similarly neglects to identify a bargain under which plaintiff could claim "benefit" and, even if the brief were to specify the particulars of any bargain, this Court would be bound to rely solely upon the allegations contained in the amended complaint. *See Orman v. Cullman*, 794 A.2d 5, 28 n.59 (Del. Ch. 2002).

misrepresentations to “holders” of stock when, as alleged in this case, the board is not seeking shareholder action could give rise to *either* a direct or a derivative claim.[16] It leaves unchanged, however, the method of distinguishing a direct claim from a derivative one.[17]

In order to determine whether a claim is direct or derivative, the Court looks to the nature of the harm and the relief available upon success of the suit.” To state a direct claim, the shareholder must allege either an injury that is different from what is suffered by other shareholders or one that involves a contractual right of shareholders that is independent of the corporation’s rights.[19] As discussed above, the specific injury asserted by plaintiff is unclear. To the extent that plaintiff was deprived of accurate information upon which to base investment decisions and, as a result, received a poor rate of return on her Rite Aid shares, she experienced an injury suffered by all Rite Aid shareholders in proportion to their pro rata share ownership. This would state a derivative claim. Although plaintiff seeks to remedy the injury on behalf of only “holders” of Rite Aid, who neither bought nor sold their stock between March 1, 1997, and October 18, 1999, this does not indicate that “holders” suffered an injury that is distinct from that suffered

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[16] *Malone*., 722 A.2d at 16-17.
[17] Id. at 17 n.45.
[18] *Kramer v. W. Pac. Indus., Inc.*, 546 A.2d 348,352 (Del. 1988).
[19] *Moran v. Household Int'l, Inc.*, 490 A.2d 1059,1070 (Del. Ch. 1985).

by buyers or sellers. Rather, holders who neither bought nor sold would have suffered any injury for the entire period during which misrepresentations are alleged to have occurred. Injury to purchasers would have begun later (at the time of purchase) and injury to sellers would have terminated earlier (at the time of sale). The temporal duration is different, but the substance of the injury is the same.

Plaintiffs amended complaint and brief obliquely assert some sort of contractual right of shareholders to accurate information from the company and from its officers, directors, and advisors. Indeed it is true, as recognized in *Malone,* that directors are obligated to be truthful in all communications with shareholders.[20] This obligation exists even, as in this case, with regard to statements that do not seek shareholder action and those that are general public statements.[21] This obligation arises from the fiduciary duties that directors of Delaware corporations *owe both* to the shareholders and to the corporation itself.[22] Even if such a legal duty may in some context be properly characterized as a contractual right,[23] such a right cannot be characterized as belonging solely to the shareholders because it is also a right of the corporation. Therefore, any breach of

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[20] *Malone,* 722 A.2d at 10-11.
[21] rd.
[22] *Id.*
[23] I question whether in any context such a characterization would be appropriate.

fiduciary duty claim based upon the *mere fact* of knowing misrepresentation is necessarily derivative. To state a *direct* claim on that basis, plaintiff must identify some resultant injury that either affects some shareholders disproportionately to their pro rata stock ownership, or affects those rights of shareholders that are traditionally regarded as "incidents" of stock ownership.[24] Plaintiff has failed to state such an injury.

D. Aiding and Abetting Breach of Fiduciary Duty Claim Against KPMG

Because the breach of fiduciary claims are dismissed with prejudice, the claim against KPMG for aiding and abetting breach of fiduciary duty is similarly dismissed with prejudice.

III. CONCLUSION

The class action claims for both common law and equitable fraud are dismissed with prejudice because the individual question of justifiable reliance will inevitably predominate over questions common to the class. Plaintiffs individual common law and equitable fraud claims are dismissed without prejudice because the amended complaint fails to adequately allege reliance and damages. The breach of fiduciary duty claim against the director defendants is dismissed with

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[24] *See In re Digex, Inc. S'holder Litig.*, 789 A.2d 1176, 1189-90 (Del. Ch. 2000) (quoting DONALD J. WOLFE, JR. & MICHAEL A. PITTENGER, *CORPORATE* AND COMMERCIAL PRACTICE IN THE DELAWARE COURT OF CHANCERY $9-2(a), at 5 17-l 8 (1998)).

prejudice because the amended complaint does not state a direct claim and disavows any derivative claim. Furthermore, even were a derivative claim intended, plaintiff has not made demand on the board of directors and has not plead facts sufficient to show why demand should be excused. Finally, for the same reasons that require dismissal of the underlying breach of fiduciary duty claim, the claim against KPMG for aiding and abetting a breach of fiduciary duty is similarly dismissed with prejudice.

IT IS SO ORDERED.