THE COURT OF CHANCERY OF THE STATE OF DELAWARE

IN AND FOR NEW CASTLE COUNTY

NOEL SAITO, KIMBERLY MADAJCZYK, and SYDNEY H. DALMAN, Plaintiffs, v. CHARLES W. McCALL, MARK A. PULIDO, RICHARD H. HAWKINS, HEIDI E. YODOWITZ, ALFRED E. ECKERT III, TULLY M. FRIEDMAN, ALTON F. IRBY III, M. CHRISTINE JACOBS, GERALD E. MAYO, JAMES V. NAPIER, DAVID S. POTTRUCK, CARL E. REICHARDT, ALAN SEELENFREUND, JANE E. SHAW, PHILLIP A. INCARNATI, DONALD C. WEGMILLER, ARTHUR ANDERSEN LLP, BEAR STEARNS & CO., and DELOITTE & TOUCHE LLP, Defendants, and McKESSON HBOC, INC., and HBOC & COMPANY aka HEALTH CARE INFORMATION TECHNOLOGY BUSINESS UNIT, a wholly-owned subsidiary of McKESSON HBOC, INC., Nominal Defendants.	)	Civil Action No. 17132-NC

O P I N I O N

Submitted: August 18, 2004
Decided: December 20, 2004

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CHANDLER, Chancellor

Plaintiffs Noel Saito, Kimberly Madajczyk and Sydney Dalman bring this action to recover damages allegedly inflicted on the former HBO & Company ("HBOC"), McKesson Corporation ("McKesson") and, following the merger of those two companies in January 1999 (the "Merger"), on McKesson HBOC, Inc. ("McKesson HBOC" or the "Company") by their directors, senior officers, Merger advisors and outside accountants. The central allegations are: (1) that HBOC's directors and senior officers presided over a fraudulent accounting scheme; (2) that McKesson's officers, directors, and advisors learned of HBOC's fraudulent scheme during their due diligence into the proposed Merger, but nonetheless McKesson's board approved the Merger; and (3) that the McKesson HBOC board acted too slowly in rectifying the accounting problems at HBOC after the Merger was completed. The fourth amended complaint[1] enumerates thirteen counts of alleged wrongdoing.[2] Defendants move to dismiss all counts. For the reasons detailed herein, I dismiss most but not all of the claims asserted.

[1] I refer to the fourth amended complaint simply as "the complaint."

[2] The complaint includes 220 paragraphs and stretches 65 pages. The problems spawned by unnecessarily verbose pleadings were magnified when several of the defendants filed separate briefs in support of their respective motions to dismiss. Briefing on the motions to dismiss in this case, *exclusive of exhibits*, exceeded 500 pages and oral argument approached four hours in length.

I. **PROCEDURAL HISTORY**

At issue today is the fifth iteration of the plaintiffs' complaint. The original complaint was the product of a race to the courthouse, hastily filed just two days after McKesson HBOC announced it had uncovered the accounting irregularities that form the basis of the complaint. Unfortunately, the first and second amended complaint improved only marginally upon the original complaint. The second amended complaint did not enumerate specific counts, failed to present claims in a readily discernable manner or connect the facts with specific claims of wrongdoing, and was generously laden with conclusory allegations.[3] From what I could gather, the second amended complaint purported to assert four claims: a due care claim, a waste claim, and two oversight claims.[4] I dismissed the due care and waste claims, with prejudice, for failure to make demand pursuant to Chancery Rule 23.1.[5] I dismissed the two oversight claims without prejudice, and encouraged plaintiffs to use "the tools at hand" to "develop additional particularized facts in order to allege properly an oversight claim that will

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[3] *See Ash v. McCall*, 2000 WL 1370341, at *1 (Del. Ch. Sept. 15, 2000).
[4] *Id.*
[5] *Id.* at *16.

meet the demand futility standard and to avoid the standing requirement of Delaware's continuing ownership rule."[6]

On January 22, 2001, a few months after I dismissed the second amended complaint, plaintiffs filed their Third Amended Complaint. This complaint added three new defendants: Bear Stearns & Company ("Bear Stearns"), Arthur Andersen ("Andersen"), and, as a nominal defendant, HBOC. Bear Stearns rendered a fairness opinion on the Merger to McKesson's directors. Arthur Andersen was HBOC's auditor. HBOC, now a wholly-owned subsidiary of McKesson HBOC, was added as a nominal defendant so that plaintiffs could bring double derivative claims. In 2001, the parties also engaged in a highly-contentious battle over access to the Company's books and records—litigation that prompted several reported decisions.[7] After that battle subsided, plaintiffs filed the instant, fourth amended complaint.[8] The latest complaint adds another new defendant, Deloitte & Touche LLP ("Deloitte"). Deloitte served as McKesson's auditor and also conducted due diligence on the Merger for McKesson.

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[6] *Id.* at *58.

[7] *Saito v. McKesson HBOC, Inc.*, 2002 Del. Ch. LEXIS 139 (Del. Ch. Nov. 13, 2002); *Saito v. McKesson HBOC, Inc*., 2002 Del. Ch. LEXIS 125 (Del. Ch. Oct 25, 2002); *Saito v. McKesson HBOC, Inc.*, 806 A.2d 113 (Del. 2002); *Saito v. McKesson HBOC, Inc.*, 2001 Del. Ch. LEXIS 96 (Del. Ch. July 10, 2001).

[8] Plaintiff Saito filed a motion under Chancery Rule 60 to obtain relief from judgment in the 220 case *after oral argument on the pending motions to dismiss*. Saito's motion was denied. *Saito v. McKesson HBOC*, C.A. No. 18553, Let. Op., Chandler, C. (Del. Ch. Aug. 18, 2004).

II. BACKGROUND[9]

This story begins in early 1998 with HBOC, a provider of healthcare computer software. The HBOC board's audit committee, consisting of defendants James Napier, Phillip Incarnati, and Donald Wegmiller, met with HBOC's auditor, Andersen, to discuss HBOC's 1997 audit.[10] During its meeting with Andersen, at which HBOC management was present, the audit committee was informed that the 1997 audit was "high risk." Andersen and the committee discussed inherent accounting-related risks facing software companies, and specifically discussed the risks arising from certain HBOC sales practices. The audit committee also discussed audit adjustments proposed by Andersen, but that HBOC management had passed upon. According to a 2002 SEC administrative proceeding initiated against the Andersen partner that oversaw the 1997 audit, Andersen did not inform the audit committee that HBOC was misapplying GAAP.[11] Instead, Andersen

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[9] The background is taken from the allegations in the complaint and documents integral to plaintiffs' claims and incorporated in the complaint. *See In re Santa Fe Pac. Corp. S'holder Litig.*, 669 A.2d 59, 69-70 (Del. 1995). Plaintiffs attached numerous documents to their Answering Brief ("AB") encouraging the Court to consider them at oral argument on the motions to dismiss. All exhibits were incorporated by reference in the complaint and may, therefore, be considered by the Court in ruling on the pending motion to dismiss.

[10] The full HBOC board included Napier, Incarnati, Wegmiller, Charles McCall, Alfred Eckert, Alton Irby, and Christine Jacobs. McCall served as CEO and chairman of the board. All of these individuals, and Andersen, are defendants in this action.

[11] SEC Administrative Proceeding, No. 3-10998, 2002 SEC LEXIS 3299, at *25 (Dec. 23, 2002). This proceeding is cited in the complaint at paragraphs 41 and 42.

reported "no significant problems or exceptions and that Andersen enjoyed the full cooperation of HBOC management."[12]

During June-July 1998, HBOC and McKesson, a healthcare supply management company, held discussions and conducted due diligence in connection with a possible business combination. McKesson's board[13] was assisted by Deloitte and Bear Stearns in connection with the Merger. The board also received input from defendant Richard Hawkins, McKesson's CFO, and defendant Heidi Yodowitz, McKesson's Controller. At a meeting on July 10, 1998, the McKesson board was briefed on the financial due diligence that had been performed on HBOC. At this meeting, HBOC's problematic accounting practices were brought to the McKesson board's attention. Thereafter, the McKesson board considered information they received outlining likely scenarios should HBOC's accounting practices result in SEC review.[14] There is no indication, however, that any of

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[12] *Id.*

[13] The McKesson board included the following individuals: Mark Pulido, Tully Friedman, David Pottruck, Alan Seelenfreund, Jane Shaw, and Carl Reichardt. All are named defendants. Pulido served as McKesson's CEO. Seelenfreund chaired the board. McKesson directors Pottruck, Shaw, and Reichardt served on the audit committee.

[14] Hawkins and Yodowitz briefed the McKesson board on this issue. A document apparently drafted by Yodowitz identified the suspect accounting practices as relating to revenue recognition and acquisition reserves/costs and indicated that there could be a potential SEC issue given that, at the time, the SEC was requiring restatements for items below normal materiality thresholds. It is unclear what portion, if any, of this document was shared with the McKesson board. Of note, the document states: "Overall, [HBOC] appear[s] to have [a] strong finance department, good information systems and management reports." AB, Ex. D (emphasis in original).

HBOC's material accounting violations came to the McKesson's board's attention, and there was no indication that what the McKesson board did know presented a reason not to proceed with the Merger. In fact, Yodowitz informed the McKesson board that "she was generally impressed with [HBOC's] finance department and system of internal controls."[15]

Two days after the July 10 McKesson board meeting, Hawkins, Bear Stearns, and Deloitte had a conference call to discuss HBOC due diligence. Deloitte identified three areas of questionable accounting practices, and identified two of these areas (HBOC's acquisition reserves and revenue recognition) as GAAP violations.[16] At a McKesson board meeting the following day (July 13), Hawkins reviewed the accounting issues raised by the board at the July 10 board meeting and steps taken by HBOC or plans in place to address them.

While in negotiations, word of the deal leaked causing HBOC's share price to decrease. McKesson, in turn, wanted to change the exchange ratio to reflect the drop in HBOC's shares. HBOC balked at the new offer and the deal stalled for several months. In October, negotiations resumed. During

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[15] AB, Ex. E.

[16] A file memo, dated July 13, 1998, from the lead Bear Stearns bankers describes these accounting problems as violating GAAP. Ex. K. But a file memo, dated July 31, 1998, from the lead Deloitte accountant states "accounting issues had been misapplied" and does not mention GAAP. AB, Ex. B.

October 14-15, McKesson and HBOC's negotiators agreed to a form of transaction by which McKesson would acquire HBOC through an acquisition subsidiary, McKesson would be renamed McKesson HBOC and HBOC would survive as a wholly owned McKesson HBOC subsidiary.[17] During the renewed negotiations, Bear Stearns and Deloitte learned that the accounting problems identified in July were still an issue and communicated this information to the McKesson board.[18] Plaintiffs allege that during the October 1998 period, HBOC's accounting problems totaled between $40 to $55 million. Nonetheless, on October 16, 1998, the McKesson board, with knowledge of the accounting issues raised by Hawkins, Yodowitz, Bear Stearns, and Deloitte, approved the Merger and agreed to pay $14 billion in McKesson stock for HBOC. The Merger was announced shortly thereafter.

The McKesson board met on October 28, 1998. At this meeting, the board members authorized the proxy statement in connection with the Merger. This proxy statement included statements of income for HBOC that reflected violations of GAAP. The proxy statement described the due

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[17] Under the terms of the Merger, McKesson paid HBOC shareholders 0.37 of a share in McKesson stock for each share of HBOC common stock.

[18] At this time, an HBOC senior sales executive resigned because HBOC's co-president Albert Bergonzi, was allegedly "out of control" and because the sales staff was suffering an apparent "revenue hangover." This executive informed McCall of his reasons for departure, but there is no indication McCall relayed this information contemporaneously to the HBOC board or later to the combined McKesson HBOC board.

diligence efforts of Deloitte[19] and included a fairness opinion of Bear Stearns,[20] but did not disclose the irregular accounting practices identified to McKesson's board before their approval of the Merger. On November 20, 1998, the board met again to discuss follow-up items related to the Merger. Shortly before the meeting, Pulido learned that HBOC terminated its CFO, Jay Gilbertson. Pulido alerted the McKesson board to Gilbertson's termination and they discussed the issue. At that same meeting, Hawkins, McKesson's CFO, briefed the board on continuing financial due diligence and informed the board that he believed in "the strength of [HBOC's] financial organization."[21]

On November 10, 1998, Andersen (despite knowledge of HBOC's questionable accounting practices) indicated to HBOC's audit committee that Andersen would issue an unqualified opinion of HBOC's financial statements.[22] Moreover, in accord with the terms of the Merger, Andersen

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[19] Deloitte consented to the inclusion of its prior reports on McKesson's financial statements in the proxy statement.

[20] An internal Bear Stearns memo dated January 28, 1999 (well after the fairness opinion was issued), states that Bear Stearns was instructed to rely upon information provided by McKesson and HBOC and not to adjust that information based on questions raised by Deloitte. AB, Ex. A.

[21] AB, Ex. N.

[22] Some of the problems were probably unknown to Andersen. The SEC has alleged that HBOC managers hid information from HBOC's own accounting staff. *SEC v. Gilbertson, Bergonzi & DeRosa*, No. C 00-3570 (N.D. Cal. Sept. 27, 2000). The SEC complaint is incorporated at paragraph 138 of the complaint.

delivered two comfort letters to McKesson before closing.[23] On January 12, 1999, the shareholders of McKesson and HBOC approved the merger and the deal closed.

The new company, McKesson HBOC, took six directors from HBOC and six directors from McKesson. This combined board included McCall, Pulido, Eckert, Friedman, Irby, Jacobs, Pottruck, Seelenfreund, Shaw, Mayo, Napier, and Reichardt. McCall, the former HBOC CEO, served as chairman and Pulido served as CEO. The six person McKesson HBOC audit committee included Eckert, Seelenfreund, Shaw, Mayo, Napier, and Reichardt. Napier previously served on HBOC's audit committee. Shaw and Reichardt had served on McKesson's audit committee.

On January 27, 1999, the combined McKesson HBOC audit committee met with its advisors to discuss the Merger. Yodowitz discussed accounting adjustments made to HBOC's financial statements. The adjustments were in areas identified by Deloitte as problematic. Yodowitz and the audit committee allegedly knew, however, that these adjustments would not account for the full amounts identified by Deloitte as needing

[23] Andersen's endorsement of HBOC was qualified, however. On January 5, 1999, before the shareholder vote regarding the Merger, Andersen informed McKesson that it had not audited HBOC's 1998 financial statements and expressed no opinion on their accuracy. Andersen also told McKesson that it had not audited HBOC's 1997 financial statement for merger-related purposes.

alteration.[24] In addition, on January 27, McKesson HBOC issued a Form 8-K that reflected the pro forma financial statements of the combined McKesson HBOC. The Form 8-K included the adjustments brought to the audit committee's attention by Yodowitz.

After the end of the first quarter of 1999, Albert Bergonzi, HBOC's former co-president, negotiated a $20 million sale of software to Data General. The transaction was a gimmick because (1) it was backdated as first quarter revenue; and (2) it required McKesson HBOC to pay a refund to Data General if it did not sell the software. Defendant McCall allegedly participated in the Data General transaction and defendants Pulido and Yodowitz allegedly knew about the transaction's material elements. Notwithstanding the improper elements of the Data General transaction, McKesson HBOC issued a press release on April 22, 1999, that included revenue from the transaction as part of first quarter earnings. Although the McKesson HBOC board was aware of the press release, there is no indication that the board (other than possibly McCall and Pulido) knew of the impropriety of the Data General transaction.

[24] The complaint does not allege how or why Yodowitz and the audit committee had such knowledge.

On April 28, 1999, McKesson HBOC announced that it would restate its earnings from previous quarters.[25] The Company announced on May 25, 1999, that it would further revise its results downward. On June 21, 1999, McKesson HBOC announced that Hawkins and Pulido had resigned and that it stripped McCall of his Chairman position. On July 14, 1999, the Company announced that its previously reported restatements would be larger than originally revealed. On July 16, the Company submitted an SEC filing in which it conceded that HBOC's financial statements were inaccurate because of improper accounting. Predictably, McKesson HBOC's stock price declined significantly.

III. ANALYSIS

Considering defendants' various motions to dismiss two pleading standards are implicated. To the extent the claims are direct, Chancery Rule 12(b)(6) implicates the pleading standard of Chancery Rule 8(a). These claims must be pled pursuant to *Solomon v. Pathe Communications Corp.*,[26] and need only set forth "a short and plain statement of the claim."[27] On the other hand, derivative claims must meet the higher standard required by Chancery Rule 23.1. To survive a motion to dismiss, a derivative plaintiff

[25] The original complaint was filed two days after the announcement.
[26] 672 A.2d 35 (Del. 1996).
[27] CT. CH. R. 8(a).

> shall allege that the plaintiff was a shareholder . . . at the time of the transaction of which the plaintiff complains or that the plaintiff's share or membership thereafter devolved on the plaintiff by operation of law. The complaint shall also allege with particularity the efforts, if any, made by the plaintiff to obtain the action the plaintiff desires from the directors or comparable authority and the reasons for the plaintiff's failure to obtain the action or for not making the effort.[28]

In considering a motion to dismiss the Court of Chancery assumes the truth of well-pleaded allegations, giving to the plaintiff "the benefit of all reasonable inferences that can be drawn from . . . [the] pleading."[29] Conclusory statements without supporting factual averments will not be accepted as true for purposes of a motion to dismiss.[30] As noted, the complaint identifies thirteen counts of alleged wrongdoing. I will address each in turn.

A. Count I

The first count is a fiduciary duty claim, which alleges that the pre-merger, McKesson Directors breached their duties of good faith and loyalty.[31] According to the complaint:

> [T]he Former McKesson Director Defendants knew, before approving and closing the Merger, of HBOC's improper

[28] CT. CH. R. 23.1.
[29] *In re USA Cafes, L.P. Litig.*, 600 A.2d 43, 47 (Del. Ch. 1991); *see also In re Santa Fe Pacific Corp. S'holder Litig.*, 669 A.2d 59, 65-66 (Del. 1995).
[30] *In re Tri-Star Pictures, Inc. Litig.*, 634 A.2d 319, 326 (Del. 1995).
[31] Compl. ¶ 150.

> accounting practices and that they posed a 'high risk' of an SEC restatement. Despite their knowledge, the Former McKesson Director Defendants authorized Pulido [McKesson's CEO and a director] to negotiate the Merger, took affirmative steps to execute and disseminate the false and misleading Form S-4 and Joint Proxy Statement/Prospectus and then to close and consummate the Merger in violation of their fiduciary duties.[32]

Even if I were to accept plaintiffs' allegations as true, this conduct occurred *before* plaintiffs owned stock in McKesson. Both Madajczyk and Dalman became McKesson stockholders when they exchanged their HBOC stock in the stock-for-stock merger with McKesson. Saito purchased McKesson stock after the terms of the merger agreement were agreed to.

Standing to bring a derivative claim requires plaintiffs to be stockholders of the corporation: (1) "at the time of the transaction of which [they] complain[];"[33] (2) when the suit commences; and (3) throughout the course of the litigation.[34]

Madajczyk and Dalman's claims fail because they did not own McKesson shares at the time the conduct alleged in Count I occurred.[35] Saito's claims under Count I require a more piecemeal analysis. On October 20, 1998, Saito purchased his McKesson stock.[36] Importantly, this purchase

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[32] Compl. ¶ 151.
[33] 8 *Del. C.* § 327.
[34] *See Lewis v. Anderson*, 477 A.2d 1040 (Del. 1984).
[35] *Id*.
[36] Compl. ¶ 5.

is after both the McKesson board's approval of the Merger[37] and its grant of authority to Pulido to negotiate the Merger on the board's behalf. [38]

In *In re Beatrice Companies, Inc. Litigation*,[39] the Delaware Supreme Court stated that a plaintiff "must have been a stockholder at the time the terms of the merger were agreed upon because it is the terms of the merger, rather than the technicality of its consummation, which are challenged."[40] In other words, the alleged wrong occurred, if at all, when the Merger agreement was approved not when the deal was consummated. Because Saito acquired his stock in McKesson after the approval of the Merger terms, he lacks standing to challenge these actions.[41]

I am, however, unwilling to dismiss Saito's Count I in its entirety. The allegations concerning the dissemination of an allegedly false proxy statement does not predate Saito's stock ownership. Moreover, the duties of a board when disseminating proxy materials are distinct from a board's responsibilities when considering and approving a transaction. As such, the allegations in Count I, as they relate to false and misleading proxy statements state a separate and actionable harm.

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[37] The Merger was approved on October 16, 1998.
[38] Compl. ¶ 69.
[39] 1987 WL 36708 (Del. Feb. 20, 1987) (ORDER).
[40] *Id.* at *3.
[41] The reason was not addressed in *Ash* because previous complaints did not allege the precise date that Saito acquired stock in McKesson.

Still I must determine what to do with this aspect of Count I. Defendants do not challenge Saito's standing to bring a disclosure claim relating to the proxy statement, but instead argue that the disclosure claim is direct.[42] Because the disclosure claim, as alleged, states a distinct and separable shareholder harm, I conclude that Saito has stated a direct claim in Count I as it relates to the alleged false or misleading proxy statement. In the interests of judicial economy, however, I will *sua sponte* stay Saito's disclosure claim. Currently, there are two Delaware state court actions arising out of McKesson's proxy statement and asserting disclosure claims. Both of those courts have stayed the actions in favor of an ongoing California federal class action.[43]

B. Count II

Court II alleges that the "McKesson HBOC Director Defendants"—the combined, post-merger directors—"breached their fiduciary duties by failing to pursue claims for monetary redress against the former HBOC directors, Bear Stearns, Arthur Andersen, Deloitte and HBOC [the 'Third Parties']."[44] Count II is deficient on grounds of ripeness because plaintiffs fail to allege that the McKesson HBOC Director Defendants have made a

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[42] *See* Tr. of Oral Arg. at 20.
[43] *Derdiger v. Tallman*, 2000 WL 1041216 (Del. Ch. July 20, 2000); *Caravetaa v. McKesson HBOC, Inc.*, 2000 WL 1611101 (Del. Super. Sept. 7, 2000).
[44] Compl. ¶ 156.

definitive decision whether to sue any of the Third Parties. Moreover, plaintiffs fail to allege that the remedies against the Third Parties are lost or time barred. Absent these allegations, Count II pleads facts that "[have] not yet matured to a point where judicial action is appropriate"[45] and, therefore, is premature and fails to allege any harm for which this Court at present could hold the McKesson HBOC directors accountable.[46]

C. Count III

Count III alleges that Richard Hawkins[47] and Heidi Yodowitz[48] breached their fiduciary duties by taking "affirmative steps" toward closing the Merger. These steps included finding ways to "camouflage accounting adjustments" despite their knowledge of HBOC's improper accounting practices.[49] In addition, plaintiffs allege that Hawkins and Yodowitz "signed a Power of Attorney form authorizing the Form S-4 Registration Statement to be signed on their behalf, despite the fact that they had actual knowledge

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[45] *Stroud v. Milliken Enters., Inc.,* 552 A.2d 476, 480 (Del. 1989).
[46] Plaintiffs assert in the complaint that "Defendants' inaction has made it more difficult or impossible for McKesson HBOC (or HBOC) to make a significant recovery from Andersen, relative to damages inflicted on those companies." Compl. ¶ 157. Andersen, however, has appeared in this action and is actively defending the allegations against it, suggesting that recovery may be available from it.
[47] During the relevant period, Hawkins served as McKesson's Vice President and CFO. Compl. ¶ 11.
[48] During the relevant period, Yodowitz served as McKesson's Controller and Chief Accounting Officer. *Id*. ¶ 13.
[49] *Id*. ¶ 162.

of materially false and misleading representations and omissions in that document."[50]

Plaintiffs lack standing to bring Count III. As discussed above,[51] neither Madajczyk nor Dalman owned McKesson stock at the time these alleged breaches of duty occurred.[52] Saito, also, did not own stock in McKesson before October 20, 1998, and these allegations point to conduct arising from the Merger negotiations.[53]

D. Count IV

Count IV is styled as a "breach of contract [claim] brought on behalf of McKesson against HBOC based on the Merger Agreement."[54] Allegedly, "[u]nder the terms of the Merger Agreement, HBOC represented and

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[50] *Id.*

[51] *See* discussion *supra* § III, Part A (discussing contemporaneous ownership requirement).

[52] The complaint alleges that the relevant acts taken by Hawkins and Yodowitz occurred between July 10 through July 12, 1998 and October 16, 1998. *See* Compl. ¶¶ 53, 59-62, 69.

[53] *Id.*; *see also supra* notes 34-35 (focusing on the time frame in which the terms of the Merger were set and not the consummation date as the latter is immaterial for establishing the contemporaneous ownership requirement).

[54] Pls.' Answering Br. in Opp'n to Defs.' Mot. to Dismiss at 50. In *Ash*, 2000 WL 1370341, at *16 (Del. Ch. Sept. 15, 2000), I suggested that this claim was potentially viable. The facts, as now presented, dictate a different result. Still, despite dismissing Count IV on issues of standing, another point merits mention. HBOC is a nominal defendant, not a named defendant. This Court sought clarification regarding this procedural oddity but plaintiffs have not, to this Court's satisfaction, addressed the issue. Plaintiffs' prayer for relief does not seek relief from HBOC in the form of rescission (the form of relief I suggested in *Ash*) or monetary damages. Thus, even if plaintiffs sought rescission, it would be impractical given that it has been five years since the Merger was consummated. In addition, awarding monetary damages against HBOC would be a pointless endeavor as it is now a wholly owned subsidiary of McKesson HBOC.

warranted that information supplied by HBOC or its subsidiaries for inclusion in the Joint Proxy Statement would not contain any untrue statements of material fact or omit to state material facts."[55] HBOC therefore breached the Merger Agreement when it provided financial statements that were materially false and misleading.

Plaintiffs cannot proceed on Count IV. The alleged breach of contract claim seeks relief from harm occurring before the effective date of the merger (*e.g.*, false statements inducing McKesson to enter into the Merger) and, therefore, those claims must be brought on behalf of McKesson.[56] For the reasons discussed above, all three plaintiffs were not McKesson stockholders at the time the terms of the Merger Agreement were negotiated.[57]

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[55] Compl. ¶ 167.

[56] As I discussed in *Ash* 2000 WL 1370341, at *16:

> If HBOC directors possessed knowledge of suspect accounting practices at HBOC before the merger, one would think such knowledge might give rise to colorable claims that McKesson, as an acquiror, could assert against HBOC under fraud-based theories or perhaps for breaches of provisions in the parties' merger agreement . . . . [S]uch facts could give rise to claims that McKesson might bring directly attacking the merger seeking rescission or rescissory damages; or, if McKesson HBOC was unwilling to assert contract-based claims, shareholders might endeavor to bring those claims derivatively on behalf of McKesson HBOC.

[57] *See* discussion *supra* § III, Part A (discussing contemporaneous ownership requirement); *see also supra* note 61.

E. Count V

Count V seeks redress against the McKesson HBOC Director Defendants for "failing to timely correct HBOC's false financial statements, monitor the accounting practices of McKesson HBOC following the merger, implement sufficient internal controls to guard against the wrongful practices they knew about before the Merger and disclose HBOC's false financial statements."[58] In *Ash v. McCall*,[59] I dismissed, without prejudice, this oversight claim because it failed to meet the high liability standards set forth in *In re Caremark International, Inc. Derivative Litigation*.[60] Here, after using the "tools at hand," the complaint appears—barely—to state a claim under *Caremark*.

Under Chancellor Allen's formulation in *Caremark*, "[t]he theory here advanced is possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment."[61] A derivative plaintiff must allege facts constituting "a sustained or systematic failure of the board to exercise oversight – such as an utter failure to attempt to assure a reasonable

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[58] Compl. ¶ 178.
[59] 2000 WL 1370341, at *16.
[60] 698 A.2d 959 (Del. Ch. 1996).
[61] *Id.* at 967. *See also Rattner v. Bidzos*, 2003 Del. Ch. LEXIS 103 (Del. Ch. Sept. 30, 2003) ("a claim for failure to exercise proper oversight is one of, if not the, most difficult theories upon which to prevail").

information and reporting system exists."[62] In other words, liability is premised "on a showing that the directors were conscious of the fact that they were not doing their jobs."[63] As plaintiffs admit, in order to state a claim under *Caremark* in this context, they must show that the McKesson HBOC board: (1) should have known that unlawful accounting improprieties were occurring or had occurred; and (2) made no good faith effort to remedy the unlawful accounting improprieties.[64] Giving plaintiffs "the benefit of all reasonable inferences that may be drawn from the facts,"[65] I conclude that the *Caremark* standard is implicated in these circumstances.[66]

To proceed further, plaintiffs must jump two hurdles. Defendants challenge the oversight claim on both Chancery Rules 12(b)(6) and 23.1 grounds. The following analysis answers both because the facts plaintiffs allege present a colorable claim and excuse demand.[67]

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[62] *Caremark*, 698 A.2d at 671.
[63] *Guttman v. Jen-Hsun Huang*, 823 A.2d 492, 506 (Del. Ch. 2003).
[64] AB at 56 (citing *Caremark*, 698 A.2d at 971).
[65] *In re Walt Disney Co. Deriv. Litig.,* 825 A.2d 275, 285 (Del. Ch. 2003) (citing *Grobow v. Perot*, 539 A.2d 180, 187 (Del. 1988)).
[66] Although a *Caremark* claim is difficult to advance, on a motion to dismiss I must find "that the plaintiff would not be entitled to relief under *any set of facts that could be proven* to support the claim." *Id*. (emphasis added) (citing *Rabkin v. Philip A. Hunt Chem. Corp.,* 498 A.2d 1099, 1104 (Del. 1985)).
[67] Chancery Rule 23.1 is a heightened pleading standard requiring plaintiffs to comply with stringent requirements of factual particularity that differ substantially from the permissive notice pleadings governed solely by Chancery Rule 8(a).

Plaintiffs allege well-pled facts sufficient to infer that separately, both the HBOC and McKesson boards were aware (or should have been) of accounting irregularities at HBOC. To the extent that knowledge proves material to the problems McKesson HBOC faced during the three months following the Merger, those issues will be resolved on a more fully developed record. At this stage of litigation, the following allegations are sufficient. The HBOC audit committee knew that the 1997 audit was "high risk." The audit committee discussed the accounting risks facing software companies in general and specifically discussed the risks arising from HBOC's sales practices.[68] At a meeting on July 10, 1998, the McKesson board came to know that certain HBOC accounting practices were a problem. Yodowitz apparently informed the board that there could be a potential SEC issue given that the SEC was requiring restatements for items below normal materiality thresholds. Later that fall, when negotiations

[68] Nominal defendant, McKesson HBOC, indicated in its briefs and at oral argument that even if HBOC's audit committee knew of accounting irregularities such knowledge could not be imputed to the McKesson HBOC board because four of the six original HBOC directors were outside directors and not on the HBOC audit committee. The Court declines to accept this head in the sand argument. In *Ash* the Court was not willing to impute knowledge to the non-audit committee members despite the Court finding that HBOC "at some organizational level, knew of and responded to public criticism of its accounting practices." *Ash*, 2000 WL 1370341, at *15. Here, unlike *Ash*, the allegations of knowledge stem beyond articles in trade magazines and newspapers. Plaintiffs have alleged well-pled facts that indicated at least four members knew of HBOC accounting problems—the three members of the audit committee and McCall. A reasonable inference, which the Court is entitled to draw at this procedural stage, is that that information was communicated to the other HBOC board members who later served on McKesson HBOC's board.

revived, the McKesson board knew that the issues identified in July remained and that HBOC's accounting practices were at least a $40 to $55 million problem.[69]

After the McKesson board approved the merger, they learned that HBOC terminated its CFO, Jay Gilbertson. On January 27, 1999, after consummation of the merger, the combined McKesson HBOC audit committee met with its advisors to discuss the transaction.[70] Yodowitz discussed accounting adjustments made to HBOC's financial statements, adjustments in the same areas identified by Deloitte as problematic. Importantly, Yodowitz and the audit committee allegedly knew that these adjustments would not account sufficiently for the problems identified by Deloitte as needing alteration. Thus, viewing the above facts in a light most favorable to plaintiffs, it can be argued that the McKesson HBOC board, a board comprised of directors from both sides of the transaction, knew or should have known that the HBOC accounting problems were unlawful. At

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[69] Accepting plaintiffs' allegations as true is not an invitation to revisit the Court's earlier finding that the plaintiffs have not alleged facts sufficient to rebut the business judgment rule which attached to the former McKesson directors decision to approve the merger. See *Ash*, 2000 WL 1370341, at *15. Nevertheless, the facts alleged, concerning the knowledge the McKesson board had, combined with the knowledge the new HBOC directors brought with them, is sufficient to raise a colorable claim of bad faith for the delay in making the July 1999 restatements and the firing of those responsible for the accounting problems infecting HBOC.

[70] Napier, who had access to the Andersen reports, served on both HBOC's and McKesson HBOC's audit committees.

a minimum, the new board's audit committee was comprised of directors from McKesson who should have known HBOC accounting practices were problematic. Those directors, regardless of their pre-Merger knowledge of the accounting problems, now had the benefit of serving with former HBOC directors who also should have known not only the existence of those problems but the extent of the problems.

Paramount to plaintiffs' timeliness assertion is the allegation that the combined board had the requisite knowledge either when the merger was consummated or shortly thereafter. Yet, despite McKesson HBOC's knowledge of substantial accounting problems at HBOC, it appears that nothing was done for several months. McKesson HBOC did not issue its first restatement of earnings until the end of April, and an additional two months elapsed before the senior management responsible for the whole debacle was terminated. Perhaps symbolic of the McKesson HBOC board's failure to perform its duties is the Data General transaction. Despite the board's knowledge of accounting problems, Bergonzi, HBOC's co-president at the time, was able to negotiate a $20 million gimmick transaction—a transaction that board members McCall and Pulido were allegedly aware of. Although the facts later adduced may prove otherwise, the procedural posture of the case requires me to focus on the plaintiffs' complaint and read

it generously. Viewed in that manner, Count V survives defendants' motion to dismiss.[71]

F. Count VI

Count VI asserts a fiduciary duty claim against the former directors of HBOC for allegedly "failing to monitor HBOC's internal accounting practices before the Merger and disclose HBOC's false financial statements and (as to McCall, Eckert and Mayo) using HBOC's non-public information for their own financial benefit."[72] Count VI asserts a double derivative claim on behalf of McKesson HBOC and in turn on HBOC, now a wholly-owned subsidiary of McKesson HBOC.

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[71] In *Ash*, I suggested that well-pled facts alleging a lack of good faith might excuse demand. See *Ash*, 2000 WL 1370341, at *15. A committee of the board, acting in good faith, would have openly communicated with each other concerning the accounting problems Andersen disclosed and would have shared the information with the entire McKesson HBOC board. In addressing the demand futility issue the relevant question for this Court is whether the plaintiffs can refute the presumption that McKesson HBOC's board of directors could have properly exercised its independent and disinterested business judgment in responding to a demand. *See Rales v. Blasband*, 634 A.2d 927, 933-934 (Del. 1993) ("Where there is no conscious decision by the corporate board of directors to act or refrain from acting, the business judgment rule has no application. The absence of board action, therefore, makes it impossible to perform the essential inquiry contemplated by *Aronson.*"). I conclude that the combined McKesson HBOC had enough indicators and enough resources (namely each other) to discover the existence and extent of HBOC accounting problems once the merger was consummated. I also conclude that a demand on the April 1999 board to address these issues would directly call into question the good faith of McKesson HBOC's audit committee. The substantial likelihood of liability these directors faced for a breach of their duty of good faith disabled the entire McKesson HBOC board from mustering an independent and disinterested majority.

[72] Compl. ¶ 183.

In *Ash*, I dismissed, without prejudice, this oversight claim for failure to comply with the continuous ownership requirement. None of the plaintiffs are presently, or were at the time of filing the complaint, shareholders of HBOC. In *Ash*, I stated:

> [A]s presently drafted, the amended complaint does not implicate either of the two exceptions to the standing requirement in the merger context. Nor have plaintiffs argued that the merger was perpetrated merely to deprive the shareholders of standing to bring a derivative action or that the merger was in reality merely a reorganization. Nevertheless, it is conceivable that the plaintiffs might be able to allege, consistent with Rule 11, that the merger was designed in part to thwart shareholder derivative claims arising out of the HBOC board's failure to monitor the company's internal accounting practices.[73]

Despite this invitation, plaintiffs have failed to allege adequately that the merger was designed to thwart shareholder derivative claims.

In conclusory and prolix averments, the complaint alleges that the Merger was restructured in October of 1998 "to fraudulently hinder or eliminate the ability of HBOC shareholders to assert claims on behalf of HBOC, and the Merger is the subject of claims by McKesson HBOC asserting fraudulent conduct in connection with the Merger."[74] Here,

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[73] 2000 WL 1370341, at *13. The two exceptions are "(i) if the merger itself is subject of a claim of fraud or (ii) if the merger is in reality merely a reorganization which does not affect plaintiff's ownership in the business enterprise." *Id.* at *12.
[74] Compl. ¶ 185.

lacking facts to support these legal conclusions, plaintiffs simply insert the names of certain defendants into the relevant legal standard.

Indeed, the transaction appeared restructured.[75] Notwithstanding this change, allegations in the complaint suggest that once word of the deal leaked, the McKesson board would not proceed "until the companies agreed to adjust the exchange ratio to reflect the decline in HBOC's share price."[76] A restructuring of this type is a logical outcome following a decline in HBOC's share price and does not support an inference that the transaction was altered purposefully as a ruse designed to eliminate plaintiff's derivative claims. To find otherwise would vitiate 8 *Del. C.* § 327 by allowing a plaintiff to avoid the statute's requirements simply by pointing to an unfavorable modification of the terms of a merger.

Separately, plaintiffs argue that Count VI is a double derivative claim, and therefore § 327 is satisfied. Despite this argument's appeal,[77] I must conclude that plaintiffs lack standing to pursue Count VI. I begin with *In re First Interstate Bancorp Shareholder Litigation.*[78] There, the plaintiff contended that his ownership of pre-merger First Interstate and post-merger

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[75] *Id.* ¶¶ 65, 70.
[76] *Id.* ¶ 63.
[77] *See Ash*, 2000 WL 1370341, at *13 n.47.
[78] 729 A.2d 851, 867-68 (Del. Ch. 1998), *aff'd sub nom. Bradley v. First Interstate*, 748 A.2d 913, Walsh, J. (Del. Mar. 21, 2000) (ORDER). *See also Lewis v. Ward*, 2003 Del. Ch. LEXIS 111, at *13 n.15 (Del. Ch. Oct. 29, 2003) (commenting on *Blasband*'s incompatibility with *Lewis v. Anderson*).

Wells Fargo common stock met the *Lewis* requirement of continuous ownership, since any claims belonging to First Interstate passed to Wells Fargo at the consummation of the merger. As a stockholder of Wells Fargo, plaintiff was then entitled to assert those claims (the subsidiary's cause of action) derivatively. That assertion, as well as plaintiffs' claims, was found to be inconsistent with *Lewis v. Anderson*.[79]

In this case, plaintiffs' effort to circumvent *Lewis v. Anderson* by casting Count VI in terms of a double derivative action must fail. It remains the the law of Delaware that "a derivative shareholder must not only be a stockholder at the time of the alleged wrong and at the time of commencement of suit but that he must also maintain shareholder status throughout the litigation."[80] Here, plaintiffs Madajczyk and Dalman[81] were not McKesson HBOC shareholders before January 12, 1999, so they cannot bring a derivative suit, double or otherwise.[82]

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[79] 447 A.2d 1040 (Del. 1984).

[80] *Id*. at 1046. Plaintiffs' policy argument that, without standing, Count VI will be left unasserted and without remedy, was addressed in *Lewis*. *Id.* at 1050. McKesson HBOC inherited HBOC's choses in action, including Count VI. If McKesson HBOC fails to pursue Count VI (assuming it states a claim), McKesson HBOC's shareholders could bring an action for failure to assert a claim, which they have already done in Count II.

[81] Clearly, Saito cannot pursue this claim as he was never a shareholder of HBOC.

[82] This claim must also fail because plaintiffs have failed to allege that McKesson HBOC was a shareholder of HBOC at the time the alleged harm occurred.

G. Count VII

Count VII alleges that the "Former HBOC Director Defendants provided substantial assistance to the Former McKesson Director Defendants' breaches of fiduciary duty by knowingly assisting and participating in their representations and omissions, and their breaches of fiduciary duty."[83] The complaint does not specify when the aiding and abetting occurred. As explained in Count I, all three plaintiffs lack standing to challenge the HBOC directors' conduct before October 20, 1998. Saito, alone, however, does have standing to challenge the events connected to the dissemination of an allegedly false proxy statement. Nevertheless, because the complaint contains only conclusory allegations of knowing participation in the former McKesson directors' breaches of fiduciary duty, it does not plead facts sufficient to meet the stringent standard required for an aiding and abetting claim.[84]

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[83] Compl. ¶ 192.

[84] The complaint merely recites the legal standard with the names of certain defendants inserted and the standard for "knowing participation" is stringent. "Knowing participation in a board's fiduciary breach requires that the third party act with the knowledge that the conduct advocated or assisted constitutes a breach." *Malpiede v. Townson*, 780 A.2d 1075, 1097-98 (Del. 2001).

H. Count VIII

Count VIII alleges "Bear Stearns breached its duties of professional care in that they [sic] failed to plan, structure, and perform its work in a professional manner and failed to use the degree of care normally expected of reasonably prudent financial advisors."[85] Plaintiffs did not assert a claim against Bear Stearns until they filed the third amended complaint on January 22, 2001—almost two years after the filing of the original complaint. A derivative plaintiff must make a new demand for all new claims that are not "validly in litigation"[86] at the time the amended complaint is filed. Plaintiffs make no effort to identify the directors who would have received the demand for this new claim and, therefore, the claim is dismissed pursuant to Rule 23.1. Plaintiffs argue that any claim related to the Merger was "validly in litigation" as of April 30, 1999, when plaintiffs filed their original complaint. This argument, however, does not adequately consider the fact that they have sued new parties.

The leading Delaware case on this subject, *Harris v. Carter*, does not support plaintiffs' position that claims against new parties can be treated as "validly in litigation." In *Harris*, no new defendants were brought into the case. The Court in *Harris* actually suggested that claims against new

[85] Compl. ¶ 197.
[86] *Harris v. Carter*, 582 A.2d 222 (Del. Ch. 1990).

defendants should not be treated as "validly in litigation" when it stated that the "power to amend or supplement a well-instituted derivative suit without recourse to Rule 23.1, does not acknowledge a shareholder right to institute *new* corporate 'claims' against an *existing defendant* . . . after a disinterested board takes control of the corporation."[87] Implicit here is the assumption that claims against new defendants will require a new demand with respect to the new defendants.

The rationale employed by former Chancellor Allen in *Harris* buttresses this conclusion. In *Harris*, the Chancellor used a definition of "claims" from the Restatement (Second) of Judgments when describing the contours of the "validly in litigation" standard. Chancellor Allen described a claim under Rule 23.1 as any legal theory grounded upon "the acts and transactions alleged in the original complaint."[88] The Restatement (Second) of Judgments does not consider causes of action against different defendants as a single claim, even though such defendants may be sued to recover for a single injury.[89] Commentary to Section 49 of the Restatement states that a

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[87] *Id.* at 231 (emphasis added).
[88] *Id.*
[89] RESTATEMENT (SECOND) OF JUDGMENTS § 49.

"claim against others who are liable for the same harm is regarded as separate."[90]

Adhering to the reasoning in *Harris* serves the ultimate purpose of Rule 23.1. A board of directors, unless legally disabled, should be presented with the opportunity to manage litigation that seeks to redress harm inflicted upon the corporation. The identity of the defendant certainly influences a board's decision as to whether to initiate litigation and, consequently, the demand futility analysis. Given these considerations, I see no reason to allow plaintiffs to assert demand futility against the McKesson HBOC board as of April 30, 1999, when no claim was asserted against Bear Stearns until 2001.[91]

I. Count IX

Count IX is asserted against Bear Stearns for breach of contract. Plaintiffs did not assert a claim against Bear Stearns until they filed the third amended complaint on January 22, 2001. This claim was not "validly in

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[90] *Id.* cmt. a.

[91] I must also note that this case is unique because of the large gap of time between the original complaint and the filing of the third and fourth amended complaints. Given the large gaps in the conduct of this litigation, requiring the plaintiffs to have made a demand on the Company with respect to the claims against the new defendants would not have been particularly disruptive to the flow of litigation. The circumstances of the instant litigation actually counsel strongly in favor of making a demand on the McKesson HBOC board. The original complaint in this action was filed hastily following the Company's restatement announcement. Allowing plaintiffs to assert all manner of claims against defendants not named in that document would, in my opinion, reward their race to the courthouse at the expense of the orderly administration of justice.

litigation" on April 30, 1999. Like Count VIII, plaintiffs make no effort to identify the directors who would have received the demand for this new claim and, therefore, it must be dismissed pursuant to Rule 23.1.

J. Count X

Count X is asserted against Bear Stearns for aiding and abetting breach of fiduciary duty. Plaintiffs did not assert a claim against Bear Stearns until they filed the third amended complaint on January 22, 2001. This claim was not "validly in litigation" on April 30, 1999. Like Counts VIII and IX, plaintiffs make no effort to identify the directors who would have received the demand for this new claim and, therefore, it must be dismissed pursuant to Rule 23.1.

K. Count XI

Count XI is asserted against Deloitte. Plaintiffs did not assert a claim against Deloitte until they filed the instant complaint. This claim was not "validly in litigation" on April 30, 1999. Like Counts VIII, IX, and X, plaintiffs make no effort to identify the directors who would have received the demand for this new claim and, therefore, it must be dismissed pursuant to Rule 23.1.

L. Count XII

Count XII is asserted against Andersen for aiding and abetting the McKesson HBOC directors' alleged breaches of fiduciary duty. Plaintiffs did not assert a claim against Andersen until they filed the third amended complaint on January 22, 2001. This claim was not "validly in litigation" on April 30, 1999. Like Counts VIII through XI, plaintiffs make no effort to identify the directors who would have received the demand for this new claim and, therefore, it must be dismissed pursuant to Rule 23.1.

M. Count XIII

Count XIII relates to pre-Merger breaches of fiduciary duty of the former directors of HBOC. As such, plaintiffs lack standing to assert this claim for the reasons described in Count VI. Additionally, Count XIII is asserted against Andersen for aiding and abetting the HBOC Directors' alleged breaches of fiduciary duty. Plaintiffs did not assert a claim against Andersen until they filed the third amended complaint on January 22, 2001. This claim was not "validly in litigation" on April 30, 1999. Like Counts VIII to XII, plaintiffs make no effort to identify the directors who would have received the demand for this new claim and, therefore, it is dismissed pursuant to Rule 23.1.

IV. CONCLUSION

Count I, except Saito's post-October 20, 1998, claim regarding the inaccurate disclosures in the McKesson proxy statement, is dismissed on standing grounds pursuant to 8 *Del. C.* § 327 and Rule 23.1. Count II is dismissed on ripeness grounds. Count III is dismissed on standing grounds pursuant to 8 *Del. C.* § 327 and Rule 23.1. Count IV is dismissed on standing grounds pursuant to 8 *Del. C.* § 327 and Rule 23.1. Defendants' motion to dismiss Count V is denied. Count VI is dismissed on standing grounds pursuant to 8 *Del. C.* § 327 and Rule 23.1. Count VII is dismissed for failure to state a claim under Rule 12(b)(6). Counts VIII through XII are dismissed for failure to adequately plead demand futility pursuant to Rule 23.1. Count XIII is dismissed on standing grounds pursuant to 8 *Del. C.* § 327 and for failure to adequately plead demand futility pursuant to Rule 23.1.

IT IS SO ORDERED.