STATE OF RHODE ISLAND AND PROVIDENCE PLANTATIONS

PROVIDENCE, SC. **SUPERIOR COURT**

[Filed: April 29, 2019]

EDWARD BORON, Derivatively on Behalf of CVS HEALTH CORPORATION, Plaintiff,	:	
v.	:	**C.A. No. PC-2017-4398**
RICHARD M. BRACKEN, LISA G. BISACCIA, EVA C. BORATTO, TROYEN A. BRENNAN, HELENA B. FOULKES, STEPHEN B. GOLD, DAVID W. DORMAN, LARRY J. MERLO, DAVID M. DENTON, HELENA B. FOULKES, J. DAVID JOYNER, JONATHAN C. ROBERTS, ANDREW SUSSMAN, PER G.H. LOFBERG, RICHARD J. SWIFT, C. DAVID BROWN II, JEAN-PIERRE MILLON, ANNE M. FINUCANE, TONY L. WHITE, WILLIAM C. WELDON, NANCY-ANN M. DEPARLE, and ALECIA A. DECOUDREAUX, Defendants,	:	
-and-	:	
CVS HEALTH CORPORATION, a Delaware corporation, Nominal Defendant.	:	

DECISION

STERN, J. The Plaintiff Edward Boron (Plaintiff) filed this Verified Stockholder Derivative Complaint (Complaint) on behalf of CVS Health Corporation (CVS) alleging that members of CVS's Board of Directors (the Director Defendants or collectively the Board) breached their fiduciary obligations to CVS and its stockholders, wasted corporate assets, unjustly enriched themselves and committed civil conspiracy, thereby causing CVS to incur damages. The Board,

as well as various CVS executive officers also named as defendants (the Officer Defendants), move this Court for an order taking judicial notice of certain exhibits and dismissing the Complaint for failure to appropriately plead demand futility.[1]

I

Background

CVS, a Delaware corporation with principal executive offices located in Woonsocket, Rhode Island, is the largest "integrated pharmacy health care provider" in the United States based upon revenues and prescriptions filled. (Compl. ¶¶ 14, 34.) CVS's clients include "employers, insurance companies, unions, government employee groups, health plans, Medicare Part D plans, Managed Medicaid plans, plans offered on the public and private exchanges, other sponsors of health benefit plans and individuals throughout the United States." *Id.* ¶ 38.

Customers can fill prescriptions from CVS retail locations in at least three ways: (1) by purchasing prescriptions with the assistance of a third-party payer (TPP), such as a private insurance company, Medicare, or Medicaid; (2) by paying the "retail" or "cash" price without insurance; or (3) by purchasing through an alternative prescription-benefits program. *Id.* ¶¶ 66, 67, 73, 83-85, 88; *see also* Defs.' Mem. Supp. Mot. Dismiss Pl.'s Verified Stockholder Derivative Compl. 7 (Defs.' Mem.) Most CVS customers purchase prescriptions with the help of a TPP through a negotiated cost split, also known as a "copayment" or "co-insurance." Compl. ¶ 66. The amount a TPP and a customer pay CVS, respectively, depends on a process known as "adjudication." *Id.* ¶¶ 69, 73.

[1] The Director Defendants are C. David Brown II, Jean-Pierre Millon, Larry J. Merlo, David W. Dorman, Richard J. Swift, Anne M. Finucane, Tony L. White, William C. Weldon, Nancy-Ann M. DeParle, Richard M. Bracken, and Alecia A. DeCoudreaux. The remaining named defendants are Officer Defendants.

Based on data CVS reports during adjudication, TPPs set a customer's copayment to fill a prescription. *Id.* ¶ 74. As a required component of the adjudication process, CVS submits to TPPs what is known as the "usual and customary" (U&C) price for the drug being dispensed. *Id.* ¶ 73. The National Council for Prescription Drug Programs (NCPDP) defines the U&C price as the cash price available to the general public, exclusive of sales tax or other amounts. *Id.* A drug price cannot exceed the U&C price, and in some cases, the copayment may not exceed a percentage of the U&C price. *Id.* ¶¶ 75, 76. The TPPs pay the difference between the adjudicated amount and the copayment, or the "reimbursement" amount. *Id.* ¶ 69.

In 2006, stores including Wal-Mart, Costco, and Target began offering generic drugs at significantly reduced prices; these companies were able to absorb lower margins because pharmacy sales accounted for such a small amount of total sales. *Id.* ¶¶ 80, 81. According to the Complaint, CVS wanted to compete with the big-box stores by retaining and attracting cash-paying customers but was unwilling to lower prices charged to TPPs. *Id.* ¶ 90. Thus, in November of 2008, CVS launched a custom branded generic prescription drug program, the Health Savings Pass (HSP) program, which offered discounts to cash-paying customers on generic drugs for a nominal fee. *Id.* ¶¶ 83-85. A majority of CVS's cash-paying customers "flocked to the HSP program." *Id.* ¶ 88. However, despite that most cash-paying customers were paying a discounted price, CVS continued to submit to TPPs during adjudication the price charged to the minority of customers who paid the non-HSP cash price. *Id.* ¶ 90.

Because insured customers were still obliged to pay a cost split, their copayments sometimes exceeded the amount paid by cash-paying customers filling prescriptions through the HSP program without insurance. *Id.* The Plaintiff contends that CVS violated the law by failing to report the HSP price as the U&C price, which would have effectively reduced insured

customers' copayments. *Id.* ¶¶ 96-99. "Numerous former employees/whistleblowers and governments" associated with the HSP program have instituted actions against CVS. *Id.* ¶ 105. CVS ultimately discontinued the HSP program in or about April 2017. *Id.* ¶ 141.

On September 15, 2017, the Plaintiff filed the Complaint. On April 13, 2018, this Court rendered a decision denying the Defendants' motion to stay this case pending the outcome of the various civil actions filed against CVS, reasoning that the Defendants had "put the cart before the horse" by not first filing an answer or a motion to dismiss. On May 21, 2018, the Defendants filed the present motion. After hearing oral argument and reviewing the papers, this Court renders the following Decision.

II

Standard of Review

"'[A] motion to dismiss is to test the sufficiency of the complaint.'" *Palazzo v. Alves*, 944 A.2d 144, 149 (R.I. 2008) (quoting *R.I. Affiliate, ACLU, Inc. v. Bernasconi*, 557 A.2d 1232 (R.I. 1989)). A court must assume the truth of a complaint's allegations and "examine the facts in the light most favorable to the nonmoving party." *A.F. Lusi Constr., Inc. v. R.I. Convention Ctr. Auth.*, 934 A.2d 791, 795 (R.I. 2007) (citations omitted). This Court may only grant a motion to dismiss upon being convinced that a plaintiff would not be entitled to relief "under any conceivable set of facts." *Estate of Sherman v. Almeida*, 747 A.2d 470, 473 (R.I. 2000).

III

Analysis

In derivative shareholder actions, a plaintiff's pleading obligation is significantly higher than mere notice pleading. *See Mehrvar ex rel. KVH Indus., Inc. v. Van Heyningen*, No. N.C./ 04-0375, 2005 WL 2385939, at *3 (R.I. Super. Sept. 27, 2005). Rule 23.1 of the Superior Court

Rules of Civil Procedure (Rule 23.1) requires that a shareholder plaintiff allege that he or she previously demanded the board of directors to take a desired corporate action or the reasons why making such a demand would have been futile.[2] *See id.*, at **1-2 (citing *Hendrick v. Hendrick*, 755 A.2d 784, 794 (R.I. 2000)). A shareholder must plead demand or demand futility with "particularity." *See id.*, at *3 (citation omitted) ("Mere notice pleading is insufficient to meet the plaintiff's burden of showing demand excusal in a derivative case."); *see also Brehm v. Eisner*, 746 A.2d 244, 254 (Del. 2000) ("Rule 23.1 is not satisfied by conclusory statements or mere notice pleading.").

Rule 23.1's heightened pleading standard reflects the equitable principle known as the "demand" requirement, which "is a corollary to the general proposition of corporate law that directors, rather than shareholders, manage the business affairs of a corporation." *See Mehrvar ex rel. KVH Indus., Inc.*, 2005 WL 2385939, at *3 (citing *Aronson v. Lewis*, 473 A.2d 805, 811 (Del. 1984)), *overruled on other grounds in Brehm*, 746 A.2d at 254). A derivate action "by its very nature . . . impinges on the managerial freedom of directors." *Stone ex rel. AmSouth Bancorporation v. Ritter*, 911 A.2d 362, 366 (Del. 2006).[3] The demand requirement "preserve[s] the primacy of board decisionmaking regarding legal claims belonging to the corporation." *In re Am. Int'l Grp. Inc.*, 965 A.2d 763, 808 (Del. Ch. 2009). Similarly, the obligation to allege futility in the absence of demand serves the policy purpose of encouraging

[2] Rule 23.1 provides in pertinent part: [t]he complaint shall also allege with particularity the efforts, if any, made by the plaintiff to obtain the action the plaintiff desires from the directors . . . and . . . the reasons for the plaintiff's failure to obtain the action or for not making the effort."

[3] *South v. Baker*, 62 A.3d 1, 13 (Del. Ch. 2012) (explaining the derivative form contravenes the "cardinal precept" that directors, as opposed to shareholders, are vested with the authority to manage the business and affairs of the corporation, including the determination of whether to pursue litigation).

intra-corporate dispute resolution. *See Rattner v. Bidzos*, No. Civ.A. 19700, 2003 WL 22284323, at *7 (Del. Ch. 2003).

Rhode Island courts have not had great occasion to consider demand futility analysis; however, as the parties have correctly identified, Delaware law applies because CVS is a Delaware corporation. *See* G.L. 1956 § 7-1.2-711(h) ("In any derivative proceeding in the right of a foreign corporation" a court must apply "the laws of the jurisdiction of incorporation of the foreign corporation."); *see also Kamen v. Kemper Fin. Servs., Inc.*, 500 U.S. 90, 108-09 (1991). Fundamentally, "the entire question of demand futility is inextricably bound to issues of business judgment and the standards of that doctrine's applicability."[4] *Aronson*, 473 A.2d at 812. A plaintiff must hurdle the threshold presumptions of the business judgment rule before initiating a derivative suit; otherwise, black-letter corporate law tasks directors with deciding whether to sue on a corporation's behalf. *Rales v. Blasband*, 634 A.2d 927, 933 (Del. 1993).

The Delaware courts have developed two similar tests to determine whether demand is futile; the test that applies depends on whether a shareholder is challenging board action or a board's failure to act. The first test, enunciated in *Aronson*, applies to the assessment of demand futility if a derivative suit challenges an affirmative board decision. 473 A.2d at 812; *see also Rales*, 634 A.2d at 933 ("The essential predicate for the *Aronson* test is the fact that a *decision* of the board of directors is being challenged in the derivative suit.") (Emphasis in original.) Under the *Aronson* test, demand is futile if a complaint's particularized facts create a reason to doubt

[4] The business judgment rule is a "presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company." *Aronson*, 473 A.2d at 812. If the business judgment rule applies, business decisions made by disinterested directors "will not be disturbed if they can be attributed to any rational business purpose. A court under such circumstances will not substitute its own notions of what is or is not sound business judgment." *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del. 1971).

that "(1) the directors are disinterested and independent" or "(2) the challenged transaction was otherwise the product of a valid exercise of business judgment." *Aronson*, 473 A.2d at 814. The second variation of futility analysis, announced by the *Rales* court, applies in cases of director inaction: where it is alleged that a board's inaction excuses demand, a court should consider "whether or not the particularized factual allegations of a derivative stockholder complaint create a reasonable doubt that, as of the time the complaint is filed, the board of directors could have properly exercised its independent and disinterested business judgment in responding to a demand." *Rales*, 634 A.2d at 934.

For purposes of either *Aronson* or *Rales*, demand is excused if suing would have a "materially detrimental impact on a director, but not on the corporation and the stockholders." *Rattner*, 2003 WL 22284323, at *8 (citation omitted); *In re SAIC Inc. Derivative Litig.*, 948 F. Supp. 2d 366, 382 (S.D.N.Y. 2013) (citing *Guttman v. Huang*, 823 A.2d 492, 501 (Del. Ch. 2003) ("[T]he difference between *Rales* and *Aronson* may blur in cases . . . [where] the particularized allegations essential to creating reasonable doubt as to a substantial likelihood of personal liability for breach of fiduciary duties may also implicate the question whether the Board can avail itself of business judgment protections.")). Where directors are exposed to liability, they may be materially and detrimentally affected by deciding to sue. Thus, demand is excused if a plaintiff sufficiently pleads a claim for breach of fiduciary duty against a majority of the board. *Guttman*, 823 A.2d at 500.

However, because it is often the case that a derivative suit essentially asks the directors to sue themselves, courts have grappled with maintaining the integrity of the demand requirement:

> "The conundrum for the law in this area is well understood. If the legal rule was that demand was excused whenever, by mere notice pleading, the plaintiffs could state a breach of fiduciary duty claim against a majority of the board, the demand requirement of the law

> would be weakened and the settlement value of so-called 'strike suits' would greatly increase, to the perceived detriment of the best interests of stockholders as investors. But, if the demand excusal test is too stringent, then stockholders may suffer as a class because the deterrence effects of meritorious derivative suits on faithless conduct may be too weak." *Id.*

To balance the interests of the shareholders and directors, Delaware courts have held "except in egregious circumstances, 'the mere threat of personal liability for approving a questioned transaction, standing alone, is insufficient to challenge either the independence or disinterestedness of directors.'" *H-M Wexford LLC v. Encorp, Inc.*, 832 A.2d 129, 149 (Del. Ch. 2003). Rather, only a "substantial likelihood of personal liability" will prevent a director from considering a demand with impartiality or otherwise exercising business judgment in determining whether to sue on a corporation's behalf. *In re Chemed Corp., S'holder Derivative Litig.*, Civ. Action No. 13-1854-LPS-CJB, 2015 WL 9460118, at *9 (D. Del. Dec. 23, 2015); *see also In re Intel Corp. Derivative Litig.*, 621 F. Supp. 2d 165, 170-71 (D. Del. 2009).

If shareholders want to extend more protection to directors, the shareholders can include an "exculpatory" provision in the corporation's charter. Faced with such a provision, a shareholder cannot establish that directors bear a substantial likelihood of personal liability without pleading a non-exculpated claim. *See Wood v. Baum*, 953 A.2d 136, 141 (Del. 2008). However, Delaware law precludes shareholders from exculpating directors for particularly egregious acts evidencing scienter including "any breach of the director's duty of loyalty to the corporation or its stockholders" or "acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law." 8 Del. C. 1953 § 102(b)(7)(i), (ii). Exculpatory provisions are designed to enable directors to make potentially "value-maximizing" business decisions without the fear of personal liability. *In re Cornerstone Therapeutics Inc., Stockholder Litig.*, 115 A.3d 1173, 1185 (Del. 2015).

The inquiry before this Court is whether a majority of the Board faces a substantial likelihood of liability based on the Complaint's particularized allegations. Such an analysis "is conducted on a claim-by-claim basis." *Teamsters Union 25 Health Servs. & Ins. Plan v. Baiera*, 119 A.3d 44, 58 n.71 (Del. Ch. 2015) (citation omitted). Here, because the Board is even-numbered, the Plaintiff needs to show that half the Board (six Director Defendants) cannot disinterestedly consider a demand. *See In re infoUSA, Inc. S'holders Litig.*, 953 A.2d 963, 990 (Del. Ch. 2007). The parties agree that Director Defendant Larry J. Merlo, as CVS's Chief Executive Officer, inside director and a member of the Board, lacks independence. (Defs.' Mem. 27 n.14.) Thus, to demonstrate demand futility, the Plaintiff needs to establish that at least five of the other Director Defendants lack independence. The Plaintiff argues demand is futile because the Director Defendants face a substantial likelihood of liability for (1) approving CVS's "unlawful" business plan; (2) disseminating false and misleading information; (3) authorizing CVS's stock-repurchase program; and (4) approving substantial executive compensation packages. (Pl.'s Mem. Opp'n Defs.' Mot. Dismiss Pl.'s Verified Stockholder Derivative Compl. 11, 21, 22, 23 (Pl.'s Mem.)). This Court will address these theories in turn.

A

Likelihood of Liability

1

Approving CVS's "Unlawful" Business Plan

The Plaintiff's first and most developed theory of liability concerns the Director Defendants' role in adopting or otherwise continuing to approve of the HSP program. The Plaintiff alleges the Director Defendants consciously decided not to discontinue or modify the program despite having been confronted with "red flags" notifying the Board that the program

was exposing CVS to liability. The Defendants counter that this Court should assume the Director Defendants were not aware of CVS's daily operations because all members of the Board, except Mr. Merlo, are "outside directors."

The Plaintiff has alleged what is akin to a failed-oversight theory of liability, otherwise referred to as a "*Caremark*" (*In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959 (Del. Ch. 1996)) claim, or one which maintains "directors failed to act when they otherwise should have done so." *In re Chemed Corp., S'holder Derivative Litig.*, 2015 WL 9460118, at *12 (citation omitted). A showing of bad faith is a "*necessary condition* to director oversight liability." *In re Citigroup Inc. S'holder Derivative Litig.*, 964 A.2d 106, 123 (Del. Ch. 2009) (emphasis in original). Establishing bad faith generally "requires a showing that the directors *knew* they were not discharging their fiduciary obligations or that they demonstrated a *conscious* disregard for their duties." *In re Intel Corp. Derivative Litig.*, 621 F. Supp. 2d at 174 (emphasis in original). Only an "utter failure" will satisfy the requisite showing of bad faith. *Lyondell Chem. Co. v. Ryan*, 970 A.2d 235, 240 (Del. 2009) (citation omitted).

The Plaintiff seemingly contends the *Caremark* framework is limited to cases where the directors disabled themselves from becoming aware of liability-creating activities—as opposed to a situation where directors consciously chose to allow intra-corporate misconduct.[5] However, the *Caremark* theory is not so narrow. For example, the Southern District of New York applied

[5] In any case, the Plaintiff has failed to explain how the Director Defendants acquired "actual knowledge" of the HSP program's illegality. The Plaintiff relies on *In re Abbott Labs. Derivative S'holders Litig.*, but the case is factually distinguishable. 325 F.3d 795 (7th Cir. 2003). There, the court found the directors were aware of known violations of law because they were provided with direct warning letters; whereas here, the Plaintiff has failed to provide such a direct route to notice and instead asks this Court to make inferences based on circumstantial allegations. *Id.* at 808-09. As alleged in the Complaint, CVS received notice of the initiation of a government investigation into possible wrongdoing connected to the HSP program. (Compl. ¶ 128.) A warning letter is, of course, the end product of an investigation where wrongdoing has been conclusively established.

Caremark where, as here, the plaintiff accused the directors for "time and again being placed on notice of [liability-creating activities], and either perpetuating or turning a deliberate blind eye to them." *In re SAIC Inc. Derivative Litig.*, 948 F. Supp. 2d at 378 (applying Delaware law). Because the Plaintiff's theory of liability is premised on the assertion that red flags repeatedly notified the Board of illegal activities relative to the HSP program, this Court will apply *Caremark.*

As eluded to this Court must consider whether the Complaint supports an inference that the Director Defendants knew the HSP program was exposing CVS to liability.[6] Even "directors' good faith exercise of oversight responsibility may not invariably prevent employees from violating criminal laws, or from causing the corporation to incur significant financial liability, or both." *Stone ex rel. AmSouth Bancorporation*, 911 A.2d at 373. Stockholders cannot usurp the Board "simply by describing the calamity and alleging that it occurred on the directors' watch." *South*, 62 A.3d at 14. To establish knowledge in the *Caremark* context, a plaintiff must allege directors were presented with "red flags" or indications of liability-creating activity that could or should have put the directors on notice of a problem. *Id.* at 15; *see also In re Forest Labs., Inc. Derivative Litig.*, 450 F. Supp. 2d 379, 395-96 (S.D.N.Y. 2006). "'Red flags' are only useful when they are either waived in one's face or displayed so that they are visible to the careful observer." *In re Citigroup Inc. S'holders Derivative Litig*., No. 19827, 2003 WL 21384599, at *2 (Del. Ch. 2003) (collecting cases).

Here, Plaintiff contends that the Director Defendants knew the HSP program was exposing CVS to legal liability because they acknowledged the importance of regulatory compliance relative to CVS's prescription drug business and were aware of CVS's previous legal

[6] This Court will leave for another day the issue of whether the HSP program itself was in fact illegally constituted.

troubles; various investigations and lawsuits asserting claims related to the HSP program did or should have notified the Director Defendants that the program was illegally structured; and a presumption of knowledge is appropriate because the "Pharmacy Services" segment is CVS's "core business."[7] (Pl.'s Mem. 12-17); *see also* Compl. ¶¶ 35, 41, 46.) The Defendants counter that this Court should ignore previous, unrelated instances of illegality; that the Plaintiff misconstrues the timing and extent of litigation arising in connection with the HSP program; and that the Plaintiff's core operations theory is inapposite because CVS never identified the program as a central part of its business. This Court will consider the Plaintiff's alleged red flags in turn to determine whether they support an inference of knowledge coextensive with bad faith or scienter.

a

Knowledge of Regulation in the Pharmaceutical Business and Previous Non-Compliance

The Plaintiff emphasizes that CVS violated the law in numerous ways unrelated to the HSP program—causing CVS to enter settlement and corporate integrity agreements with regulators—to support an inference that the Director Defendants knew the HSP program was illegal. Specifically, the Plaintiff directs this Court's attention to "subpoenas and investigative

[7] The Complaint does state that the Director Defendants "caused" CVS to violate the law with respect to various other instances of alleged misconduct unrelated to the HSP. (Compl. ¶ 57.) However, this Court need not accept that conclusory statement in light of Rule 23.1's particularized pleading requirement. The Plaintiff offers little, if any, detail about these instances, and he does not tie the Director Defendants into any of these instances or even allege that the Director Defendants were with CVS at the time. It is clear these instances are offered to lead this Court into drawing an impermissible connection between the previous wrongdoing and the wrongdoing relative to the HSP program. While a plaintiff could, theoretically, tie together various instances of wrongdoing to establish a systematic dereliction of duty, the Plaintiff has not pled a theory of liability to that effect. The Plaintiff specifically stated in his supporting memorandum that this is not a case of "sustained or systematic failure of the board to exercise oversight," but rather a case where the Director Defendants "had actual knowledge of the compliance issues relating to the HSP program and the U&C pricing scheme." (Pl.'s Mem. 18.)

demands" along with the fact that CVS settled charges of misconduct with such entities. (Pl.'s Mem. 2); *see also* Compl. ¶¶ 56-63. The Plaintiff also notes generally that the Director Defendants signed annual reports filed with the Securities and Exchange Commission (SEC) acknowledging the importance of legal compliance. (Compl. ¶¶ 52-54.)[8]

The Plaintiff's line of reasoning is unavailing. He does not explain how unrelated instances of illegality and subsequent settlements could have possibly alerted the Board to problems with the HSP program. In fact, Delaware courts have categorically rejected the imposition of a heightened state of alertness for future wrongdoing where the company has engaged in previous, unrelated wrongdoing. *See In re Dow Chem. Co. Derivative Litig.*, Civil Action No. 4349-CC, 2010 WL 66769, at *13 (Del. Ch. 2010) (categorizing as "too attenuated" the plaintiff's argument that because bribes had occurred in the past for which the company paid a fine, the board should have suspected similar conduct); *In re Citigroup Inc. S'holder Derivative Litig.*, 964 A.2d at 129 (holding the plaintiffs "utterly failed to show how Citigroup's involvement with the financial scandals at Enron has any relevance to Citigroup's investments in subprime securities."). For the same reasons, this Court declines to adopt a rule that would heighten the burden on directors where, as here, they expressly acknowledge the importance of legal compliance. To infer bad faith based on aspirational statements in annual reports would significantly undermine the demand requirement. Thus, CVS's unrelated non-compliance and the Director Defendants' stated intention to comply with the law do not constitute red flags supporting an inference of bad faith.

[8] The Plaintiff also notes that other discount retailers had been sued over programs like the HSP program; however, the Plaintiff does not explain how that information would have come to the Director Defendants' attention.

b

Investigations and Civil Actions Related to the HSP Program

The Plaintiff contends the Director Defendants knew the HSP program was illegal as structured because investigations and litigation concerning the program "multiplied in 2012." (Pl.'s Mem. 13); *see also* Compl. ¶¶ 128-41. The Defendants counter that the Plaintiff blurs and exaggerates the timeline and leapfrogs to inappropriate inferences.

i

Subpoenas

The Complaint alleges that in February of 2013, CVS filed an annual report (2012 Annual Report) disclosing that in January of 2012, the company had received a subpoena from the Office of Inspector General (OIG), requesting information about the HSP program, as well as an investigative demand from the Office of the Texas Attorney General requesting the same. (Compl. ¶¶ 128-29.)[9] The Plaintiff asserts that these investigations constituted red flags that should have notified the Board of corporate misconduct.

Courts have had occasion to consider the importance of subpoenas and what inferences can be drawn from them for purposes of a *Caremark* claim, explaining that the receipt of subpoenas, alone, is an insufficient basis for inferring directors were aware of corporate misconduct. *In re Chemed Corp., S'holder Derivative Litig.*, 2015 WL 9460118, at *18 (citing *In re Johnson & Johnson Derivative Litig.*, 865 F. Supp. 2d 545, 566 (D.N.J. 2011)). Based on the Complaint's assertions, what can be inferred is that by February 2013, most of the Director Defendants were aware that the OIG and the State of Texas instituted investigations into the HSP

[9] The Complaint also alleges CVS disclosed the same in its 2013 annual report filed on February 11, 2014. (Compl. ¶ 130.)

program.[10] However, this Court finds significant that in disclosing the subpoenas, the Director Defendants discussed the subpoenas as investigations into "possible" wrongdoing—far from an acknowledgment or admission that CVS executives engaged in actual misconduct. (Compl. ¶¶ 128, 130); *see also In re Chemed Corp., S'holder Derivative Litig.*, 2015 WL 9460118, at *18 (reasoning that directors' acknowledgment in the Form 10-K referencing "alleged" wrongdoing did not amount to an acknowledgment of wrongdoing relative to a corporation's billing practices). Thus, while the subpoenas are relevant for inferring knowledge of issues with the HSP program, those subpoenas do not of themselves suggest the Director Defendants acted in bad faith.

ii

Civil Actions

The Complaint asserts that certain civil actions brought against CVS should have apprised the Board of HSP-related legal issues. (Compl. ¶ 132.) The Plaintiff references a consolidated action of two cases, *Corcoran* (California) and *Podgorny* (Illinois), which allege CVS "overcharged for generic drugs by . . . failing to report [CVS's] true U&C prices." (Compl. ¶ 133.) The Plaintiff alleges that in October 2015, Director Defendant David M. Denton signed a quarterly report acknowledging the existence of the consolidated action, and that the other Director Defendants acknowledged the same (in February 2016) through disclosures in an annual report (2015 Annual Report). *Id.* ¶ 134. The Complaint also highlights that a California court partially denied CVS's motion to dismiss certain claims. *Id.* ¶ 136.

[10] Even though the Complaint indicates the State of Texas ultimately filed a lawsuit against CVS alleging wrongdoing relative to the HSP program, the lawsuit was not publicly disclosed until January 2017—just a few months prior to April 2017—the latest date the Plaintiff estimates CVS discontinued the HSP program. The Complaint does not allege the Director Defendants knew about the Texas lawsuit prior to its public disclosure.

What can be properly inferred from these allegations is that by February 2016, the Director Defendants collectively learned that a consolidated action accused CVS of overpricing generic drugs. It cannot be inferred that the Director Defendants were aware of the consolidated action in October 2015 when Mr. Denton learned of it. Absent an allegation that Mr. Denton communicated notice to the other Director Defendants, "Delaware law does not permit the wholesale imputation of [a] director's knowledge to every other [director] for demand excusal purposes." *Desimone v. Barrows*, 924 A.2d 908, 943 (Del. Ch. 2007). Moreover, even when the Director Defendants learned about the consolidated action in February 2016, such notice could not have informed them that the HSP program was "illegal." At such an early point in the litigation, the cases contained nothing more than unsubstantiated allegations of wrongdoing. *See In re Chemed Corp., S'holder Derivative Litig.*, 2015 WL 9460118, at *19; *see also In re Johnson & Johnson Derivative Litig.*, 865 F. Supp. 2d at 567 ("[K]nowledge of unsubstantiated allegations . . . do not suggest that the Board was aware of continued corporate misconduct.").[11]

The Complaint cites two other HSP-related cases in addition to *Corcoran* and *Podgorny*: *Sheet Metal* and *Omlansky*. (Compl. ¶¶ 105, 135.) However, these cases are unhelpful to the Plaintiff in terms of inferring bad faith because the Director Defendants are not alleged to have learned about *Sheet Metal* and *Omlansky* until February 2017 through disclosures in CVS's 2016 Annual Report. *Id.* ¶¶ 137, 138. In *In re Johnson & Johnson Derivative Litig.*, a derivative shareholder action, the court refused to infer directors consciously disregarded a *qui tam* suit disclosed in a Form 10-K because the disclosure preceded the derivative action by only three months, reasoning that three months was too short a lapse to infer the board knew about

[11] Moreover, this Court cannot draw any inferences in the Plaintiff's favor based on the California court's denial of CVS's motion to dismiss. Courts are, of course, obliged to accept a complaint's allegations as true at the motion to dismiss stage, and the Complaint does not even allege the Director Defendants knew about the California court's ruling.

misconduct and consciously decided in bad faith not to act. 865 F. Supp. 2d at 568. Here, the Complaint alleges the Director Defendants discontinued the HSP program in April 2017 at the latest—just two months after the Director Defendants are alleged to have learned of *Sheet Metal* and *Omlansky*. Therefore, the Plaintiff's reference to various class actions does not infer that the Director Defendants acted in bad faith. (Compl. ¶ 132.)

c

Core Operations Doctrine

The Plaintiff theorizes in the alternative that the "core operations" doctrine supports an inference that the Board knew of legal issues with the HSP program. The Defendants counter that the Plaintiff has not alleged that the Director Defendants identified the HSP program as a top corporate priority; therefore, the core operations doctrine is inapplicable.

In some situations, courts will presume an executive must have known information regarding a business's core operations. *See In re SAIC Inc. Derivative Litig.*, 948 F. Supp. 2d at 384 (explaining that the core operations doctrine provides "[k]nowledge of the falsity of a company's financial statements can be imputed to key officers who should have known of facts relating to the core operations of their company that would have led them to the realization that the company's financial statements were false when issued"). The theory is that "facts critical to a business's core operations or an important transaction generally are so apparent that their knowledge may be attributed to the company and its key officers." *Pittleman v. Impac Mortg. Holdings, Inc.*, No. SACV 07-0970 AG (MLGx), 2009 WL 648983, at *3 (C.D. Cal. 2009) (citation omitted).

However, an inference of scienter may be drawn only in '"exceedingly rare' cases where an event is so prominent that it would be 'absurd' to suggest that key officers lacked knowledge

of it." *Id.* (citing *South Ferry LP, No. 2 v. Killinger*, 542 F.3d 776, 786 (9th Cir. 2008)). It is unclear whether the core operations theory even applies in demand futility cases. *See Pfeiffer v. Toll*, 989 A.2d 683, 693-94 (Del. Ch. 2010*), abrogated on other grounds by Kahn v. Kolberg Kravis Roberts & Co., L.P.*, 23 A.3d 831, 837 (Del. 2011) (distinguishing the inferences of knowledge that are appropriate to draw under the traditional 12(b)(6) standard as opposed to the more rigid Rule 23.1 standard); *see also In re Fitbit, Inc. Stockholder Derivative Litig.*- CONSOLIDATED, C.A. No. 2017-0402-JRS, 2018 WL 6587159, n.179 (Del. Ch. 2018) (opining that reliance on the core operations doctrine, alone, does not establish scienter).

Usually, only inside directors or executives holding "key" or "top" positions are presumed to know the details of a company's core operations. *See In re Forest Labs., Inc. Derivative Litig.*, 450 F. Supp. 2d at 391 (citing *In re Ramp Networks, Inc. Sec. Litig.*, 201 F. Supp. 2d 1051, 1076 (N.D. Cal. 2002)). In contrast, outside directors are presumed to know very little about a company's day-to-day workings. *See Taylor v. Kissner*, 893 F. Supp. 2d 659, 671 (D. Del. 2012) (citation omitted) ("[T]here is no authority to support the attribution of knowledge to Outside Directors who are not alleged to be directly involved in the day-to-day operations of the company."); *Guttman*, 823 A.2d at 503 ("Entirely absent from the complaint are well-pled, particularized allegations of fact detailing the precise roles that these [outside] directors played at the company, the information that would have come to their attention in those roles, and any indication as to why they would have perceived the accounting irregularities."). The Plaintiff's core operations theory is, therefore, a nonstarter because the Director Defendants (excluding Mr. Merlo) appear to be outsiders in that they are not alleged to have served as executive officers involved in CVS's day-to-day operations.

More importantly, a core operations theory is inappropriate unless the company has identified the operation as "critical" to its success or holding some other "special importance." *Rosenbloom v. Pyott,* 765 F.3d 1137, 1145 (9th Cir. 2014) (opining a drug described by the board as a "top corporate priority" and as "two of the top three future growth opportunities in our portfolio" demonstrated that the drug was a core part of a drug manufacturer's operation); *see also In re Forest Labs., Inc. Derivative Litig.*, 450 F. Supp. 2d at 391 (stating that "knowledge of facts critical to the continued viability of major transactions or 'core' business operations have been imputed to a company" and its executives). Here, the Complaint does not allege that the Director Defendants identified the HSP program as holding such *special* importance or centrality to CVS's business such that all information relating to the HSP and its intricacies ought to be imputed to the entire Board. It is not as if the Director Defendants expressly coupled the HSP program with CVS's future profitability, or implied that the discontinuity of the program would put CVS's business in jeopardy. The Complaint refers in broad, sweeping terms to the importance CVS's pharmacy business and then jumps to assumptions about the HSP program's importance. In the absence of allegations of the program's relative importance, the Plaintiff is not entitled to a core operations inference. *See In re SAIC Inc. Derivative Litig.*, 948 F. Supp. 2d at 384-85 (holding plaintiff's "broad and unspecified" reference to government contracts, as opposed to the individual government contract at issue, did not support a core operations inference). Otherwise, to justify demand excusal, a plaintiff could rely on the simple allegation that wrongdoing pertained to an important project; such "hair-trigger" demand excusal would vitiate the demand requirement. *Guttman*, 823 A.2d at 502. Therefore, the Plaintiff is not entitled to an inference of director knowledge based on the core operations doctrine.

Taken together and viewed in the light most favorable to the Plaintiff—other than the presence of subpoenas notifying the Board of preliminary investigations and unsubstantiated allegations contained in early stage civil actions—the Plaintiff has not demonstrated a basis for inferring the Director Defendants acted in bad faith by failing to modify or discontinue the HSP program before they did. Therefore, the Plaintiff's *Caremark* claim does not demonstrate that a majority of the Board faces a substantial likelihood of liability.

2

Disseminating False and Misleading Information

In addition to the Plaintiff's *Caremark* claim, he argues that the Director Defendants face a substantial likelihood of liability for "knowingly caus[ing] CVS to issue false and misleading statements regarding its financial condition." (Pl.'s Mem. 21.) Specifically, the Plaintiff points to SEC reports detailing increases in net revenues and profits and concludes that the reports contained false information because they did not disclose that CVS's revenue/profit growth was "achieved only through the unlawful U&C pricing scheme." *Id.*

"Whenever directors communicate publicly or directly with shareholders about the corporation's affairs . . . directors have a fiduciary duty to shareholders to exercise due care, good faith and loyalty." *Malone v. Brincat*, 722 A.2d 5, 10 (Del. 1998). Thus, "[i]t follows *a fortiori* that when directors communicate publicly or directly with shareholders about corporate matters the *sine qua non* of directors' fiduciary duty to shareholders is honesty." *Id.* (Italics in original). The issue in a non-disclosure case "is whether [directors] breached their more general fiduciary duty of loyalty and good faith by knowingly disseminating to the stockholders false information about the financial condition of the company." *Id.*

"To successfully state a duty of loyalty claim against directors for providing information [or omitting it] in the absence of a request for stockholder action, a stockholder must allege that he received 'false communications' from directors who were 'deliberately misinforming shareholders about the business of the corporation.'" *Orloff v. Shulman*, No. Civ.A. 852-N., 2005 WL 3272355, at *14 (Del. Ch. 2005) (citing Ja*ckson Nat'l Life Ins. Co. v. Kennedy*, 741 A.2d 377, 389 (Del. Ch. 1999)). A plaintiff must also allege reliance, causation and damages relative to the misinformation. *Wilkin ex rel. Orexigen Therapeutics, Inc. v. Narachi*, C.A. No. 12412-VCMR, 2018 WL 1100372, at *14 (Del. Ch. 2018) (collecting cases). The Delaware Supreme Court "'set a high bar for *Malone*-type claims . . . to ensure that [Delaware] law was not discordant with federal standards.'" *Id.* (quoting *Metro Commc'n Corp. BVI v. Advanced Mobilecomm Techs. Inc.*, 854 A.2d 121, 158 (Del. Ch. 2004)). As with the Plaintiff's *Caremark* claim, the non-disclosure claim fails because the Plaintiff has not adequately alleged scienter: regardless of the theory of liability, scienter is an indispensable element of every non-exculpated claim, which requires a demonstration that directors knowingly violated the law. *See* 8 Del. C. 1953 § 102(b)(7).

Moreover, the Plaintiff has not pled a single fact going to the element of reliance. The Complaint's only suggestion of reliance comes through the Plaintiff's allegation that CVS's stock price increased substantially based on unlawful profit increases associated with falsely reported U&C prices. (Compl. ¶ 159.) However, to accept that allegation as support for reliance would oblige this Court to apply the "fraud on the market" theory, which assumes a company's stock price reflects any public misinformation. *See Alessi v. Beracha*, 849 A.2d 939, 944 (Del. Ch. 2004). Delaware courts have prohibited reliance on fraud on the market in non-disclosure claims. *See id.* (citing *Malone*, 722 A.2d at 13). Because the Plaintiff has not alleged

individualized shareholder reliance, the Director Defendants do not face a substantial likelihood of liability for knowingly causing CVS to issue false and misleading statements.

3

Authorizing CVS's Stock Repurchase Program

The Complaint states that the Director Defendants wrongfully repurchased stock[12] at a time when they knew CVS stock was trading at artificially-inflated valuations due to the U&C pricing; therefore, the Director Defendants "wasted" CVS's assets.[13] (Pl.'s Mem. 22.) The Defendants counter that because the Plaintiff has not established scienter, the Director Defendants obviously did not know the HSP program was inflating CVS's stock price.

In Delaware, a waste claim involves the '"diversion of corporate assets for improper or unnecessary purposes."' *Taylor*, 893 F. Supp. 2d at 673 (quoting *Michelson v. Duncan*, 407 A.2d 211, 217 (Del. 1979)). Such a claim requires a showing that "the consideration received by the corporation was so inadequate that no person of ordinary sound business judgment would deem it worth that which the corporation paid." *Orloff*, 2005 WL 3272355, at *11. "Corporate waste is 'confined to unconscionable cases where directors irrationally squander or give away corporate assets.'" *Taylor*, 893 F. Supp. 2d at 673 (citing *Brehm*, 746 A.2d at 263). *"[A]ny substantial* consideration received by the corporation," as well as a "*good faith judgment* that . . .

[12] The Plaintiff cites repurchases authorized on the following dates—September 19, 2012; December 17, 2013; and December 15, 2014—in which CVS repurchased millions of shares at average prices between $93.28 and $107.94. (Compl. ¶¶ 142, 147-156.)

[13] The Plaintiff also alleges that the repurchases benefited CVS insiders, including three of the Director Defendants. Compl. ¶¶ 159-164.) The Complaint does not state whether the pattern of trading by the Director Defendants varied significantly from their past practice; therefore, the case cited by the Plaintiff for support, *In Re Countrywide Fin. Corp. Derivative Litig.*, 554 F. Supp. 2d 1044, 1066-68 (C.D. Cal. 2008), is inapposite. The Plaintiff appears to argue (in the alternative) that Director Defendants Brown, Finucane and Merlo are "interested" for purposes of demand futility because they sold stock during relevant times. Delaware courts have specifically disavowed this argument for demand futility. *See Gutman*, 823 A.2d at 502.

[a] transaction is worthwhile" bars a successful waste claim. *Lewis v. Vogelstein*, 699 A.2d 327, 336 (Del. Ch. 1997) (emphasis in original).

This Court has already determined that the Plaintiff has not demonstrated scienter; accordingly, the Director Defendants are presumed to have acted with sound business judgment in exercising a quintessential director duty: deciding whether to employ corporate funds to repurchase stock.[14] The absence of scienter essentially undercuts the Plaintiff's waste claim.

More importantly, the Plaintiff has not alleged facts that, if proven true, would demonstrate that CVS paid such inadequate consideration for its stock repurchases that no person of sound and ordinary judgment would have entered into the transactions. *See In re Citigroup Inc. S'holder Derivative Litig.*, 964 A.2d at 136. Buying back stock at the market price will rarely support an action for waste because the market price is, by definition, the price at which an ordinary person would purchase shares. *Id.* Frankly, the Plaintiff has done little more than retrieve a stock chart, compare CVS's current stock price to the prices at the time the repurchases were made, and conclude that because of the difference between the two price points, the Director Defendants committed waste by authorizing the repurchases. Such hindsight second-guessing directly implicates and contravenes the business judgment rule.

While the Plaintiff alleges the Director Defendants failed to disclose that CVS derived outsized profits and revenue from the HSP program—thereby causing CVS's stock to appreciate to artificially-inflated valuations—the Complaint's financial conclusions are not supported by *any* factual predicate. The Plaintiff has not explained how the HSP program impacted CVS's financial performance or even alleged that CVS was underperforming benchmark indices. Such

[14] The Plaintiff's failure to adequately allege scienter distinguishes the *Countrywide* case in which the court found a "strong inference of scienter" and therefore determined there was reason to doubt whether a stock repurchase program was the product of a sound exercise in business judgment. 554 F. Supp. 2d at 1082-83.

information could and should have been acquired through research and a valid books and records request as permitted under Delaware law. *See* 8 Del. C. 1953 § 220; *King v. VeriFone Holdings, Inc.*, 12 A.3d 1140, 1146 (Del. 2011) (explaining that a "failure to proceed" with a books and records request before initiating a derivative suit is "ill-advised"). Without details supporting the Plaintiff's assertion that the HSP program drove CVS's financial performance, this Court cannot assess the viability of the Plaintiff's waste claim for purposes of demand futility. Accordingly, the Plaintiff has not demonstrated that a majority of the Director Defendants face a substantial likelihood of liability for authorizing the at-issue stock repurchases.

4

Approving Substantial Executive Compensation

The Plaintiff's final theory for demand futility relates to executive compensation. The Plaintiff asserts that the Board's Management Planning and Development Committee (Committee), which consists of five Director Defendants, "approved lavish compensation packages for CVS's top executives" during the HSP program's operation. (Pl.'s Mem. 23); *see also* Compl. ¶¶ 171-72. According to the Plaintiff, the Committee members breached their duty of loyalty because they knew CVS executives were misstating U&C prices; the executives' legal compliance was not considered in calculating executive compensation; and the Committee only met an estimated five times annually from 2013 to 2016. (Pl.'s Mem. 23-24.) The Complaint also asserts the Board should have clawed-back compensation after witnessing CVS's stock decline. Considering the shortcomings of the Plaintiff's other theories for demand futility, the executive compensation claim cannot survive scrutiny. As explained time and again, there is no basis for inferring the Director Defendants were actually or constructively aware of issues surrounding U&C pricing.

Therefore, this Court is left with little more than an allegation that the Committee could have done a better job aligning incentives relative to executive compensation. Such argumentation bespeaks a breach of the duty of care—not the duty of loyalty. *See MCG Capital Corp. v. Maginn*, Civ. Action No. 4521-CC, 2010 WL 1782271, at *19 (Del. Ch. 2010) (holding a derivative complaint asserting directors should have taken alternative steps in making compensation decisions constituted, at most, a breach of the duty of care). Nevertheless, the Plaintiff has steadfastly staked his position on the premise that the case at bar implicates the duty of loyalty. (Pl.'s Mem. 24) (arguing the Defendants' supporting cases are inapplicable to the instant one given they only involved the duty of care). Accordingly, the Plaintiff has not demonstrated that the Director Defendants face a substantial likelihood of liability for breaching their duty of loyalty by making the complained of executive compensation decisions.

In sum, the Plaintiff has not alleged particularized facts demonstrating demand is futile because the Director Defendants do not face a substantial likelihood of liability for (1) approving CVS's "unlawful" business plan; (2) disseminating false and misleading information; (3) authorizing CVS's stock repurchase program; and (4) approving substantial executive compensation. As such, the Plaintiff has not demonstrated a basis for demand futility that would entitle the Plaintiff to bring this action on CVS's behalf.

IV

Conclusion

Based on the foregoing, this Court finds the Plaintiff has not demonstrated—through particularized factual allegations—that demand is futile and therefore grants the Defendants' motion to dismiss. Counsel for the Defendants shall prepare and submit the appropriate Order for entry.

RHODE ISLAND SUPERIOR COURT

Decision Addendum Sheet

TITLE OF CASE:	Edward Boron, Derivatively on Behalf of CVS Health Corporation v. Richard M. Bracken, et al. and CVS Health Corporation
CASE NO:	PC-2017-4398
COURT:	Providence County Superior Court
DATE DECISION FILED:	April 29, 2019
JUSTICE/MAGISTRATE:	Stern, J.

ATTORNEYS:

For Plaintiff:	Robert M. Duffy, Esq.
For Defendant:	Robert C. Corrente, Esq.