STATE OF RHODE ISLAND AND PROVIDENCE PLANTATIONS

PROVIDENCE, SC. **SUPERIOR COURT**

(FILED: October 1, 2013)

NATALIE GORDON, Derivatively on Behalf of Nominal Defendant CVS CAREMARK CORPORATION,	:	
Plaintiff,	:	
v.	:	**C.A. No. PB 12-3098**
THOMAS M. RYAN, EDWIN M. BANKS, C. DAVID BROWN II, DAVID W. DORMAN, ANNE M. FINUCANE, KRISTEN E. GIBNEY WILLIAMS, MARIAN L. HEARD, LARRY J. MERLO, JEAN-PIERRE MILLON, TERRENCE MURRAY, C.A. LANCE PICCOLO, RICHARD J. SWIFT, and TONY L. WHITE,	:	
Defendants,	:	
-and-	:	
CVS CAREMARK CORPORATION,	:	
Nominal Defendant.	:	

DECISION

SILVERSTEIN, J. Plaintiff Natalie Gordon (Plaintiff) has filed this derivative suit on behalf of Nominal Defendant CVS Caremark Corporation (CVS). Before the Court is the Defendants'[1] motion to dismiss the Plaintiff's Verified Amended Shareholder Derivative Complaint (Complaint). Defendants argue that Plaintiff failed to make a pre-suit demand

[1] "Defendants" shall refer to the Individual Defendants—Thomas M. Ryan, Edwin M. Banks, C. David Brown II, David W. Dorman, Anne M. Finucane, Kristen E. Gibney Williams, Marian L. Heard, Larry J. Merlo, Jean-Pierre Millon, Terrence Murray, C.A. Lance Piccolo, Richard J. Swift, and Tony L. White—and CVS.

on the Board of Directors of CVS (the Board) and did not plead sufficient justification as to why demand would be excused, and that Plaintiff lacks standing as a shareholder to maintain the action.

I

Facts

CVS, a Delaware corporation, with its principal place of business in Woonsocket, Rhode Island, is the largest pharmacy healthcare provider in the United States. The Individual Defendants are current or former members of the Board. Plaintiff asserts that she "is, and at all relevant times was, a shareholder of nominal defendant CVS." (Pl.'s Am. Compl. ¶ 10). The Complaint asserts that the Individual Defendants breached their fiduciary duties owed to CVS from September 2007 to the present. Among the reasons for the claimed breach are three instances of misconduct involving the sale and/or distribution of prescription medication.

A

Pseudoephedrine Sales

The first instance of misconduct resulted in CVS entering into a non-prosecution agreement for violation of The Combat Methamphetamine Epidemic Act of 2005 (CMEA.) The CMEA was enacted by Congress as a combatant against the production of the illegal drug, methamphetamine. The CMEA placed limits and conditions on the sale of medication that included the ingredient pseudoephedrine (PSE) because illegal drug manufacturers were able to divert PSE for the manufacture of methamphetamine. The regulation of PSE sales included a daily limit of PSE dosage sales to individuals and the

requirement that sales records be kept. On top of the federal requirements, some states imposed additional monthly limits on the sale to individuals.

Initially, CVS complied with the federal regulations by moving the PSE drugs "behind the counter" and implementing paper logbook systems to record individual sales. Later, in 2007, CVS adopted a system called "MethCheck," which automatically tracked PSE sales and could prevent sales in excess of federal daily limits as well as state monthly limits.

In order to comply with the monthly limit regulations imposed by various states, a special feature called "Lookback" needed to be enabled. The "Lookback" feature was only enabled in states that imposed monthly sales limits. If the "Lookback" feature was not enabled, the "MethCheck" system was unable to identify multiple PSE sales to the same customer on the same day, meaning that a purchaser could elude the federal daily limit by making multiple separate purchases. Due to this failure, in states that did not impose monthly sales limits, PSE sales increased. In particular, the practice of smurfing—where methamphetamine producers hire individuals to purchase PSE at multiple locations to supply their labs—became prevalent at CVS stores, especially in Nevada and California. As a result, on October 14, 2010, CVS entered into a non-prosecution agreement with federal investigators, whereby it acknowledged that it had illegally sold PSE and accepted the imposition of a $75 million fine in civil penalties and forfeited $2.6 million in profits earned as a result of illegal conduct.

B

Oxycodone Sales

Starting in 2010, two CVS pharmacy stores (Sanford Pharmacies) located in Sanford, Florida, became the subject of a Drug Enforcement Administration (DEA) investigation. The Sanford Pharmacies ranked first and second on a DEA list of the top thirty-four Florida CVS pharmacies for purchasing oxycodone in 2010. The investigation discovered that between January 2008 and December 2011, the Sanford Pharmacies, combined, purchased from its distributors more than seven million dosage units of oxycodone. In 2011 only, the Sanford Pharmacies purchased oxycodone sufficient to supply eight times the population of Sanford, Florida.

In December 2010, a CVS attorney and two district supervisors met with representatives from the DEA to discuss the oxycodone diversion problem in Florida. Prescription records of the Sanford Pharmacies show that prescriptions were filled for controlled substances based on prescriptions written by doctors who were the subject of action by the DEA or the State of Florida, and many of the doctors were located in South Florida, more than 200 miles away. As a result of the investigation, the Sanford Pharmacies were permanently stripped of their licenses to sell controlled substances in September 2012.

C

Failure to Monitor Narcotic Sales

In April 2013, CVS announced that it would pay an $11 million penalty to avoid civil charges by the DEA for violations that occurred at CVS pharmacies in Oklahoma. Specifically, these violations related to recordkeeping requirements that were not

followed between 2005 and 2011. The investigation showed various violations, including filling a prescription issued by a dentist whose license had expired, filling prescriptions with inaccurate license numbers, and using false DEA registration numbers for a prescribing doctor. These events occurred after the filing of Plaintiff's Complaint.

II

Procedural History

Plaintiff filed this action on June 18, 2012, and subsequently amended her Complaint on November 30, 2012. Thereafter, Plaintiff filed a Supplemental Verified Shareholder Derivative Complaint on April 26, 2013, which referenced the violations discussed supra § I.C. Plaintiff did not make any pre-suit demand on the Board but instead alleges that demand should be excused as futile. Defendants moved to dismiss the Complaint.

III

Standard of Review

"'The sole function of 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, 1232 (R.I. 1989)). The Court must "assume the allegations contained in the complaint are true, 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). Thus, the Court may only grant the motion if it "appears beyond a reasonable doubt that a [non-movant] 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). Finally, the Rhode Island Supreme Court continues to ascribe

to the traditional notice pleading standard and has yet to formally adopt (or reject) the newer, federal standard on a motion to dismiss, as set forth in Bell Atlantic Corp. v. Twombly, 550 U.S. 544 (2007) and Ashcroft v. Iqbal, 556 U.S. 662 (2009). See Narragansett Elec. Co. v. Minardi, 21 A.3d 274, 277 (R.I. 2011) (applying notice pleading standard after Twombly and Iqbal). Therefore, this Court will apply the traditional Rhode Island standard.

IV

Analysis

A

Demand Futility

The derivative suit developed to allow shareholders to bring action against directors on behalf of the corporation. Aronson v. Lewis, 473 A.2d 805, 811 (Del. 1984). However, because the action belongs to the corporation, most jurisdictions require that the opportunity to bring suit should first be given to the corporation. Kamen v. Kemper Fin. Servs., Inc., 500 U.S. 90, 96 (1991). This pre-suit demand requirement "allows the directors to exercise their business judgment and determine whether litigation is in the best interest of the corporation." Id.

In the absence of a pre-suit demand to bring the action by the Board, the Plaintiff must plead with particularity the reasons why demand would be futile. Super. R. Civ. P. 23.1; Hendrick v. Hendrick, 755 A.2d 784, 794 (R.I. 2000); see also Del. Ch. Ct. R. 23.1 (requiring demand futility to be pled with particularity); Brehm v. Eisner, 746 A.2d 244, 254 (Del. 2000) ("[Rule 23.1] pleadings must comply with stringent requirements of factual particularity that differ from the permissive notice pleadings."). In determining

whether pre-suit demand was futile, this Court will apply Delaware substantive law, the state of CVS's incorporation. See Kamen, 500 U.S. at 108-109 (noting that demand requirements are matters of substantive law and are resolved according to the law of the state of incorporation).

Delaware law regarding pre-suit demand futility is well-developed. Specifically, two different tests have emerged as the determinants of whether demand futility has been pled with particularity. When a plaintiff challenges affirmative board action as the basis of the suit, then demand will be excused as futile if the complaint raises a reasonable doubt that (1) the directors are disinterested or independent; or (2) the transaction was the product of a valid exercise of business judgment. See Brehm, 746 A.2d at 256 (setting out *Aronson* test). When a plaintiff challenges a board of directors' failure to act, then the *Rales* test will apply. The *Rales* test analyzes whether, at the time the complaint was filed, the board of directors could have exercised its "independent and disinterested business judgment in responding to a demand." Rales v. Blasband, 634 A.2d 927, 934 (Del. 1993). To determine which test to apply, the Court must decide whether the challenged action of the Board was either a failure of the Board to act or a conscious decision of the Board. In re Intel Corp. Derivative Litig., 621 F. Supp. 2d 165, 172 (D. Del. 2009).

In In re Intel, the court considered whether to apply the *Aronson* or *Rales* test. There, the court noted that it was unclear from plaintiff's complaint whether the plaintiff was asserting a conscious decision by the board of directors not to take action or a failure to monitor. However, the court went on to state that the *Aronson* test still would not apply to a case when the allegations were those of conscious inaction. Id. at 173. Thus,

the court applied the *Rales* test because it would not be possible to "address the business judgment of an action not taken . . . ." Id.

Plaintiff's basis for her Complaint is that the various violations of federal law, leading to the fines and closure of pharmacies, gave a majority of the Board actual knowledge of the illegal wrongdoing and the Board consciously decided not to act. However, Plaintiff does not allege that the Board ever had actual knowledge about the alleged illegalities until after it was informed by federal agencies, at which point the Board took corrective action. Plaintiff's reliance on In re Abbott Labs. Derivative S'holder Litig., 325 F.3d 795 (7th Cir. 2003) is misplaced, as that case has not only not been followed by subsequent Delaware case law, but it also involves a factually different scenario. See In re Intel, 621 F. Supp. 2d at 173 (stating that Abbott is not a "faithful application of Delaware law"). In In re Abbott, the court concluded that the directors were aware of the known violations because they were provided with direct evidence in the form of warning letters. Here, Plaintiff fails to plead any such direct knowledge on the part of the Board to form the basis of a conscious decision. Rather, the Plaintiff argues that Defendants consciously failed to monitor CVS for potential violations. Therefore, the *Rales* test applies.

In deciding whether director liability exists in a case of failure to monitor, Delaware courts look to In re Caremark Int'l Inc. Derivative Litig., 698 A.2d 959 (Del. Ch. 1996).[2] There, the court recognized claims predicated upon alleged inaction by directors that "allowed a situation to develop and continue which exposed the corporation

[2] The Court finds it interesting that In re Caremark guides the discussion, as the corporate entity in that case was Caremark Rx, Inc. Caremark Rx, Inc. merged with CVS Corporation on March 22, 2007, which resulted in the creation of the Nominal Defendant in this case, CVS Caremark Corporation.

to enormous legal liability . . . is possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment." In re Caremark, 698 A.2d at 967. To succeed in showing that directors are liable for their failure to monitor, a plaintiff will need to show "that the directors *knew* they were not discharging their fiduciary obligations or that they demonstrated a *conscious* disregard for their duties." In re Intel, 621 F. Supp. 2d at 174 (emphasis in original) (discussing standard of liability under Caremark and its progeny). In these instances, the Delaware courts have said that awareness of "red flags" and failure to act can be sufficient to establish liability. La. Mun. Police Employees' Ret. Sys. v. Pyott, 46 A.3d 313, 340 (Del. Ch. 2012). However, "red flags" are "only useful when they are either waived [sic] 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 212384599, at *2 (Del. Ch. June 5, 2003).

Plaintiff raises several arguments as to why the directors should have been aware of "red flags." First, Plaintiff claims that the cumulative nature of the violations suggests that the Board's awareness should have been heightened and, therefore, the Board should have discovered the violations. However, previous unrelated illegalities are insufficient to impose heightened awareness on the Board. See In re Citigroup Inc. S'holders Derivative Litig., 964 A.2d 106, 129 (Del. Ch. 2009) ("Plaintiffs have not shown how involvement with the [un]related scandals should have in any way put the director defendants on a heightened alert to [other] problems . . . ."). Here, while the various illegalities all had to do with the distribution of controlled substances (to be expected from the nation's largest pharmacy), the violations are significantly different. The PSE sales dealt with the failure to implement the "Lookback" function, the Sanford

Pharmacies dealt with overprescribing drugs, and the Oklahoma violations dealt with recordkeeping errors. The Board cannot be held to a state of raised awareness because the violations (while all dealing with controlled substances) are not sufficiently related.

In a similar fashion, Plaintiff also argues that Defendants disregarded "red flags" that should have informed them of the violations. One such "red flag," Plaintiff contends, was the fact that two of the Defendants were on the board of directors of the National Association of Chain Drug Stores (NACDS), which gave presentations on prescription drug monitoring. However, there is no allegation that this information was ever presented to the Board. Similarly, Plaintiff also points to the fact that top CVS officials were warned of CMEA violations by various CVS employees, and that two CVS employees knew about the failure to implement "Lookback" and the consequences of such an action. However, Plaintiff fails to state who these individuals are or whether the Board was aware of these warnings or not. Also, Plaintiff's contention that the license revocation of the Sanford Pharmacies should have raised "red flags" fails because Plaintiff does not allege any specific Board knowledge but instead states that the in-store pharmacists had knowledge of the increased narcotic sales. When pleading the reason for demand excusal, the Plaintiff must plead such facts with particularity. Brehm, 746 A.2d at 254. Such conclusory allegations, as made by Plaintiff, are insufficient. See In re Citigroup, 964 A.2d at 126-27 ("The allegations in the Complaint amount essentially to a claim that Citigroup suffered large losses and that there were certain warning signs that could or should have put defendants on notice of the business risks . . . . Plaintiffs then conclude that because defendants failed to prevent the [] losses associated with certain business risks, they must have consciously ignored these warning signs or knowingly

failed to monitor the Company's risk in accordance with their fiduciary duties. Such conclusory allegations, however, are not sufficient to state a claim for failure of oversight that would give rise to a substantial likelihood of personal liability. . . ."). To assist plaintiffs in pleading particularized facts, Delaware has enacted a provision that allows shareholders of a company to inspect the corporation's books and records. See Del. Code Ann. tit. 8 § 220 (2010). Here, Plaintiff made no such demand for inspection of CVS documents, even though such an inspection might have led to the discovery of facts pertinent to the Complaint. Accordingly, the Plaintiff has failed to particularly allege that the Board had notice of "red flags," especially considering that "red flags" are only useful if they are waved in one's face. In re Citigroup, 2003 WL 212384599, at *2.

Moreover, Plaintiff argues that demand should be excused because a majority of the Board faces substantial liability for failing to prevent the illegal conduct underlying the civil fine and, thus, would not be independent to evaluate a pre-suit demand. Initially, the fact that CVS was fined over $75 million is not enough in itself for this Court to conclude that a majority of the Board is disqualified. See Stone ex rel. AmSouth Bancorp. v. Ritter, 911 A.2d 362, 370-71 (Del. 2006). For the Board to face substantial liability, a complaint must plead that:

> "(a) the directors utterly failed to implement any reporting or information system or controls; or (b) having implemented such a system or controls, consciously failed to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention. In either case, imposition of liability requires a showing that the directors knew that they were not discharging their fiduciary obligations."

Id. at 370. Simply put, CVS satisfied both prongs. CVS implemented various controls, such as an Audit Committee and a Code of Ethics. See Ash v. McCall, No. C.A. 17132,

2000 WL 1370341, at *15 n.57 (Del. Ch. Sept. 15, 2000) ("[T]he existence of an audit committee . . . is some evidence that a monitoring and compliance system was in place."). Additionally, whenever an issue was brought before the Board, it did take corrective action. For example, the Board took action once the problem with the "Lookback" feature was brought to their attention and had the feature enabled across the country.

Plaintiff also argues that the Board members who served on the Audit Committee are exposed to a substantial risk of liability because of their failure to discover the illegal conduct. Plaintiff asserts that it is reasonable to assume that the Audit Committee knew about the lack of procedure for dispensing controlled substances, and that by failing to remedy the situation, the Audit Committee breached their fiduciary duties. However, Plaintiff does not plead with specificity that the Audit Committee actually had any knowledge whatsoever about these lack of procedures. There are no allegations concerning the Audit Committee meeting, who would have been present, or what would have been discussed. Rather, Plaintiff claims that it is "reasonable to assume" that the Audit Committee knew about the lack of protocols. (Pl.'s Opp'n. p. 31). Additionally, the mere fact that an Individual Defendant served on the Audit Committee does not create a substantial likelihood of liability. See Playford v. Lowder, 635 F. Supp. 2d 1303, 1309-10 (M.D. Ala. 2009) (applying Delaware Law) ("[The argument that] certain board members faced a substantial likelihood of liability because they served on . . . the audit[] committee . . . through which they knew or should have known that certain public statements were false and misleading . . . [has] been routinely rejected by Delaware courts."). Thus, it has not been shown with particularity that the members of the Audit Committee face a substantial risk of liability and are considered interested directors.

The sole interested director, therefore, is Defendant Larry J. Merlo, who earns substantial compensation in his role as CVS's CEO and President. See Rales, 634 A.2d at 937 (stating there is reasonable doubt as to a director's ability to be independent when he or she is also an employee). Even so, there remains an independent and disinterested majority of the Board that could have considered a pre-suit demand had such demand been made by Plaintiff. Accordingly, Plaintiff has not pled with particularity facts that would support a conclusion that a pre-suit demand would have been futile.

Additionally, under Delaware General Corporation Law § 102(b)(7), a corporation may limit the monetary personal liability of a director for a breach of their fiduciary duty except for: (1) a breach of the director's duty of loyalty; (2) acts or omissions not in good faith or that involve intentional misconduct or a knowing violation of the law; (3) unlawful payments of dividends or unlawful stock purchase redemptions; and (4) any transaction which a director derived an improper benefit. See Del. Code Ann. tit. 8 § 102(b)(7) (2006). CVS shareholders voted to grant the protections afforded by § 102(b)(7) to the Board and added such protections to CVS's Amended and Restated Certificate of Incorporation. While Plaintiff alleges a breach of the Individual Defendants' fiduciary duties, she does not allege any of the four exceptions to § 102(b)(7). See Laties v. Wise, No. Civ. A. 1280-N, 2005 WL 3501709, at *2 (Del. Ch. Dec. 14, 2005) (dismissing derivative complaint when corporation enacted § 102(b)(7) and complaint failed to assert bad faith, intentional misconduct, or knowing violation of the law). Plaintiff's failure to particularly plead a breach based on one of the four exceptions is sufficient cause in itself to dismiss the complaint.

B

Standing as a Shareholder

Plaintiff alleges in her Complaint that she "is and at all relevant times was, a shareholder of nominal defendant CVS." Plaintiff argues that this language is sufficient to grant standing because it employs the language of the rule requiring contemporaneous ownership of the corporation's stock.[3] Specifically, Plaintiff argues that at this time it is unnecessary to plead with particularity the factual events regarding her ownership of the CVS stock, but rather a blanket statement such as the one provided is sufficient to satisfy standing.

Defendants argue that the conclusory statement employed by Plaintiff is insufficient to confer standing upon a shareholder derivative plaintiff. Defendants assert that it is Plaintiff's duty to set forth the date of stock purchase and state continuous ownership from that date. Defendants point to the fact that the "relevant times" in this instance dates back to at least 2007, when the "MethCheck" system was implemented.

Delaware courts have yet to definitively rule on whether such boilerplate language is sufficient to adequately plead shareholder standing. See Litt v. Wycoff, No. Civ. A. 19083-NC, 2003 WL 1794724, at *11 n.1 (Del. Ch. Mar. 28, 2003) ("presum[ing]" that such boilerplate language confers standing on Plaintiff). Non-Delaware courts have dealt with the issue while purportedly applying Delaware law. See DiLorenzo v. Norton, C.A. No. 07-144 (RJL), 2009 WL 2381327, at *3 (D.D.C. July 31, 2009) (applying Delaware law) (finding boilerplate language insufficient to confer

[3] While it is unclear whether the Rhode Island or Delaware statute controls on this issue, both parties consent to the fact that the two laws are sufficiently similar (Hr'g Tr. 28 & 48-49, June 13, 2013).

standing); In re Verisign, Inc. Derivative Litig., 531 F. Supp. 2d 1173, 1202 (N.D. Cal. 2007) (applying Delaware law) (same); In re THQ, Inc. Derivative Litig., No. BC357600, 2007 WL 4990689, at *7 (Los Angeles County Super. Ct. Oct. 11, 2007) (applying Delaware law) (finding boilerplate language sufficient to confer standing); see also Galdi v. Jones, 141 F.2d 984, 992 (2d Cir. 1944) (holding that an allegation that follows the language of Rule 23(b) is sufficient to survive a motion to dismiss). The Court finds that Plaintiff has not adequately pled her status as a shareholder of CVS during the time of the transaction by merely using the boilerplate language of the rule. Plaintiff offered to supply the Court with the information regarding the stock ownership but failed to do so. Plaintiff's counsel offered, "If Your Honor wants us to divulge when Ms. Gordon became a shareholder, we'd obviously be willing to do that." The Court responded: "If you're willing to do it, sure." (Hr'g Tr. 48, June 13, 2013.) Therefore, in any amended complaint, the Plaintiff must unambiguously indicate the dates she purchased CVS stock, and whether or not she has continuously owned CVS stock from the date of purchase.

V

Conclusion

Based on the foregoing analysis, the Court finds that Plaintiff has failed to allege, with the required particularity, facts that would support a conclusion that pre-suit demand was excused as futile. Additionally, Plaintiff has not asserted proper standing as a shareholder of CVS. Thus, Defendants' motion to dismiss is granted without prejudice. Counsel for the Defendants may present an order consistent herewith.

RHODE ISLAND SUPERIOR COURT
Decision Addendum Sheet

TITLE OF CASE:	**Natalie Gordon v. Thomas M. Ryan, et al.**
CASE NO:	**PB 12-3098**
COURT:	**Providence County Superior Court**
DATE DECISION FILED:	**October 1, 2013**
JUSTICE/MAGISTRATE:	**Silverstein, J.**
ATTORNEYS:	
For Plaintiff:	**Donald A. Migliori, Esq.** **Badge Humphries, Esq.** **Beth A. Keller, Esq.** **Michael J. Hynes, Esq.**
For Defendant:	**William R. Grimm, Esq.** **Adam S. Hakki, Esq.**