IN THE COURT OF CHANCERY OF THE STATE OF DELAWARE

IN AND FOR NEW CASTLE COUNTY

IN RE CAREMARK INTERNATIONAL, INC. DERIVATIVE LITIGATION	)))	Cons. C.A. No. 13670

DEFENDANTS' OPENING BRIEF
IN SUPPORT OF THEIR MOTION TO DISMISS

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NATURE AND STAGE OF THE PROCEEDINGS

On August 5, 1994, the original complaint (the "Complaint") in this derivative action was filed against nominal defendant Caremark International Inc. ("Caremark" or the "Company") and all of the thirteen directors who constitute the current board of directors of Caremark (the "Board" or the "Director Defendants").[1] Shortly thereafter, four additional derivative complaints were filed alleging similar claims against the Director Defendants. On September 14, 1994, plaintiffs submitted an order consolidating the five actions for all purposes and designating the Complaint in the original action (C.A. No. 13670) as the complaint in the consolidated action.

Plaintiffs accuse the Director Defendants of gross mismanagement, waste of corporate assets and associated breaches of fiduciary duty in connection with what plaintiffs describe as "a pervasive and systematic course of conduct involving violations of federal Medicaid and Medicare insurance laws . . . which have caused Caremark (along with certain officers of the Company) to be investigated and indicted by federal authorities." (Comp. ¶ 2). On September 14, 1994, defendants moved to dismiss the Complaint on the grounds that plaintiffs failed to comply with the requirements of Chancery Court Rule 23.1 by neither making a pre-suit demand on Caremark's Board nor pleading particularized facts demonstrating that such a demand would be futile. This is defendants' opening brief in support of their motion to dismiss the Complaint.

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[1]For the convenience of the Court, a copy of the Complaint is attached hereto as Exhibit A. All references herein to the pleadings and other documents filed with the Court in this proceeding are identified by reference to the applicable docket number as "Dkt. __." All references herein to the paragraphs of the Complaint are identified as "Comp. ¶ __." Copies of all unreported opinions cited herein are included in alphabetical order in the compendium filed contemporaneously herewith.

PRELIMINARY STATEMENT

Defendants' motion to dismiss the Complaint in this action involves one of the first applications of the Supreme Court's recent ruling in Rales v. Blasband, Del. Supr., 634 A.2d 927 (1993). As this action does not involve a challenge to a business decision by the Board of Caremark, Rales dictates that the two-part test for demand excusal under Aronson and its progeny will not apply. In order to excuse a pre-suit demand in this context, Rales requires plaintiffs to demonstrate, by particularized allegations of fact in the Complaint, that a majority of the Director Defendants could not adequately consider a demand by plaintiffs for corrective action with respect to the purported wrongs alleged in the Complaint. As will be shown, plaintiffs have not met this heightened pleading standard. A reading of plaintiffs' Complaint reveals that plaintiffs have disregarded completely the requirements of (and the policies behind) Chancery Court Rule 23.1.

The Complaint is based solely on a Wall Street Journal article discussing (i) a recent indictment of Caremark, three of its present or former employees and two other individuals for allegedly violating federal Medicare and Medicaid rules governing payments to doctors, and (ii) three other federal investigations of allegedly improper payments by Caremark. The Complaint was filed only one day after the Wall Street Journal article was published. Plaintiffs conspicuously have failed to name as defendants the Caremark employees and third parties who allegedly have exposed the Company to penalties for supposedly violating the federal health care regulations. Instead, plaintiffs sued the entire Caremark Board, asserting that the Director Defendants are responsible

for the alleged wrongs and purported injuries which may be suffered by Caremark. Plaintiffs have failed to allege with particularity why the Director Defendants are either interested or lack independence to consider a pre-suit demand regarding the matters alleged in the Complaint. Since the Complaint concedes that not one of the thirteen members of the Caremark Board has been indicted or is under investigation for any of the alleged wrongdoings, plaintiffs have not (and cannot) demonstrate demand futility. To give effect to the policy of allowing directors to run the business and affairs of Delaware corporations, plaintiffs' Complaint must be dismissed.

STATEMENT OF FACTS[2]

A. The Parties.

Plaintiffs allegedly own Caremark common stock. (See Comp. ¶ 3).

Nominal defendant Caremark is a Delaware corporation based in Northbrook, Illinois. (Comp. ¶ 4). Caremark was incorporated in August 1992 as a wholly owned subsidiary of Baxter International, Inc. ("Baxter"). On November 30, 1992, Baxter distributed to its stockholders all of the outstanding shares of common stock of Caremark. (Comp. ¶ 5). Caremark is a provider of alternative site health care services, including infusion therapy, growth hormone therapy, and hemophilia therapy. Caremark provides its services in numerous locations in the U.S. and abroad. (Comp. ¶ 4). In fiscal 1993, Caremark's total revenues were approximately $1.78 billion. (Comp. ¶ 4). According to the Company's Form 10-K for the fiscal year ended December 31, 1993, approximately 14% of Caremark's revenues were attributable to Medicare and Medicaid patients. (Id.).

The individual defendants are the thirteen members of the current Caremark Board. (Comp. ¶¶ 6, 8, 21(a)). Plaintiffs concede that ten of the thirteen members of the Board are outside directors who are not employees of Caremark. (See Comp. ¶ 8). Defendant C. A. Lance Piccolo has been Chairman of the Board, Chief Executive Officer and a director of Caremark since 1992. (Comp. ¶ 6). Defendant

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[2]For purposes of their motion to dismiss the Complaint, defendants acknowledge that the Court must accept as true the well-pleaded factual allegations of the Complaint. See, e.g., Rales, 634 A.2d at 931. Conclusory factual and legal allegations, however, are not accepted as true. Id. For the record, defendants dispute vigorously the factual contentions and legal conclusions set forth in the Complaint.

James G. Connelly has been President, Chief Operating Officer and a director of Caremark since 1992. (Id.). Defendant Thomas W. Hodson has been a Senior Vice President, Chief Financial Officer and a director of Caremark since 1992. (Id.). (Defendants Piccolo, Connelly and Hodson are collectively referred to herein as the "Inside Directors"). Defendants Raymond D. Oddi, Peter F. Whitington, Blaine J. Yarrington, Ira J. Harris, Ralph W. Muller, Kenneth N. Pontikes, Nancy G. Brinker, Vincent A. Calarco, Roger L. Headrick and Phillip B. Rooney (collectively, the "Outside Directors") are all directors of Caremark who are not employees of the Company. (Comp. ¶ 8). With the exception of defendant Brinker, who has been a Caremark director since 1993, all of the Outside Directors have been directors of Caremark since 1992. (Id.).[3]

B. Plaintiffs' Allegations of Wrongdoing.

In the Complaint, plaintiffs generally describe supposed wrongdoing by Caremark and certain of its employees and then rely solely upon conclusory and

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[3]The Complaint notes that the Caremark directors receive directors' fees which are taken in the form of stock options. (Comp. ¶¶ 7, 9). According to the Complaint, the Inside Directors hold options to purchase Caremark stock and restricted performance stock subject to, among other factors, annual performance-based vesting conditions. (Comp. ¶ 7). Plaintiffs also note that the Company's March 22, 1994 proxy statement states that the Caremark "pay philosophy" for executives emphasizes "pay-for-performance" incentives with compensation based in part upon pre-tax earnings growth. (Comp. ¶ 7). As to the Outside Directors, the Complaint notes that each Outside Director receives, in lieu of one-third of his annual retainer of $33,000, an option to purchase shares of Caremark common stock and that the Outside Directors may elect to receive Caremark stock options in lieu of all or a portion of the remaining two-thirds of their annual retainer. (Comp. ¶ 9). All of the Outside Directors elected to receive all of their compensation through the date of the 1998 annual meeting of Caremark stockholders in the form of stock options. (Comp. ¶ 9).

unsupported allegations in an attempt to link the Director Defendants to such wrongdoing. (See, e.g., Comp. ¶¶ 11, 13, 14, 20(b), 20(c), 21(a), 21(b)).

1. Allegations of Wrongdoing By Caremark And Its Employees.

Plaintiffs allege that Caremark and certain of its employees violated the federal Medicaid and Medicare insurance laws by paying illegal kickbacks to physicians and hospitals to induce the referral of Medicare and Medicaid beneficiaries for services supplied by Caremark. (Comp. ¶¶ 2, 11). Plaintiffs cite four examples of this alleged illegal conduct which are the predicates for their derivative claims against the Director Defendants. (See Comp. ¶¶ 11-16).

a. The OIG Investigation.

Plaintiffs assert that Caremark was notified in August 1991 that the Office of the Inspector General of the U.S. Department of Health and Human Services ("OIG") and the U.S. Department of Justice were investigating Caremark to determine whether the Company's fee-for-service and other arrangements with physicians and hospitals in connection with infusion therapy services violated federal laws prohibiting payment of remuneration to induce the referral of Medicare and Medicaid beneficiaries (the "OIG Investigation"). (Comp. ¶ 12). Plaintiffs acknowledge that, at the time Caremark was notified in August 1991 of the OIG Investigation, Caremark was a unit of Baxter, the Company had not been incorporated and the Director Defendants were not serving as Caremark directors. (Comp. ¶ 12). Plaintiffs do not allege in the Complaint that the OIG Investigation resulted in any charges being filed against Caremark or any of its directors, officers or employees.

b. The Minneapolis Indictment.

Plaintiffs' principal allegations of wrongdoing center around an August 4, 1994 indictment by a federal grand jury in Minneapolis of two Caremark vice presidents, a former general manager of Caremark, a vice president of Genentech, Inc. and a physician (the "Minneapolis Indictment"). (Comp. ¶ 15). The Minneapolis Indictment charges that Caremark, two of its employees, a former Caremark employee and the Genentech employee conspired to pay over $1.1 million in kickbacks to the physician to induce him to prescribe a synthetic growth hormone produced by Genentech. (Comp. ¶ 15). The indictment was based on conduct that allegedly occurred between 1986 and 1994. (Comp. ¶ 15). No other information concerning the Minneapolis Indictment is provided by plaintiffs. Plaintiffs concede in the Complaint that none of the Director Defendants were named as defendants or otherwise implicated in the Minneapolis Indictment. (See Comp. ¶ 15).

c. The Ohio Investigation.

The balance of plaintiffs' allegations with respect to alleged wrongful conduct by Caremark employees are based exclusively on a Wall Street Journal article which appeared on August 4, 1994 (the "Journal Article"), the day before the Complaint was filed. (See Comp. ¶ 16).[4] Plaintiffs allege that the Journal Article reported that federal investigators were investigating alleged "payoffs" by Caremark to a physician in

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[4]The Court may presume that the Journal Article contained a report on the Ohio Investigation and the Joint Venture Investigation. However, the Court should not accept what was reported as true, nor should this Court accept what "federal authorities" purportedly told a Wall Street Journal reporter as true. This double and triple hearsay does not constitute "well-pleaded factual allegations."

Columbus, Ohio (the "Ohio Investigation"). (Comp. ¶ 16). The Journal Article noted that an indictment with respect to this investigation could come within the next few weeks. (Comp. ¶ 16). Plaintiffs allege that the Journal Article also reported that investigators are planing to interview between 100 and 120 doctors in Columbus, Ohio who allegedly received large payments from Caremark. (Comp. ¶ 16). The Journal Article, according to plaintiffs, also revealed that federal authorities foresee pursuing possible civil restitution claims (including possible treble damages) in connection with the Ohio Investigation. (Comp. ¶ 16).

d. The Joint Venture Investigation.

Plaintiffs also allege that the Journal Article reported that the Minneapolis Indictment is separate from another investigation involving a Caremark joint venture at the University of Minnesota Hospital (the "Joint Venture Investigation"). (Comp. ¶ 16). Plaintiffs provide no further information regarding the Joint Venture Investigation.

Plaintiffs infer that the Journal Article indicated that the unspecified "activities being investigated" took place after Caremark was spun-off from Baxter in 1992 since the Journal Article reported that "some of the activities under investigation took place while Caremark was part of Baxter." (Comp. ¶ 16; emphasis in Complaint). Plaintiffs claim that the Minneapolis Indictment and the possibility of further indictments as a result of the ongoing federal investigations "could result in millions of dollars in losses [to Caremark] from criminal fines, civil restitution, and lost revenues from the possible exclusion [of Caremark] from participation in the Medicare and Medicaid programs." (Comp. ¶ 11; see also Comp. ¶ 2).

2. Allegations Of Wrongdoing By The Director Defendants.

As part of their effort to connect the Caremark Directors to the foregoing allegations, plaintiffs allege that the Director Defendants have engaged in gross mismanagement, waste of corporate assets and associated breaches of fiduciary duty by failing to stop a "pattern" of illegal payoffs by Caremark officers and employees from 1992 until at least early-1994. (Comp. ¶¶ 2, 11, 14). Plaintiffs' allegations do not provide any specific instance of wrongdoing committed by any of the Director Defendants. Instead, the Director Defendants' alleged liability is premised on plaintiffs' conclusory allegations that the Director Defendants had knowledge of the "ongoing" OIG Investigation after August 1991 and "failed to stop the pattern of illegal conduct by Caremark officers and employees" which resulted in payments until early-1994 by Caremark to doctors for referring Medicare and Medicaid patients. (See Comp. ¶ 14).

Plaintiffs allege that the Director Defendants, who did not become Caremark Directors until 1992, knew of the alleged illegal conduct as a result of August 1991 notification of the OIG Investigation. (Comp. ¶¶ 6, 8, 12, 14). Plaintiffs assert that, following notification of the OIG Investigation in 1991, "Caremark publicly asserted that it was curbing its practice of making payments to doctors for Medicare and Medicaid patients"; plaintiffs, however, fail to cite any specific statement by Caremark to this effect. (Comp ¶ 14).

Plaintiffs contend that Caremark and the Director Defendants were aware that violations of the Medicare and Medicaid laws could result in criminal fines and civil penalties, including the exclusion of Caremark from participation in the Medicare and

Medicaid programs. (Comp. ¶ 13). Furthermore, plaintiffs assert that defendants disclosed in Caremark's Form 10-K for fiscal year ended December 31, 1992 (the "1992 10-K") that defendants were aware that the imposition of these penalties could have a materially adverse effect on the Company's business, although no specific language is quoted from the 1992 10-K. (Comp. ¶ 13). Plaintiffs note that Caremark's 10-K for the fiscal year ended December 31, 1993 (the "1993 10-K") states (i) that approximately 14% of the Company's $1.783 billion in net revenues in 1993 was attributable to Medicare and Medicaid patients, and (ii) that "there can be no assurance that exclusion from these programs would not adversely affect Caremark's ability to attract and retain non-Medicare and Medicaid business." (Comp. ¶ 13).[5]

Plaintiffs assert in conclusory fashion that the Inside Directors, "concerned only with increasing the Company's short term earnings -- and thereby maximizing their incentive bonuses and the value of their stock options -- failed to exercise proper supervision and control over the Company's operations and practices and directed, encouraged, concealed and/or ratified the unlawful practices that are fully described [in the Complaint]." (Comp. ¶ 7). Plaintiffs further allege, remarkably, that the Outside Directors, due to their receipt of Caremark stock options as director fees, "also had a strong incentive to encourage short term earnings." (Comp. ¶ 9). Plaintiffs offer no particularized facts to support these conclusions.

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[5]Additionally, plaintiffs assert that the 1993 10-K reveals that the exclusion of Caremark from Medicare or Medicaid programs and/or an indictment which has not been dismissed within a 90-day period are events of default under the Company's $150 million bank credit agreement. Plaintiffs acknowledge that no borrowings were outstanding as of December 31, 1993 under this facility. (Comp. ¶ 13).

Plaintiffs allege generally that the Director Defendants breached their fiduciary duties by, among other things, failing to supervise adequately the operations of Caremark, failing to supervise adequately the employees and managers of Caremark (and failing to instruct them to act with honesty and integrity), failing to correct the improper practices referred to in the Complaint, recklessly exposing Caremark to millions of dollars of losses (including the loss of future business opportunities), and failing to institute legal actions against those responsible for permitting Caremark to engage in the alleged illegal conduct. (Comp. ¶ 20). Plaintiffs also assert that each of the Director Defendants, individually or jointly, committed unspecified acts or omissions to act that constituted waste of corporate assets, mismanagement, gross negligence and violations of the Director Defendants' fiduciary duties. (Comp. ¶ 23). Plaintiffs further allege that each Director Defendant breached his duty of care to Caremark by acting on unspecified occasions in a grossly negligent fashion. (Comp. ¶ 28).

Conceding that all of their claims are derivative in nature (Comp. ¶¶ 1, 2, 21), plaintiffs nevertheless commenced this action without making a pre-litigation demand on the Caremark Board. (Comp. ¶ 21).

ARGUMENT

THE COMPLAINT MUST BE DISMISSED FOR FAILURE TO COMPLY WITH RULE 23.1.

In recognition of the "cardinal precept of the General Corporation Law of the State of Delaware ... that directors, rather than shareholders, manage the business and affairs of the corporation," Aronson v. Lewis, Del. Supr., 473 A.2d 805, 811 (1984), Chancery Court Rule 23.1 requires plaintiffs to allege in their Complaint, with particularity, either that they have demanded that the board of directors pursue the corporate claim and the demand has been wrongfully refused or that the making of such a demand is excused because the directors are incapable of making an impartial decision regarding such litigation. Ch. Ct. R. 23.1. As this Court is well aware, "[t]he demand requirement is not a 'mere formalit[y] of litigation,' but rather an important 'stricture[] of substantive law.'" Levine v. Smith, Del. Supr., 591 A.2d 194, 207 (1991) (citation omitted). By filing this lawsuit without making a pre-suit demand, plaintiffs are attempting to deprive the corporation (and its directors) of the right and option to redress alleged wrongs. See Pogostin v. Rice, Del. Supr., 480 A.2d 619, 624 (1984) ("the derivative action impinges on the managerial freedom of directors").

Decisions whether to take action to assert corporate rights and, if so, what action to take are decisions for the board of directors, which governs the corporation on behalf of all the shareholders. See, e.g., Levine, 591 A.2d at 203. The demand requirement, as a fundamental element of this system of corporate governance, is imposed to ensure that in the first instance the board of directors, rather than an individual shareholder or his counsel, makes such decisions after having been given a full and fair

opportunity to investigate and to decide what, if any, action should be taken. See, e.g., Daily Income Fund, Inc. v. Fox, 464 U.S. 523, 531 (1984) (the derivative action "could, if unrestrained, undermine the basic principle of corporate governance that the decisions of a corporation -- including the decision to initiate litigation -- should be made by the board of directors or the majority of shareholders"). As our Supreme Court has noted:

> The purpose of pre-suit demand is to assure that the stockholder affords the corporation the opportunity to address an alleged wrong without litigation, to decide whether to invest the resources of the corporation in litigation, and to control any litigation which does occur.

Spiegel v. Buntrock, Del. Supr., 571 A.2d 767, 773 (1990); accord Kaplan v. Peat, Marwick, Mitchell & Co., Del. Supr., 540 A.2d 726, 730 (1988). Thus, "the demand requirement... exists at the threshold, first to insure that a stockholder exhausts his intracorporate remedies, and then to provide a safeguard against strike suits." Aronson, 473 A.2d at 811-12 (citations and footnotes omitted).

In a traditional derivative action challenging the propriety of an affirmative decision by the directors relating to the challenged transaction, a pre-suit demand will be excused if the plaintiff alleges particular facts creating a reasonable doubt that (i) the directors are disinterested or independent, or (ii) the challenged transaction was otherwise the product of a valid exercise of business judgment. Aronson, 473 A.2d at 814. Although Aronson correctly stresses the importance of the demand requirement (and deference to board decisions regarding the conduct of derivative litigation), the Supreme Court has held that the two-part test for demand excusal articulated in Aronson does not apply in a case where, as here, the derivative complaint does not challenge a business

decision by the board of directors. Rales, 634 A.2d at 933-34. Because the Aronson test for demand futility essentially addresses whether the directors of a corporation have acted in conformity with the business judgment rule in approving a challenged transaction, Rales, 634 A.2d at 933, such an analysis is inapplicable in situations "where the board that would be considering the demand did not make a business decision which is being challenged in the derivative suit." Rales, 634 A.2d at 933-34.

In Rales, the Supreme Court described three principal scenarios in which the Aronson test is inapplicable to determine whether a pre-suit demand would be futile:

> (1) where a business decision was made by the board of a company, but a majority of the directors making the decision have been replaced; (2) where the subject of the derivative suit is not a business decision of the board; and (3) where, as here, the decision being challenged was made by the board of a different corporation.

Rales, 634 A.2d at 934 (emphasis supplied; footnotes omitted). By alleging that the Director Defendants failed to supervise or to correct allegedly improper payment practices by Caremark employees (see Comp. ¶¶ 7, 14, 20), the Complaint does not challenge a "conscious decision" by the Caremark Board. Accordingly, the demand excusal allegations of the Complaint are not subject to the two-part inquiry under Aronson and, instead, must be reviewed under the narrower test set forth in Rales.

In a case (such as this) where the derivative claims do not challenge a business judgment by the defendant directors, Rales dictates that a pre-suit demand will be excused or futile only if ". . . 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. The Supreme Court emphasized in Rales that:

> where directors are sued derivatively because they have failed to do something (such as a failure to oversee subordinates), demand should not be excused automatically in the absence of allegations demonstrating why the Board is incapable of considering a demand. Indeed, requiring demand in such circumstances is consistent with the board's managerial prerogatives because it permits the board to have the opportunity to take action where it has not previously considered doing so.

Rales, 634 A.2d at 934 n. 9. Thus, in order to excuse demand in this case, plaintiffs bear the burden of alleging particularized facts showing that a majority of the Director Defendants could not exercise their disinterested business judgment on a demand for corrective corporate action. Id. at 937. See also Pogostin, 480 A.2d at 624, 626 (the first part of the Aronson test for demand futility requires plaintiff to demonstrate the disqualifying interests or lack of independence of a majority of the directors "at the time the complaint was filed").[6]

As demonstrated below, plaintiffs' conclusory and generalized allegations of demand futility in the Complaint fail to satisfy the particularized pleading requirements of Chancery Court Rule 23.1 and cannot serve to deprive the Caremark Board of its fundamental prerogative to manage the Company's business and affairs.

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[6]The Rales test essentially requires the application of the first prong of the Aronson test to determine whether the board "could have considered a pre-suit demand without being affected by improper influences." See Rales, 634 A.2d at 935 n. 12 (citing Aronson). Accordingly, as in Rales, opinions applying the first prong of the Aronson test to a particular set of facts are cited herein as instructive precedent. See Rales, 634 A.2d at 936-37.

A. Plaintiffs Have Failed To Allege Particularized Facts Creating A Reasonable Doubt That The Director Defendants Have A Disqualifying Interest Regarding The Matters Alleged In The Complaint.

Five subparagraphs in the Complaint purport to explain why plaintiffs failed to make a pre-suit demand on the Caremark Board. (See Comp. ¶ 21 (a) - (e)). All of these allegations, however, fail to create any doubt as to the ability of the Caremark Board to have considered a pre-suit demand regarding the subject of the Complaint "free of personal financial interest and improper extraneous influences." Rales, 634 A.2d at 935 (footnote omitted).

1. Plaintiffs Allege That The Director Defendants Would Have To Sue Themselves.

In the Complaint, plaintiffs assert that:

> (a) The Director Defendants, who are presently all of the members of the Board of Directors, have for some time been aware of the wrongs forming the basis for the claims alleged [in the Complaint] and the materiality of such wrongs (as evidenced by the Company's filings with the Securities and Exchange Commission that were required to be signed by the Director Defendants, in which the Company disclosed the federal investigations alleged [in the Complaint] and the material adverse effect of penalties which could be imposed if the conduct was allowed to continue), but have chosen not to protect Caremark or seek to recover amounts due it and have failed to take action with respect to these claims because any such action would require them to sue themselves, their friends, and their business associates. Prior to the wrongs alleged herein, the Director Defendants also knew (or should have known) of the egregious conduct on the part of Caremark's officers but either affirmatively approved of or acquiesced to such acts.

(Comp. ¶ 21(a)). Essentially, this allegation combines three separate justifications for excusing demand: (1) that the Director Defendants failed to bring suit despite their knowledge of the alleged underlying wrongs; (2) that the Director Defendants are interested in any decision with respect to the alleged underlying wrongs since they would be required to sue themselves, their friends and their business associates; and (3) that the Director Defendants would be interested in a decision with respect to the alleged underlying wrongs since the defendants affirmatively approved of and/or acquiesced to such acts. As the Supreme, this Court and several other courts have held repeatedly, such generalized and conclusory allegations are wholly insufficient to excuse demand.

Plaintiffs' first justification for excusing demand -- that the Director Defendants had knowledge of alleged illegal conduct yet chose not to take action (see Comp. ¶¶ 14, 21(a)) -- was squarely addressed, and rejected, in Allison v. General Motors Corp., 604 F. Supp 1106 (D. Del.) (applying Delaware law), aff'd, 782 F.2d 1026 (3d Cir. 1985). In Allison, plaintiff filed a two count derivative complaint on behalf of General Motors Corporation ("GM") against certain present and former directors of GM. Both counts alleged that the GM directors breached their fiduciary duties by knowingly producing and selling certain GM cars with defective braking systems, concealing the alleged defect, and providing false and incomplete disclosures to a federal government agency and consumers. Allison, 604 F. Supp. at 1111. Defendants moved to dismiss based on Rule 23.1, Fed. R. Civ. P., and plaintiff argued that demand was excused because of defendants' "[f]ailure to bring suit despite knowing for four years

of the alleged underlying wrongs." Id. at 1113. The District Court rejected this argument:

> [T]he GM Board's knowledge of wrongs and failure to institute suit, without more, is inadequate to excuse demand. A general allegation that the Board acquiesced, as signified by its failure to file remedial litigation, is not sufficiently particular to demonstrate demand futility.

Id. (citations omitted). The plaintiff in Allison, like plaintiffs here, failed to "offer some particularized legally cognizable reason why the ... Board is unable to redress the alleged wrong." Id.

This Court also has rejected repeatedly similar "failure to take action" claims. See, e.g., Lewis v. Fites, Del. Ch., C.A. No. 12,566, slip op. at 5-6, Berger, V.C. (Feb. 18, 1993) ("The complaint alleges that Caterpillar's directors have been aware of the alleged wrongs for more than two years but have taken no action because they participated in and approved the alleged wrongs and would have to sue themselves. Allegations of this sort offered as an excuse for failure to make demand have been rejected repeatedly"); Richardson v. Graves, Del. Ch., C.A. No 6617, slip op. at 8-9, Longobardi, V.C. (June 17, 1983) (rejecting the claim that "the corporation's inaction in seeking redress against [four employees found guilty of illegal activities] is proof that a demand would have been futile" because "[s]uch conclusions have no basis in fact and in law"); Stotland v. GAF Corp., Del. Ch., C.A. No. 6876, slip op. at 14, Longobardi, V.C. (Sept. 1, 1983) (rejecting plaintiffs' claim that the "board's failure to seek redress itself prior to the filing of this suit is proof that any demand on the board would have been futile"). Thus, plaintiffs' claim that demand is excused because the Director

Defendants had knowledge of the alleged wrongs but failed to take action must be rejected.

As to plaintiffs' contention that Director Defendants have a disqualifying interest because they would have to sue themselves (see Comp. ¶ 21(a), (c)), the Supreme Court made clear in Aronson that this type of generalized pleading will not excuse demand:

> Plaintiff's final argument is the incantation that demand is excused because the directors otherwise would have to sue themselves, thereby placing the conduct of the litigation in hostile hands and preventing its effective prosecution. This bootstrap argument has been made to and dismissed by other courts. Its acceptance would effectively abrogate Rule 23.1 and weaken the managerial power of directors.

Aronson, 473 A.2d at 818 (citations omitted). Accord Pogostin, 480 A.2d at 625; Lewis v. Fites, slip op. at 5-6; Decker v. Clausen, Del. Ch., C.A. Nos. 10684, 10685, slip op. at 5, Berger, V.C. (Nov. 6, 1989); Grobow v. Perot, Del. Ch., 526 A.2d 914, 924 (1987), aff'd, Del. Supr., 539 A.2d 180 (1988).

Furthermore, plaintiffs' argument that the Director Defendants affirmatively approved of and/or acquiesced in the alleged underlying wrongs (see Comp. ¶ 21(a), (d)), without specific factual allegations supporting such claims, also has been held repeatedly not to excuse demand.[7] For example, in Richardson, the corporation,

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[7]See, e.g., Aronson, 473 A.2d at 817 ("mere directorial approval of a transaction, absent particularized facts supporting a breach of fiduciary duty claim, or otherwise establishing the lack of independence or disinterest of a majority of the directors, is insufficient to excuse demand."); Levine, 591 A.2d at 207-208; Pogostin, 480 A.2d at 625 ("we note that plaintiffs' bootstrap allegations of futility, based on claims of (continued...)

three of its directors and a vice president had been indicted by a federal grand jury and pled nolo contendere to antitrust violations, wire fraud and racketeering. Richardson, slip op. at 1-2. Plaintiff argued that demand was futile because the balance of the directors "'authorized, acquiesced in and/or ratified'" the unlawful conduct. Id. at 2. This Court rejected that argument, finding it significant that a majority of the board was not implicated in the indictments and the lawsuits filed in reaction to the indictments. Id. at 7. The Court also questioned "the use of the terms 'authorized, acquiesced in and ratified,'" stating that such terms "are obviously conclusory." Id. at 8. As the Court stated:

> Where was the corroboration that they authorized, acquiesced in or ratified the illegal conduct? Counsel for the plaintiff could point to no part of the complaint to substantiate the charges.

Id.

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[7](...continued)
directorial participation in and liability for the wrongs alleged, coupled with a reluctance by directors to sue themselves, were laid to rest in "Aronson"); Grobow, 526 A.2d at 924 ("It is now well-settled that an allegation that a majority of directors approved, participated, or acquiesced in a challenged transaction will not, in and of itself, establish demand futility"); Emerald Partners v. Berlin, Del. Ch., C.A. No. 9700, slip op. at 15, Hartnett, V.C. (Dec. 23, 1993) ("mere allegation of participation in the approval of a challenged transaction is insufficient to excuse a pre-suit demand"); Haber v. Bell, Del. Ch., 465 A.2d 353, 359 (1983) ("[a]llegations that the members of a Board of Directors 'approved or acquiesced in' the action which plaintiffs attack are ... not sufficient to excuse a demand for redress before suit"); Kaufman v. Beal, Del. Ch., Cons. C.A. Nos. 6485, 6526, slip op. at 9, Hartnett, V.C. (Nov. 3, 1983) ("mere allegations of approval of a challenged transaction or participation by directors in alleged wrongful conduct, absent a showing of self interest or bias by a majority of the Board, have been held to be insufficient to excuse a demand"); Kaufman v. Belmont, Del. Ch., 479 A.2d 282, 288 (1984).

Of course, the "acquiescence" allegation in the Complaint falls far short of the deficient demand excusal argument in Richardson because plaintiffs in this case concede that none of the Director Defendants are the targets of the government investigations. Similarly, as in Richardson, the Complaint does not contain a specific allegation that any of the Director Defendants acquiesced in the allegedly illegal activities which are the subjects of the government investigations involving certain of Caremark's operations. Accordingly, plaintiffs' "acquiescence" argument is wholly inadequate to excuse demand.

2. Plaintiffs Assert the Director Defendants Participated In The Alleged Underlying Wrongs.

In the Complaint, plaintiffs allege:

> (b) The Director Defendants participated in, acquiesced and/or approved the wrongs alleged [in the Complaint] and did so in affirmative violation of their duties to Caremark and its stockholders and have permitted the wrongs alleged and/or have remained inactive although they have long had knowledge of those wrongs. The Directors Defendants therefore participated in the long-term continuing course of corporate misconduct and mismanagement.

(Comp. ¶ 21(b)). Although this statement is repetitious of paragraph 21(a) of the Complaint in many respects, plaintiffs generally allege in paragraph 21(b) that the Director Defendants could not adequately consider a demand since they participated in or permitted the alleged wrongs. The Complaint, however, is completely devoid of any factual support for plaintiffs' claim that the Director Defendants "participated in the long-term continuing course of corporate misconduct and mismanagement." Plaintiffs simply rely on baseless assertions that the Director Defendants had knowledge of the alleged

underlying wrongs and allowed them to continue (presumably to increase the value of the Director Defendants' stock options). (See Comp. ¶¶ 2, 7, 9, 11, 14).

"As this Court has stated before, stockholders bringing claims on behalf of a corporation must realize that futility cannot be evidenced by boiler-plate allegations devoid of pertinent factual support." Stotland, slip op. at 16-17. In Allison, like here, plaintiff in conclusory terms alleged that demand was excused because the individual defendants, "as members of the GM Board, participated in the underlying wrongs, i.e., the decision to manufacture and sell X-cars with . . . false and incorrect information to the government and the public." Allison, 604 F. Supp at 1114. In rejecting this argument, the District Court stated:

> [U]nless a plaintiff makes sufficiently particular allegations of participation, self-dealing, bias, bad faith, or corrupt motive, failure to make a demand will not be excused. Plaintiff has not made particular allegations of this nature. The mere fact that plaintiff names members of the Board of Directors as defendants or even makes conclusory allegations of director wrongdoing does not suffice to excuse demand.

Id. (citation omitted).

There are no particular allegations in the Complaint describing how the Director Defendants "participated" in the alleged underlying wrongs -- the supposed payment of illegal kickbacks -- or even approved of such conduct. In fact, in plaintiffs' descriptions of the OIG Investigation, the Minneapolis Indictment, the Ohio Investigation and the Joint Venture Investigation, there is no mention whatsoever of any Caremark director being named, implicated, charged, indicted or even investigated. Plaintiffs

merely rely on conclusory allegations that the Director Defendants knew of the alleged unlawful conduct and permitted it to occur.

As discussed above at pages 19-21, conclusory allegations that directors affirmatively approved and participated in alleged wrongdoing are insufficient to excuse demand. Not surprisingly, mirror image allegations that the directors failed their oversight duties or otherwise failed to prevent wrongdoing by the corporation have been held repeatedly to be insufficient to excuse demand. For example, in Shields v. Erickson, 710 F. Supp. 686, 687 (N.D. Ill. 1989), plaintiffs alleged that demand was excused because the directors failed to maintain a system of internal financial controls which would have prevented the corporation from incurring $127.3 million in fines and from being suspended from receiving new defense contracts as a result of fraudulently overcharging the federal government, paying bribes to government personnel and taking improper tax write-offs. The District Court determined that plaintiffs had not alleged sufficiently that a presuit demand would have been futile:

> All the directors are accused of the same kind of participation in the wrongdoing: approving or acquiescing in the alleged misdeeds and permitting the corporation to operate with insufficient accounting controls. There are no specific allegations of self-dealing as to any directors, or that the directors have personally benefitted from the illegal activities, or that any director is criminally culpable. At most, the directors are accused of negligence. This is insufficient to subject any director to criminal liability or to demonstrate that the directors would not consider a claim for relief.

Id. at 692 (emphasis added). Accord Citron v. Daniell, 796 F. Supp. 649 (D. Conn. 1992) (finding allegations of the directors' failure to maintain adequate internal financial

controls insufficient to excuse demand despite allegations that United Technologies engaged in bribery and other illegal practices to procure defense contracts).

As in Shields and Citron, plaintiffs in this case seek, in effect, to impose a per se rule that, whenever corporate employees engage in wrongdoing resulting in indictment or similar action against a company, board members could potentially be liable for failure to "adequately supervise" those employees, and the board is therefore not in a position to respond to a demand. However, plaintiffs must plead particularized facts to support their contention that the Director Defendants -- who are not even accused of knowledge or acquiescence or participation in the alleged wrongful acts -- are nonetheless disabled from determining what, if any, remedial action should be taken by the Company. Because plaintiffs' allegations in the Complaint fail to demonstrate that any of the Director Defendants have any disqualifying personal interest relating to the activities pertinent to the government investigations, the motion to dismiss should be granted in all respects. See also, Mozes v. Welch, 638 F. Supp. 215, 219-23 (D. Conn. 1986) (refusing to excuse demand despite guilty plea by General Electric to defrauding the federal government); In re E. F. Hutton Banking Practices Litig., 634 F. Supp. 265, 270-73 (S.D.N.Y. 1986) (refusing to excuse demand despite the company's guilty plea to 2,000 charges of mail and wire fraud resulting in the company incurring fines and costs of approximately $11 million).

3. Plaintiffs Allege That The Director Defendants Have a Conflict of Interest.

As another justification for plaintiffs' failure to make a demand, the Complaint contains the general allegation that:

> (c) Because of their participation in the mismanagement of Caremark, the Director Defendants are in no position to prosecute this action. Each of them is in an irreconcilable conflict of interest regarding the prosecution of this action, and cannot exercise the requisite independence to make good faith business judgments.

(Comp. ¶ 21(c)). Essentially, plaintiffs' argument is that the Director Defendants have a disqualifying conflict of interest (or some self-interest) in a decision regarding the subjects of plaintiffs' Complaint. However, plaintiffs have not attempted to plead what that self-interest may be beyond the conclusory allegations that the Director Defendants would have to sue themselves.

Delaware law is well-settled that plaintiffs' incantation that the Director Defendants have a "conflict of interest" -- presumably because they are threatened with the possibility of personal liability for their "participation in the mismanagement of Caremark" -- cannot serve to show a disqualifying personal interest and thus excuse demand. See e.g., Stotland, slip op. at 16 ("Bare claims of potential personal liability of the GAF board members are insufficient" [to excuse demand]); Haber, 465 A.2d at 358 (rejecting claim that defendant directors could not adequately consider a demand because they were potentially "liable for the injurious transactions").[8]

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[8]In response to a variation of this argument in which plaintiffs claimed that the defendant directors had a conflict of interest because the company's insurer would not cover the directors' liability in a suit brought by the company, then-Vice Chancellor Berger stated:

> Decker's allegation that BAC's liability insurance would not cover an action brought by the company against its own directors and the allegation that the directors recommended a charter amendment limiting their liability are but

(continued...)

Plaintiffs may attempt to find support for their conclusory claims of demand futility in the Supreme Court's recent pronouncement in Rales that:

> Directorial interest also exists where a corporate decision will have a materially detrimental impact on a director, but not on the corporation and the stockholders. In such circumstances, a director cannot be expected to exercise his or her independent business judgment without being influenced by the adverse personal consequences resulting from the decision.

Rales, 634 A.2d at 936. This language from Rales fails to bolster plaintiffs' claims in this case for several reasons. First, plaintiffs have not described at all (much less with the requisite particularity mandated by Rule 23.1) how a decision as to the alleged underlying wrongs would have a "materially detrimental impact" on the Director Defendants. The Complaint acknowledges that none of the thirteen Director Defendants has been indicted or is under investigation for the alleged payment of illegal kickbacks. Thus, a suit to recover damages on behalf of Caremark against those responsible for any such improprieties would not be detrimental to the Director Defendants. Second, the finding of director interest in Rales was predicated on the Supreme Court's acceptance of a Third Circuit finding that plaintiff had raised a reasonable doubt as to the applicability of the business judgment rule to the approval of the challenged transaction by certain of the director defendants. Based solely upon that binding determination, the

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[8](...continued)

> variations on the "directors suing themselves" and "participating in the wrongs" refrain. They provide no particularized facts creating a reasonable doubt that the directors are disinterested or independent.

Decker, slip op. at 6.

Supreme Court concluded that pre-suit demand was excused, in part, because the liability of certain of the director defendants in that case was more than a "mere threat" and might be a "substantial likelihood." Rales, 634 A.2d at 936.

Here, unlike in Rales, there has been no preliminary assessment of the Director Defendants' potential liability. Indeed, the Complaint pales in comparison to the allegation in Lewis v. Fites that demand was excused because the Caterpillar directors faced the risk of personal liability due to the entry of a SEC consent order establishing federal securities law violations by the corporation. Since the SEC consent order did not contain any findings as to the directors, then - Vice Chancellor Berger found that the directors did not face the "substantial likelihood" of liability required to excuse demand. Slip op. at 6. Of course, since the Director Defendants have not even been named in connection with any of the government investigations, the Director Defendants cannot be deemed to be "interested" due to the risk of personal liability.

Moreover, apart from a few woefully conclusory allegations, plaintiffs have utterly failed to connect the alleged illegal conduct by a handful of Caremark employees (which is the subject of plaintiffs' derivative lawsuit) to any specific acts or omissions by the Caremark Board. Plaintiffs' conclusory, unsupported allegations regarding the Director Defendants' liability exposure must be disregarded in determining whether pre-suit demand is excused:

> Moreover, upon a motion to dismiss [under Rule 23.1], only well-pleaded allegations of fact must be accepted as true; conclusory allegations of fact or law not supported by allegations of specific fact may not be taken as true. A trial court need not blindly accept as true all allegations, nor

> must it draw all inferences from them in plaintiffs' favor unless they are reasonable inferences.

Grobow v. Perot, Del. Supr., 539 A.2d 180, 187 (1988) (emphasis supplied). Thus, plaintiffs' Complaint, which only contains conclusory allegations unsupported by particularized facts, must be dismissed.[9]

4. Plaintiffs Allege That The Director Defendants Have Acted With Gross Negligence And Have A Pecuniary Interest In A Decision Regarding The Alleged Wrongs.

In a further effort to excuse their failure to make a pre-suit demand, plaintiffs allege that:

> (d) The Director Defendants cannot defend their actions by any alleged "independent" business judgment since each of them is responsible for the wrongs alleged, has acted with gross negligence, and would have a personal pecuniary interest adversely affected if an action were brought, since each would be required to sue himself.

(Comp. ¶ 21(d)). Consistent with the rest of the Complaint, plaintiffs fail to describe specifically how the Director Defendants have a "personal pecuniary interest" in a decision concerning how to deal with the alleged illegal conduct described in the Complaint. There are no allegations whatsoever in the Complaint (nor could there be)

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[9]Plaintiffs also state in conclusory fashion that the Director Defendants "cannot exercise the requisite independence" with respect to a demand regarding the alleged underlying wrongs. (Comp. ¶ 21(c)). To establish lack of independence, plaintiffs must show that the Director Defendants are beholden to another person or so under that person's influence that the directors' discretion would be sterilized. Rales, 634 A.2d at 936. The Complaint, however, does not even begin to suggest that any member of the Caremark Board -- much less a majority of the Director Defendants -- is incapable of acting independently of any third party. (See Comp. ¶¶ 6,8,21). Plaintiffs' allegations in this respect boil down to the same, well-worn "sue themselves" refrain which, as discussed above, is insufficient to excuse demand.

that the Director Defendants would receive some personal pecuniary benefit by making a decision not to pursue the derivative claims.[10] Moreover, as demonstrated above, plaintiffs' tiresome "sue themselves" refrain does not establish a disqualifying interest on the part of the Director Defendants. See, supra, p. 19.

Indeed, the only allegation of interest directed at the Outside Directors -- who comprise a large majority of the Board -- relates to their receipt of director fees which they have elected to receive in the form of options to purchase Caremark stock. (Comp. ¶ 9). This allegation of interest is also insufficient as a matter of law. See, e.g., Grobow, 539 A.2d at 188 (allegations that directors are paid for their services as directors "do not establish any financial interest"); Decker, slip op. at 6, ("The fact that they receive salaries for serving as directors ... is insufficient to excuse demand"); Lewis v. Straetz, Del. Ch., C.A. No. 7859, Hartnett, V.C. (Feb. 12, 1986); Moran v. Household Int'l, Inc., Del. Ch., 490 A.2d 1059, 1074-75, aff'd, Del. Supr., 500 A.2d 1346 (1985).

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[10]See, e.g., Pogostin, 480 A.2d at 624 ("[d]irector interest exists whenever divided loyalties are present, or a director either has received, or is entitled to receive, a personal financial benefit from the challenged transaction which is not equally shared by the stockholders") (citation omitted); Cede & Co. v. Technicolor, Inc., Del. Supr. 634 A.2d 345, 362 (1993) ("a director who receives a substantial benefit from supporting a transaction cannot be objectively viewed as disinterested or independent"); Grobow, 539 A.2d at 188 ("[i]n order to satisfy Aronson's first prong involving director disinterest, plaintiffs must plead particularized facts demonstrating either a financial interest or entrenchment of the part of the GM directors").

5. Plaintiffs Allege That It Would Be To The Director Defendants' Detriment To Sue.

In a final effort to justify their failure to make a demand before filing the Complaint, plaintiffs assert that demand is excused because:

> (e) The directors of Caremark cannot defend their actions by any alleged "independent" business judgment in seeking to have this action dismissed or by not bringing this action against themselves and their business associates, because it would undoubtedly be to the benefit of Caremark and to the detriment of the Defendant Directors to recover the damages caused by the defendants and to assert these derivative claims.

(Comp. ¶ 21(e)). In short, plaintiffs' final purported basis for excusing demand is their conclusory assertion that it would be "to the detriment" of the Director Defendants to assert the derivative claims set forth in the Complaint. Id. This is but another variation (and a slight variation at that) of the frequently-rejected argument that the threat of personal liability disqualifies directors from considering a demand. This is not the law of Delaware. See, e.g., Pogostin, 480 A.2d at 625 ("bootstrap allegations of futility, based on claims of ... liability for the wrongs alleged, coupled with a reluctance by directors to sue themselves, were laid to rest in Aronson"). Moreover, plaintiffs' "likelihood of liability" allegations are even more glaringly insufficient where, as here, none of the Director Defendants is alleged to be responsible for the underlying wrongs. See, e.g., Lewis v. Fites, slip op. at 6 (purportedly heightened threat of the directors' personal liability from entry of SEC consent order did not excuse demand where "Consent Order does not contain any admission of wrongdoing and does not include any findings concerning Caterpillar's directors"). Thus, plaintiffs have pleaded no

particularized facts showing why the Director Defendants are disqualified or otherwise incapable from considering a demand in accordance with their fiduciary duties.

CONCLUSION

For all of the foregoing reasons, defendants respectfully request that their motion to dismiss plaintiffs' Complaint pursuant to Chancery Court Rule 23.1 be granted in all respects and the Complaint be dismissed with prejudice.

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