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IN THE COURT OF CHANCERY OF THE STATE OF DELAWARE
IN AND FOR NEW CASTLE COUNTY

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

PLAINTIFFS' BRIEF IN OPPOSITION TO DEFENDANTS' MOTION TO DISMISS

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NATURE AND STAGE OF THE PROCEEDINGS

On August 5, 1994, plaintiffs commenced two derivative actions (later consolidated under the above caption) following the announcement of several grand jury indictments of Caremark International Inc. ("Caremark" or "the Company") and its senior officers for violations of the federal laws prohibiting, inter alia, the payment of "kickbacks" by healthcare providers to physicians in return for patient referrals.

Since the initial filings, plaintiffs' consolidated complaint has twice been amended and supplemented to include additional facts that have come to light concerning the pervasiveness of Caremark's kickback scheme and the ever-increasing number of investigations and lawsuits that have ensued.

On January 13, 1995, defendants jointly moved to dismiss plaintiffs' Second Amended Complaint ("Defendants' Motion"). On January 25, 1995, they filed Defendants' Opening Brief in Support of Their Motion to Dismiss Plaintiffs' Second Amended Complaint ("Defendants' Opening Brief" or "Def. Br.").

On February 23, 1995, "PrimeTime Live" broadcast the results of an ABC News investigation of Caremark's kickback scheme, aptly titled "Dollars for Doctors." As a result of the facts presented in that program, Caremark's recently-filed Form 10-K for the year ended December 31, 1994 (the "1994 10-K") and other recently disclosed facts about Caremark's nationwide kickback scheme, plaintiffs are now seeking leave of this Court to file

their Third Amended and Supplemental Complaint (the "Complaint"),[1] from which certain of the facts presented in this brief are derived.

Plaintiffs respectfully request that the Court favorably consider their Motion for Leave to Amend the Second Amended Complaint, while denying Defendants' Motion.

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[1] The filing of amended and supplemental complaints to supplement original claims with newly disclosed information is governed by Chancery Court Rule 15(d), not Rule 15(a) as defendants contend. See, Def. Br. at 41. Rule 15(d) amendments are liberally granted. Norm Gershman's Things to Wear Inc. v. Dayon, Del. Ch., C.A. No. 11733, Chandler, V.C. (Dec. 8, 1992); Citron v. Lindner, Del. Ch., C.A. No. 6150, Berger, V.C. (Nov, 13, 1985).

PRELIMINARY STATEMENT

Since August 1991, Caremark has been the target of one of the largest medical fraud investigations in the history of the U.S. Department of Justice ("DOJ") and the Office of the Inspector General of the Department of Health and Human Services ("HHS-OIG"). The investigation arises from Caremark's illegal practice of directly and/or indirectly paying kickbacks to doctors in return for patient referrals.

Caremark was spun-off from Baxter International, Inc. ("Baxter") in November 1992 (the "spin-off"), after the HHS-OIG investigation and the related criminal proceedings described below were in full force. By the time of the spin-off, Caremark's board of directors (the "Board" or the "Director Defendants") knew that (i) the Company's widespread "fee for services" arrangements with physicians were of questionable legality under federal and state anti-kickback laws; (ii) indictments and investigations, among other things, evidenced that the Company was nevertheless continuing with such arrangements until as recently as late 1994; and (iii) civil and criminal penalties available under the federal anti-kickback laws -- including the loss of over $130 million in Medicare and Medicaid revenues in 1991 alone -- would have a materially adverse effect on Caremark's business. Indeed, the Director Defendants specifically acknowledged these risks in Caremark's Form 10-K for the year ended December 31, 1992 (the "1992 10-K") and in almost every subsequent Caremark public filing since the spin-off.

Moreover, Caremark's former president and Chief Executive Officer ("CEO") and its current Chairman and CEO each have publicly

affirmed that Caremark would terminate or modify its "fee for services" arrangements. Despite these public promises, however, Caremark's illegal kickback arrangements have continued on a nationwide scale under the Board's knowing eyes. The adverse impact this continuing illegality will have on Caremark's business has yet to fully unfold.[2/]

The Director Defendants' knowledge of the grave consequences attendant to Caremark's illegal kickback arrangements, coupled with their failure to honor Caremark's public commitments to discontinue such arrangements, demonstrates that they consciously permitted the kickback arrangements to continue, or recklessly disregarded the consequences of those practices. As demonstrated below, the Board's intentional or reckless conduct was "so extreme or curious as to itself raise a legitimate ground to justify further inquiry and judicial review" (Kahn v Tremont Corporation, Del. Ch., C.A. No. 12339, Allen, C. (April 22, 1994), slip op. at 16); and will not be protected under Caremark's charter provision adopting 8 Del. C. §102(b)(7). As a result, there is a substantial likelihood that the Director Defendants will be found liable for their misconduct. Accordingly, demand should be excused, and Defendants' Motion should be denied.

2/ Contrary to defendants' contention (Def. Br. at 1, 41-43), it is the continuing new revelations about Caremark's widespread kickback schemes -- which already involve over a dozen cities across the country -- and the resulting indictments, class action lawsuits, and state and federal investigations, that have caused plaintiffs to supplement the initial complaint twice between August and December 1994, and to request leave of this Court to file their Third Supplemental Complaint.

STATEMENT OF FACTS

A. Caremark And Its Board

Caremark is a health care company which specializes in providing alternatives to in-patient hospital care. Comp. ¶8. One of Caremark's former specialties was its home infusion business, which in 1994 accounted for $291 million or 12% of Caremark's revenues. Comp. ¶16.[3/] Caremark derived most of its patient care revenues, including revenues from its home infusion business, from third party payors, such as Medicare and Medicaid. Comp. ¶16.

The Caremark Board had thirteen members at the time the initial complaints in this consolidated action were filed. Three Director Defendants are officers of the Company: C.A. Lance Piccolo ("Piccolo"), Caremark's Chairman of the Board and Chief Executive Officer since August 1992; James G. Connelly, III ("Connelly"), Caremark's President and Chief Operating Officer since August 1992; and Thomas W. Hodson ("Hodson"), Caremark's Senior Vice President and Chief Financial Officer since August 1992. Comp. ¶13. These Director Defendants were senior employees of Baxter prior to the spin-off. The remaining Director Defendants, except Nancy G. Brinker ("Brinker"), have served as Caremark directors since 1992.[4/] Brinker joined the Board in 1993. Id.

[3/] Home infusion therapies involve, among other things, intravenous feeding for patients unable to ingest or absorb nutrients due to gastrointestinal illness. Comp. ¶9.

[4/] Defendant Oddi was previously a senior vice president and chief financial officer of Baxter. Defendant Yarrington was on Baxter's board of directors from 1988 to 1992. Comp. ¶12.

B. Caremark's Scheme To Circumvent Laws Prohibiting Kickbacks To Physicians

In November 1987, Congress enacted the Omnibus Budget Reconciliation Act of 1987, which made it unlawful for physicians to receive direct or indirect fees (i.e., kickbacks) for referring patients to health care providers (such as Caremark) or for prescribing a specific drug company's product to patients (the "Medicare Referral Payments Law"). Comp. ¶¶ 18-19. At about the same time, state statutes and regulations were enacted to prohibit payments to physicians for referring patients to health care providers with whom they have a financial relationship. Comp. ¶20.

Some time after the Medical Referral Payments Law was enacted, and continuing until at least late 1994, Caremark embarked upon a company-wide (and thus nationwide) scheme to increase its revenues by circumventing federal and state laws prohibiting the payment of kickbacks to physicians in return for patient referrals. Comp. ¶2. Specifically, Caremark engaged in a systematic course of paying doctors for referring Medicare and Medicaid patients to Caremark and for prescribing drugs that were distributed by Caremark at highly inflated prices. Comp. ¶¶2, 35-42, 45-78.

These "fees for services" arrangements with doctors throughout the country became the subject of a wide ranging investigation by the HHS-OIG in August 1991, shortly after "safe harbor" regulations under the Medicare Referral Payments Law were issued to identify appropriate business relationships among physicians and health care providers. Comp. ¶ 21. By August 1991, the HHS-OIG had issued subpoenas to Caremark for 800 contracts

between Caremark and physicians, and a federal grand jury had been empaneled. Comp. ¶ 22.

In response, on September 9, 1991 Caremark spokesmen including Charles Blanchard, Caremark's President and CEO at that time, announced that Caremark was discontinuing home care to Medicaid and Medicare patients because "[t]he regulations [under the Medicare Referral Payments Law] are drawn very narrowly, and do not address physician involvement in home care." Comp. ¶ 24.

C. The Director Defendants Take Office With Knowledge of Caremark's Wrongdoing

Caremark was spun-off from Baxter on November 30, 1992, at which time the Director Defendants (except Ms. Brinker) became members of the Board. Comp. ¶ 27.

By the time of the spin-off, the Director Defendants were aware of: (i) the on-going HHS-OIG investigation; (ii) the onerous civil and criminal sanctions that the Company and its representatives could face for violating the Medicare Referral Payments Law; (iii) the material adverse effect that the HHS-OIG investigation and resulting indictments could have on the Company's business operations; and (iv) the fact that Caremark had publicly committed to discontinue its illegal arrangements with physicians. Comp. ¶27. This knowledge is confirmed by Caremark's 1992 10-K, signed by all Director Defendants, except Brinker, in which the Director Defendants admit that:

> The OIG and the Department of Justice are investigating Caremark to determine whether Caremark's fee-for-service and other arrangements with physicians and hospitals (the federal law prohibiting the payment of remuneration to induce the referral of

> Medicare and Medicaid patients). Caremark has received several document requests from the OIG and the Department of Justice. Civil penalties for violating the Medicare Referral Payments Law include exclusion from participation in the Medicare and Medicaid program. Criminal penalties could include fines of up to $25,000 per violation or up to five years imprisonment, or both, subject to increases under the Federal Organizational Sentencing Guidelines. If imposed, such penalties could have a material adverse effect on Caremark's business. The outcome of this investigation is not presently determinable. Growth in sales slowed following initial publicity related to this investigation as well as reported investigations of others. Based on these changes and discussions with customers, Caremark believes that this publicity has adversely affected revenues from certain patient care services and may continue to do so. (Emphasis added)

Comp. ¶28.[5/]

The Director Defendants have never denied the merits of the HHS-OIG investigation. They also have refused to provide public assurance that Caremark had not violated the Medicare Referral Payments Law, and have expressly acknowledged that Caremark's "fee for services" payments put the Company at risk:

> No assurance can be given that the OIG or the United States Department of Justice will not seek a determination that Caremark's past or current policies and practices regarding contracts and relationships with healthcare providers violate the Medicare Referral Payments Law and no assurance can be given that Caremark's interpretation of these laws will prevail if challenged. A determination that contracts and relationships entered into by Caremark violate the Medicare Referral Payments Law could have a material adverse effect on the business of Caremark. (Emphasis added.)

[5/] The Director Defendants have reviewed and approved similar disclosures concerning the HHS-OIG investigation in virtually all of the Company's filings from 1992 to the present. See Comp. ¶ 29-33.

Caremark has, however, through its present and former CEO's, publicly committed to terminating or modifying its "fee for services" arrangements on at least two separate occasions. Comp. ¶¶ 24, 79.

Despite these public commitments, indictments and civil proceedings instituted thus far indicate that "fee for services" arrangements continued on a widespread basis at Caremark until at least late 1994. These indictments and civil actions, which are described below, appear to be just the tip of an iceberg only beginning to surface.

D. **The Minnesota Federal Grand Jury Indictment**

On August 4, 1994, a grand jury in Minneapolis indicted Caremark, Company vice presidents James R. Mieszala ("Mieszala") and Joseph L. Herring ("Herring"), and a former general manager, Judy F. Giel ("Giel"). Comp. ¶45. The fifty-one count indictment (the "Minnesota Indictment") charged Caremark, Mieszala, Herring, Giel and others with conspiring to pay over $1.1 million in kickbacks to Dr. David R. Brown ("Dr. Brown") to induce him to unnecessarily prescribe Protropin, a synthetic growth hormone produced by Genentech, Inc. and marketed by Caremark at inflated prices. Comp. ¶45. As was typical of Caremark's illegal arrangements, the kickbacks to Dr. Brown were disguised as grants for fictitious medical studies and for other phony services. Comp. ¶45. Most importantly, the Minnesota Indictment makes clear that Caremark's illegal activity continued at the Company's highest management levels until some time in 1994 -- well after the

Director Defendants became aware of the widespread "fee for services" arrangements.

The Minnesota Indictment implicates Caremark's prior CEO, Blanchard, and describes incriminating memoranda and other documents that originated at Caremark's Chicago headquarters as late as 1993. Comp. ¶46. Among the incriminating documents is a report entitled "Return on the Investment in Research Grants -- An Analysis of Caremark Inc." (the "Research Grants Report"). The Research Grants Report analyzes the return which Caremark enjoys for every dollar invested in purported research, concluding that Caremark received $6.55 for each "research" dollar invested. In another document, Herring explicitly stated that 150 referrals would result in a $50,000 "research grant." Comp. ¶47.

On November 24, 1994, the federal indictment against Dr. Brown was expanded to include charges of defrauding Medicaid, Medicare, John Hancock Insurance Co., and Aetna Insurance Co. of $391,152. Comp. ¶51. Caremark's potential liability relating to the Minnesota Indictment alone is reported to be $12 million. Comp. ¶52. The Wall Street Journal has reported that the investigation was also expanded to include between 100 and 120 additional doctors who had received large payments from Caremark through 1994. Comp. ¶50.

At least two class action lawsuits arising from the illegal Protropin scheme have been commenced by Protropin patients on behalf of hundreds of other patients and their health maintenance organizations against Caremark. These lawsuits allege that the during the period of 1986 until the present, Caremark paid Dr. Brown millions of dollars which were falsely masked as research

grants, consulting fees, marketing agreements and other things, to prescribe Protropin at exceedingly inflated prices. Comp. ¶83(b).

E. The University of Minnesota Hospital Investigation [6/]

In October 1993, it was publicly disclosed that Caremark was the subject of a governmental inquiry arising from its joint venture with the University of Minnesota ("UM") Hospital. Comp. ¶¶35-41. Caremark was using this joint venture to funnel monies to doctors in UM's home infusion program through a non-profit corporation called Physician Managed Care ("PMC") that was set up to mask the illegality of the "kickback" arrangement. Comp. ¶36. In violation of the Medicaid and Medicare laws, the contract between Caremark and PMC provided that the doctors were to receive 18% of all revenues. Comp. ¶¶37-38.

In less than three years -- and continuing well after the Director Defendants became aware of Caremark's illegal practices -- Caremark pulled in a profit of $17 million under the illegal

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6/ Defendants' contention that the Court should ignore factual allegations which are derived from newspaper stories as "double and triple hearsay" is meritless and, in any event, premature. Compare Def. Br. at 11-12 n.4 with Lewis v. Curtis, 671 F.2d 779, 787-88 (3d Cir. 1982), cert. denied, 459 U.S. 880 (1982) (District Court abused discretion by refusing to permit amendment of complaint to include facts from an article in The Wall Street Journal). All factual allegations must be accepted as true for purposes of determining whether the complaint states a claim, regardless of the source of the allegations or their evidentiary support. See Heineman v. Datapoint Corp., Del. Supr., 611 A.2d 950, 953 (1992) ("At this juncture, the Court is not engaged in a weighing of evidence"). Only at the summary judgment and trial stages should the Court consider whether proffered evidence has the earmarks of trustworthiness to permit its admission under the rules of evidence. See and compare In re Columbia Securities Litigation, 155 F.R.D. 466, 474-479 (S.D.N.Y. 1994) (statements reported in Forbes and Reuters admissible on summary judgment); United States Football League v. NFL, 1986-1987 Trade Cas. (CCH) ¶ 67,101 (S.D.N.Y. May 16, 1986) (article inadmissible on summary judgment to prove truth of allegations about NFL).

referral arrangement and the UM's doctors received another $3 million. Comp. ¶37. The doctor who negotiated the illegal joint venture on behalf of the UM, Dr. Randall Moore, was rewarded by Caremark for his illegal conduct with a position as medical director at Caremark's Chicago headquarters. Comp. ¶41.

On March 2, 1995, the University of Minnesota announced the results of an audit of the joint venture arrangement. The audit concluded that the joint venture was not protected under the federal "safe harbor" rules and that it was uncertain whether regulatory authorities or a Court would determine the joint venture arrangement to be "legally defensible." Comp. ¶43.

F. The Ohio Federal Investigation, Grand Jury Empanelment and Criminal Indictment

On August 4, 1994, The Wall Street Journal reported that federal investigators in the Columbus, Ohio area were scrutinizing doctors who had received regular "payoffs" from Caremark during 1991 through 1994, resulting in a pending grand jury indictment. Comp. ¶53. This was confirmed on September 20, 1994 when a federal grand jury in Columbus indicted a doctor on charges that he accepted $134,600 in kickbacks from a "home infusion company" for the referral of patients from 1991 through September 1994. Comp. ¶53.

The unnamed company has been uniformly reported by media sources such as The Wall Street Journal and Financial World as Caremark. Comp. ¶¶53, 55. Additionally, government officials have disclosed that this indictment is only "one of multiple federal criminal cases being pursued related to Caremark." Comp. ¶55.

G. The Atlanta Kickback Scheme, Civil Lawsuit and Federal Investigation

Caremark's kickback scheme in Atlanta has resulted in a class action suit (the "Booth action") and an investigation by the network television program "Prime Time Live".

The Booth action, a class action brought on behalf of hundreds of AIDS patients, advances RICO (The Racketeer Influenced and Corrupt Organizations Act) claims against Caremark in connection with a fraudulent scheme to "plunder one million dollars in insurance benefits." The complaint in the Booth action alleges that "Caremark had developed a fraudulent scheme that it has implemented on a nationwide basis whereby it pays criminal kickbacks to physicians . . . for unwarranted patient referrals for unconscionable fees and charges," including overbilling for drugs critical to AIDs patients by as much as 500%. Comp. ¶¶59-60.

In describing the Booth Action, "PrimeTime Live" newscaster Sam Donaldson recently reported in a nationwide broadcast titled "Dollars for Doctors" that:

> Booth began shopping around and found he could get the same drugs and similar home care services for elsewhere for much less, like at Midtown Medicine. . . . Allen Booth wondered why Dr. Rankin would refer him to a company [Caremark] with such high prices. He told us this woman, Ellen Sweet, who was Dr. Rankin's office manager, finally told him a secret - if Rankin referred a patient to Caremark, he would get 25 percent of all the money Caremark collected from the patient's insurance company. (emphasis added)

Comp. ¶ 62.

Donaldson also reported that although, as part of the settlement of the Booth action, Booth had signed a statement characterizing his claim as "a misunderstanding," PrimeTime's

investigation uncovered independent evidence pointing to the truth of the allegations in the Booth action. Comp. ¶¶61-62. Donaldson stated that "[w]e tracked down five former Caremark employees, two of whom agreed to go on camera with identities concealed, who described for us an elaborate scheme involving doctors" that was so lucrative that some doctors received as much as $50,000 per month, and even $100,000 per month over a two or three month period. Comp. ¶¶63, 65-66. Two of the doctors involved in the scheme made so much money from the kickbacks and overbilling they were able to move from middle class neighborhoods to mansions. Comp. ¶66.

H. The Detroit "Dollars for Docs" and State Investigations

The Detroit kickback scheme -- which Caremark's Detroit employees openly referred to as "Dollars for Docs" -- involved the payment of kickbacks of up to $100,000 to doctors in return for patient referrals. Comp. ¶67. Dr. Bruce A. Margolis, president of Caremark's Detroit office, personally received $11.5 million from Caremark for patient referrals between 1988 and 1992 through a joint venture called Caremark Physician Health Resources. Comp. ¶¶68-72. Margolis used the joint venture to provide services, while he ran the kickbacks through a privately owned company. Comp. ¶68. Caremark's senior management, including executive vice president Sheldon A. Asher, was intimately aware of the operation of the joint venture, and induced Margolis to continue at Caremark when he contemplated leaving the Company. Comp. ¶69.

The widespread existence of the "Dollars for Docs" scheme has been confirmed by numerous sources. One former Caremark

pharmacist in Detroit publicly stated that: "[p]robably two-thirds of the payments [at the Detroit office] were just paying off doctors." Comp. ¶74. An internal Caremark document from 1992 indicates that one of Margolis' prime referrers, Dr. Joseph Natole, split $600,000 in profits with Caremark. Comp. ¶71. Finally, a Michigan assistant attorney general concluded that "the overdiagnosis and the Caremark issue are intertwined. The more you overdiagnose, the more you made. Ninety-five percent of [Dr. Natole's] cases are misdiagnosed."[7] Comp. ¶71.

I. The FTC Investigation

Caremark's illegal practices apparently are not limited to kickbacks. The Federal Trade Commission ("FTC") is investigating Caremark for anti-competitive practices which Caremark engaged in with certain drug manufacturers (including Pfizer, Bristol-Myers, Squibb and Rhone-Poulenc Rorer). Comp. ¶82. On November 26, 1994, the FTC announced that it was expanding its inquiry into Caremark's contractual alliances with drug manufacturers, including "such matters as competition, pricing, restrictions on the availability of drugs and efforts to influence what doctors prescribe." Id.

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[7] Not surprisingly, Dr. Natole is currently being investigated by the State of Michigan as part of a medical license renovation hearing. Id.

J. The Scope And Effect Of The Kickback Schemes

The scope of Caremark's illegal scheme and the resulting fall-out is continuing to come to light. Most recently, on February 23, 1995, "PrimeTime Live" aired the results of its "Dollars for Doctors" investigation. Comp. ¶¶62-66, 84. Reporter Sam Donaldson concluded: "PrimeTime has learned Caremark's deals with doctors extended well beyond Atlanta. Hundreds of doctors all around the country, including cancer specialists, internists and obstetricians had financial arrangements of various kinds with Caremark, deals that are now the subject of a widespread federal investigation." Comp. ¶84 (emphasis added).

The effects of the notoriety and the various legal proceedings that have resulted from Caremark's scheme already have significantly impacted Caremark's business. Comp. ¶¶83-87. For example, Caremark has sold its home infusion business back to Caremark's founder, James Sweeney ("Sweeney") of Coram Healthcare Corp ("Coram"), at a fire sale price. Although Baxter paid $586 million for Caremark's home infusion business in 1987, Caremark sold the business to Coram for $310 million in cash and securities, with Caremark remaining liable for penalties and fines resulting from the OIG-HHS and related state law investigations. Comp. ¶¶85-87.

Additionally, the Director Defendants recently admitted publicly in Caremark's Form 10-K for the year ending December 31, 1994 that Caremark is attempting to settle the multitude of federal and state investigations and proceedings involving the Company and members of its senior management. CNBC reporter Dan Dorfman has

reported that the potential settlement costs could range from $400 to $700 million. Comp. ¶¶86-87.

Thus, the Complaint alleges with particularity and detail that the Director Defendants have consciously or with reckless abandon exposed Caremark, its resources, and its reputation, to enormous long-term, permanent damage. This is not simply a case of second-guessing a business risk undertaken by a board of directors for short-term profit. The Director Defendants in this case embarked on or knowingly countenanced a perilous, indeed, foolhardy course of action with criminal overtones, which they promised to abate but did not (until it was too late to stop the hemorrhaging).

ARGUMENT

In their opening brief, defendants argue that their motion to dismiss should be granted because (1) plaintiffs' have not made a pre-suit demand, and have failed to plead demand futility with the particularity required by Chancery Court Rule 23.1; and (2) plaintiffs' claims -- which, according to defendants, allege only breaches of the duty of care -- are barred by Caremark's charter provision adopting 8 Del. C. § 102(b)(7). Def. Br. at 19, 28. For the reasons that follow, both arguments should be rejected and Defendants' Motion to dismiss should be denied.

POINT I

THE COMPLAINT ADEQUATELY PLEADS DEMAND FUTILITY

The traditional Aronson standard for determining whether demand on a board of directors would have been futile is:

> whether, under the particularized facts alleged, a reasonable doubt[8] is created that: (1) the directors are disinterested and independent [or] (2) the challenged transaction was otherwise the product of a valid exercise of business judgment.

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[8] The "reasonable doubt" standard is not a restrictive evidentiary test. Consequently, a court should not force a plaintiff "to plead evidence without the benefit of discovery." Pogostin v. Rice, Del. Supr., 480 A.2d 619, 625 (1984). Accord Grobow v. Perot, Del. Supr., 539 A.2d 180, 186 (1988) ("test for demand futility should be whether the well-pleaded facts of the particular complaint support a reasonable doubt of business judgment protection, not whether the facts support a judicial finding that the directors' actions are not protected by the business judgment rule"); Heineman v. Datapoint Corp., Del. Supr., 611 A.2d 950, 952 (1992) ("[w]hile countervailing evidence might incline the fact finder to discredit the allegations, at this juncture the Court is not engaged in a weighing of evidence").

Rales, Del. Supr., 634 A.2d 927, 933 (1993), quoting Aronson v. Lewis, Del. Supr., 473 A.2d 805, 814 (1984).[9]

As the Supreme Court recently made clear, the "essential predicate" for applying the Aronson test "is the fact that a decision of the board of directors is being challenged in the derivative suit." Id. (emphasis in original) Thus, the Court "should not apply the Aronson test for demand futility where the board that would be considering the demand did not make a business decision which is being challenged in the derivative suit." Id. at 933-34.[10]

Instead, the Court must examine "whether the board that would be addressing the demand can impartially consider its merits without being influenced by improper considerations." Id. at 934. To do so, the Court "must determine whether or not the particularized factual allegations ... create a reasonable doubt that, as of the time the complaint is filed, the board of directors

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[9] All well-pleaded allegations of the Complaint "must be accepted as true in this procedural context." Rales, 634 A.2d at 935. "An allegation, though vague or lacking in detail, is nevertheless 'well-pleaded' if it puts the opposing party on notice of the claim being brought against it. Precision Air, Inc. v. Standard Chlorine of Delaware, Inc., Del. Supr., C.A. No. 335, 1994, slip op. at 7 (Feb. 9, 1995), citing Diamond State Tel. Co. v. University of Del., Del. Supr., 269 A. 2d 52, 58 (1970). Thus, a motion to dismiss pursuant to Rule 23.1 should be denied if "any set of facts" can be discerned from the complaint that would show futility of demand. See e.g., Grobow v. Perot, 539 A. 2d at 188.

[10] In Rales, the Supreme court identified three "principal scenarios" in which this situation would occur: "(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 ... the decision being challenged was made by the board of a different corporation." Id. at 934.

could have properly exercised its independent and disinterested business judgment in responding to a demand." Id.

In their opening brief, defendants argue that this Court must follow the Rales approach because plaintiffs "do not identify or challenge any specific decision by the Board." Def. Br. at 4. According to defendants, plaintiffs have alleged "only that the Director Defendants knew of the alleged wrongs and failed to take corrective actions." Def. Br. 26. That argument, however, is based upon an unreasonably restrictive reading of both Rales and the Complaint.

In Rales, the Supreme Court did not hold that formal or specific board action was required for application of the Aronson standards for determining demand futility. Instead, the Supreme Court required only a "conscious decision by directors to act or refrain from acting." Rales, 634 A.2d at 933, citing Aronson, 473 A.2d at 813 (emphasis added). A thorough review of the Complaint in this action demonstrates that plaintiffs have sufficiently alleged such a conscious decision by the Caremark Board to refrain from putting a stop to Caremark's pervasive and egregious illegal activities, which already have resulted in the "fire sale" of Caremark's home infusion and a plethora of indictments, investigations and lawsuits.

The Complaint charges that the Director Defendants knowingly or recklessly permitted Caremark's "fee for services" arrangements with physicians to continue unabated, even though they knew that the arrangements were of questionable legality under the Medicare Referral Payments Law and other federal and state anti-kickback laws. Comp. ¶¶ 2, 26. The Complaint alleges that from

the time they first took their Board seats the Director Defendants were aware that (1) Caremark's "fee for services" arrangements with physicians were being investigated by the federal government; (2) Caremark's exposure with respect to such arrangements was in the hundreds of millions of dollars; and (3) senior management had publicly committed to discontinuing such arrangements. Nevertheless, the arrangements continued on a nationwide basis. These allegations demonstrate that the Director Defendants consciously decided to ignore the warning signs alleged in the Complaint, or recklessly refrained from acting to ensure that the Company discontinued the practices that put Caremark at risk. Under either scenario, the Board necessarily made a conscious decision which has now been called into question.

Accordingly, the Aronson standard for demand futility should be applied in this case. However, even if the Rales approach is followed, the same result will follow. As demonstrated below, given the Complaint's specific allegations of egregious conduct, demand should be excused as futile under either Aronson or Rales.

A. The Complaint Creates A Reasonable Doubt That Defendants' Conduct Was The Product of Valid Business Judgment

Demand must be excused under the "second prong" of the Aronson standard if the Complaint creates a reasonable doubt that the Board's decision to permit Caremark's illegal practices to continue was the product of a valid exercise of business judgment. See, Aronson, 473 A.2d at 814.

Ordinarily, the business judgment rule creates a presumption that independent, disinterested directors making a

business decision act on an informed basis, in good faith, and with the honest belief that their actions are in the corporation's best interest. Grobow v. Perot, 539 A. 2d at 187. Where, however, a board's decision is "so extreme or curious to [itself] raise a legitimate ground to justify further inquiry and judicial review," that decision will not pass muster under the second prong of the Aronson test. Kahn v. Tremont Corp., slip op. at 16.

It has long been the law in Delaware that a director cannot knowingly or recklessly "shut his eyes" to pervasive wrongdoing. Accordingly, his failure to take action despite obvious warning signs can reflect the "conscious . . . decision to refrain from acting" that is discussed in Rales. See Rales, 634 A.2d at 933, citing Aronson, 473 A.2d at 813. As stated in Graham v. Allis-Chalmers Manufacturing Co., Del. Supr., 188 A. 2d 125 (1963):

> [t]he question of whether a corporate director has become liable for losses to the corporation through neglect of duty is determined by the circumstances. If he has recklessly reposed confidence in a obviously untrustworthy employee, has refused or neglected cavalierly to perform his duty as a director, or has ignored either wilfully or through inattention obvious danger signs of employee wrongdoing,the law will cast the burden of liability upon him.[11]

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[11] These duties are equally applicable to outside directors. As this Court held in Lutz v. Boas, Del. Ch., 171 A. 2d 381, 395 (1961):

> non-affiliated directors have the same responsibility as that of the ordinary directors of a Delaware corporation. . . . These non-affiliated directors were concerned with the board for varying periods. . . . These men are prime examples of what can happen when a man undertakes a substantial

(continued...)

Id. at 130.

Based upon this reasoning, courts consistently have held that a director's knowing or even reckless failure to act under circumstances where he is on notice of a corporate problem is wrongful conduct which cannot be protected by the business judgment rule, and, accordingly, obviates the need for pre-suit demand. The decision in Freedman v. Braddock, Index No. 24708/92 (N.Y. Sup. Ct. May 17, 1993) is a prime example. Freedman was a derivative action against Citibank's directors for their failure to supervise the activities of a mortgage subsidiary. The complaint alleged that Citicorp was given notice of the subsidiary's unsound lending practices and inadequate loan procedures by the Office of the Comptroller of the Currency, but had failed to take adequate steps to remedy these deficiencies. The Court, applying Delaware law, held that the complaint raised a reasonable doubt that the defendants' failure to act -- despite knowledge of the wrongdoing -- was the product of valid business judgment. Accord Decker v. Clausen, Del. Ch., C.A. No. 10684, Berger, V.C. (Nov. 6, 1989), slip op. at 8 (allegations that bank knew or should have known about problems with student loans, or made no effort to discover

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[11] (...continued)
> responsibility with public overtones without any appreciation of his obligation thereunder. Based upon my view of the evidence I make certain findings of fact: these non-affiliated directors gave almost automatic approval to the management [sic] Agreement; they did not examine the registration statements carefully; they did not discuss securities at their meetings or discuss any of the other facts which would have been pertinent to a reasonable discharge of their duties . . . .

such problems, "could possibly be enough to create a reasonable doubt" under Aronson second prong).[12]

The Complaint in this case alleges that the Director Defendants intentionally or recklessly "shut their eyes" to widespread misconduct, even though they knew that such misconduct could lead to materially adverse consequences to Caremark's business. Like Freedman, the director defendants' reckless or intentional disregard of such wrongdoing, and its consequences, could not have been the product of valid business judgment.

Accordingly, the Complaint creates a reasonable doubt sufficient to excuse demand under Aronson's second prong.

B. The Complaint Also Creates A Reasonable Doubt That The Director Defendants Are Disinterested

Both Aronson and Rales recognize that directors are interested in a challenged transaction when a complaint alleges conduct that is sufficiently egregious to establish a substantial likelihood that they could be held liable for their conduct. See Aronson, 423 A.2d at 815 ("[where] a transaction may be so egregious on its face that board approval cannot meet the test of business judgment and a substantial likelihood of director liability exists," the directors have a disabling interest). Two recent cases involving Baxter, Caremark's former corporate parent, demonstrate that the allegations in the Complaint create a reasonable doubt that the director Defendants are disinterested.

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[12] In re Baxter International, Inc. Shareholders Litigation, Del. Ch., C.A. No. 13130, Balick, V.C. (March 7, 1995) is distinguished from these cases because the Court in Baxter found that the "complaint does not include anything specific about the alleged scheme suggesting that the directors must have known of it." Slip op. at 7.

Miller v. Loucks, 1992 U.S. LEXIS 16966 (N.D. Ill. 1992), demonstrates the application of the "egregious conduct" principle on facts similar to those alleged here. The case arose from Baxter's efforts to have itself removed from the Arab League's boycott blacklist by, among other things, agreeing to pay $2.7 million dollars in bribes to certain officials of the Saudi Arabian government. These efforts exposed Baxter to civil and criminal liability for violations of the Export Administration Act of 1979, the Internal Revenue Code and the Foreign Corrupt Practices Act, and resulted in investigations by the U.S. Attorney's Office in Chicago, a federal grand jury, the U.S. Department of Commerce, the DOJ and the SEC.

Before the results of those investigations were announced,[13] three Baxter shareholders filed derivative suits seeking to hold Baxter's board of directors and certain of its officers accountable for losses suffered by Baxter in connection

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[13] In Miller v. Loucks, demand was excused even though none of Baxter's directors had been indicted. Thus, Miller v. Loucks disposes of defendants' argument that the Complaint here is deficient because plaintiffs have not alleged that the Director Defendants are under indictment or investigation. See also In re Storage Technologies Corporation Securities Litigation, 804 F. Supp. 1368, 1375-76 (D. Colo. 1992) (court held, applying Delaware law, that complaint adequately plead demand futility under the first prong of Aronson where complaint sufficiently alleged that directors allowed securities fraud and insider trading to occur, even though the directors themselves did not personally engage in the fraud); Boeing Co. v. Shrontz, Del. Ch., C.A. No. 11273, Berger, V.C. (Apr. 20, 1992) (allegations that the Boeing board knew of illegal acts and did nothing to remedy them stated a claim for director neglect); Miller v. Schreyer, 606 N.Y.S.2d 642, 643 (N.Y. App. Div. 1994) (demand futile where plaintiffs alleged that the magnitude of the transactions, the long duration of the practice, and the means by which the scheme was carried out were "circumstances that should have come to the attention of senior managerial supervisors and arouse suspicion at the highest levels of the corporation").

with the bribery scheme. Two of the plaintiffs made demands on the Baxter board before filing their complaints. The third alleged demand futility, even though only one or two of Baxter's eighteen board members were directly implicated in his complaint.

The Court, applying Delaware law, held that demand was excused because "the alleged conduct is so egregious on its face that it created a substantial fear of criminal or civil liability in the board during pending Grand Jury investigations and, thereby, rendered the entire eighteen-member board of directors incapable of exercising valid business judgment at the time the suit was filed." Miller v. Loucks, 1992 U.S. Dist. LEXIS 16966 at *28. In so doing, the Court specifically rejected the defendants' argument that demand was required because the plaintiff had not implicated a majority of the Baxter directors in the alleged wrongdoing: "Due to the unavailability of discovery at this stage of the litigation, this Court refuses to impose an added burden of pleading evidence of each Defendant's exact contribution to the alleged Middle East misconduct." Id. at n.14.

A comparison of the facts alleged in the Complaint with In re Baxter International, Inc. Shareholders Litigation also demonstrates that the director Defendant's conduct was egregious enough to create a substantial likelihood of liability. In Baxter, lower level employees had engaged in a systematic scheme to overcharge the Veteran's Administration ("VA") for medical supplies. After an investigation by the VA, Baxter officials (but not its board) sent a letter to the VA stating that such conduct had been corrected. The VA found that such conduct had not been corrected, proposed to suspend Baxter from receiving any new

contracts, and debarred two of the defendants from competing for government contracts.

The plaintiffs brought a derivative action alleging that Baxter's directors had "violated their fiduciary duty to exercise reasonable care in the oversight and supervision of Baxter's corporate affairs and management . . . ." Slip op. at 2. The defendants argued that the plaintiffs had not demonstrated a disabling interest because the alleged breach of care was protected under Section 102(b)(7). The Court accepted defendants' argument because the Baxter plaintiffs had not alleged -- as plaintiffs do here -- that defendants' conduct was in bad faith, intentional or involved a knowing violation of the law. Id. at 5-6. The Baxter plaintiffs also did not allege -- as the plaintiffs do here -- that the directors knowingly decided to ignore obvious warnings of employee wrongdoing. Id. at 7. Had they done so, the Court likely would have excused demand.

Indeed, Vice Chancellor Balick, citing Allis-Chalmers and Miller v. Schreyer, 606 N.Y.S.2d 642 (N.Y. App. Div. 1994), explicitly contrasted cases in which directors knowingly decided to allow an improper practice to continue, with cases like Baxter, in which "plaintiff's claim is premised on a presumption that employee wrongdoing would not occur if directors performed their duty properly." Slip op. at 6. Thus, had the Baxter plaintiffs -- like plaintiffs here -- sufficiently alleged facts demonstrating that the Baxter board knew about the wrongdoing, and allowed it continue, they would have demonstrated demand futility under the first prong of Aronson:

> Assuming that the directors were aware of the VA's investigation, without a specific allegation to that effect, the last event alleged before the proposed suspensions was the letter of April 1991 stating that corrective measures had been taken. Assuming, further, that the improper practice continued, without an allegation that wrongdoing was admitted or proven, the complaint does not plead with particularity what obvious danger signs were ignored or what additional measures the directors should have taken.

Slip. op. at 7 (emphasis added).

The Complaint here alleges that the Director Defendants knew about (i) the massive investigation targeting Caremark; (ii) the existence of admittedly questionable arrangements with doctors that the Board admitted were potentially illegal; and (iii) management's publicly announced commitment to change Caremark's corporate policy to discontinue "fee for services" arrangements. Nevertheless, the Director Defendants allowed Caremark to continue such arrangements. Under Delaware law, these allegations create a reasonable doubt that the Director Defendants are disinterested because of the "substantial likelihood" that they will be held liable for breaching their fiduciary obligations to Caremark. Accordingly, the Director Defendants are disabled from adequately considering a pre-suit demand under the first prong of Aronson.[14]

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[14] Moreover, Caremark's Section 102(b)(7) provision does not preclude this Court from finding that demand would have been futile. See Emerald Partners v. Berlin, Del. Ch., C.A. No. 9700, Hartnett, V.C. (Dec. 23, 1993)(noting that the defendants in that case had not cited "any persuasive authority in support of their argument that demand cannot be excused because 8 Del C. § 102(b)(7) protects the directors from personal liability.").

C. The Cases Relied Upon by Defendants Differ Materially From the Present Case

Defendants cite several cases which, they claim, demonstrate that the allegations in the Complaint are insufficient to demonstrate futility of demand. Their reliance on these cases is misplaced.

1. Cases Alleging That Directors "Approved" The Alleged Wrong

Two of the cases cited by defendants hold that "generalized and conclusory allegations of director approval or participation are wholly insufficient to excuse demand." Def. Br. at 29. Neither case addresses the type of detailed, specific allegations contained in the Complaint.

In Richardson v. Graves, Del. Ch., C.A. No. 6617, Longobardi, V.C. (June 17, 1983) (pre-Aronson), the complaint alleged that demand was futile because the company and four of its fourteen directors had been indicted for antitrust violations, while six other directors had authorized or acquiesced in the indicted directors' conduct. The court rejected the demand futility allegations because the six directors that allegedly had acquiesced -- who together constituted a majority of the Board -- had not been on the board at the time of the wrongdoing.

In Allison v. General Motors Corp., 604 F. Supp. 1106 (D. Del.), aff'd, 782 F. 2d 1026 (3d Cir. 1985), the plaintiffs alleged that demand was futile "because the individual defendants, as members of the GM Board, participated in the underlying wrongs; i.e., the decision to sell X-cars with a known brake deficiency and the decision to submit false and incorrect information to the

government and the public." Allison, 604 F.Supp. at 1114. The Court rejected that claim because the plaintiff had failed to plead "that the individual defendants constitute a majority of the Board." Id. Indeed, the complaint in Allison was brought against only four of GM's twenty-six directors, and two of its former directors. Compare Allison, 604 F.Supp at 1110 (four director defendants) with Grobow v. Perot, Del. Supr., 539 A.2d at 185 (twenty-six GM board members).

2. Cases Alleging That Directors Failed To Take Remedial Action Or Would Be Required To Sue Themselves

The other four cases cited by defendants involve allegations that directors had failed to take remedial action or would be required to sue themselves. Def. Br. at 32-40. Three of the cases are readily distinguishable from the case at bar. The fourth demonstrates the Complaint sufficiently alleges demand futility.

The derivative complaint in Lewis v. Fites , Del. Ch., C.A. No. 12566, Berger, V.C. (Feb. 18, 1993), alleged that Caterpillar Inc.'s officers and directors had breached their fiduciary duties by disseminating false and misleading periodic financial statements. The plaintiff claimed that demand would have been futile because Caterpillar's directors had agreed to the entry of a Consent Order by the SEC which -- according to the plaintiff -- raised the threat of personal liability to a "substantial likelihood." Slip op. at 6. The Court found that the Consent Decree "does not create substantial likelihood of director liability" because it "does not contain any admission of wrongdoing

and it does not include any findings concerning Caterpillar's directors." Id.

The derivative complaint in Stotland v. GAF Corp., Del. Ch., C.A. No. 6876, Longobardi, V.C. (Sept. 1, 1983), like the derivative complaint in Allison, was dismissed because the plaintiff had not adequately alleged that a majority of GAF's directors were interested in the compensation plans challenged by the plaintiff. The plaintiff alleged that four directors had received improper compensation, but the Court found that there were at least ten directors on the GAF Board at the time the compensation was approved. Slip op. at 16.

Citron v. Daniell, 796 F. Supp. 649 (D. Conn. 1992), involved derivative claims against the directors of United Technologies for, among other things, permitting the company to overcharge the federal government on large defense contracts. The Court rejected plaintiffs' demand futility argument because the complaint did not allege specific facts demonstrating that the directors had known about, or participated in, the challenged conduct. Citron, 796 F. Supp. at 652-53.

Finally, Shields v. Erickson, 710 F. Supp. 686 (N.D. Ill. 1989) ("Shields I"), demonstrates why the Complaint in the case at bar sufficiently alleges futility of demand. The derivative complaint in Shields I, like the complaint in Baxter, alleged only that the directors of Sundstrand Corporation had negligently failed to institute a systems of internal controls to prevent its employees from overcharging the federal government on defense contracts. The Company was fined and suspended from receiving new government contracts as a result. The Court refused to excuse

demand based on those allegations. Shields I, 710 F. Supp. at 692. However, after plaintiffs amended the complaint to allege facts indicating that the directors "knowingly or recklessly caused Sundstrand to maintain an inadequate system of financial and accounting controls," and "knowingly and recklessly caused the subordinates . . . to make false and misleading and materially inaccurate entries" in the company's books, the Court excused demand, stating: "[t]he previous complaint alleged only that the directors acquiesced in the misconduct and were negligent in failing to maintain controls. . . .the complaint now alleges that the defendant director's acts were knowing and reckless, rather than merely negligent." Shields v. Erickson, [1989-1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,723 at 93,904 (N.D. Ill. 1989).

None of the cases cited in Defendants' Opening Brief support their argument that the allegations in the Complaint are insufficient to excuse demand. To the contrary, a fair and impartial reading of the Complaint as a whole demonstrates that demand futility is alleged with the requisite particularity. Accordingly, Defendants' Motion should be denied.

POINT II

SECTION 102(B)(7) DOES NOT REQUIRE THE DISMISSAL OF THIS ACTION

Defendants also argue that the Complaint should be dismissed because they are insulated from liability under Section 102(b)(7). Again, their argument misses the mark.

Section 102(b)(7), which is set out in full in Defendants' Opening Brief at page 19 n.6, insulates directors from liability for monetary damages for breaches of the duty of care. See, e.g. Rothenberg v. Santa Fe Pacific Corp., Del. Ch., C.A. No. 11749, Jacobs, V.C. (May 18, 1992), slip. op. at 9, citing 5 Balotti & Finkelstein, The Delaware Law of Corporations and Business Organization, Ch. 4, § 4.19, p. 200.10 (1986). Section 102(b)(7) does not, however, shield directors from liability for "acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of the law"; that is, acts which are intentional or reckless. Kahn v. Roberts, Del. Ch., C.A. No. 12324, Hartnett, V.C. (Feb. 28, 1994), slip op. at 19 (§102(b)(7) "does not protect directors from liability resulting from acts or omissions done in bad faith"); Baxter, slip op. at 5-6 (§102(b)(7) does not shield directors from complaints alleging "bad faith, intentional misconduct, knowing violation at law"). Accord Bell Atlantic Corp. v. Bolger, 2 F. 3d 1304, 1312 (3d Cir. 1993).[15]

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[15] The cases cited by plaintiffs also recognize that §102(b)(7) does not shield directors from liability for reckless or intentional conduct. See In Re Dataproducts Corporation Shareholders Litigation, Del. Ch., C.A. No. 11164, Jacobs, V.C. (Aug. 22, 1991); Bell Atlantic Corp. v. Bolger, 2 F.3d 1304 (3d Cir. 1993).

In the case at bar, the Complaint sets forth a scheme in which defendants recklessly or intentionally made a conscious decision not to take action to stop Caremark's illegal conduct. The specific allegations of the Complaint sufficiently detail defendants' bad faith, and intentional and knowing conduct to satisfy the "notice pleading" standards applicable on a motion to dismiss. See Kahn v. Roberts, slip op. at 19 ("[w]hether or not the directors acted in bad faith ... is a question of fact not reached at this stage"). Moreover, those allegations demonstrate that the defendants' conduct "arguably" does not fall within the protections of Section 102(b)(7). See Freedman, slip op. at 8 ("[a]t this juncture, prior to discovery, plaintiffs here have arguably alleged conduct on the part of defendants which arguably falls within the exception to [Citicorp's §102(b)(7) provision]"); Boeing, slip op. at 8 (deferring ruling on motion to dismiss until after discovery concerning effect of §102(b)(7) provision). Accordingly, this Court should not determine whether Section 102(b)(7) applies until after plaintiffs have access to discovery.

Baxter does not require a different result. In Baxter, the Court held that:

> When the certificate of incorporation exempts directors from liability, the risk of liability does not disable them from considering a demand fairly unless particularized pleading permits the court to conclude that there is a substantial likelihood that their conduct falls outside the exemption. Plaintiffs claim that the directors failed to prevent employee conduct that caused the corporation to be suspended from receiving new government contracts. However, the complaint does not claim bad faith, intentional misconduct, knowing violation of law, or any other conduct for which the directors may be liable.

Slip op. at 5-6.

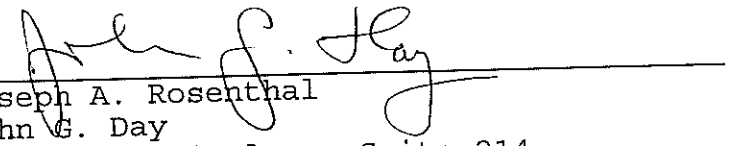
Thus, when a complaint adequately alleges such conduct, §102(b)(7) does not exempt directors from liability and does not support a motion to dismiss.

Accordingly, Defendants' Motion to dismiss pursuant to Caremark's §102(b)(7) charter provision should be denied.

CONCLUSION

Based upon the foregoing, Defendants' Motion must be denied in all respects.

ROSENTHAL, MONHAIT, GROSS & GODDESS, P.A.

By: 

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