Report of the Supplemental Investigation of the Special Demand Committee

Board of Directors of Cardinal Health, Inc.

February 4, 2014

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EXECUTIVE SUMMARY

In September 2013, the Board of Directors (the "Board") of Cardinal Health, Inc. ("Cardinal Health" or the "Company") received a second shareholder demand relating to the Order to Show Cause and Immediate Suspension of Registration that the Drug Enforcement Agency (the "DEA") issued to the Company in February 2012 (the "2012 ISO"). Before this demand (the "Stanley Demand"), the Company had received a letter sent on behalf of Isabelle Rauch in September 2012 (the "Rauch Demand"), demanding that the Company initiate an action against twenty-two present and former directors for breach of fiduciary duty relating to the 2012 ISO. The Board convened a Special Committee (the "Committee") to investigate the allegations contained in the Rauch Demand, and the Committee submitted a report (the "Original Report") and recommendation to the Board in April 2013. The Original Report concluded that the Company had implemented a rigorous system for preventing diversion in the years leading up to the 2012 ISO, and further that the Board and Audit Committee received regular updates regarding the anti-diversion system and there were no "red flags" that the system was inadequate. Accordingly, the Original Report recommended that the Company not pursue the action contemplated by the Rauch Demand. The Board adopted the recommendations of the Original Report in May 2013.

The Committee reconvened in September 2013 to review the Stanley Demand, which incorporated the allegations contained in a complaint that had been previously filed on behalf of the shareholder (the "Complaint"). The Complaint had been dismissed for failure to make a pre-suit demand on the Board to investigate the allegations. The Committee determined that the Stanley Demand and Complaint were based on facts and allegations similar to those asserted in the Rauch Demand and were the subject of the previous investigation and the Original Report. The Committee concludes that its original recommendations with respect to the Rauch Demand apply with equal force to the Stanley Demand and Complaint. Accordingly, the Committee concludes that it would not be in the best interests of the Company to pursue the action contemplated by the Stanley Demand and Complaint.

In October, the Committee received a follow-up letter from counsel for the shareholder (the "October Stanley Letter"), asserting that the Committee should investigate certain additional matters. First, the October Stanley Letter asserted that the Committee should investigate what information was provided to the Board regarding a settlement that the Company reached in December 2006 with the Attorney General for New York (the "NY AG"), including the measures that the Company implemented pursuant to the settlement and the efficacy of those measures. The Committee finds that the Board was informed of the terms of the settlement, as set forth in an Assurance of Discontinuance (the "AOD"), and received regular updates on the policies and procedures that were required under the AOD. Indeed, the AOD required the Company to report to the Audit Committee semi-annually and in writing regarding the Company's compliance with the AOD. More importantly, however, the Company was never penalized for failing to comply with the AOD, and the NY AG never even accused the Company of failing to comply with the AOD.[1] Thus, there are no injuries for which to bring an action

[1] Pursuant to the AOD, an external auditor conducted annual audits of the Company's compliance with the AOD, and submitted reports to the NY AG, for the three years that the Company was bound by the AOD's terms—*i.e.*, until 2010.

based on the Company's compliance with the AOD. And the time to bring a suit based on the underlying findings by the NY AG against the Company, as set forth in the AOD, has long run.

Second, the October Stanley Letter asserted that the Committee should investigate what information was provided to the Board regarding the Memorandum of Agreement that the Company entered into with the DEA in 2008 (the "2008 MOA"), and the Company's compliance with the 2008 MOA. Although the October Stanley Letter seems to portray this as a new issue for the Committee to investigate, it was central to the Stanley Demand and Complaint, as well as the Rauch Demand and the previous investigation and Original Report. Accordingly, the Committee has already investigated this issue thoroughly.

Third, the October Stanley Letter asserted that the Committee should investigate the Company's alleged failure to prevent diversion and report suspicious orders in West Virginia, as alleged in a complaint filed by the Attorney General for West Virginia in June 2012. The Board has been informed of this complaint, which relies heavily on the allegations that the DEA asserted in connection with the 2012 ISO. As discussed, those matters were investigated in response to the Rauch Demand and were the subject of the Original Report, and the conclusions of the Original Report apply with equal force to the complaint filed by the Attorney General for West Virginia.

For the foregoing reasons, and as set forth fully in the Original Report and the ensuing supplemental report, the Committee recommends that the Board reject the Stanley Demand. The Committee also submits that no further action is necessary regarding the matters raised in the October Stanley Letter, and to the extent that the October Stanley Letter was intended to be a further demand on the Board, it should also be rejected.

REPORT OF THE SPECIAL DEMAND COMMITTEE

I. THE DEMAND

On September 5, 2013, counsel for shareholder Henry Stanley, Jr. sent a letter purporting to be a shareholder demand (the "Stanley Demand") on the Board of Directors (the "Board") of Cardinal Health, Inc. ("Cardinal Health" or the "Company"). The Stanley Demand attached a Complaint that had been filed on Stanley's behalf in June 2012, and demanded that the Board "immediately investigate and commence legal action" regarding the Complaint's allegations.[2] (Stanley Demand at 1.) As set forth below, the Special Committee (the "Committee") believes that the investigation it conducted from December 2012 through April 2013 in response to a prior demand, and the report that memorialized the investigation and findings (the "Original Report"), encompass the allegations contained in the Stanley Demand and the Complaint.[3]

On October 23, 2013, Stanley sent a follow-up letter (the "October Stanley Letter") demanding that the Committee investigate certain additional matters. These matters are also addressed below.

A. The Prior Demand

The Company received a letter dated September 28, 2012, purporting to be a shareholder demand on behalf of Isabelle Rauch (the "Rauch Demand"). The Rauch Demand alleges that the Order to Show Cause and Immediate Suspension of Registration issued by the Drug Enforcement Agency (the "DEA") in February 2012 regarding the Company's Lakeland, Florida distribution center (the "2012 ISO") was the result of a failure by the Company "to implement systems to detect and prevent the diversion of controlled substances into the illegal market" in accordance with the Controlled Substances Act, the Memorandum of Agreement entered with the DEA in 2008 (the "2008 MOA"), and DEA "directives." (Rauch Demand at 1, 10.) Further, the Rauch Demand alleges that certain "Directors and Officers," defined as twenty-two present and former directors, "breached their duties of loyalty and care when they knowingly and/or recklessly failed to establish" such a system of internal controls. (*Id.* at 10.)

The Rauch Demand describes at length the three Orders to Show Cause and Immediate Suspensions of Registration issued against the Company in 2007 (the "2007 ISOs"), the Order to Show Cause issued in 2008 (together with the 2007 ISOs, the "2007/2008 DEA Action"), the 2008 MOA, and the civil penalty levied in connection with the 2008 MOA. (*Id.* at 2-5.) In particular, the Rauch Demand details the DEA's allegations in the 2007/2008 DEA Action that the Company distributed excessive quantities of hydrocodone and failed to maintain effective

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[2] One month earlier, the Sixth Circuit Court of Appeals issued a decision affirming a lower court's dismissal of the Complaint, finding that Stanley failed to "state with particularity" the reasons for his failure to make a pre-suit demand on the Board to investigate the Complaint's allegations. *See Stanley v. Arnold*, 2013 WL 4105646, at *1 (6th Cir. Aug. 14, 2013).

[3] The Committee submitted the Original Report and its recommendations to the Board at the Board meeting held on April 12, 2013, and the Board accepted the Original Report and adopted its recommendations at the Board meeting held on May 9, 2013.

controls against diversion at seven of its twenty-seven distribution centers. (*Id.*) The Rauch Demand then discusses the 2012 ISO issued in connection with the Lakeland, Florida facility, one of the facilities that was suspended in 2007, and the DEA's allegation that the Lakeland facility distributed excessive volumes of oxycodone to four Florida pharmacies despite "warning signs," and thus did not have adequate controls in place. (*Id.* at 5-8.)

The Rauch Demand claims that, as a result of the 2012 ISO, the Company "has and will continue to suffer significant harm and incur substantial costs, including, but not limited to, potential fines, attorneys' fees, consulting fees, loss of business, and reputational harm," as well as damage to the Company's "corporate image and good-will." (*Id*. at 9.) Finally, the Rauch Demand insists that the Board "take action against the Directors and Officers to recover the damages described herein for the benefit of the Company." (*Id*. at 10.)

B. The Stanley Demand

The Stanley Demand incorporates the allegations contained in the Complaint. The Complaint names as defendants the same twenty-two present and former Board members identified in the Rauch Demand. The "Factual Background" section (Complaint ¶¶ 39-106) describes the same underlying events as those described in the Rauch Demand, including the 2007 ISOs, the 2008 Order to Show Cause, and the 2008 MOA, albeit in greater detail. The Complaint then goes on to detail the events surrounding the 2012 ISO, relying on the various declarations and other court documents filed by the DEA. Finally, the Complaint describes the alleged harm to the Company, including the civil fine levied in connection with the 2008 MOA, the loss of customers and revenue, declining orders from existing customers, and the costs of rerouting controlled substances from other distribution centers in lieu of the Lakeland facility.

Similar to the Rauch Demand, the Complaint asserts that "[e]ach of the Board members was aware of, or should have been aware of, numerous red flags regarding the Company's violation of federal regulations"—specifically, the 2007 ISOs and the 2008 Order to Show Cause, the DEA's allegations against the Company set forth in the 2008 MOA, the $34 million fine, ongoing communications with the DEA following the 2008 MOA, and the warrant that the DEA issued to the Lakeland facility in late October 2011, before issuing the 2012 ISO in February. (*Id*. ¶ 116.) According to the Complaint, the defendants "disregarded their fiduciary duties . . . when, under their direction, the Company continued to, *inter alia*: disregard federal regulations, the MOA, and the Company's own practices; supply customers with controlled substances despite clear warning signs of diversion; not conduct due diligence; and not report suspicious orders to the DEA." (*Id*. ¶ 117.)

The main difference between the assertions in the Rauch Demand and in Stanley's Complaint is the aggressiveness of the terms used to characterize both the alleged misconduct and the Board's knowledge of that misconduct.[4] Specifically, the Rauch Demand states that the former directors and officers named in the letter "knowingly and/or recklessly failed to establish

[4] Most of these assertions are contained within a section of the Complaint titled "Demand is Excused" (Complaint at 35), and are advanced in support of Stanley's original argument that any pre-suit demand on the Board to investigate the Complaint's allegations would have been futile.

a system of internal controls at Cardinal Health." (Rauch Demand at 9-10.) By contrast, the Complaint states that the "Director Defendants knowingly and consciously presided over the Company's systematic violations" of the Controlled Substances Act and other applicable regulations, and any claimed lack of actual knowledge "could only be the product of willful blindness that constitutes bad faith breach of their fiduciary duties."[5] (Complaint ¶ 118.) Further, the Complaint asserts as follows:

> The Board affirmatively ***adopted, implemented, and condoned a business strategy based on the violations of law***, and the Director Defendants have profited substantially as a result. Serious violations of federal law occurred systematically at every level of the Company as a result of the Board's decision to embrace ***a policy of calculated legal violations*** . . . . The Board's decision . . . [to] cause Cardinal Health to violate the applicable regulations, is ***not a valid exercise of business judgment***. . . . The magnitude and duration of the wrongdoing . . . and the magnitude of the damages . . . reflect a ***lack of good faith*** on the part of the Director Defendants.

(*Id*. ¶ 128 (emphasis added).) In addition, the Complaint charges that "[a]ll of the Director Defendants, individually and in concert, engaged in the aforementioned conduct in breach of their fiduciary duties to the Company and conspired to, and did, abuse the control vested in them by virtue of their high-level positions in the Company." (*Id*. ¶ 135.)

Another difference between the Rauch Demand and Stanley's Complaint is the Complaint's reference to specific committees of the Board—the Audit Committee (Complaint ¶¶ 122-24) and the Governance Committee (*id*. ¶¶ 125-26)—and their members for roles in the alleged misconduct.

The Complaint asserts one count of breach of fiduciary duty against the defendants. The Prayer for Relief asks for a declaration that the defendants breached their fiduciary duties and for an award of "damages sustained by the Company as a result of the Director Defendants' breaches of fiduciary duties." (*Id*. at 43-44.)

C. The October Stanley Letter

In October 2013, the Committee's counsel, Milbank Tweed Hadley & McCloy LLP ("Milbank"), had a teleconference with Stanley's counsel. Although Stanley's counsel stated during the call that he did not have any additional information not contained in the Complaint that he wished to bring to the attention of the Committee, Stanley's counsel sent the October Stanley Letter two days later, demanding that the Committee investigate three additional matters. First, the October Stanley Letter asserted that the Committee should investigate the extent to

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[5] Additionally, the Complaint alleges that the Board violated the Company's Standards of Business Conduct, which includes the commitment to act in compliance with the law and to maintain processes to help guard against diversion, by "permitt[ing] individuals at all levels of the Company to engage in the [alleged] misconduct." (*Id*. ¶¶ 120-21.)

which the directors named in the Stanley Demand and Complaint approved or otherwise were informed about a December 2006 settlement with the Attorney General's Office of the State of New York (the "NY AG Settlement"), whether the directors received any information regarding the Company's compliance with the NY AG Settlement, and whether the directors received any reports regarding the efficacy of the anti-diversion measures the Company adopted in connection with the NY AG Settlement. (October Stanley Letter at 2.) The Committee believes it is important to note that the NY AG matter concerned Secondary Market[6] activity and "price diversion," which are activities of a completely different nature than those that later became the focus of the DEA in 2007 and were the subject of the 2007/2008 DEA Action. As noted in the Original Report, "price diversion" occurs when closed-door pharmacies (*i.e.*, pharmacies that service institutional or other non-retail customers such as nursing homes or hospitals), or other non-retail pharmacies, purchase drugs at reduced contract pricing and then resell the drugs at higher prices on the open market. (*See* Original Report at 7 n.4.) By contrast, the 2007/2008 DEA Action concerned the diversion of controlled substances, involving such issues as unjustified prescriptions for pain medication and consumer drug abuse. The strategies for detecting and preventing price diversion are very different from the strategies for detecting and preventing the diversion of controlled substances.

Second, the October Stanley Letter asserted that the Committee should investigate the directors' knowledge regarding the "ultimate settlement" that the Company reached with the DEA in 2008 (*i.e.*, the 2008 MOA), and any efforts the directors made to ensure that the Company was in compliance with that settlement. (October Stanley Letter at 2-3.) Third, the letter asked the Committee to investigate the Company's purported failure to report suspicious orders in West Virginia, as alleged in a complaint filed by the Attorney General for West Virginia, and to determine whether the directors "were aware of any issues regarding the selling, marketing, or reporting of controlled substances in West Virginia." (October Stanley Letter at 3.)[7]

It is noteworthy that the October Stanley Letter does not make any accusations of breaches of fiduciary duties, and simply asks the Committee to investigate what information the Board received regarding the matters discussed in the letter. Specifically, the October Stanley Letter fails to make any accusations that the Company did not abide by the terms of the NY AG Settlement. Neither does the letter make any accusations that the Company failed to report suspicious orders in West Virginia. We believe that it is safe to assume that Stanley would cite the NY AG Settlement and the West Virginia complaint as evidence of a failure of oversight on the part of the directors.

II. RELEVANT LEGAL STANDARDS

As discussed in the Original Report, Ohio law provides that "[a] director shall be liable in damages . . . only if it is proved by clear and convincing evidence . . . that the director's action or

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[6] The term "Secondary Market" refers to the market for purchase, sales, or trades between wholesalers.

[7] For reference, the Rauch Demand, the Stanley Demand and Complaint, the October Stanley Letter, and the Original Report are included in an appendix to this report.

failure to act involved an act or omission undertaken with deliberate intent to cause injury to the corporation or undertaken with reckless disregard for the best interests of the corporation." Ohio Rev. Code § 1701.59(E); *see also* Original Report at 5. Directors satisfy their obligation to remain informed of the corporation's activities if an information and reporting system exists within the company that will provide senior management and the directors with accurate and timely information "sufficient to allow . . . informed judgments concerning . . . the corporation's compliance with [the] law . . . ." *In re Caremark Int'l Inc. Deriv. Litig.*, 698 A.2d 959, 970-71 (Del. Ch. 1996). Where a reporting system exists, "[d]irectors will be potentially liable for breach of their oversight duty only if they ignore 'red flags' that actually come to their attention, warning of compliance problems." *Stanley v. Arnold*, No. 1:12-CV-482, 2012 WL 5269147, at *6 (S.D. Ohio Oct. 23, 2012) (quoting *Forsythe v. CIBC Emp. Private Equity Fund*, No. 657-N, 2006 Del. Ch. LEXIS 60, at *7 (Del. Ch. Mar. 22, 2006)).

III. THE INVESTIGATION

The Committee believes that the investigation that the Committee conducted in response to the Rauch Demand encompassed the subject matter of the allegations contained in the Stanley Demand and Complaint. The previous investigation reviewed the Company's efforts to implement systems to prevent diversion and report suspicious orders following the 2007/2008 DEA Action and the 2008 MOA, and the information provided to the Board and Audit Committee regarding those matters.[8] As detailed in the Original Report, Milbank reviewed documents relating to the Company's anti-diversion policies and procedures, including standard operating procedures and handbooks relating to anti-diversion measures, internal Company training materials, corporate governance guidelines and charters, and organizational charts. (Original Report at 6.) Milbank also reviewed Board and Audit Committee minutes from late 2007 to early 2012, and materials and communications conveyed to the Board and the Audit Committee during that time, relating to diversion issues. (*Id*.) In addition, Milbank interviewed twenty Company employees and two Audit Committee members. (*Id*. at 6-7.) In light of the more aggressive characterizations contained in the Stanley Demand and Complaint, and the targeted reference to the two committees and their activities, and out of an abundance of caution, the Committee authorized Milbank to conduct interviews of three additional directors who were named in the Complaint and were on the Board and the identified committees during the relevant periods.

In response to the October Stanley Letter, Milbank reviewed documents relating to the NY AG Settlement, including settlement documents, internal policies and procedures that the Company adopted following the settlement, and Board and Audit Committee minutes and other materials regarding the settlement and the ensuing policies and procedures. Milbank also reviewed the complaint filed by the Attorney General for West Virginia (as to which discovery began in November 2013) and communications to the Audit Committee regarding that action. In addition, Milbank interviewed director John Finn, who has been a member of the Board and Audit Committee since 1994, as well as [redacted], who is a Senior Vice President of Compliance and participated in the negotiation of the NY AG Settlement and the Company's

[8] The Committee also investigated the specific events surrounding the 2012 ISO.

ensuing reforms.[9] The Committee believes that the investigation relating to the matters raised in the October Stanley Letter was thorough.

IV. FINDINGS REGARDING THE STANLEY DEMAND

The Stanley Demand asks the Board to investigate and commence legal action for the named directors' alleged violation of their fiduciary duties in connection with the 2012 ISO and the directors' alleged failure to respond to "red flags," including the 2007/2008 DEA Action and the 2008 MOA. As detailed in the Original Report, the investigation showed that following the 2007/2008 DEA Action and 2008 MOA, the Company undertook extensive measures to implement a robust system to prevent diversion and report suspicious orders to the DEA, that the Board was fully informed of those measures, and that the Board did not fail to act in the face of any red flags that the system was inadequate. (*See* Original Report at 36-39.) The Original Report concluded that the Board at all times acted diligently and in good faith to fulfill its duties to the Company. (*Id*.)

As discussed above, Milbank interviewed three additional Board members after receipt of the Stanley Demand and Complaint. Specifically, Milbank interviewed Board members Dick Notebaert, Gregory Kenny, and Bruce Downey.[10] The interviews confirmed, as documented in the Original Report, that the Board and, as pertinent, its committees, were informed of the 2007/2008 DEA Action and the 2008 MOA, and received regular updates on the Company's efforts to engage with the DEA and implement policies and procedures to prevent diversion and report suspicious orders. The Board members recounted the substantial effort and resources that the Company devoted to developing a system to monitor for suspicious orders, including establishing thresholds for orders, hiring investigators and senior management responsible for compliance and anti-diversion matters, and training employees on anti-diversion policies and procedures. Further, the Board members stated that the 2012 ISO came as a surprise, because they thought that the Company's system had been effective in detecting and reporting suspicious orders and otherwise complying with the 2008 MOA, and that the system was flagging orders and customers were being terminated as a result. The directors also noted that there were no financial incentives for the Board to have disregarded the Company's obligations under the law or the 2008 MOA, because of the potential costs of running afoul of regulators.

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[9] Regarding the other matter that the October Stanley Letter demanded that the Committee investigate—the directors' knowledge regarding the 2008 MOA and any efforts the directors made to ensure that the Company was in compliance with the 2008 MOA—this is central to the Rauch Demand and the Stanley Demand and Complaint. As discussed, this issue was investigated thoroughly in response to the Rauch Demand and documented in the Original Report.

[10] Mr. Notebaert became a member of the Board in 1999, and has been a member of the Nominating and Governance Committee (the "N&G Committee") and the Human Resources and Compensation Committee since 2011; he was previously a member of those Committees from 2006 to 2008 and 1999 to 2008, respectively. Mr. Kenny joined the Board in 2007 and the N&G Committee in 2009. Mr. Downey became a member of the Board and the Audit Committee in 2009.

V. FINDINGS REGARDING THE OCTOBER STANLEY LETTER

As discussed above, the October Stanley Letter asks the Committee to investigate the extent to which the directors named in the Complaint were informed about the NY AG Settlement, or about the Company's compliance with the settlement agreement and the efficacy of the Company's compliance measures, including whether the directors received reports regarding diversion from the Chief Ethics and Compliance Officer (the "CECO"). The October Stanley Letter also asks the Committee to investigate the Company's alleged failure to detect and report suspicious orders in West Virginia, and whether the Board was aware of any such issues in West Virginia.

A. The 2005 New York Attorney General Action

In 2005, the New York Office of the Attorney General (the "NY AG") commenced an investigation of pharmaceutical distributors regarding trading in the Secondary Market for pharmaceuticals. As part of that investigation, the Attorney General began investigating Cardinal Health, and ultimately issued a subpoena to the Company on April 5, 2005 (the "NY AG Action"). (*See* State of New York, Office of the Attorney General, Subpoena Duces Tecum, April 5, 2005, at 1.)

1. The Allegations and the Settlement

The NY AG Action culminated in a settlement on December 26, 2006, memorialized in the Assurance of Discontinuance (the "AOD"). The AOD included a list of "findings" against the Company.[11] Among the findings were that the Company purchased and sold prescription drugs in the Secondary Market in violation of New York Executive Law §63(12), purchased drugs in the Secondary Market that were later deemed to be counterfeit, and purchased drugs from vendors despite indications that the vendors may have been unsuitable. (AOD at 2-3.) The findings also stated that the Company made numerous sales to purported closed-door pharmacies that it knew or should have known were diverting drugs to the Secondary Market, and sold drugs to wholesalers who were on the Company's list of excluded vendors. (*Id.* at 4-5.) Further, the Company allegedly made "third party" returns to manufacturers on behalf of other wholesalers, regardless of where the wholesaler had purchased the product, thus encouraging customers to divert drugs and then "return" them for full credit. (*Id.* at 5-6.)

While the Company voluntarily implemented various reforms during the pendency of the NY AG Action, the AOD set forth additional formal requirements for the Company. (*Id.* at 7.) These requirements included reforming the Company's wholesale distribution business, appointing additional staff to ensure compliance with the AOD, implementing purchasing and selling reforms, maintaining a code of conduct encouraging employees to prevent and detect diversion, conducting annual training of employees regarding diversion, and instituting formal procedures for the review of new customers and monitoring of existing customers for potential price diversion and improper Secondary Market activity. (*Id.* at 8-14.)

[11] The Company neither admitted nor denied the findings contained in the AOD. (AOD at 7.)

The Company was also required to retain an auditor to conduct annual audits of the Company's compliance with the AOD through 2009, based on procedures agreed upon by the Company and the NY AG. (*Id.* at 14-15.) The auditor was required to issue a report to the Company and the Attorney General following each audit. (*Id.*) Finally, the AOD required that the Company pay $3 million to the State of New York, $1 million to the Attorney General's office to cover the costs of the investigation pursuant to NY Executive Law §63(15), and $7 million to Health Research, Inc., a New York not-for-profit corporation. (*Id.* at 15.)

2. The Company's Response

In 2005, the Company implemented an Anti-Diversion Compliance Policy, and issued a manual to employees explaining the policy and related procedures. (Anti-Diversion Compliance Policy, 2005, at 1.) The manual explained the concept of price diversion by closed-door pharmacies and the employees' responsibility to report suspected diversion. (*Id.* at 1-2.) The manual also set forth specific procedures for screening and monitoring new and existing customers, and taking corrective action against customers found to be engaged in price diversion. (*Id.* at 7-9, 12.) Corrective action could include notifying the customer of the evidence of diversion, terminating sales to the customer at contract prices, notifying the manufacturer or Group Purchasing Organization of the evidence of diversion, notifying governmental authorities, and discontinuing business with the customer. (*Id.* at 12.)

The Company continued to refine its policies and procedures, and to institute new policies and procedures for preventing price diversion and improper Secondary Market activity. A subsequent version of the Anti-Diversion Compliance Policy included specific procedures for different types of customers, such as closed-door pharmacies, internet pharmacies, wholesalers, and chain pharmacy warehouses. (Anti-Diversion—Know Your Customer Compliance Manual, at 7-10; *see also* Anti-diversion Policy, Effective Nov. 1, 2006.) The Company issued procedures relating to customers' eligibility to receive contract pricing, and the circumstances in which drugs would be purchased from a manufacturer's exclusive distributor, rather than the manufacturer itself. (*See, e.g.,* Contract Pricing – Customer Eligibility, Effective Mar. 17, 2008; Prescription Pharmaceutical Purchases from Exclusive Distributors, Effective May 30, 2008.) In addition, the Company implemented procedures designed to monitor existing customers for price diversion and improper Secondary Market activity, and to assess the risks of such conduct by potential new customers, including requiring customers to provide more complete information regarding their businesses and to submit to on-site inspections in certain circumstances and establishing a purchase screening tool. (*See, e.g.*, Closed Door Pharmacy Customers, Aug. 3, 2009; New Customer Set-Up Process (Secondary Market, Anti-Diversion), Aug. 3, 2009; Periodic Customer Review/Assessment Process, Aug. 3, 2009; Purchase Screening Tool for the Pharmaceutical Business Segment, Jan. 7, 2010.) Further, the Company adopted procedures for investigating suspected price diversion or improper Secondary Market activity, and for discontinuing sales to customers on such grounds. (*See, e.g.*, Investigation Procedures – Secondary Market and Price Diversion, Aug. 3, 2009; Closure of Customer Accounts, Aug. 3, 2009.)

3. The Information Provided to the Board and Audit Committee

The Board and the Audit Committee received regular updates regarding the NY AG Action and the Company's fulfillment of the terms of the AOD—from the time the action began in 2005 through the Company's successful completion of the AOD's terms in 2010.[12] Indeed, the AOD explicitly required the CECO to report in writing semi-annually to "the relevant oversight committee of the Board of Directors," *i.e.*, the Audit Committee, regarding the Company's compliance with the AOD. (AOD at 8.)

The Audit Committee received a report on the NY AG Action in April 2005. (Report on Lawsuits and Claims as of March 31, 2005, Brendan A. Ford, Apr. 26, 2005, at 12.) The report stated that the Company received a subpoena on April 5, 2005 as part of what appeared to be an industry-wide inquiry focusing on the Secondary Market within the wholesale pharmaceutical industry, and that the Company had met with members of the Attorney General's office and started collecting responsive materials and interviewing key personnel. (*Id*.) The full Board learned of the subpoena at its May 2005 meeting. (Legal Matters and D&O Liability Insurance Update, May 2005, at 2.)

The Audit Committee received another update on the NY AG Action in advance of its November 2005 meeting. (Report on Lawsuits and Claims as of Sept. 30, 2005, Brendan A. Ford, Oct. 24, 2005, at 9.) The update stated that the investigation had expanded into additional areas relating to the Company's pharmaceutical distribution, that the Company had formed an Anti-Diversion Task Force to review the matters at issue, and that the task force had prepared a draft Anti-Diversion Policy to be implemented by November 1, 2005. (*Id.*) Similarly, in advance of its February 2006 meeting, the Audit Committee was informed that the NY AG was investigating the Company's efforts to ensure the integrity of product purchased and sold on the Secondary Market, and to prevent diversion of products sold to closed-door pharmacies and counterfeit and adulterated product. (Report on Lawsuits and Claims, Ivan K. Fong, Feb. 13, 2006, at 4.) Further, the Company was implementing measures to address these concerns, including discontinuing all purchases on the Secondary Market and instituting an anti-diversion compliance program. (*Id*.) The update also noted that the parties were engaged in discussions to resolve the issues under investigation. (*Id.*)

The Board and Audit Committee continued to receive updates on the NY AG Action, and the Audit Committee was informed that settlement discussions between the parties were taking place. (*See, e.g.*, Board of Directors Meeting Legal Report, Ivan K. Fong, May 10, 2006, at 2; Report on Lawsuits and Claims, Ivan K. Fong, July 25, 2006, at 12; Report on Lawsuits and Claims, Ivan K. Fong, Oct. 31, 2006, Appendix at 7.) At the August 2, 2006 meeting of the full Board, the Board reviewed a proposal to replace the Company's Code of Ethics with a Standards of Business Conduct, pursuant to a specific requirement of the AOD, and the Board passed a resolution approving and adopting the Standards of Business Conduct. (Board of Directors Meeting Minutes, Aug. 2, 2006, at 3, 16; AOD at 11.)

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[12] The AOD provided that the Company would adhere to the business reforms set forth in the AOD at least until January 1, 2010. (AOD at 15.)

In January 2007, following execution of the AOD in late December 2006, the Audit Committee received a presentation dedicated to the NY AG Action and settlement. (Resolution of New York Attorney General Investigation, [redacted], Jan. 30, 2007.) The presentation summarized the investigation and the allegations, and discussed the terms of the AOD, including the monetary amounts that the Company agreed to pay and the business reforms that the Company agreed to implement. (*Id*.) As discussed in the presentation, the Company agreed to: buy prescription drugs directly from the manufacturer, except in certain defined circumstances; distribute directly to "provider" customers or to wholesalers that have certified compliance with the Wholesaler Safe Product Practices form agreed to under the AOD; implement the Standards of Business Conduct, an "Ethic's Hotline," and "Know Your Customer" due diligence and audit requirements; have a CECO who would report to the CEO and the Audit Committee; and perform annual training for all employees within the pharmaceutical supply chain. (*Id*. at 4.) The Audit Committee was also informed in the context of a broader update that the AOD required semi-annual reporting on anti-diversion efforts, and that sixty-six investigations had been conducted to date, resulting in the closure of thirty-five accounts. (CECO Update, Daniel J. Walsh, Jan. 30, 2007, at 6.)

The Audit Committee continued to receive periodic updates on the Company's compliance with the AOD, as formally required under the AOD. (*See, e.g.*, CECO Update, Daniel J. Walsh, May 1, 2007, at 6-8; CECO Update, Daniel J. Walsh, Nov. 6, 2007, at 2, 6; CECO Update, Daniel J. Walsh, Jan. 2008, at 2, 7; CECO Update, Daniel J. Walsh, May 2008, at 2, 7.) For example, the Audit Committee was informed that the Company was planning to conduct internal audits to evaluate the Company's compliance with the AOD. (CECO Update, May 1, 2007, at 6; CECO Update, Nov. 6, 2007, at 6.) The Audit Committee was also informed that the Company was obtaining Contract Pricing Declarations from closed door pharmacy customers, revised the Anti-Diversion—Know Your Customer manual, developed a web-based training module and trained more than 2,300 employees on diversion issues, and supplemented existing product "spike" reports to monitor sales to chain warehouse, wholesaler and closed door pharmacy customers. (CECO Update, Nov. 6, 2007, at 6.) Further, the Audit Committee learned that the Company was requiring wholesalers to sign the Wholesaler Safe Product Practices certification, and ceasing to sell pharmaceutical products to wholesalers who refused to comply, as well as conducting site visits of wholesaler customers. (CECO Update, May 1, 2007, at 7; CECO Update, Nov. 6, 2007, at 6; CECO Update, Daniel J. Walsh, May 2008, at 7.) The Audit Committee also learned that the Company's external auditor, Ernst & Young ("E&Y"), began its review of the agreed-upon procedures under the AOD and submitted its first audit report to the NY AG on December 28, 2007. (CECO Update, May 1, 2007, at 8; CECO Update, Daniel J. Walsh, Jan. 2008, at 7.)

In November 2008, Craig Morford, who was elected CECO in May 2008, provided the Audit Committee with an update on a variety of matters, including the Company's compliance with the AOD. (Chief Compliance Officer Q1 Update, Craig Morford, Nov. 2008.) The update summarized the background of the AOD and discussed areas of recent activity relating to the AOD, including the review of wholesaler customer licenses, the completion of wholesaler customer annual audits, the commencement of a project to enhance effectiveness of purchase screening activity, and the completion of over 500 closed-door pharmacy site visits. (*Id*. at 10.) The update also stated that the Company had trained over 3,400 employees on price diversion

and Secondary Market sales, and that the Company was improving procedures for recordkeeping and internal communication. (*Id*.)

The Audit Committee also received a presentation focused exclusively on the Company's performance under the AOD. (New York Attorney General Assurance of Discontinuance (AOD) Status Report, Craig Morford, Nov. 4, 2008.) That presentation provided a more detailed summary of the NY AG Action and the terms of the AOD, including the buy-side and sell-side restrictions under the AOD. (*Id*. at 2-3.) The presentation also reviewed the mechanisms that the Company was employing to comply with the AOD, including: conducting site visits of wholesaler and closed-door pharmacy customers; requiring closed-door pharmacy customers to make certain declarations relating to price diversion; administering annual training to over 3,000 employees; gathering and monitoring sales data to detect spikes in ordering; conducting internal audits twice per year; and engaging E&Y to conduct audits of the agreed-upon procedures. (*Id*. at 5.) Further, the presentation discussed the actual, suspected, and potential issues with wholesaler customers and the remedial action the Company was taking in response, which included reviewing customer certifications and licenses and terminating customers found to not be compliant with the necessary certifications. (*Id.* at 6-9.)

In advance of the February 2009 meeting, the Audit Committee received another update on the Company's compliance with the AOD, learning that E&Y had submitted an audit report to the NY AG in December 2008, that the Company had worked with the NY AG to revise the Wholesaler Safe Product Practices to include updated due diligence requirements, that the Company was reviewing its wholesaler customers and had discontinued business with certain customers as a result, and that the Company had continual monitoring in place to ensure compliance with the AOD. (Chief Compliance Officer Q2 Update, Craig Morford, Feb. 2009, at 4, 10.) In May 2009, the Audit Committee was informed that the NY AG had not raised any questions or concerns regarding the December 2008 E&Y audit, and further that the Company had substantially completed its review of wholesaler customers, was further enhancing its procedures, and that the internal audit group was scheduled to conduct another review of AOD compliance in June 2009. (Chief Compliance Officer Q3 Update, Craig Morford, May 2009, at 5.) The update also stated that the Company continued to monitor compliance with the AOD. (*Id*. at 13.)

The full Board received an update on the Company's compliance with the AOD in advance of its August 2009 meeting. (Annual Compliance Program Review, Craig Morford, Aug. 2009, at 3, 6.) The update informed the Board that the price diversion procedures developed in connection with the NY AG Action would be integrated into the Company's broader anti-diversion program. (*Id*. at 6.) The update also noted that E&Y would complete its final annual audit in December 2009. (*Id.* at 15.) Similarly, in advance of its November 2009 meeting, the Audit Committee received a report noting that the final E&Y audit was in progress and the results would be submitted to the NY AG by January 1, 2010. (Compliance: Quarterly Compliance Program Update – FY '10 Q1, Craig Morford, Nov. 2009, at 2.) The report also noted four instances of emergency medical purchases that constituted permissible deviations from standard procedure under the AOD. (*Id*. at 3.)

The Audit Committee received its final update regarding the NY AG Action and the AOD in January 2010. (Quarterly Update – FY '10 Q2 Compliance Program and Enterprise Risk Management, Craig Morford, Jan. 26, 2010, at 1.) The update noted that E&Y submitted the report of its final annual audit to the NY AG in December 2009 and the results were "solid," and that the responsibility for the implementation and oversight of the related procedures was being transferred to the Company's Quality and Regulatory Affairs group. (*Id*.) In advance of its August 2010 meeting, the full Board learned that the Company had successfully completed the three-year price diversion compliance program under the AOD, and that E&Y submitted its final audit report in December 2009. (Annual Update – FY '10 Ethics and Compliance Program, Craig Morford, July 27, 2010, at 1, 4.)

B. The 2012 West Virginia Attorney General Action

The October Stanley Letter asserts that the Committee "should investigate the Company's alleged failure to report suspicious orders in West Virginia and determine whether the Director Defendants were aware of any issues regarding the selling, marketing, or reporting of controlled substances in West Virginia." (October Stanley Letter at 3.) The complaint filed by the Attorney General for West Virginia is based on the issuance of the 2012 ISO and the DEA's allegations in support thereof. (*See* Complaint dated June 26, 2012, at 6-7, *West Virginia v. Cardinal Health, Inc.*, No. 12-11111.) As discussed above, the issuance of the 2012 ISO and the supporting allegations were the subject of the prior investigation and the Original Report by the Committee. Further, the Audit Committee was informed of the filing of the complaint and the allegations that the Company failed to prevent the diversion of controlled substances and to properly report suspicious orders to the West Virginia Board of Pharmacy. (Cardinal Health, Inc. Minutes of Meeting of the Board of Directors, June 27, 2012; Report of Lawsuits and Claims, July 31, 2012, at 5-6.) Finally, the parties agreed only recently to certain limited discovery, in November 2013.

VI. RECOMMENDATIONS ON MERITS OF ALLEGATIONS

As discussed, the Board is responsible for ensuring that an information and reporting system is in place such that the Board will receive sufficient information to make informed judgments regarding the Company's compliance with its legal obligations. *See supra* Part II; *Caremark*, 698 A.2d at 970-71. Regarding the Stanley Demand and Complaint, the allegations were the subject of the previous investigation conducted in response to the Rauch Demand. The Original Report concluded that the Company implemented a rigorous system for preventing diversion and reporting suspicious orders, and that the Board received regular updates regarding the system. As stated in the Original Report, at no time did the Board fail to act in the face of any red flags that the Company's anti-diversion controls were inadequate. Thus the Company cannot recover monetary damages from any past or present directors and should not pursue the action contemplated by the Stanley Demand and Complaint, as it would not be in the best interests of the Company. (*See* Original Report at 38.)[13]

[13] *See also* Original Report at 39 (discussing other factors supporting the conclusion that litigation of the sort requested in the Rauch Demand was not in the best interests of the Company).

The Committee notes that, as has been reported publicly, the resolution of the 2012 ISO left open the possibility for the government to seek civil fines from the Company for the activity that was the subject of the DEA's action. Accordingly, there is a possibility that the Company will in the future be making one or more payments to the government tied to the matters the Committee has examined. The Company has been communicating with government representatives in that connection. The Committee has given full consideration to the possibility of payments of the kind described, and that possibility does not alter the Committee's analysis or affect the finality of its recommendation as to legal action by the Company against members of the Board. This is so because, regardless of the remaining issue of such payments, the Committee's investigation has revealed no shortfall, much less a culpable shortfall, by any of the directors in the discharge of their oversight responsibilities as to the Company's distribution of controlled pain medications.

Regarding the October Stanley Letter, and its assertion that the Committee should investigate the information provided to the Board regarding the NY AG Settlement and the measures that the Company implemented in response, the Board and the Audit Committee were informed of the terms of the AOD and received regular updates on the practices and procedures that the Company implemented in response. Among other things, the Board was informed that the Company was implementing the requisite buying and selling reforms, including by purchasing drugs directly from manufacturers except in limited circumstances, and selling only to wholesalers that signed the Wholesaler Safe Product Practices form agreed to under the AOD. Further, the Board was informed that the Company was scrutinizing wholesaler customers, including by conducting site visits and investigations, and that the Company had issued new policies and procedures relating to price diversion and Secondary Market activity, and was training thousands of employees on those policies and procedures.

The Board was also informed about the efficacy of the new procedures, including that the Company had terminated numerous wholesaler customers, that the Company was conducting internal audits each year to ensure compliance with the AOD, and that E&Y was conducting its annual audits and submitting its reports to the NY AG, pursuant to the AOD. In 2010, the Board was told that the Company had successfully completed the three-year period during which the Company was required to follow the terms of the AOD.

Further, the time in which the NY AG or any other party could bring an action against the Company based on the underlying findings in the AOD has long since run. The Company has fully complied with the terms of the AOD and the NY AG never suggested that the Company failed to abide by the AOD—thus there would be no injuries for which to bring such an action. Moreover, the statute of limitations for any action based on the AOD has run.[14]

[14] The statute of limitations for breach of fiduciary duty under Ohio law is four years, which begins to run at the time of the alleged breach. *Union Sav. Bank v. Lawyers Title Ins. Corp.*, 191 Ohio App. 3d 540, 549-50 (Ohio Ct. App. 2010) (citing Ohio Rev. Code § 2305.09). The NY AG Action was settled in December 2006, and the Company was required to abide by the terms of the settlement until January 1, 2010. Thus, the deadline for filing a complaint for any alleged breach of fiduciary duty for the actions leading to the AOD ran in December 2010, and the deadline for filing a complaint for failure to abide by the terms of the AOD (if there were any factual basis for such an assertion) would have been December 31, 2013.

Regarding the action by the Attorney General for West Virginia, the allegations contained in the complaint were the subject of the previous investigation and the Original Report, and the conclusions of the Original Report apply with equal force to the complaint. This matter is in its very early stages, and thus the particulars of its outcome for the Company are still unknown. However, as with the open issue of possible civil payments by the Company to the federal authorities, the ultimate resolution of the West Virginia lawsuit would not change the Committee's conclusions. The Committee's investigation has thoroughly probed the directors' knowledge and conduct regarding the Company's activities in the distribution of controlled pain medication broadly, not excluding the Company's activities in West Virginia. The Committee's determination that there is no basis for finding liability on the part of any past or present members of the Board is independent of, and would not be influenced by whether the state of West Virginia ultimately obtains any relief from the Company.

The Committee finds that no further investigation or action is warranted regarding the matters raised in the October Stanley Letter, and to the extent that the October Stanley Letter was intended to be a further demand on the Board, it should also be rejected.

CONCLUSION

For the foregoing reasons, the Committee recommends that the Company not pursue the legal action requested by the Stanley Demand, or take any further action regarding the October Stanley Letter. Further, to the extent the October Stanley Letter was meant to be a further demand on the Board, it should also be rejected.