SUPERIOR COURT OF THE STATE OF CALIFORNIA

IN AND FOR THE COUNTY OF SAN MATEO

PUBLIC SCHOOL TEACHERS' PENSION AND RETIREMENT FUND OF CHICAGO,

Plaintiff,

v.

GARY S. GUTHART, et. al.,

Defendants,

-and-

INTUITIVE SURGICAL, INC.,

Nominal Defendant.

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CASE NO. CIV 526930

MEMORANDUM DECISION AND ORDER ON DEMURRER

Defendants Gary Guthart, et. al.,[1] have by Demurrer moved to dismiss this director/officer liability claim on grounds that no pre-suit demand for corporate action was made. Such demand is a prior condition for

[1] Defendant Gary S. Guthart ("Guthart") is one of sixteen Defendant directors and officers of nominal Defendant Intuitive Surgical, Inc., the other named Defendants being: directors Lonnie M. Smith ("Smith"), Eric H. Halvorson ("Halvorson"), Alan J. Levy ("Levy"), Floyd D. Loop ("Loop"), Craig H. Barratt ("Barratt"), Amal M. Johnson ("Johnson"), Mark J. Rubash ("Rubash"), and George Stalk, Jr. ("Stalk"); and officers, Marshall M. Mohr, Salvatore J. Brogna, Augusto V. Castello, Jerome J. McNamara, Mark Meltzer, Colin Morales, and David J. Rosa.

shareholder derivative suits such as this one, somewhat generally similar to the filing of a government tort claim prior to suits in tort against a public entity.

For the reasons that follow, the Court is of the opinion that Plaintiff has adequately alleged demand futility that excuses the making of any such demand. The Court finds, by the clear and convincing evidence now before me (taken true as alleged and as judicially noticed below), that any such demand was futile and, therefore, this lawsuit may proceed. Accordingly, the pending motion for dismissal must be and is Denied.

Claim Made.

Suit is brought by shareholder/institutional investor Public School Teachers' Pension And Retirement Fund Of Chicago arising out of its investment in Intuitive Surgical, Inc., a company that manufactures and markets a robotic-controlled surgical system called "daVinci". By this shareholder derivative action, Plaintiff seeks recovery for the company of over $77 Million in losses on account of allegedly undisclosed and concealed product defects that later came to light with resulting serious devaluation of the publicly traded stock in the company. Plaintiff also seeks restitution of illegal profits from the Defendant director/officers' insider trading, as well as declaratory relief compelling certain corporate governance reforms. [2]

Applicable Law.

As a preliminary matter, all parties are agreed that the substantive merits of the motion are to be determined under Delaware law, the dispositive issue being whether or not the claimant has raised, by particularized fact allegations, a reasonable doubt that the corporate directors were incapable of making an impartial decision regarding the litigation. See Delaware Chancery Court Rule 23.1 (a); *Rales v. Blasband* (Del.1993) 473 A.2d 927, 932.[3] However, the procedural rules as to the scope of what things the Court can consider by way of judicial notice, beyond the pleadings themselves, is a matter of California law. Compare *Vaughn v. LJ International, Inc.* (2nd Dist. 2009) 174 Cal. App.4th 213, 218-219, a shareholders derivative action

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[2] In its First Amended Complaint, Plaintiff asserts causes of action for Breach of Fiduciary Duty (1st c/a), Unjust Enrichment (2nd c/a), Insider Trading (3rd c/a), Insider Trading Violation of Calif. Civil Code § 25402 (4th c/a), and Corporate Waste (5th c/a).

[3] This is not a case where the business judgment rule, set forth in *Aronson v. Lewis* (Del.1984) 473 A.2d 805, applies, as claimant here does not challenge a specific board inaction or board decision. Rather, the gravamen of the case here is based upon director/officer lack of oversight and insider-trading done under the cloak of alleged concealment of product defects.

where the issue of pre-suit approval was a matter of British Virgin Islands law and the standards of review on demurrer were controlled by California law. See also *Lewis v. O.J. LeBaron* (3rd Dist. 1967) 254 Cal. App.2d 270, 278-279, a shareholders suit where service of process was a matter of California law and standing to sue a matter of Nevada law; 3 Witkin *California Procedure* (5th Edition 2008) Actions, § 46, noting that the law of the forum state "...determines the sufficiency of process *or other notice,* and the time when the action is deemed commenced [emphasis added]."

Requests For Judicial Notice.

Defendants' requests for judicial notice: The Court rules on the Defendants' judicial notice requests as follows:

- Granted as to Exhibits A and B to Mr. Tassin's Declaration, which set forth the historical stock prices for Intuitive stock. See *In re Marriage of Brigden* (1978) 80 Cal.App.3d 380, 385 fn. 3, taking judicial notice of stock prices.

- Granted only as to the fact of filing of public documents attached as Exhibits C and D to Mr. Tassin's Declaration, which are Intuitive's Form 10-Q filed with the SEC on October 19, 2011 and Intuitive's Schedule 14A filed with the SEC on March 6, 2013; otherwise Denied. The truthfulness and proper interpretation of these documents remains disputable. See, e.g., *StorMedia Inc. v. Superior Court* (1999) 20 Cal.4th 449, 456 fn. 9, taking judicial notice only of the existence of a document filed with the SEC; the California Supreme Court noted that the truthfulness and proper interpretation of that document remained disputable.

- Denied as to Exhibits A through H to Mr. Harris' Declaration. Exhibits A through H are: a chart created by Defendants which purportedly summarizes judicially noticeable stock price information; presentation slides created by Intuitive; minutes of Intuitive's board meetings; and a catalog regarding the "da Vinci" system from Intuitive's website. Defendants offer these documents for the purpose of showing that the directors were not discussing the Tip Cover defects at board meetings on February 3, 2011 and April 19, 2012. However, these documents are not proper subjects of judicial notice, as they appear to raise factual issues that are open to dispute that should not be resolved on demurrer. See, e.g., *Jara v. Suprema Meats, Inc.* (1st Dist. 2004) 121 Cal. App.4th 1238, 1252 – 1260, holding that minority shareholder's fact-intensive breach of fiduciary claims should have been determined at trial, rather than by *in limine* dismissal.

Plaintiff's request for judicial notice: The Court rules on the Plaintiffs' judicial notice requests as follows:

- Denied as to Exhibit A to Mr. Molumphy's Declaration, which is a chart created by Plaintiff purportedly summarizing information in Intuitive's judicially noticeable SEC filings.

- Granted only as to the fact of filing of public documents attached as Exhibits B through I to Mr. Molumphy's Declaration, which are Intuitive's SEC filings; otherwise Denied. The truthfulness and

proper interpretation of these documents remains disputable. See, e.g., *StorMedia Inc. v. Superior Court*, *supra*, 20 Cal.4th at p. 456 fn. 9.

- Granted as to Exhibit J to Mr. Molumphy's Declaration, which is a copy of U.S. District Judge Edward J. Davila's Order denying in part and granting in part the motion to dismiss in *In re Intuitive Surgical Securities Litigation*, No. 5:13-CV-01920-EJD.

No Disinterested Directors.

Within the pleadings and matters just judicially noticed, it is clear and convincing that pre-suit demand should and must be excused.

None of the nine directors of the company Intuitive Surgical, Inc. were sufficiently disinterested, independent, or conflict-free such that a fair and neutral decision would have been made on any pre-suit demand . And this is abundantly apparent from the following facts:

- All directors on Intuitive's nine-member Board face liability for failure of oversight. (FAC ¶¶ 213-214, 216, 220, 224, 229, 233, 238, 241, 243, 245, 247.)

- All nine directors face liability for misleading SEC filings and other public statements. (FAC ¶ 215.) Intuitive made statements regarding the safety of the "da Vinci" system and Intuitive's compliance with FDA regulations, and these statements were false and misleading because they failed to disclose known defects in the "da Vinci" system and Intuitive's regulatory violations, including unreported and misclassified Medical Device Reports ("MDRs") and secret recalls.

- All nine directors face liability for approving a wasteful stock repurchase program. (FAC ¶ 217.)

- Five directors, Guthart, Smith, Loop, Levy, and Halvorson, face liability for insider trading. (FAC ¶¶ 211-212, 218-219, 222-223, 226-227, 230-231, 234-235.)

- Two inside directors are not independent by virtue of their current and former executive officer positions. Guthart is the current President and CEO. Smith is the Chairman of the Board. The company's 2013 proxy statement admits that these directors are not independent. (FAC ¶¶ 221, 225)

- Two outside directors are conflicted. Loop has been affiliated with the Cleveland Clinic since 1970, where he served as the CFO and Chairman of the Board of Governors from 1989 through 2004, and

Cleveland Clinic is one of the biggest proponents of the "da Vinci" system and employs at least two physicians who are compensated as Intuitive consultants. Accordingly, Cleveland Clinic is dependent upon Loop and the Company for financial compensation, and Loop is dependent upon Cleveland Clinic to continue to promote the "da Vinci" system. Rubash was the CFO of Heartflow, Inc. from March 2012 until June 2013, Smith has been a member of Heartflow's Board since December 2011, therefore Rubash was beholden to Smith. (FAC ¶¶ 236, 239.)

Lack of Oversight.

Plaintiff has shown that all nine directors faced a substantial likelihood of personal liability for failure of oversight under the controlling case of *In re Caremark Intern, Inc. Derivative Litigation* (Del. Ch. 1996) 698 A.2d 959.

Under Delaware law, a claim of directorial liability for failure of oversight is called a *Caremark* claim. *Guttman v. Huang* (Del. Ch. 2003) 823 A.2d 492, 506. *Caremark* applies where the plaintiff alleges "either (1) that the directors knew or (2) should have known that violations of law were occurring and, in either event, (3) that the directors took no steps in a good faith effort to prevent or remedy that situation, and (4) that such failure proximately resulted in the losses complained of." *In re Caremark Intern. Inc. Derivative Litigation* (Del. Ch. 1996) 698 A.2d 959, 971.

To state a *Caremark* claim, a plaintiff must plead facts showing that:

> (a) the directors utterly failed to implement any reporting or information system or controls; or
> (b) having implemented such a system or controls, consciously failed to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention. In either case, imposition of liability requires a showing that the directors knew that they were not discharging their fiduciary obligations. Where directors fail to act in the face of a known duty to act, thereby demonstrating a conscious disregard for their responsibilities, they breach their duty of loyalty by failing to discharge that fiduciary obligation in good faith.

Stone ex rel. AmSouth Bancorporation v. Ritter (Del. 2006) 911 A.2d 362, 370.

Courts have found that the complaint presents a substantial likelihood of directorial liability for failure of oversight where the plaintiff alleges systematic misconduct with respect to the company's core business and facts permitting the reasonable inference of the directors' knowledge or reckless disregard of the misconduct. *In re SFBC Intern., Inc. Securities & Derivative Litigation* (D.N.J. 2007) 495 F.Supp.2d 477, 485-487 ("*SFBC*"); *In re Countrywide Financial Corp. Derivative Litigation* (C.D. Cal. 2008) 554 F.Supp.2d 1044, 1081-182 ("*Countrywide Financial*"); *Rosenbloom v. Pyott* (9th Cir. 2014) 765 F.3d 1137, 1151-1157 ("*Rosenbloom*").

SFBC, supra, 495 F.Supp.2d 477, was a shareholder derivative action against a company engaged in the business of providing clinical testing, development and consulting services to pharmaceutical and medical device companies. The plaintiffs alleged that the directors were liable for failing to correct the company's unethical clinical testing practices. The plaintiffs alleged abuses of company's human test subjects and deliberate falsification of test data. The plaintiffs alleged unsanitary conditions at the company's principal Miami testing facility, located at the company's headquarters, and that the Miami facility was ultimately condemned by the building department. Further, the plaintiffs detailed that the company had received multiple citations from the FDA for test procedure violations. The U.S. District Court, applying Delaware law, held the allegations raised a substantial likelihood of liability for failure of oversight. *Id.* at p. 485. The court explained,

> The [company's] directors certainly should have known about the company's performance of its core business, and assuming the truth of Plaintiffs' allegations, about the particularly reprehensible manner in which it was done. Under these circumstances, the Court finds that the Complaint avers sufficient obvious signs of wrongdoing to support the allegation that the Demand Directors knew or should have known that they were not fulfilling their obligations by failing to take action in response to the company's widespread problems. In short, the Complaint contains "the kind of fact pleading that is critical to a *Caremark* claim," meaning that it shows the directors were conscious of the fact that they were not doing their jobs.

Id. at p. 486.

Countrywide Financial, supra, 554 F.Supp.2d 1044, was a shareholder derivative action against a company whose business was originating and servicing home loans. The plaintiffs alleged that the company had not adhered to its underwriting standards and had begun building a portfolio of risky loans; the directors would have necessarily known of the underwriting problems because of their role on board committees which were tasked with monitoring the company's financial performance, business operations, and risk exposures, yet the directors failed to take corrective action. The U.S. District Court, applying Delaware law, held that the shareholders' allegations were sufficient to show substantial likelihood of directorial liability for failure of oversight. *Id.* at p. 1082. The court concluded that the complaint established a strong inference of deliberate recklessness by the directors by alleging unchecked misconduct with respect to the company's core business and the directors' roles on various board committees tasked with monitoring the company's financial performance and risks. *Id.* at pp. 1061, 1081. The court explained, "It defies reason, given the entirety of the allegations, that these Committee members could be blind to widespread deviations from the underwriting policies and standards being committed by employees at all levels." *Id.* at p. 1082.

Rosenbloom, supra, 765 F.3d 1137, was a shareholder derivative action against a manufacturer of specialty pharmaceuticals, including Botox. The plaintiffs alleged that the directors knew or should have known of the company's promotion of Botox for off-label purposes in violation of federal laws but failed to prevent the unlawful conduct. The plaintiffs alleged that: Botox was one of the company's most important products; for a 13-year period, the company aggressively promoted the sale of Botox for off-label purposes; and, during this 13-year time period, the board adopted strategic plans expressly predicated on immediate growth in off-label sales of the drug, the board closely monitored Botox sales for on- and off-label use, and the company received several letters from the FDA and complaints from physicians regarding off-label marketing of Botox. The Ninth Circuit, applying Delaware law, held that the allegations strongly supported an inference that the board knew of and did nothing about illegal promotion of Botox for off-label purposes. *Id.* at pp. 1151-1157. The court emphasized,

> It would be surprising, to say the least, if such significant, continuing, and diverse breaches of FDA regulations in relation to a star product at [the company] passed unnoticed by the Board for so long, even as the Board carefully monitored off-label sales, repeatedly discussed and authorized a number of the allegedly illegal programs, and built strategic plans around off-label Botox sales.

Id. at p. 1154.

Under the above-cited cases, it is clear that substantial *Caremark* claim liability risks are adequately stated. Here, the particularized allegations, taken together, demonstrate that all nine members of the Board faced a substantial likelihood of personal liability for failure of oversight. First, the particularized allegations show endemic misconduct regarding Intuitive's core business. The allegations show: a defect with Tip Cover, a component of the Monopolar Scissors; that the Monopolar Scissors is the most commonly used instrument for Intuitive's sole product, the "da Vinci" system, and Intuitive's systematic effort to conceal the defect and violate FDA regulations by misclassifying and failing to report MDRs related to the defect and issuing secret recalls. (FAC ¶¶ 99, 100, 102-107, 111-113, 115-120, 123-124.) Second, the particularized allegations create a reasonable inference that Intuitive's entire Board of Directors knew of the misconduct. The allegations show that: the Board regularly discussed Intuitive's reporting practices and compliance with FDA regulations; three Defendant directors were on the Audit Committee, which is tasked with overseeing compliance with regulatory requirements; between January 2010 and December 2011, Intuitive received hundreds of complaints regarding the Tip Cover; on February 3, 2011, and again on April 19, 2012, the Board discussed the fact that the Tip Cover remained a significant area of risk; yet, Intuitive's response to complaints regarding the Tip Cover was to violate FDA regulations by misclassifying and failing to report MDRs related to the defect and issuing secret recalls.

(FAC at ¶¶ 8 fn. 1, 37, 52, 55, 108, 100, 111-113, 115-120, 123-124, 140-149.) Intuitive allegedly did not begin accurately reporting MDRs until after September 2012, when MDR reporting policies caught the attention of the FDA. Given the entirety of the allegations, it defies reason that Intuitive's nine directors could be blind to widespread regulatory violations being committed with respect to the Company's sole product.

Defendants maintain Plaintiff has not sustained its burden of proving demand futility because the Complaint fails to detail exactly what each individual director knew and did in response to such information. Defendants are correct that in certain situations, courts did not excuse the demand requirement because of the absence of particularized allegations as to what each director knew and what he or she did about that knowledge. However, demand futility is to be evaluated based on the facts of each particular case rather than through the invocation of rigid rules. See *Grobow v. Perot* (Del. 1988) 539 A.2d 180, 186 stating that "[r]easonable doubt" for demand futility purposes "must be decided by the trial court on a case-by-case basis employing an objective analysis," and not by "rote and inelastic" criteria (overruled on other grounds by *Brehm v. Eisner* (Del. 2000) 746 A.2d 244). Under the unique facts of this case, Plaintiff has demonstrated a substantial likelihood that a majority of the Board faces personal liability.

False and Misleading Statements.

Not only did they face *Caremark* liability, but also all nine directors faced a probable liability risk of personal liability for false and misleading statements.

In this regard, this Court will respect the findings already made by U.S. District Judge Edward J.Davila at the pleading stage in the related securities fraud case, *In re Intuitive Surgical Securities Litigation*, No. 5:13-CV-01920-EJD, as to reasonable reliance. Judge Davila found that it is plausible that a reasonable investor would reasonably rely on the company's statements of safety and the alleged failure to disclose unreported Medical Device Reports and secret recalls, and that this gives rise to a plausible inference that the statements regarding "daVinci" safety created an impression that differed materially from the product defects that actually existed.

Sufficient particularized pleading of reasonable reliance being so established, Plaintiff here also makes sufficient particularized allegations showing that the company's directors were aware of these unreported MDRs and secret recalls.

Plaintiff alleges that from October 11, 2011, through July 18, 2013, Intuitive's Board allowed Intuitive to make false and misleading statements in SEC filings regarding the safety of the "da Vinci" system. These

statements were that the "da Vinci" system represents a new generation of surgery that combines the benefits of minimally invasive surgery for patients with the ease, use and precision of open surgery, and that despite articles and papers questioning the safety and efficacy of the "da Vinci" system, the "da Vinci system" is a safe and effective surgical method. (FAC ¶¶ 170, 172.) Plaintiff alleges that Intuitive's failure to disclose additional unreported MDRs and its failure to disclose those to the FDA and the three secret recalls that took place during the time period rendered the statements false and misleading. (FAC at ¶¶ 162-175.) Plaintiff alleges it may be inferred that Intuitive's Board knew of the statements regarding the safety of the" da Vinci" system that were false and misleading because the Tip Cover defect was discussed at Board meetings, the da Vinci system is essentially Intuitive's entire business, and the Board regularly monitored Intuitive's interactions with the FDA.

The FAC alleges that: the Board regularly discussed Intuitive's reporting practices and compliance with FDA regulations; three Defendant Board members were on the Audit Committee, which is tasked with overseeing compliance with regulatory requirements; between January 2010 and December 2011, Intuitive received hundreds of complaints regarding the Tip Cover; on February 3, 2011, and again on April 19, 2012, the Board discussed the fact that the Tip Cover remained a significant area of risk; yet, Intuitive's response to complaints regarding the Tip Cover was to violate FDA regulations by misclassifying and failing to report MDRs related to the defect and issuing secret recalls (FAC at ¶¶ 8 fn. 1, 37, 52, 55, 108, 100, 111-113, 115-120, 123-124, 140-149.)

Insider Trading.

Furthermore, Plaintiff has also shown that a majority of the directors, five of the company's nine, faced a substantial personal liability risk for insider trading.

Particularly alleged by Plaintiff is insider-trading by two inside directors: Lonnie Smith, now Chairman of the Board and formerly \CEO of the company; and Gary Guthart, current President/CEO of the company.

Specifically, Plaintiff alleges as follows: In October 2011, after the Company sent three secret corrective letters regarding defects in the "da Vinci" system, Levy sold 2,500 shares for over $1 million in proceeds and Loop sold 5,000 shares for over $2 million in proceeds. Between late October and early December 2012, after the September 2012 meeting between Intuitive and the FDA during which the FDA imposed stricter MDR reporting requirements on the Company but before the significance of the heightened MDR reporting requirements reached the market, Guthart sold 4,500 shares for almost $2.6 million in proceeds, and Halvorson sold 500 shares for $270,000 in proceeds. Further, in late January 2013, after the Company learned of the FDA safety probe but

before the probe was disclosed to the public, Guthart sold 4,500 shares for almost $2.6 million in proceeds and Halvorson sold 1,500 shares for over $885,000 in proceeds. (FAC ¶¶ 211-212, 218-219, 222-223, 226-227, 230-231, 234-235.)

Also particularly alleged by Plaintiff is insider trading by three of the outside directors: Eric Halvorson, a member of the Board's Audit Committee and Compensation Committee at the times material; Floyd Loop, a member of the Board's Governance Committee at the times material; and Alan J. Levy, a member of the Board's Governance Committee and Compensation Committee at the times material.

In that regard, for the reasons discussed above, Plaintiff has alleged sufficient facts to support the reasonable inference that the entire Board was aware of the secret recalls, the September 2012 meeting between Intuitive and the FDA during which the FDA imposed stricter MDR reporting requirements on the Company, and the 2013 FDA probe. Indeed, the allegations show that soon after the September 2012 meeting and the 2013 FDA probe, the Board met again to discuss MDR reporting. (FAC ¶¶ 122, 140, 146-147.) Thus, the timing and amount of these directors' sales permit the strong inference that the sales were motivated by inside information.

Not only is it the reasonable inference that the selling directors themselves made their sales based upon inside information that they had, but also Plaintiff's particularized allegations support the additional reasonable inference that those same directors actively encouraged selected officers of the company to make similar inside-information-based stock sales. (FAC ¶¶ 184; 185.)

Defendants argue that some of the sales cannot be used to support a claim for insider trading because the sales were made pursuant to a Rule 10b-5-1 plan. However, a 10b5–1 trading plan does not provide an absolute defense to a claim of insider trading. *Stocke v. Shuffle Master, Inc.* (D. Nev. 2009) 615 F.Supp.2d 1180, 1193. SEC regulations require that a 10b5–1 plan specify the amount of securities to be sold, the date and price of the sales, or a formula for determining the amount, date and price, and that the plan was "entered in good faith." *Ibid.* Thus, the defense that sales were pursuant to a 10b5–1 plan requires an additional factual finding of good faith, which cannot be resolved on demurrer. Compare *Jara v. Suprema Meats, Inc.* (1st Dist. 2004) 121 Cal. App.4th 1238, 1252 – 1260, holding that minority shareholder's fact-intensive breach of fiduciary claims should have been determined at trial, rather than by *in limine* dismissal.

ORDER.

For the above-stated reasons, Plaintiff Public School Teachers' Pension And Retirement Fund Of Chicago has made a more than adequate showing of reasonable doubt that Intuitive Surgical, Inc.' s directors were incapable of making an impartial decision regarding the initiation of this litigation. Demand futility is shown.

Accordingly, the Demurrer of the Defendant Director/Officers Gary S. Guthart, et.al, is Overruled. Defendants herein to Answer the First Amended Complaint within 20 days of Notice of Entry of this Order. Plaintiff's Counsel to give Notice of Entry.

Dated: March 26, 2015.

IT IS SO ORDERED.

JUDGE OF THE SUPERIOR COURT