SIMPSON THACHER

MEMORANDUM

SEC Charges CVS With Misleading Investors Through Materially Misleading Disclosures and Use of Improper Accounting

April 24, 2014

On April 8, 2014, the Securities and Exchange Commission ("SEC") charged CVS Caremark Corp. ("CVS") with violating the federal securities laws by failing to accurately disclose significant financial setbacks and overstating its financial performance through improper accounting.[1] CVS, which has neither admitted nor denied the charges, has agreed to pay $20 million to settle the case.

I. THE ALLEGATIONS

The complaint in *Securities and Exchange Commission* v. *CVS Caremark Corp.*, filed in the United States District Court for the District of Rhode Island, alleges securities laws violations with regard to both of CVS's business segments – Caremark, the company's pharmacy benefits manager ("PBM"), and CVS retail, which is comprised of the company's drug store chain.

A. Materially Incomplete and Misleading Disclosures

According to the complaint, in CVS's September 2009 prospectus supplements for a $1.5 billion senior note offering, the company "failed to disclose material changes in its affairs that had occurred after the fiscal year ended December 31, 2008 and which had not been described in any subsequently filed Form 10-Q or Form 8-K."[2] Specifically, the prospectus supplements allegedly omitted reference to:

- The fact that CVS had lost several large PBM contracts for 2010, resulting in a 125% increase in net lost revenue for the 2010 PBM selling season, and
- The fact that CVS "fared very poorly" in benchmarks (released by the Centers for Medicare & Medicaid Services) for the Medicare Part D bidding process for 2010; an internal CVS document projected that in the "annual bidding process that allocates

[1] *See* Complaint, *Securities and Exchange Commission* v. *CVS Caremark Corp.* (D.R.I. 2014); *see also* Press Release, U.S. Securities and Exchange Commission, "SEC Charges CVS With Misleading Investors and Committing Accounting Violations" (Apr. 8, 2014). CVS was charged with violations of Section 10(b) of the Securities Exchange Act and Rule 10b-5 thereunder; Section 17(a) of the Securities Act; and provisions of the securities laws requiring issuers to file accurate quarterly reports, keep accurate books and records, and devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that its financial statements conform with GAAP.

[2] Complaint at 6.

> 'covered lives' – persons covered by Medicare Part D – to insurance companies whose bids fall below the 'benchmark,'" CVS "stood to lose 580,000 covered lives and as much as $101 million of 2010 EBIT (earnings before interest and taxes)."[3]

As a result, the complaint asserts that CVS misled investors regarding the expected financial results of the PBM segment.

According to the complaint, CVS only disclosed the full extent of its financial setbacks in an earnings call on November 5, 2009. In the same call, however, CVS allegedly further misled investors by materially misrepresenting the PBM segment's retention rate for 2010. In arriving at its announced retention rate of 92% – as opposed to the actual retention rate of 88% – CVS had allegedly manipulated the rate, "changing the way that it was calculated, and thereby excluding the expected $1.7 billion revenue loss from its lack of success in the Medicare Part D bidding process."[4] According to the complaint, CVS did not disclose the change in its calculation methodology, thus concealing the actual extent of its loss of business.

B. Improper Accounting and Related Materially Misleading Disclosures

In October of 2008, CVS acquired the Longs chain of drugstores. In connection with that acquisition, CVS's accounting firm prepared a valuation for the Longs purchase price acquisition ("PPA"). According to the complaint, in CVS's Form 10-Q filed on November 5, 2009, the reported value of Longs tangible assets was reduced by $212 million as compared with the valuation firm's draft report, and there was a corresponding increase in "goodwill." The complaint alleges that the "reduction of tangible assets resulted primarily from a $189 million decrease in the reported value of the Longs stores' personal property"; CVS completely wrote off all personal property in most of the Longs stores.[5] CVS's alleged failure to recognize $189 million in expenses, in violation of GAAP, materially overstated the company's operating profit, income from continuing operations, net income, and earnings per share ("EPS").

CVS also allegedly "made a one-time catch-up adjustment reversing $49 million of depreciation taken on Longs assets" since the acquisition, "and it did not take an additional $19 million of depreciation that would otherwise have been taken on Longs personal property in the third quarter."[6] As a result of the depreciation reversal, CVS's EPS increased by approximately 2.4 cents in the third quarter of 2009.

Because of its allegedly improper accounting, the complaint asserts that certain statements in CVS's Form 10-Q of November 5, 2009 were materially false and misleading – in particular, CVS's statements that, as compared with the third quarter of 2008, "consolidated operating

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[3] *Id*.

[4] *Id*. at 7.

[5] *Id*. at 9.

[6] *Id*. at 8.

expenses had increased due to Longs integration costs" and that "retail operating expenses had decreased as a percentage of net revenues due to lower depreciation expense offset by Longs integration costs."[7] Likewise, according to the complaint, certain statements made by the company's then-CEO in the November 5, 2009 earnings call were materially false and misleading. Specifically:

- The statement that EPS in the third quarter was 65 cents, "just above" the company's guidance of 62-64 cents was materially false and misleading, because EPS only reached that level as a result of the improper PPA accounting and the depreciation reversal; and
- The statement that "compared to the third quarter of 2008, retail operating expenses had decreased as a percentage of net revenue due to 'good spending discipline' partially offset by one-time Longs integration expenses" was materially false and misleading, because if it were not for the depreciation reversal, retail operating expenses would have actually increased.[8]

II. LESSONS LEARNED

The charges brought by the SEC serve as an important reminder of some basic, yet crucial, principles:

- A company's discussion of MD&A must be fair and balanced – *i.e.*, it must accurately disclose all known material trends, whether positive or negative.
- Misstatements of even small amounts could be material if they mask a trend.
- Making changes to calculation methodologies could be material, particularly to the extent such modifications change the direction of a trend.

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If you have any questions or would like additional information, please do not hesitate to contact Yafit Cohn at (212) 455-3815 or yafit.cohn@stblaw.com, or any other member of the Firm's Public Company Advisory Practice.

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[7] *Id*. at 9.

[8] *Id*. at 10. The SEC also brought an administrative proceeding against the then-retail controller at CVS for his alleged orchestration of the improper accounting adjustment, which the controller agreed to settle, without admitting or denying the charges, by paying a $75,000 penalty and being barred for at least one year from practicing as an accountant for a publicly traded company or other SEC-regulated entity.

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