

IN THE SUPREME COURT OF THE STATE OF DELAWARE

CLARE C. MARSHALL, )  
 ) No. 27, 2009  
 ) Court Below - Court of  
 ) Chancery of the State of  
 Plaintiff Below, ) Delaware in and  
 Appellant, ) for New Castle County  
 ) C.A. No. 3892  
 )  
 )  
 v. )  
 )  
 )  
 CHARLES H. SALIGMAN, PATRICK C. )  
 RICHMOND, YVONNE M. CRAIG, MARTIN )  
 R. ROTHSCHILD, ELAINE A. LASATER, )  
 WILLIAM M. LEWIS, GILBERT W. )  
 COULSON, RACHEL N. LIEBERMAN, )  
 TIMOTHY M. STOCKDALE AND CARLOS B. )  
 HUELVA, )  
 )  
 Defendants Below, )  
 Appellees, )  
 )  
 - and - )  
 )  
 SECURANCE INCORPORATED, )  
 )  
 )  
 Nominal Defendant Below, )  
 Appellee. )

APPELLANTS' OPENING BRIEF

Filed by A, Counsel for Appellant

February 17, 2009

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### **NATURE OF PROCEEDINGS**

On January 6, 2009, the Court of Chancery issued a Memorandum Opinion granting the Defendants' Motion to Dismiss pursuant to Court of Chancery Rules 12(b)(6) and 23.1. Plaintiff filed a Notice of Appeal with the Delaware Supreme Court on January 16, 2009. This is Plaintiff's Opening Brief.

### **SUMMARY OF THE ARGUMENT**

This Court should reverse the Court of Chancery's judgment in its entirety because the Plaintiff adequately plead particularized facts to show that demand was futile pursuant to Court of Chancery Rule 23.1, and adequately stated a claim of oversight liability against Officer Defendants pursuant to Court of Chancery Rule 12(b)(6). Specifically, the Court of Chancery erred in granting Defendants' Motion to Dismiss pursuant to Rule 23.1 because the Plaintiff plead particularized facts to show that the Director Defendants faced a substantial likelihood of personal liability. Director Defendants faced a substantial likelihood of liability because they failed to act in response to "red flags" that showed that their audit committee was either circumvented or inadequate. Because the Director Defendants faced a substantial likelihood of liability, they could not exercise their independent and disinterested business judgment in responding to a shareholder demand, and demand should have been excused as futile. Furthermore, the Court of Chancery committed legal error by misapplying the pleading standard in determining demand futility and conflating it to a more rigorous one necessary to win a judgment on

the merits. In alleging demand futility, a shareholder need not demonstrate a reasonable success on the merits.

The Court of Chancery also incorrectly held that Plaintiff failed to state a claim. Delaware law imposes fiduciary duties of loyalty and care upon corporate officers and directors to be reasonably informed concerning the corporation. This duty impresses upon officers to exercise a good faith judgment that the corporation's information and reporting system is adequate to assure that appropriate information comes to their attention in a timely manner as a matter of ordinary operations. The Officer Defendants did not fulfill their oversight duties because they failed to discover the fraudulent scheme being perpetrated by senior managers over whom they either closely worked or supervised, despite being uniquely positioned to do so. For at least three years, the Officer Defendants utterly failed to attempt to assure that a reasonable information and reporting system existed within the corporation. Their actions constitute a conscious disregard for the duties imposed upon them by virtue of their position as a fiduciary.

Moreover, the Officer Defendants failed to notice "red flags" that were waved in their faces showing that the corporation's internal controls were inadequate. This failure ultimately led the company to sustain more than \$520 million in fines, restitution, and penalties. Because the Court of Chancery failed to recognize the existence of the "red flags" that should have alerted the Officers to illegal conduct, the Court should reverse the decision below in its entirety.

## STATEMENT OF FACTS

Defendant Securance Inc. is a Delaware corporation. (Compl. 5.) Director Defendants Saligman, Richmond, Craig, Rothschild, Lasater, Lewis, and Coulson have been members of the Board at all relevant times. Id. at 3. Officer Defendants Lieberman, Stockdale, and Huelva have served as Senior Officers of Securance at all relevant times. Id. at 4-5. Plaintiff Clare C. Marshall has continuously owned shares of Securance common stock at all times relevant to this action. Id. at 3.

Securance provides managed care services to Medicaid and Medicare recipients. (Compl. 6.) It is required to either spend 80% of the premiums it receives on direct medical services, or refund to the States any amounts below that benchmark, a metric known as the "medical loss ratio." Id. at 7-8. In 2005, three senior Securance officials created a fraudulent scheme to illegally increase net profits by falsely overstating the medical loss ratio in four states that accounted for 40% of the company's premium annual revenue. Id. at 10. From 2005-2007, the managers falsified data to retain substantial premium revenues that, by law, should have been reimbursed to the states. Id. Instead, Securance transferred unspent Medicaid premiums to a wholly-owned subsidiary to hide profits from state regulators while at the same time artificially inflating the corporation's publicly reported net income. Id. at 11-12. From 2005-2007, Securance illegally withheld \$120 million from the affected states, and falsely reported these funds as net income in its financial statements. Id. at 12. As a result, Securance's stock

price dramatically increased, with company earnings handily beating expectations. Id. at 13.

Though senior company officials failed to discover the fraud, industry analysts became suspicious after they noticed disparities in Securance's filings. (Compl. 13.) The suspicions were expressed in print and online business publications and ultimately led to state and federal investigations into the company's practices. Id. at 14.

The senior managers responsible for the scheme plead guilty to conspiracy in May 2008. (Compl. 11.) In their plea bargains the Senior Managers stated that they had the support of the Company's senior officers. Id. at 15. As a result of this fraud, Securance plead guilty to one count of mail fraud and was given \$400 million in criminal penalties. Id. at 16. Securance must also make \$120 million in restitution to the four states and cannot do business there for three years. Id. Since the fraud was uncovered, Securance has lost over \$3 billion in market capitalization, and its stock price has dropped 66% (\$73 per share). Id. at 6.

The 2008 fraud was not Securance's first run-in with the law. In 2004, Securance entered into consent decrees with Virginia and Connecticut Medicaid agencies over claims that the company had improperly denied medical services to boost profits. (Compl. 19-20.) Though there was no admission of guilt, Securance paid \$200,000 in fines and promised to comply with applicable law. Id. at 20. Despite this, the Securance defendants failed to strengthen or attempt to restructure the Company's compliance system. Id. at 21.

## ARGUMENT

I. Under Court of Chancery Rule 23.1, shareholder demand is excused as futile when the board cannot exercise independent and disinterested business judgment. To establish demand futility, a plaintiff need only allege particularized facts that create doubt that the board is capable of exercising such judgment. Did the Court of Chancery err in granting Defendants' Motion to Dismiss where Plaintiff adequately plead particularized facts to show demand was futile?

### A. Standard of Review

The Court's review of a decision of the Court of Chancery dismissing a complaint under Rule 23.1 is de novo and plenary. Brehm v. Eisner, 746 A.2d 244, 253 (Del. 2000) (overruling Aronson v. Lewis, 473 A.2d 805 (Del. 1984), and ridding of the abuse of discretion standard for review of Rule 23.1 complaints). In reviewing such a decision, the Court should draw all reasonable inferences in favor of the plaintiff. Id.

### B. Merits of the Argument

1. The Court of Chancery erred by holding that plaintiffs failed to plead particularized facts to show a substantial likelihood of personal liability on part of the Director Defendants when Plaintiff adequately showed that Director Defendants failed to act in response to "red flags."

The right of a stockholder to pursue a derivative action is limited to situations where the stockholder has demanded that the directorial board pursue a corporate claim and they have wrongfully refused to do so, or where demand is excused because directors are incapable of acting impartially as to the litigation. Del. Ch. Ct. R. 23.1; see also Rales v. Blasband, 634 A.2d 927, 934 (Del. 1993). A stockholder derivative complaint therefore needs to assert

particularized factual allegations that create a reasonable doubt that the board of directors can properly exercise its independent and disinterested business judgment in responding to the demand. Rales, 634 A.2d at 934. If the derivative complaint satisfies the burden, demand will be excused as futile. Id. Additionally, in alleging demand futility, a shareholder need not demonstrate a reasonable success on the merits. Id.

Demand is excused as futile if the board cannot be seen as disinterested. Rales, 634 A.2d at 936. A disinterested board is one where a corporate decision will not find the directors personally liable. Id. But "the mere threat of personal liability . . . is insufficient to challenge either the independence or disinterestedness of directors." Aronson, 473 A.2d at 815. The threat for liability must rise to a "substantial likelihood." Id.; see also In re Baxter Int'l, Inc. S'holders Litig., 654 A.2d 1268 (Del. Ch. 1995).

Director liability to the corporation for breach of the duty of oversight may arise from "an unconsidered failure of the board to act in circumstances in which due attention would, arguably, have prevented the loss." In re Caremark Int'l Inc. Deriv. Litig., 698 A.2d 959, 967 (Del. Ch. 1996). "[B]ut absent cause for suspicion there is no duty upon the directors to install and operate a corporate system of espionage to ferret out wrongdoing which they have no reason to suspect exists." Graham v. Allis-Chambers Mfg. Co., 41 Del. Ch. 78, 84 (Del. 1963). That is to say corporate directors are entitled to believe that, unless "red flags" surface, officers and employees are exercising their duties in the best interest of the corporation

and in compliance with the law. Stone v. Ritter, 911 A.2d 362, 370 (Del. 2006). Directors will be potentially liable for breach of their oversight duty only if they ignore "red flags" that actually come to their attention. Id. In summary, demand can be excused as futile if a board is not disinterested. Interest in litigation can be determined by substantial likelihood of liability, and liability for breach of oversight duty can result from ignoring "red flags."

In dismissing the Complaint for failure to satisfy Rule 23.1, the Court of Chancery erred by misconstruing "red flags." Specifically, the Court of Chancery incorrectly ruled that the Director Defendants did not face a substantial likelihood of liability because there were no "red flags" that would have alerted defendants to any problems with Securance's audit committee. But the Court of Chancery's ruling failed to apply any case law in defining "red flags." Chancellor Siegel stated "[w]hat exactly qualify as 'red flags' . . . has not been further explained in our cases." (Mem. Op. 24.) Chancellor Siegel failed to note the definition this Court applied in Stone: "red flags" are "facts showing that the board ever was aware that . . . internal controls were inadequate, that these inadequacies would result in illegal activity, and that the board chose to do nothing about problems it allegedly knew existed." Stone, 911 A.2d at 370.<sup>1</sup>

In Stone, this Court affirmed the judgment of the Court of Chancery holding that there were no "red flags" to show the inadequacies of internal controls. Id. at 364. This Court found no

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<sup>1</sup> Stone sets the foundation for the "good faith" analysis in oversight cases. That analysis is only applicable in the absence of "red flags."

"red flags" because the corporation had a reasonable reporting system in place (two committees, one overseeing the other), and the allegations were further refuted by the report of an independent consultant. Id. at 371. Unlike in Stone, the Director Defendants did not have two committees. The only system in place was the audit committee that failed to detect recent regulatory violations. Additionally, unlike in Stone, the Director Defendants did not contract a private consultant to ensure the reliability of the system in place. Following this line of analysis, it is reasonable to conclude that there were "red flags" to alert the Director Defendants that the audit committee had been circumvented or was otherwise inadequate. Those "red flags" in particular were the 2004 consent decrees.

The Court of Chancery relied on Graham v. Allis-Chambers Mfg. Co. to disqualify the consent decrees as "red flags." (Mem. Op. 24.) Though Chancellor Siegel noted that the consent decrees occurred immediately prior to the year in which the Senior Managers started their scheme, Chancellor Siegel held that, like in Graham, the decrees were insignificant. (Mem. Op. 24-25.) Specifically, Chancellor Siegel found that the decrees were insignificant because they disavowed any admission of wrongdoing on part of the Director Defendants and were immaterial to the company's operations. (Mem. Op. at 25.)

The Court of Chancery's analysis ignores two central aspects of Graham and considers elements unsupported by case law. This Court held in Graham that the consent decrees were "notice of nothing"

because the decrees were from more than twenty years prior to the trying of the case. Graham, 41 Del. Ch. at 83, 84. Additionally, none of the directors in place were the same as from the consent decrees, and though three were aware of the consent decrees, they each took individual steps to ensure that no remnants of those decrees prejudiced the corporation during their leadership. Id. These two elements were crucial in the Court's analysis. See id. Graham, therefore leads to the conclusion that the timing of the decrees and the composition of the board are of crucial importance to defining the decrees as "red flags."

Securance entered into consent decrees in 2004, the year before the Senior Managers began their defrauding scheme. (Compl. 19.) The Director Defendants comprised the Board when the decrees were issued. Though the decrees did not involve allegations of fraud, they did, however, concern Medicaid regulatory violations. Id. at 20. Additionally, the same audit committee was in place when the consent decrees were issued as when the Senior Managers defrauded Medicaid. Id. 20. Unlike in Graham, where the decrees were twenty years old and the board of directors was completely different, the decrees here were entered only one year before the origin of this action. Because the same board is still in place, the consent decrees here were "red flags" that should have put the board on notice that "internal controls were inadequate [and] that these inadequacies would result in illegal activity." Stone, 911 A.2d at 370. Still, the board did nothing and the corporation lost more than \$3 billion in market

capitalization, paid \$400 million in criminal penalties, and must reimburse \$120 million to the defrauded States. (Compl. 1.)

Chancellor Siegel also disqualifies the consent decrees as "red flags" because there was no admission of wrongdoing on part of the Director Defendants and the fines were immaterial to the Company's operations. (Mem. Op. 25.) Graham, on the other hand, gives zero importance to either issue. See generally Graham, 41 Del. Ch. 78. The directors in Graham were also not liable and the Delaware Supreme Court made no issue as to the amount Allis-Chambers was fined. Id. There is no indication that either of those issues is of any importance to the finding of whether the decrees are "red flags." Chancellor Siegel's holding, therefore, is unfounded and lacks support.

As this Court previously held did in Rales, this Court should also use its common sense and find that the Director Defendants were not disinterested, breached their fiduciary duty of oversight by failing to respond to "red flags," and find that demand was therefore futile. See Rales, 634A.2d at 936 (using common sense to find that defendants had disqualifying financial interests). The 2004 consent decrees were in fact "red flags" waved in the face of the Director Defendants, yet they failed to act. See Wood v. Baum, 953 A.2d 136, 143 (Del. 2008) (stating red flags "are only useful when they are either waved in one's face or displayed so that they are visible to the careful observer").

2. The Court of Chancery misapplied the standard for considering a Motion to Dismiss pursuant to Rule 23.1 by conflating the pleading standard with the more rigorous one necessary to win a judgment on the merits and by failing to draw all reasonable inferences in Plaintiff's favor.

Court of Chancery Rule 23.1 requires that a plaintiff asserting demand futility make particularized allegations concerning the "reasons for the plaintiff's failure to obtain the action or for not making the effort." Del. Ch. Ct. R. 23.1. The alleged particularized facts must create a doubt that the board of directors is capable of acting in an independent and disinterested manner as to the plaintiff's demand. See Rales, 634 A.2d at 934. "In this context, futility does not mean that there is no likelihood that a board will agree to the demand." Heineman v. Datapoint Corp., 611 A.2d 950, 952 (Del. 1992) (citing Levine v. Smith, 591 A.2d 194, 200 (Del. 1991)). Additionally, Plaintiff need not demonstrate a reasonable probability of success on the merits to establish demand futility. See Rales, 634 A.2d at 934. To the contrary, a court should accept as true all particularized allegations and draw all reasonable inferences in favor of the plaintiff. See Brehm, 746 A.2d at 255.

In granting the Defendant's Motion to Dismiss, the Court of Chancery erred by holding the plaintiff to a higher standard than that set under Rule 23.1. Specifically, Chancellor Siegel committed legal error by setting the legal standard to a more rigorous one in which Plaintiff was asked to allege facts sufficient to win judgment on the merits. In dismissing the complaint, Chancellor Siegel relied on Caremark language stating that the lack of oversight theory "might be the most difficult theory in corporate law upon which a plaintiff

might hope to win a judgment." (Mem. Op. 23.); see also Caremark, 698 A.2d at 967 (emphasis added). But that Caremark standard is misapplied here because this Court has held that plaintiffs need not demonstrate a reasonable probability of success on the merits to establish demand futility. See Rules, 634 A.2d at 934. Plaintiffs do not bear the duty to allege particular facts sufficient to "win a judgment." The Court of Chancery was not in a posture to determine whether plaintiffs were entitled to judgment. Chancellor Siegel therefore erred in relying on that language to make the court's decision on the motion for summary judgment. Moreover, Caremark was considering the approval of a settlement agreement and not ruling on a motion to dismiss. Caremark, 698 A.2d at 959. The application of Caremark as a standard for a motion to dismiss is therefore questionable.

The Court of Chancery also failed to accept as true all particular allegations and all reasonable inferences that logically flow from them. See Brehm, 746 A.2d at 255. Instead, Chancellor Siegel dismissed many of the Plaintiff's allegations as "conclusory rhetoric" that did not "impress . . . as sufficient to support an inference that the Director Defendants consciously failed to discharge their oversight responsibilities." (Mem. Op. 23.) Chancellor Siegel accepted as factual allegations the nature of the corporation's business, the 80% medical loss ratio benchmark, the existence of a compliance system overseen by the audit committee, Senior Managers' guilty pleas to conspiracy that included allegations of senior officer involvement, the dramatic increases in the Company's reported net

income, and the sky rocketing stock prices. Id. at 22-23. But the Court of Chancery failed to draw reasonable inferences from these allegations in favor of the plaintiff.

For example, Plaintiff alleged that demand was futile because Senior Managers' guilty pleas to conspiracy included allegations that Senior Officers were involved. (Mem. Op. 23.) Though the Senior Officers were not identified, considering that Director Defendants Saligman, Richmond, and Craig were also Senior Officers of the corporation, a reasonable inference is that the Board was not disinterested because of the possibility that Directors Saligman, Richmond, and Craig were the unidentified Senior Officers and demand was therefore futile. This inference flows logically from the particular allegations if drawn in favor of the plaintiff.

Furthermore, considering the nature of the HMO business, it would be reasonable to conclude that a \$39 million net income increase in one year, to an additional \$16 million increase in the following two years is grounds for suspicion. A one-hundred and twelve percent (112%) net income increase over three years in an industry where profits are legally limited to a 20% band of premium revenue is cause for concern. (Compl. 8, 9.) Analysts praised the company for its successes, but also questioned whether Securance was making such large profits illegally. Id. at 13-14. Analysts suspected wrongdoing on the part of the corporation because of the nature of the HMO business, still the Director Defendants themselves suspected and did nothing. Analysts' suspicions led Goldman Sachs' Thadeus Gipp to investigate and uncover the fraud. (Compl. 15.) This leads to a reasonable

inference that the Director Defendants failed to respond to obvious "red flags" that outside analysts were able to identify, was therefore substantially likely to be held liable, was an interested party, and demand was consequently futile. Again, the Court of Chancery failed to accept as true the Plaintiff's allegations and failed to draw these reasonable inferences in favor of the Plaintiff. The Court of Chancery gave no explanation as to why certain allegations were ignored, why inferences weren't reasonably drawn, and simply dismissed them as "conclusory rhetoric." (Mem. Op. 22.)

II. For proper corporate oversight, Delaware law imposes upon corporate officers the fiduciary duties to exercise due care and appropriate attention. An officer who fails to take notice of "red flags" may be held liable for failing to properly exercise his fiduciary duties. Did the Court of Chancery err when it held that the Plaintiff did not state a claim where the Officer Defendants failed to fulfill their oversight responsibilities by their utter failure to act and respond to "red flags" waved in their faces?

As a preliminary note, Plaintiff understands the burden faced in trying to establish a claim assessing liability to an officer for the failure to exercise proper oversight over the activities of the corporation. As one court put it, "the theory here advanced is possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment." In re Caremark International Inc., 698 A.2d 959, 967 (Del. Ch. 1996). Despite that high standard, Plaintiff respectfully requests this Court to reverse the decision of the Chancery Court below, and hold that the Officer Defendants failed to exercise proper oversight in monitoring Securance's activities and have thus violated their duty of loyalty to the corporation.

#### A. Standard of Review

"We review de novo a decision to grant a motion to dismiss under Court of Chancery Rule 12(b)(6), to 'determine whether the trial judge erred as a matter of law in formulating or applying legal precepts.'" Gantler v. Stephens, 2009 WL 188828 at \*5 (Del. Supr. 2009) (internal citations omitted). "Dismissal is appropriate only if it appears 'with reasonable certainty that, under any set of facts that could be proven to support the claims asserted, the plaintiff would not be entitled to relief.' In reviewing the grant or denial of a motion to dismiss, we view the complaint in the light most favorable to the non-

moving party, accepting as true its well-pled allegations and drawing all reasonable inferences that logically flow from those allegations.” Id. (internal citations omitted).

## **B. Merits of the Argument**

### **1. The Court of Chancery should be reversed because the Officer Defendants failed to fulfill their oversight responsibilities by their utter failure to act in implementing an adequate information and reporting system.**

As the Court of Chancery stated in the opinion below, Delaware case law was unclear as to whether the test for director liability applies with equal force to the actions of directors. (Mem. Op. 26.) This Court recently resolved this issue by declaring that directors and officers owe the same fiduciary duties. Gantler, 2009 WL 188828 at \*9. “In the past, we have implied that officers of Delaware corporations, like directors, owe fiduciary duties of care and loyalty, and that the fiduciary duties of officers are the same as those of directors. We now explicitly so hold.” Id. As a result, the Securance officers are to be held to the same standard as would its directors in determining whether they breached their fiduciary duties to the corporation’s shareholders.

Delaware law imposes fiduciary duties of care and loyalty upon corporate officers and directors. Gantler, 2009 WL 188828 at \*9. These duties include being reasonably informed concerning the corporation and monitoring the corporation’s compliance with law as well as its business performance. Caremark, 698 A.2d at 970. To fulfill these responsibilities in the oversight context, Delaware courts require that such officers “exercise a good faith judgment that

the corporation's information and reporting system is in concept and design adequate to assure the board that appropriate information will come to its attention in a timely manner as a matter of ordinary operations." Id. The Court of Chancery stated that such officers' duties demand that they assure that the corporation has an adequate information and reporting system in place, and that the failure to do so could render an officer liable for losses caused by non-compliance with applicable legal standards. Id. A plaintiff must satisfy a four-part test to demonstrate that a corporation's officers breached their duty of care by failing to properly oversee and control its employees. One must demonstrate either: (1) that the [officers] knew or (2) should have known that violations of law were occurring and, in either event, (3) that the [officers] 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. Id. at 971.

There are two primary scenarios in which corporate officers may be held liable for breach of the duty to exercise due care and appropriate attention. The first occurs when officers make a decision that results in loss because the decision was ill advised or negligent. Caremark, 698 A.2d at 967. In such a case, the business judgment rule will protect an officer from liability provided that the process used to reach the decision was either rational or employed in a good faith effort to advance the corporate interests. Id. The other situation arises from "an unconsidered failure...to act in circumstances in which due attention would, arguably, have prevented the loss." Id. The case at bar invokes the second situation.

In Caremark, the court evaluated a settlement agreement that involved claims that members of the corporation's board of directors had breached their fiduciary duty of care to the corporation because of alleged violations of federal and state law. 698 A.2d at 960. The corporation was accused of violating the terms of the Anti-Referral Payments Law ("ARPL") that prohibit health care providers from paying any remuneration to induce Medicare or Medicaid patient referrals. Id. at 961-62. As a result of the alleged violations, Caremark paid approximately \$250 million civil and criminal fines and reimbursements to public and private parties. Id. at 960-61. In approving the settlement agreement, the court held that the record did not reflect a conclusion that the defendants had breached a fiduciary duty, noting that their actions neither lacked good faith in the exercise of their monitoring duties nor had they conscientiously permitted a known violation of law to occur. Id. at 972.

To support that conclusion, the court relied upon several actions taken by the corporate directors indicating they had not breached their fiduciary duties. For example, the corporation announced that it would pay no management fees to physicians for services for Medicare and Medicaid patients in response to a government investigation. Caremark, 698 A.2d at 962. The company also took additional steps designed to comply with the ARPL by publishing guidelines to assure compliance. Id. at 963. The company also implemented a policy that required its regional officers to approve each contractual relationship that the company entered into with a physician. Id. Moreover, not only did the company have an internal

audit plan to assure compliance with business and ethic policies, but the board of directors also reviewed an outside auditor's report that stated there were "no material weaknesses" in the corporation's control structure. Id. Despite the actions taken by the board of directors, the company was ultimately indicted and entered a guilty plea for mail fraud. Id. at 966. As part of the resolution of the claims, "no senior officers or directors were charged with wrongdoing", and the government specifically stipulated that "no senior executive of Caremark participated in, condoned, or was willfully ignorant of wrongdoing in connection with the home infusion business practices." Id. at 965.

The instant case can be distinguished from the facts of Caremark. Unlike the senior officials of Caremark, the Officer Defendants did not fulfill their fiduciary duty of care because they failed to faithfully exercise their monitoring duties. For almost three years, Securance officers failed to discover the fraudulent scheme being perpetrated by the senior managers they either supervised or with whom they closely worked. Moreover, the Officer Defendants failed to supervise the corporation with a critical eye as they failed to notice the discrepancies between the medical loss ratios filed with state regulatory bodies and those filed with the SEC. The Officer Defendants were in a unique position to closely monitor these reports by virtue of their access to privileged information, yet still failed to discover what industry analysts outside the corporation were able to uncover. This lack of oversight demonstrates that the Officer

Defendants either failed to exercise informed judgment or turned a blind eye to the reality of the corporation's financial situation.

By failing to properly oversee the company, the Officer Defendants satisfy the Caremark test for breach of a fiduciary duty. They either knew or should have known that the company was violating the law by shifting revenues from its medical loss ratios in a blatant attempt to increase profits. By doing nothing, the Officer Defendants failed to make a good faith effort to remedy the situation. That failure to act proximately resulted in great losses to the corporation, as Securance paid approximately \$520 million in restitution, fines, and penalties. The Officer Defendants' failure to act constituted "an unconsidered failure of the board to act in circumstances in which due attention would, arguably, have prevented the loss." Caremark, 698 A.2d. at 967.

One of the earlier cases on the law of officer and director oversight liability is Graham, 41 Del.Ch. 78 (Del. 1963). In that case, the company brought a derivative action against its directors and several non-director employees to recover damages resulting from violations of certain federal antitrust laws. Id. at 80. After the facts established that the defendants had no actual knowledge of illegal activity within the company, the company then argued that the directors were liable because they failed to take action designed to learn of and prevent such violations. Id. To establish that the defendants were put on notice of possible illegal activity, the plaintiffs cited two consent decrees that the company entered into with the FTC more than twenty years before. Id. at 83. In holding for

the defendants, the court held that directors are entitled to rely on the honesty and integrity of their employees until something occurs that gives them suspicion otherwise. Id. at 85. "Absent cause for suspicion there is no duty upon directors to install and operate a corporate system of espionage to ferret out wrongdoing which they have no reason to suspect exists." Id. This Court has recently affirmed the continuing validity of this holding. See Stone, 911 A.2d 362 (Del. 2006).

A lack of good faith is necessary in order to hold officers and directors liable for failing to exercise proper oversight. See Caremark, 698 A.2d at 971. As a general rule, where a claim for liability against an officer or director is predicated upon ignorance of liability-creating activities within the corporation, "only a sustained or systematic failure of the [officers] to exercise oversight - such as an utter failure to attempt to assure a reasonable information and reporting system exists - will establish the lack of good faith that is a necessary condition to liability." Caremark, 698 A.2d at 971. "A failure to act in good faith may be shown...where the fiduciary intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties." Stone, 911 A.2d at 369. As the Court described it:

[it must be shown 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 the 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.”  
Id. at 370.<sup>2</sup>

Stone involved an appeal of a Court of Chancery decision dismissing a derivative claim against certain present and former AmSouth directors. The corporation, which operated approximately 600 banking branches, had paid about \$50 million in fines and penalties resulting from its failure to comply with certain federal banking laws and regulations. Stone, 911 A.2d at 365. No fines, penalties, or regulatory actions were taken against the board, nor was any blame assigned to any individual director. Id. at 365-66. In hindsight, the corporation’s internal controls failed to prevent the company from incurring significant liability. Id. at 371. The fact that the reporting procedures ultimately proved ineffective did not change the fact that the board had received and approved relevant policies and procedures, delegated to certain employees the responsibility for filing necessary reports and monitoring compliance, and exercised oversight by relying on periodic reports from those individuals. Id. at 373. In such a case - where there were no “red flags” or any other indication that the directors had acted in bad faith - the court evaluates good faith based on the [officers’] actions, and not by whether the conduct resulted in an unintended adverse outcome. Id.

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<sup>2</sup> Plaintiff reasserts that “officers of Delaware corporations, like directors, owe fiduciary duties of care and loyalty, and that the fiduciary duties of officers are the same as those of directors.” Gantler, 2009 WL 188828 at \*9. As a result, the Officer Defendants are to be held to the same standard as would other corporate directors.

The Officer Defendants here meet the Stone standard as they utterly failed to implement any reporting or information system or control. Like the defendants in Stone, the Officer Defendants here were assigned no individual liability by the government. However, unlike the directors in Stone, the record fails to reflect any actions taken by the Officer Defendants to ensure that the corporation complied with the applicable statutory and regulatory framework. For nearly three years, the Officer Defendants failed to do anything in furtherance of a reasonable information and reporting system that would keep themselves apprised of the corporation's activities. This inactivity satisfies the bad faith standard as it constitutes "a sustained and systematic failure to act" in the face of a known duty. Caremark, 698 A.2d at 971. This lack of action constitutes a "conscious disregard" for the duties imposed upon the officers by virtue of their position as a fiduciary. Stone, 911 A.2d at 369. Because the Officer Defendants violated the fiduciary duty of oversight that they owed to the corporation, the decision of the Court of Chancery should be reversed.

**2. The Court of Chancery should be reversed because the Officer Defendants failed to adequately respond to the "red flags" that were waved in their faces.**

This Court has stated that "red flags" are "facts showing that the board was aware that [the corporation's] internal controls were inadequate, that these inadequacies would result in illegal activity, and that the board chose to do nothing about problems it allegedly knew existed." Stone, 911 A.2d at 370. A corporate officer can be held liable for failing to take notice of red flags, but such warnings "are

only useful when they are either waved in one's face or displayed so that they are visible to the careful observer." In re Citigroup Inc. S'holders Litig., 2003 WL 21384599 at \*2 (Del.Ch. 2003).

The Citigroup case involved a claim by certain shareholders that certain current and former directors had failed to exercise reasonable control over the corporation's officers, employees, and agents of its subsidiaries for losses incurred from the corporation's investments in Enron. 2003 WL 21384599 at \* 1. The plaintiffs claimed that there were a series of red flags that should of put the corporation on notice of the weakness of its internal controls. Id. at 2. These "red flags," however, merely consisted of a series of internal e-mails and memoranda that was circulated at subsidiary levels of the corporation. Id. "There is nothing in the Amended Complaint to suggest or to permit the court to infer that any of these ever came to the attention of the board of directors or any committee of the board. How, exactly, a member of the Citigroup board of directors was supposed to be put on inquiry notice by something he or she never saw or heard of is not explained." Id. As the plaintiff could not show how the "red flag" would have been "waved in the face" of the directors, the court dismissed the complaint. Id. at 3.

The instant case can be distinguished from Citigroup because there were clear signals to the officers that the system in place failed to adequately prevent illegal activity. As early as 2004, the corporation demonstrated the problems it was having in controlling efforts to improperly boost profits. Also, the company should have been alerted to problems when its earnings almost doubled over the

course of one year without any major explanation. Moreover, Securance had reason to believe that its information and reporting systems were inadequate in complying with state laws as the company had illegally offered improper incentives for doctors to deny services to patients. These "red flags" were displayed in a manner such that, with careful observation, the true facts should have been discovered. Because the Officer Defendants failed to notice the "red flags" that were being waved in front of their faces, they failed to exercise their fiduciary duties. The Court of Chancery erred in reaching a contrary conclusion, and as a result, should be reversed.

#### **CONCLUSION**

For the foregoing reasons, Plaintiff respectfully requests this Court to reverse the Court of Chancery's judgment against the Plaintiff in its entirety. Plaintiff requests 30 minutes to be heard orally.

Respectfully Submitted,

Team A