

In the
Supreme Court of Delaware

CLARE C. MARSHALL,
Appellant

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,
Appellees

- and -

SECURANCE INCORPORATED
Appellee.

No. 27, 2009

BRIEF FOR THE APPELLANT

Filed by B, Counsel for Appellant
February 17, 2008

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NATURE AND STAGE OF THE PROCEEDINGS

This stockholder derivative action brought by Plaintiff-Appellant, Ms. Clare C. Marshall on July 3, 2008, on behalf of Securance Incorporated ("Securance" or the "Company"), against its board of directors ("Director Defendants" or the "Board") and three of its non-director senior officers (the "Officer Defendants") asserting claims of breaches of their fiduciary duty of loyalty by failing to act in good faith to fulfill their oversight responsibilities. Specifically, as a result of Defendants' failure to implement any reasonable internal compliance system and their conscious disregard of "red flags," Securance paid over \$500 million in fines and restitution, was banned from doing business in four states, and Securance suffered a loss of \$3 billion in its market capitalization.

Subsequently, Defendants' filed a motion to dismiss the derivative complaint in this action pursuant to Court of Chancery Rules 12(b)(6) and 23.1 for, respectively, failure to state a claim and failure to adequately plead that pre-suit demand is excused.

On January 6, 2009, the Court of Chancery (Seigel, C), issued a memorandum opinion granting Defendants' motion to dismiss. It is from this judgment that plaintiff now appeals.

SUMMARY OF ARGUMENT

This court should reverse the order of the court below, dismissing the derivative complaint for failure to adequately allege demand futility under Court of Chancery Rule 23.1. Contrary to the assertion of the court below, the mere fact that plaintiff admits that the board had "some form" of regulatory compliance program, namely an "audit committee," does not make it a reasonable one, as required under *Stone*.

Even if this court holds that the compliance program was reasonable, the defendants consciously failed to monitor and oversee operations of such system by ignoring "red flags" including the fact that soon after the board implemented profit-based incentive compensation plan for senior executives giving the executives incentives to inflate the results of their business segment. The first red flag came to fruition when, in the following year, Securance was investigated for systematically denying medical services to the Company's indigent and disabled members to boost profits by offering financial incentives to doctors for the purpose of boosting profits. The company was forced to pay a fine and enter into consent degrees promising to comply with state law and not offer doctors financial incentives for denying claims. This red flag was, too, ignored.

Appellant has sufficiently stated a claim for fiduciary oversight liability against the Officer Defendants and therefore, the motion to dismiss granted by the court below, pursuant to Court of Chancery Rule 12(b)(6), should be reversed. The oversight liability test for director oversight claims set out in *Stone* should not apply with equal force to non-director officers. While the court below appropriately analogized this problem to that of whether the business judgment rule applies to corporate officers, its conclusion that officers should be afforded the same protection is misguided. Not only is Delaware law generally lacking in its attention to corporate officers, Delaware courts have yet to hold that the business judgment rule applies with equal force to officers. Officers, as agents of companies, should be held to a higher standard of fiduciary duty to the company because of their direct involvement with the day-to-day operations of the company. Further, in this era of corporate scandal and economic crisis, increasing the prospect for civil liability for

officers breaching fiduciary duties will serve as an important safeguard against corporate misconduct. Finally, the policy reasons behind the business judgment rule and limited oversight liability as they apply to directors do not apply to corporate officers.

STATEMENT OF THE FACTS

The Parties

Appellant Clare C. Marshall owns 1,000 shares of Securance common stock, having continuously held such shares at all relevant times. *Compl.* at ¶3. Nominal Defendant Securance, is a publicly-traded Delaware corporation, specializing in managed healthcare. *Id.* at ¶7. Director Defendants are and at all relevant times of the complaint have been the seven members of the board. *Id.* at ¶¶4-5. Officer Defendants, are the company's most senior non-director officers. *Id.* at ¶6.

Securance's Business Model

The state and federal governments pay Securance a premium for every Medicaid and Medicare recipient who enrolls in one of Securance's managed health care plans and, in turn, enters into contracts with health care providers to service Securance enrollees. *Id.* at ¶¶8,10-14.

Under Securance's contracts with the states, each state pays Securance a premium for every Medicaid and Medicare recipient that enrolls in one of Securance's managed plans. The company must then either use 80% of such premiums or refund the difference.

Red Flags Disregarded

In 2003, the board approved an "incentive compensation plan" that affected all Officer Defendants. *Id.* at ¶38. In early 2004, state investigators in Virginia and Connecticut examined claims that Securance was systematically denying certain medical services to Medicaid patients

to boost profits. It was asserted that Securance had offered improper financial incentives for doctors to deny needed services to patients in order to increase profits. *Id.* at ¶¶39-40. Thereafter, Securance entered into court approved consent decrees with Virginia and Connecticut, promising to comply with applicable law and agreed to pay fines of \$200,000. *Id.* at ¶42.

The Particulars of Securance's Fraud

In early 2005, three senior managers attempted to boost profits by overstating the percentage of premiums used to state regulators in Ohio, Pennsylvania, New York and New Jersey, and thus did not have to return the portion under 80%. During this time, the senior managers should have reported medical loss ratios of 74-76%. In sum, the Company failed to refund to the states \$120 million. *Op.* at 6-7. The fraud resulted in the Company's net income nearly doubling.

The Fallout and its Aftermath

In March 2008, the Medicaid control units for the four affected states launched a joint investigation in cooperation with the FBI. The investigation uncovered that three senior managers committed this fraud and those managers subsequently plead guilty to conspiracy to commit Medicaid fraud. *Id.* at 13-15. In their plea agreements, the senior managers confirmed that they acted with the express or implied support of the Company's senior officers. Subsequently, Securance plead guilty to mail fraud and agreed to pay \$520 million in criminal penalties and refunds and was disqualified from doing business for three years in the affected states. As a part of its settlement, Securance agreed to establish a new and separate compliance committee that will be more engaged and proactive.

Questions Presented

- I. Whether demand is excused, where the only evidence of a reporting system is an audit committee and a part-time chief compliance officer and where the company's past regulatory troubles, including fines, were ignored by the board.

- II. Whether appellant has sufficiently stated a claim against Officer Defendants where oversight liability should not apply with equal force to officers because the Supreme Court of Delaware has yet to hold that the business judgment rule applies with the same force to officers as directors; officers, as agents, should be held to a higher standard of fiduciary care; and the policy bases underlying the business judgment rule in its application to directors do not apply to officers.

ARGUMENT

- I. WHERE THE ONLY EVIDENCE OF A CORPORATION'S INFORMATION AND REPORTING SYSTEM IS AN AUDIT COMMITTEE AND A PART-TIME CHIEF COMPLIANCE OFFICER AND WHERE THE COMPANY'S PAST REGULATORY TROUBLES INCLUDING FINES WERE IGNORED BY THE BOARD, AN "ADEQUATE" REPORTING SYSTEM DID NOT EXIST, THE COMPANY IGNORED "RED FLAGS" AND THEREFORE, DEMAND IS EXCUSED. *STONE V. RITTER*, 911 A.2D 362 (DEL. 2006); *IN RE CAREMARK INT'L INC. DERIVATIVE LITIG.*, 698 A.2D 959 (DEL. CH. 1996).

SCOPE AND STANDARD OF REVIEW

This court's review of the decision of the court below, dismissing plaintiff's claim for failure to adequately plead demand futility, pursuant to Court of Chancery Rule 23.1, is *de novo* and plenary. *Wood v. Baum*, 953 A.2d 136, 140 (Del. 2008) (citing *Brehm v. Eisner*, 746 A.2d 244, 253-4 (Del. 2000)); Del. Ch. Ct. R. 23.1 (2009).

MERITS OF ARGUMENT

In a derivative action, if a plaintiff does not make a demand on the board, they must allege facts showing why such a demand would have been futile had it been made. Del. Ch. Ct. R. 23.1; *Stone*, 911 A.2d 362, 366-7 (Del. 2006) (citing *Aronson v. Lewis*, 473 A.2d 805, 811 (Del.1984), *overruled on other grounds by Brehm*, 746 A.2d 244). Demand is only futile and, thus, excused when a derivative complaint alleges facts that create a *reasonable doubt* that, at the time the complaint was filed, the directors could have exercised their "independent and disinterested business judgment in responding to a demand." *Stone*, 911 A.2d at 367 (emphasis added) (quoting *Rales v. Blasband*, 634 A.2d 927 (Del. 1993)). The court must draw all reasonable inferences in the plaintiff's favor; however, conclusory allegations may not be considered. *Wood*, 953 A.2d at 140 (citation omitted).

Oversight is one of directors' two principal functions¹. Where, as in the oversight claim, no business decision is involved, the standard for determining demand futility is outlined in this court's decision in *Stone*, 911 A.2d at 367. The *Stone* court expressly approved the oversight liability test developed by Chancellor Allen in *In Re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959 (Del. Ch. 1996). *Stone*, 911 A.2d at 365. The court held that the necessary condition predicate for director oversight liability is either: (a) the directors failed to implement information reporting system adequate in concept and design to insure that the board receive appropriate information in a timely manner and as a matter of course of ordinary operations; or (b) having implemented such system, the board failed to monitor such system, a classic example of which is ignoring so-called "red flags." *Stone*, 911 A.2d at 370-3; *Caremark* at 970; *Guttman v. Huang*, 823 A.2d 492, 505 (Del.Ch. 2003). If a court finds that the allegations are not "mere threats," but that "substantial likelihood of personal liability exists²," demand is excused. *Wood*, 953 A.2d at 141 n.11.

Here, Securance's information and reporting "system" consisted of the board's not particularly proactive or engaged audit committee and one

¹ See generally JESSE A. FINKELSTEIN AND R. FRANKLIN BALOTTI, THE DELAWARE LAW OF CORPORATIONS AND BUSINESS ORGANIZATIONS § 4.16[B] (3d ed. 1997). The other principal function is decision-making. *Id.*

² The court below expressly rejected this Court's "potentially personally liable" language in *Stone*. *Op.* at 17; *Stone*, 911 A.2d at 372. Although this Court has not used the language since *Stone*, other courts and commentators have cited it. *Id.*; see, e.g., *In re First Bancorp Derivative Litig.*, 465 F.Supp.2d 112, 119 (D.P.R. 2006); Bradley W. Voss et al, *Stone v. Ritter: The Delaware Supreme Court Applies The Caremark Standard To A Director "Oversight" Claim And Clarifies The "Fiduciary Duty of Good Faith,"* 9 Del. L. Rev. 153, 157 (2007). This court should take this opportunity to clarify whether the standard is "potentially personally liable" or "substantial likelihood of personal liability." Appellant assumes, without conceding, that the latter standard applies.

part-time³ Chief Compliance Officer. *Compl.* at ¶34; *Op.* at 11. Thus, the system was not adequate.

Even if this court holds that this "system" was indeed adequate - the defendants ignored clear "red flags." After the company's regulatory troubles in Virginia and Connecticut, caused by the company's profits-based Incentive Compensation Plan, which included fines and consent decrees, and where the company promised to stop any wrongdoing, the board utterly disregarded these red flags and did not attempt to improve the system until the current regulatory troubles occurred. *Id.* at ¶¶39-44. Therefore, since defendants failed to implement an adequate compliance system and ignored "red flags," a substantial likelihood of personally liability exists and demand is, therefore, excused.

A. The company's information and reporting system was not adequate.

Relevant and timely information is an essential predicate to satisfy the board's duty of oversight under Delaware General Corporate Law § 141. Del. Code Ann. tit. 8, § 141 (2009); *Caremark*, 698 A.2d at 970. The reporting system must be reasonably designed to provide management and the board information sufficient to allow them to reach informed judgments concerning the corporation's compliance with applicable law, as well as business performance. *Id.* If a corporate reporting system is not adequate in *concept and design*, directors are liable for any losses caused by any non-compliance of applicable legal standards. *Stone*, 911 A.2d at 368-70; *Caremark*, 698 A.2d at 969-70.

When no information and reporting system exists, courts apply the *Stone/Caremark* test and easily find directorial oversight liability. *See*,

³ The General Counsel was also the Chief Compliance Officer. *Op.* at 3.

e.g., *ATR-Kim Eng Fin. Corp. v. Araneta*, 2006 WL 783520 (Del. Ch. 2006). However, when some form of information and reporting system exists, the question is more difficult.

The *Stone* court did not explicitly rely on any particular test in assessing whether the reporting system was *adequate* or *reasonable*. *Stone*, 911 A.2d at 368. The court's only attempt to define what constitutes a reasonable or adequate system is that information must come to the board's attention "in a timely manner and as a course of generally operations." *Id.* (citing *Caremark*, 698 A.2d at 970). The vague "standard" regarding information coming to the board's attention in a timely manner, as articulated in *Stone*, is not workable. *Stone*, 911 A.2d at 368 (citing *Caremark*, 698 A.2d at 970); see, e.g., *Ash v. McCall*, 2000 WL 1370341, at *15 n. 57 (Del. Ch. 2000) (admittedly having a problem deciding whether certain claims are proof of a lack of a reasonable reporting system or a malfunction or breakdown of such system). In *Caremark*, Chancellor Allen explained that an utter failure to implement a reasonable system "will establish the lack of *good faith* that is a necessary condition to liability." *Caremark*, 698 A.2d at 971 (emphasis added). He further explained that "[a]ny *rational* person attempting in *good faith* to meet an *organizational governance responsibility*" should take the federal organizational sentencing guidelines⁴ into account. *Id.* at 970 (emphasis added). Thus, whether the system is in accord with the federal organization sentencing guidelines should "be considered in determining the appropriate level of board oversight of a company's compliance systems." Rebecca Walker, *The Importance of Board Oversight of a*

⁴ Although the federal sentencing guidelines have been limited on constitutional grounds by *United States v. Booker*, 543 U.S. 220 (2005), and are now advisory, they are still afforded "considerable weight." *United States v. O'Keefe*, 208 Fed. App'x. 126, 130 (3rd Cir. 2006) (citation omitted).

Company's Compliance Program: the Implications of Stone v. Ritter, COMPLIANCE AND ETHICS MAGAZINE, April 2007, at 4. This court should take this opportunity to expressly adopt the detailed, comprehensive, multi-factor and thus, easy to apply, sentencing guidelines standard in deciding whether a reporting system is adequate.

According to the sentencing guidelines, U.S. Sentencing Guidelines Manual ("USSG") § 8B2.1 (2009), an "effective compliance and ethics program" must contain, at the very least, the following: (1) the organization must put in place a compliance system to prevent and detect criminal conduct, *id.* at 8B2.1(b)(1); (2) the board shall be knowledgeable about the content and operation of the system, *id.* at 8B2.1(b)(2)(A); (3) high-level personnel must ensure the program is *effective*, *id.* at 8B2.1(b)(2)(B); (4) specific individuals must be assigned overall responsibility for the system, *id.*; (5) specific individuals must be assigned day-to-day responsibility for the system, *id.* at 8B2.1(b)(2)(C); (6) the organization must conduct periodic training programs, *id.* at 8B2.1(b)(4)(A); (7) the organization must take steps to ensure the program is followed, including monitoring and auditing, *id.* at 8B2.1(b)(5)(A); (8) have and publicize a system which allows anonymous reporting, *id.* at 8B2.1(b)(5)(C); (9) the program must be promoted and enforced through incentives as well as disciplinary measures, *id.* at 8B2.1(b)(6); (10) once criminal conduct has been detected, the organization must respond by making any necessary modifications to the program, *id.* at 8B2.1(b)(7).

In *Stone*, the court held that an adequate reporting system existed. *Id.* at 371. However, since *Stone* expressly approved of *Caremark*, relying on the *Caremark* sentencing guidelines standard is appropriate. *Id.*; *Caremark*, 698 A.2d at 970. Applying the sentencing guidelines outlined

above to the reporting system in *Stone*: (1) the system comprising an officer (the "BSA Officer"), an entire compliance department and security department tasked with complying with the act in question was clearly reasonable to prevent and detect criminal conduct, *Stone*, 911 A.2d 371 (the "[board] dedicated considerable resources to the . . . compliance program and put into place numerous procedures and systems to attempt to ensure compliance"); (2) the board was indeed knowledgeable about the content and operation of the system, *id.* (the BSA Officer was tasked with "presenting . . . policy and program changes to the [board]"); (3) high-level personnel including the board had periodic updates from the BSA Officer and enacted various written policies to ensure compliance, *id.* at 371-2; (4) a specific individual was assigned overall responsibility for the compliance program - the "BSA Officer", *id.*; (5) specific individuals were assigned the day-to-day responsibility for the system; the compliance department of nineteen professionals including a compliance manager and a compliance reporting manager as well as a corporate security department, the head of which was a former secret service agent, were tasked with ensuring compliance, *id.*; (6) all employees were periodically trained, including the board, *id.*; (7) an audit was performed on a quarterly basis and there was constant monitoring by the compliance department, auditing committee and security department, *id.*; (8) the system did not allow for anonymous reporting, *id.*; (9) the record is unclear as to whether there were incentives for complying with the system or consequences for failing to comply, *id.*; (10) the program in *Stone* did not detect any conduct so this prong is inapplicable, *id.* Therefore, the *Stone* compliance system clearly meets seven of ten factors, does not meet one, the record is

unclear on one and one is inapplicable. *Id.* Overall, this was a more than adequate compliance system.

Another standard courts apply is that "demand futility is *ordinarily* found" if a failure involves a scheme "of significant magnitude and duration." *In re Oxford Health Plans* ("Oxford II"), 192 F.R.D. 111, 117 (S.D.N.Y. 2000) (emphasis added). In *Oxford II*, a securities fraud was perpetrated for several years that caused tens of millions of dollars of damage, and the court held that demand is excused as futile. See *id.*; *In re Oxford Health Plans, Sec. Litig.* ("Oxford I"), 182 F.R.D. 42 (S.D.N.Y. 1998).

In the instant case, the compliance system was inadequate. The court below did not even attempt to use a standard to determine whether Securance's "system" was adequate or reasonable. The court, dismissively and without relying on any authority, reasons that because plaintiff's complaint admits that "some form of regulatory compliance program" existed, part (a) of the *Stone* test is inapplicable, ignoring the fact that *Stone* required a program to be adequate and reasonable. *Op.* at 20 (emphasis added); *Stone*, 911 A.2d at 368-9. Applying the sentencing guidelines, under *Caremark*, to the instant case: (1) the system was comprised of a part-time chief compliance officer and an audit committee which, according to Securance's second settlement with the states, was not particularly engaged or proactive, *Op.* at 11; (2) unlike *Stone*, there is nothing in the record to suggest that the board was knowledgeable about the content or operation of the "system"; (3) there is nothing in the record to suggest high level personnel did anything at all to ensure the program is effective; (4) a specific individual was assigned overall responsibility for the system, albeit on a part-time basis, *id.*; (5)

unlike *Stone*, there was no compliance department; (6) there is nothing in the record to suggest that there were periodic training programs; (7) there is nothing in the record to suggest that the company monitored or audited the "system"; (8) the "system" provided no mechanism for anonymous reporting; (9) there is nothing in the record to suggest that there were disincentives or incentives to complying with the program; (10) as in *Stone*, the system did not detect any criminal conduct. Here, the "system" barely satisfies one prong (4) of the sentencing guidelines, under *Caremark*. 698 A.2d at 970; USSG § 8B2.1.

Further, the scheme in question easily meets the *Oxford II*, 192 F.R.D. at 117, standard of a scheme "of significant magnitude and duration." Here, as in *Oxford II*, the scheme lasted several years. *Id.* However, damages here were in the hundreds of millions dollars, dwarfing the tens of millions of dollars of damages in *Oxford II*. *Op.* at 14; 182 F.R.D. 42.

Therefore, because the "system" in the instant case is not reasonable or adequate under either the *Caremark* standard or under *Oxford* - demand is excused. *Caremark*, 698 A.2d at 970; *Oxford II*, 192 F.R.D. at 117.

B. The company ignored "red flags."

If this court holds that the system described above is indeed adequate, directorial oversight liability still exists where the directors "consciously failed to monitor or oversee [the system's] operations" - i.e., when so-called "red flags" were ignored. *Stone*, 911 A.2d at 364, 370. "Red flags" are useful when they are either "waved in one's face or displayed so that they are visible to the careful observer." *Wood*, 953

A.2d at 143 (quoting *In re Citigroup Inc. S'holders Litig.*, 2003 WL 21384599, at *2 (Del. Ch. 2003)).

In *In re Countrywide Fin. Corp. Derivative Litig.*, 554 F.Supp.2d 1044, 1081-2 (C.D.Cal. 2008) (construing Delaware law), the court held that (i) the massive rise in high-risk loans; and (ii) the increased delinquencies in high-risk loans both constituted "red flags" and, thus, satisfy the *Stone* test to excuse demand. *Id.* at 1060, 1081-2. In another relatively minor "red flag" claim, the Seventh Circuit, construing Delaware law, *In re Abbott Labs. Derivative S'holders Litig.* 325 F.3d 795, 808 (7th Cir. 2003), held that two boilerplate warning letters from the FDA and a newspaper article were "red flags" that excused demand. Lastly, in *In re Brocade Commc'ns Systems, Inc. Derivative Litig.*, 2009 WL 35235 (N.D. Cal. 2009) (construing Delaware law), the court held that the fact that when a CEO did not deliver to the audit committee documentation for a certain stock option grant, later found to be fraudulent, was a "red flag" and demand was excused. *Id.* at 20-21.

Here, the regulatory issues with Virginia and Connecticut in 2004 were clear "red flags." The company committed fraud by wrongfully denying claims of its indigent and disabled members in order to boost profits, allegedly under the express or implied consent of the senior officers. *Op.* at 13; *Compl.* at ¶31. A likely reason for an employee to attempt to illegally boost the company's profits is if it benefits him financially, such as the profits-based Incentive Compensation Plan the board put in place. After being discovered, the company entered into consent decrees in which it promised to follow applicable law and paid a fine of \$100,000

to each state. *Id.* However, the directors recklessly⁵ disregarded these “red flags” and made absolutely no changes to the company’s compliance system. *Id.* at 14. It took the current crisis - fines of \$400 million and being banned for three years from states which account for 40% of the company’s business - for the company to establish a “new and separate compliance committee” that would be “more engaged and proactive.” *Id.* at 14, 21.

These “red flags” are much more egregious and easier to appreciate than the red flags in *Countrywide*. 554 F.Supp.2d 1044, *Abbott Labs*, 325 F.3d 795 or *Brocade*, 2009 WL 35235. In *Countrywide*, the “red flags” could arguably have been explained away as being a part normal business cycle or a hurting economy. *Id.* Here, however, the first fraud cannot be explained away by anything benign. The instant “red flags” are also more egregious than the red flags in *Abbott Labs*. 325 F.3d at 808. Ignoring fraud and state fines is much more of a conscious failure than ignoring a couple of boilerplate letters from the FDA and one article. Nor does *Brocade*, rise to the level of recklessness here. 2009 WL 35235. In *Brocade*, the committee did not receive a reply from the CEO about a stock option grant. *Id.* Although suspicious, this doesn’t rise to the level of employees perpetrating a fraud followed by the company being caught and fined by two states. *Op.* at 13.

Therefore, there were “red flags,” they were “waved in [the board’s] face” and the directors, having failed to improve the compliance system after the first fraud, “demonstrate[ed] a conscious disregard for their

⁵ The court below rejected the plaintiff’s assertion that the board “recklessly” disregarded their oversight responsibility. *Op.* at 19-20. The court stated that this court’s holding in *Stone* required it to reject a *recklessness* or *scienter* standard. *Id.* This is in direct contravention of this court’s precedent. *Wood*, 953 A.2d at 141 (“a plaintiff must plead particularized facts that demonstrate that directors acted with *scienter*”) (emphasis added).

responsibilities" and a breach of their duty of loyalty. *Stone*, 911 A.2d at 370; *Wood*, 953 A.2d at 143. Consequently, pre-suit demand is excused.

II. APPELLANT HAS SUFFICIENTLY STATED A CLAIM AGAINST OFFICER DEFENDANTS BECAUSE THE STONE TEST FOR DIRECTOR OVERSIGHT LIABILITY DOES NOT APPLY WITH EQUAL FORCE TO THE OFFICER DEFENDANTS AND THEREFORE, THE MOTION TO DISMISS GRANTED BY THE COURT BELOW, PURSUANT TO COURT OF CHANCERY RULE 12(B)(6), SHOULD BE REVERSED. STONE, 911 A.2D 362.

STANDARD AND SCOPE OF REVIEW

The decision of the Court of Chancery granting a motion to dismiss for failure to state claim, under Court of Chancery Rule 12(b)(6), is reviewed *de novo*. *Feldman v. Cutaia*, 951 A.2d 727, 730 (Del. 2008) (citing *Dunlap v. State Farm Fire & Cas. Co.*, 878 A.2d 434, 438 (Del. 2005)). This Court must accept well-pled allegations as true and draw reasonable inferences in favor of the plaintiff. *Id.* However, conclusory allegations need not be treated as true. *Id.* (citing *White v. Panic*, 783 A.2d 543, 549 (Del.2001)). Dismissal is only appropriate if "under any set of facts that could be proven to support the claims asserted, the plaintiff would not be entitled to relief." *Id.* (quoting *VLIW Tech. v. Hewlett-Packard*, 840 A.2d 606, 610-11 (Del.2003)).

MERITS OF THE ARGUMENT

In *Stone*, this court held that "Caremark articulates the necessary conditions for assessing *director* oversight liability." *Stone*, 911 A.2d at 365 (emphasis added). Although *Stone* did not address the issue of officer oversight liability the *Stone* test should not apply with equal force to non-director officers whose direct involvement in the day-to-day operations of the company necessitates a higher standard of

accountability. In light of the fact that current case law has yet to address the question directly, the court below appropriately analogized the issue of oversight liability to the application of the business judgment rule to officers. *Op.* at 27. However, the court's conclusion that corporate officers should be afforded the same level of protection as directors is misguided and inconsistent with Delaware case law, and sound policy rationale. *Id.* Therefore, the Chancery Court's holding, dismissing the claims against Secruance's non-director, Officer Defendants pursuant to Rule 12(b)(6) is improper and should be reversed.

A. Delaware law is vague in its treatment of corporate officers and, further, the Delaware Supreme Court has yet to hold that the business judgment rule applies with equal force to officers acting as officers.

In Delaware, the business judgment rule provides a presumption that in making a decision, directors were informed, acted in good faith and honestly believed that the decision was in the best interest of the corporation. *Aronson*, 473 A.2d at 811. While some courts and commentators alike often blindly assert that the business judgment rule applies with equal force to both corporate directors and officers, the business judgment rule should not be applied to protect corporate officers in the same broad manner as it does directors. Lyman Johnson, *Corporate Officers and the Business Judgment Rule*, 60 Bus. Law. 439, 443 (2005). Not only does Delaware law lack clarity and focus on the role and duties of officers, but also, upon closer inspection, Delaware courts have feebly and inconsistently adopted the rule as to corporate officers.

Currently, respected corporate law treatises including the American Law Institute's ("ALI") *Principles of Corporate Governance* and the Fletcher treatise, apply the business judgment rule to corporate officers

and directors with equal strength. Johnson, *supra*, at 441 (citing AMERICAN LAW INST., *PRINCIPLES OF CORPORATE GOVERNANCE*, § 4.01(c) (1994) and WILLIAM FLETCHER, *FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS*, §§ 1029-39 (1975)).

However, both of these aforementioned treatises lack substantial support for their blanket adoption of the rule. *Id.* at 442. The only case support that the ALI relied on was a 1971 Delaware Chancery Court decision, *Kaplan v. Centex Corp.*, a stockholder derivative action where the defendants were two corporations with which the subject corporation was involved in joint ventures. *Kaplan v. Centex Corp.*, 284 A.2d 119, 119 (Del. Ch. 1971). The court, in dicta, stated that the decision of executive officers at question in that case "may" come within the judgment rule and that it "probably" applied in that case "in the light of subsequent ratification by the board of directors." *Id.* at 124.

The ALI also refers to a corporate law treatise which cited no case law but rather, referred to Fletcher's treatise. HARRY G. HENN & JOHN R. ALEXANDER, *LAW OF CORPORATIONS*, § 242, at 663 (3d ed. 1983). The Fletcher treatise in addition to citing *Kaplan*, relied on a 1970 Delaware Supreme Court decision, *Kelly v. Bell*. FLETCHER, *supra* at §§ 1029-39 (citing *Kelly v. Bell*, 266 A.2d 878,878 (Del. 1970) and *Kaplan* 284 A.2d 119). *Kelly* stated that payments made by the corporation to the county pursuant to a private deal were governed by the business judgment rule and directors were not liable to corporation for such payments. *Kelly*, 266 A.2d at 868. This case is not dispositive however because it "did not involve a challenge to the independent action of officers *qua* officers properly acting within their official sphere." Johnson, *supra*, at 444. In fact, to this day, Delaware courts have yet to hold that the business judgment rule applies to corporate officers acting within the sphere of their authority.

When the Delaware Supreme court does state that the business judgment rule protects officers and directors alike, it is always in the context of the actions of directors, and not officers. *Id.* at 443.

Courts that have applied Delaware law in extending the business judgment rule's protection to protect both directors and officers, similarly cited weak, if any authority at all. *Id.* However, in *Platt v. Richardson*, the court stated that the business judgment rule "applies only to directors of a corporation and not to officers." *Platt v Richardson*, 1989 WL 159584 (M.D. Pa. 1989). While *Platt* has been criticized for "ignoring" *Kelly* and *Kaplan*, leading scholars have argued that the court was not denying precedent but perhaps instead, making "a strong statement about the lack of authority for extending the business judgment rule to corporate officers." Johnson, *supra*, at 444.

Here, the court is not obligated to rely on conclusory commentary of treatises or dicta in far from convincing court decisions. *Platt*, for example, while controversial, was not a break from precedent, but rather an attempt to correct a long line of statutory and judicial confusion. *Platt*, 1989 WL 159584. In light of this, the court should consider, instead, the practical implications of the lower court's holding and reverse its decision to dismiss appellant's complaint.

B. Officers, as agents, should be held to the higher standard of fiduciary duty of care, especially considering their ability to bind the company and their extensive knowledge and direct involvement with daily operations.

Courts that have held that the business judgment rule applies with equal force to corporate officers have essentially disregarded an important legal difference between officers and directors. Officers, unlike individual directors, are agents of their respective corporations

and as such have the power to bind the company, which as a legal fiction, lacks the power to act on its own. *Restatement (Third) of Agency* § 3.03 cmt. c, illus. 1 (2006); see also *Restatement (Second) of Agency* § 14C, cmt. b. (1958). (an individual director "has no power of his own to act on the corporation's behalf"). Agency law requires that officers as agents be held to the customary standard of ordinary care. *Id.* However, when courts apply the business judgment rule to officers, they are ignoring agency law and adopting instead, a weaker standard for officers than required. In *Omnibank of Mantee v. United Southern Bank*, the court held that the officer involved breached his duty of reasonable care but then applied the business judgment rule to the officer, which necessarily implicated a lower standard of care. *Omnibank*, 607 So.2d 76 (Miss. 1992). This decision, by broadly applying the business judgment rule to an officer, wrongly held that officer to a gross negligence standard of care afforded to directors versus the *reasonable standard* of care his status as an agent required. *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985).

In the instant case, the officers are, of course, agents of the corporation and thus, their actions bind Securance. Granting the non-director Officer Defendants the degree of protection afforded by the business judgment rule is imprudent considering this power to bind. Additionally, the Officer Defendants role in the company differed greatly from that of the Directors. The nature of their positions, unlike those of the directors, afforded them much greater knowledge of company affairs and the actions of senior managers. Specifically, in this case, the company's most senior non-director officers, Lieberman, Stockdale and Huelva, owed the company and its stockholders both the fiduciary duties of loyalty and care. *Restatement (Third) of Agency* § 3.03 cmt. c, illus. 1

(2006). These duties required the Officer Defendants to “remain proactively engaged in the Company’s affairs and to act in good faith to oversee the operations of the Company so as to ensure compliance with applicable law.” *Compl.* at ¶6. In fact, Lierberman, the Chief Operating Officer, supervised the department in which two of the guilty senior officers worked while Huelva, the Chief Accounting Officer, similarly supervised the day-to-day activities of the department in which the third Senior Manager who supported the illegal activities worked. *Id.* at ¶31. Further, Stockdale, as the General Counsel and Chief Compliance Officer, worked closely with each of the Senior managers in their preparation of the Company’s Medicaid reports to the relevant state agencies. *Id.* By shielding these Officer Defendants with as much force as the business judgment rule protects Directors, the court is essentially leaving the company and its shareholders vulnerable to corporate misconduct.

C. The policy reasons behind the business judgment rule and limited oversight liability as they apply to directors are not applicable to corporate officers because officers occupy a meaningfully differently role in the corporate structure.

Even when courts have stated that the business judgment rule should be applied to corporate officers and directors in the same broad manner, they fail to explain why or how this serves corporate or public policy. Johnson, *supra*, at 454. The policy rationales that underlie the business judgment rule, as applied to directors, are less convincing when applied to officers and their unique responsibilities and duties in the corporate context. Rationales that support the application and protections of the business judgment rule include encouraging directors to serve and take risks, preserving the board’s central decision-making role in corporate governance and avoiding judicial encroachment into business decisions.

Id. While, arguably, some of the rationales could loosely support application of the business judgment rule to officers, doing so would not only undermine the traditional duty of care owed by officers to directors but also would unjustly deprive stockholders of an important tool used to ensure officer accountability.

When applied to directors, the business judgment rule provides the proper amount of liability protection that would induce directors to take business risks despite the lack of incentives in the form of high compensation and large stock options that officers enjoy. Brian R. Cheffins & Randall S. Thomas, *Regulation and the Globalization of Executive Pay, Global Markets, Domestic Institutions-Corporate Law and Governance in a New Era of Cross-Border Deals*, 155 (Curtis Milhaupt ed., 2003). Generally, corporate executive officers receive higher salaries than do directors and because much of that pay is performance based, officers simply stand to gain much more from taking business risks. Joann S. Lublin, *Executive Pay Keeps Rising, Despite Outcry*, *Wall St. J.*, Oct. 3, 2003, at B1. Because it is so difficult for corporations to retain competent directors considering their particularly unfavorable risk/reward ratio, the business judgment protection for directors is a necessity. In contrast, the business judgment protection provides too much of a cushion for corporate officers. More importantly due to the nature of their roles and responsibilities within the company, officers have extensive knowledge of corporate affairs and the activities of senior management and other lower level employees. Del. Code Ann. tit. 8, § 142 (2009). Officers then, are in a much better position to make informed business decisions and also to monitor the behavior of other employees. As such, application

of business judgment protection is incongruent if the law desires proper transparency to ensure corporate accountability.

Preserving the board's role in corporate governance is yet another policy rationale for applying the business judgment rule to directors. Delaware statutory law indicates one responsibility of the board of directors as, "the business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors." Del. Code Ann. tit. 8, § 141(a) (2009). Courts have recognized the connection between preserving directors' centralized authority within the company as laid out in the statute and the protection that the business judgment rule provides against both stockholder and judicial intervention in corporate affairs. *Citron v. Fairchild Camera & Instrument Corp.*, 569 A.2d 53, 64 (Del. 1989). The Supreme Court of Delaware, in *Zapata Corp. v. Maldonado*, stated that, "directors of Delaware corporations derive their managerial decision making power to initiate or refrain from entering litigation from 8 Del. C. § 141(a)." *Zapata*, 430 A.2d 779, 782 (Del. 1981). The fundamental principle that directors, and not the judiciary nor stockholders, retain authority to oversee corporate affairs, including decisions concerning whether or not to pursue litigation, does not support the application of the business judgment rule to officers. On the contrary, the statutory foundation indicates that courts should respect the decisions of the board in deciding to pursue a claim against a corporate officer in order to satisfy this statutory scheme of corporate governance. If courts apply the business judgment rule to officers it would serve only to undermine the board's power to hold its officers liable for fiduciary wrongdoing under

the ordinary standard of care applicable to officers. *Johnson, supra*, at 464.

Finally, although it could be argued that holding officers liable for negligence by refusing them refuge in the business judgment rule, is contrary to public policy by essentially permitting judges as legal, but not business experts, to encroach unto business decisions, that argument is unavailing. *Dodge v. Ford Motor Co.*, 170 N.W. 668, 684 (Mich. 1919). In this era of corporate scandal and economic crisis, allowing officers to be held liable in civil actions for breaching their fiduciary duties does, and will, serve as an important safeguard against corporate misconduct. Far from litigious clutter, shareholder derivative suits that consequently demand a higher degree of liability for corporate officers serve an important role in the struggle to hold companies accountable and renewing faith in stock markets and the economy as a whole.

In the case at hand, applying the business judgment rule would unjustly protect officers who, by the very nature of their positions within the company, had extensive knowledge of corporate affairs and were in the best position to monitor the actions of the senior managers involved in the fraud. *See Point 2(B), supra*. Protecting the directors, who not only lacked the first-hand knowledge of daily Securance activity at the managerial level that the officers possessed, but who also earned considerably less, is logical. Without this protection, competent directors would either become more risk averse or simply choose to leave their positions if they thought that their executive decisions would consistently be vulnerable to second-guessing by stockholders and courts. In contrast, however, the Officer Defendants in this case had a built-in incentive to take business risks in the form of the Incentive Compensation

Plan. *Op.* at 12. In fact, each of the officers was earning over two million dollars a year in salaries and bonuses. *Compl.* at ¶6. Shrouding the Officer Defendants with the same level of protection as the directors would essentially be rewarding their misconduct. So, far from unreasonable, the derivative suit appropriately seeks to hold Securance's Officer Defendants liable for failing to adequately perform managerial oversight duties and therefore, should not be dismissed.

CONCLUSION

Appellant's complaint sets forth allegations that create a reasonable doubt that, as of the time the complaint was filed, that the board of directors could have exercised its independent and disinterested business judgment in responding to a demand, had it been made. Thus, pre-suit demand is excused. Accordingly, the judgment of the court below, dismissing appellant's complaint for failure to adequately plead demand futility, should be reversed.

The court below improperly held that because, in its view, the business judgment rule applies with equal force to officers, the *Stone* test for *directorial* oversight liability must apply with the same force to officers. Consequently, the judgment of the court below, dismissing appellant's complaint for failure state to claim, should be reversed.

Respectfully Submitted,

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