

THE SUPREME COURT OF THE STATE OF DELAWARE

CLARE C. MARSHALL,)	
)	
Plaintiff Below-)	
Appellant,)	
)	
v.)	No. 27, 2009
)	
CHARLES H. SALIGMAN, PATRICK C.)	On Appeal from the Court
RICHMOND, YVONNE M. CRAIG, MARTIN)	of Chancery of the State
R. ROTHSCHILD, ELAINE A. LASATER,)	of Delaware
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.)	

APPELLANT'S OPENING BRIEF

Team C
Counsel for Appellant
February 17, 2009

TABLE OF CONTENTS

TABLE OF CITATIONS ii

QUESTIONS PRESENTED vii

NATURE OF THE PROCEEDINGS 1

SUMMARY OF THE ARGUMENT 2

STATEMENT OF THE FACTS 3

ARGUMENT 5

I. THE COURT OF CHANCERY ERRED AS A MATTER OF LAW IN FINDING THAT MARSHALL FAILED TO ADEQUATELY ALLEGE DEMAND FUTILITY UNDER COURT OF CHANCERY RULE 23.1 REGARDING DIRECTOR DEFENDANTS’ BREACH OF THEIR FIDUCIARY DUTY OF LOYALTY. 5

A. Scope of Review 5

B. Merits of the Argument. 5

1. The duty of loyalty includes a failure to act in good faith, particularly where circumstances are present which would cause suspicion for directors fulfilling their fiduciary duties. 6

2. Demand was excused pursuant to Court of Chancery Rule 23.1 as Director Defendants were not independent and disinterested, facing a substantial likelihood of liability. 8

a. Marshall alleged facts sufficient to establish reasonable doubt that the Directors were disinterested in this action as the entire board approved the Compensation Plan, 2004 consent agreements, and subsequently failed to uphold their duty of good faith in their oversight responsibilities. 9

b. In the alternative, this Court should remand this action to the Court of Chancery with leave for Marshall to amend her complaint to more fully discharge the requirements of Court of Chancery Rule 23.1. 11

II.	THE COURT OF CHANCERY ERRED AS A MATTER OF LAW BY GRANTING DEFENDANTS' MOTION TO DISMISS IN FINDING THAT MARSHALL FAILED TO ALLEGE THAT SECURANCE'S DIRECTORS AND OFFICERS BREACHED THEIR FIDUCIARY DUTIES OF LOYALTY AND GOOD FAITH BY CONSCIOUSLY OR RECKLESSLY FAILING TO OVERSEE THE DECISIONS OF THE COPORATION IN THE FACE OF RED FLAGS ALRETING THEM TO SUSPICIOUS ACTIVITY. .	12
A.	<u>Scope of Review</u>	12
B.	<u>Merits of the Argument</u>	12
1.	Securance and Director Defendants breached their fiduciary duty of loyalty by failing to meet in good faith the <u>Caremark</u> standard for oversight liability.	14
a.	Trusting subordinates is requisite for corporate success, but directors remain potentially personally liable for failing to act in good faith in discharging their oversight responsibility.	16
b.	The Director Defendants failed to adhere to the <u>Caremark</u> standard by consciously or recklessly failing to act in the presence of "red flags".	17
c.	The Director Defendants breached their fiduciary duty of loyalty by acting in bad faith for not examining Securance's records and employees with a "critical eye".	20
2.	Securance Officer Defendants occupy the same fiduciary relationship as directors toward corporate shareholders and thus are liable to Securance shareholders for breach of their duty of oversight.	22
	<u>CONCLUSION</u>	25

TABLE OF CITATIONS

DELAWARE SUPREME COURT

Aronson v. Lewis,
473 A.2d 805 (Del. 1984) 5,11

Beam ex rel. Martha Stewart Living Omnimedia Inc. v. Stewart,
845 A.2d 1040 (Del. 2004) 5

Brehm v. Eisner,
746 A.2d 244 (Del. 2000) 5

Cede & Co. v. Technicolor, Inc.,
634 A.2d 345 (Del. 1993) 12

Gantler v. Stephens,
2009 WL 188828 (Del.) 22,23

Graham v. Allis-Chalmers Mfg. Co.,
188 A.2d 125 (Del. 1963) 14,16,17,20

Grobow v. Perot,
539 A.2d 180 (Del. 1988) 9

Guth v. Loft, Inc.,
5 A.2d 503 (Del. 1939) 7,12

In re Walt Disney Co. Deriv. Litig.,
906 A.2d 27 (Del. 2006) 13

Parnes v. Bally Entm't Corp.,
722 A.2d 1243 (Del. 1999) 5

Quickturn Design Sys., Inc. v. Shapiro,
721 A.2d 1281 (Del.1998) 6,7

Rales v. Blasband,
634 A.2d 927 (Del. 1993) 6,8,9,10

Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.,
506 A.2d 73 (Del. 1986) 7

Smith v. Van Gorkom,
488 A.2d 858 (Del. 1985) 20,21

Spiegel v. Buntrock,
571 A.2d 767 (Del. 1990) 6

Stone v. Ritter,
911 A.2d 362 (Del. 2006) 7,8,13,14,15

<u>Wal-Mart Stores, Inc. v. AIG Life Ins. Co.,</u> 901 A.2d 106 (Del. 2006)	12
--	----

<u>White v. Panic,</u> 783 A.2d 543 (Del. 2001)	5
--	---

DELAWARE CHANCERY COURT

<u>Guttman v. Huang,</u> 823 A.2d 492 (Del. Ch. 2003)	7,17,18
--	---------

<u>In re Baxter Int’l, Inc. S’holders Litig.,</u> 654 A.2d 1268 (Del. Ch. 1995)	20
--	----

<u>In re Caremark Int’l Inc. Deriv. Litig.,</u> 698 A.2d 959 (Del. Ch. 1996)	7,8,13,14,16,17,19
---	--------------------

<u>In re Citigroup Inc. S’holders Litig.,</u> 2003 WL 21384599 (Del. Ch.)	17
--	----

<u>Kahn v. Portnoy,</u> 2008 WL 5197164 (Del. Ch.)	10,12
---	-------

<u>Rattner v. Bidzos,</u> 2003 Del. Ch. LEXIS 103 (Del. Ch.)	8,9,10
---	--------

<u>Ryan v. Lyondell Chemical Co., et al.,</u> 2008 WL 4174038 (Del. Ch.)	12
---	----

OTHER CASES

<u>In re Abbott Lab. Deriv. S’holder Litig.,</u> 325 F.3d 705, 802 (7 th Cir. 2003)	18,19
---	-------

<u>Meinhard v. Salmon,</u> 164 N.E. 545 (N.Y. 1928)	5
--	---

STATUTES

8 Del. C. § 102 (2006)	14,22
----------------------------------	-------

8 Del. C. § 141 (2007)	6
----------------------------------	---

RULES

Court of Chancery Rule 12(b)(6)	1,2,12,13
---	-----------

Court of Chancery Rule 23.1	1,2,5,6,8,9,11,25
---------------------------------------	-------------------

OTHER AUTHORITIES

Carter, John C., The Fiduciary Rights of Shareholders,
29 Wm. & Mary L. Rev. 823 (1988)6

Merriam-Webster New World Pocket Dictionary,
271 (4th ed. 2006)17

Veasey & Seitz, The Business Judgment Rule in the Revised Model Act,
the Trans Union Case and the ALI Project: A Strange Porridge,
63 Texas L. Rev. 1483 (1985) 16

QUESTIONS PRESENTED

- I. Whether the Court of Chancery erred as a matter of law in finding Marshall failed to allege particularized facts under Court of Chancery Rule 23.1 to show that Defendants face a substantial likelihood of liability on the fiduciary oversight claim.
- II. Whether the Court of Chancery erred as a matter of law in granting Defendants' Court of Chancery Rule 12(b)(6) motion to dismiss where this Court can infer with reasonable certainty that Marshall can prevail on a duty of oversight claim where Defendants have failed to carry out that duty in good faith.

NATURE OF THE PROCEEDINGS

Petitioner Clare Marshall ("Marshall"), a shareholder of nominal defendant Securance Incorporated ("Securance"), brought a derivative action against the Board of Directors and Officers of Securance ("Officer Defendants" of "Director Defendants", collectively "Defendants") in the Court of Chancery on July 3, 2008. (Pl. Compl. 28).

Marshall alleged the Defendants breached their duty of loyalty by failing to act in good faith when discharging their fiduciary duty of oversight. (Pl. Compl. ¶ 2.) Specifically, Marshall contends that Defendants acted with conscious or reckless indifference by failing to use a critical eye to oversee the corporation's internal reporting system by ignoring the presence of "red flags". (Pl. Compl. ¶ 48.)

Defendants moved to dismiss Marshall's complaint for failure to allege with adequate particularity that pre-suit demand was futile under Court of Chancery Rule 23.1 and failure to state a claim under Court of Chancery Rule 12(b)(6). (Op. 16.) The Court of Chancery entered a Memorandum Opinion on January 6, 2009, granting Defendants' motion to dismiss. (Op. 28.)

On January 16, 2009, Marshall filed a notice of appeal in the Supreme Court of the State of Delaware. (Notice of Appeal, 3.)

SUMMARY OF ARGUMENT

The Court of Chancery erred as a matter of law when it held that Marshall failed to allege particularized facts under Court of Chancery Rule 23.1 to show that Defendants breached their duty of loyalty and face a substantial likelihood of liability on the fiduciary oversight claim. Defendants owed the corporation and its shareholders a duty of loyalty which includes a duty to act in good faith. Defendants' sustained or systematic failure to exercise proper oversight is a failure to act in good faith, particularly here where circumstances have arisen which would cause suspicion to prudent directors fulfilling their fiduciary duties. This breach of loyalty renders a director liable for losses caused by non-compliance with applicable legal standards. Further, demand was excused pursuant to Court of Chancery Rule 23.1 as Director Defendants were not independent and disinterested, facing a substantial likelihood of liability.

The Court of Chancery further erred as a matter of law when it granted Defendants' motion to dismiss pursuant to Court of Chancery Rule 12(b)(6), failing to infer with reasonable certainty Marshall can prevail on her duty of oversight claim. Moreover, Defendants breached their duty of loyalty by acting in bad faith in the presence of red flags by not examining Securance records with a critical eye. Finally, Officer Defendants have the same fiduciary relationship as directors toward the corporate shareholders and thus become liable for their breach of duty of oversight to Securance stockholders.

STATEMENT OF THE FACTS

Marshall owns 1000 shares of common stock in Securance, a publicly held corporation. (Pl. Compl. ¶ 3.) Securance is a health maintenance organization that provides managed care services to Medicaid and Medicare recipients. (Pl. Compl. ¶ 8.) Securance subsequently contracts with individual health care providers and reports to each state the amount spent on direct medical care as a "medical loss ratio." (Pl. Compl. ¶ 14.) Securance is required to either spend 80% of its premiums on direct medical services or refund any premium below 80% to its contract states. (Pl. Compl. ¶ 15.)

In 2003, the board approved a Senior Officer Performance Compensation Plan ("Compensation Plan") that provided profit based bonuses to senior executives. (Pl. Compl. ¶ 38.) In 2004, investigators from Connecticut and Virginia uncovered that Securance was denying medical services to members and offering financial incentives to doctors who denied services in order to boost profits. (Pl. Compl. ¶ 40.) Securance entered into consent decrees whereby the corporation had to pay a \$100,000 fine to each state. (Pl. Compl. ¶ 42.)

In 2005, senior officials devised a plan to overstate medical loss ratios in Ohio, Pennsylvania, New York, and New Jersey—states encompassing 40% of the company's annual revenue. (Pl. Compl. ¶ 18.) The company transferred its unspent premiums to a wholly-owned subsidiary, Total Reinsurance, Ltd., to hide profits from state regulators. (Pl. Compl. ¶ 22.) Securance's stock ballooned when Credit

Suisse reported Securance's 2006 first quarter "results as the best in the Medicaid space [.]" A CIBC World Markets report in 2007 continued the surge when it reported Securance "handily beat expectations." (Pl. Compl. ¶ 26.) As a result of the scheme Securance stock rose from \$52.00 in January, 2005 to \$110.00 per share in December, 2008. (Pl. Compl. ¶ 25.)

In early 2008, a Goldman Sachs analyst reported that Securance was illegally shifting profits to evade state regulators. (Pl. Compl. ¶ 27.) Medicaid Fraud Units uncovered the fraudulent scheme to evade premium reimbursements. (Pl. Compl. ¶¶ 28, 30.) Three Senior Managers were convicted of conspiracy to commit Medicaid fraud. (Pl. Compl. ¶ 30.)

Only after the federal investigation had ensued did the Securance board direct the audit committee to retain independent counsel and investigate the claims of the fraudulent reporting. (Pl. Compl. ¶ 32.) Securance pled guilty to mail fraud in violation of 18 U.S.C. § 1341 and was assessed \$400 million in criminal penalties, along with the required repayment of the \$120 million misreported. (Pl. Compl. ¶ 33.)

On June 3, 2008, Securance announced a restatement of its earnings for 2005 through 2007. (Pl. Compl. ¶ 36.) On June 5, 2008, the stock price fell from \$110 to a record low of \$37 per share, representing a \$3 billion loss in the company's market capitalization. (Pl. Compl. ¶ 37.) Due to the sustained or systematic failure to exercise oversight of Securance's internal controls system, Clare Marshall, on behalf of the corporation, brought a derivative action

against Defendants for breach of duty of loyalty. (Pl. Compl. ¶¶ 52, 55.)

ARGUMENT

I. THE TRIAL COURT ERRED AS A MATTER OF LAW IN FINDING THAT MARSHALL FAILED TO ADEQUATELY ALLEGE DEMAND FUTILITY UNDER COURT OF CHANCERY RULE 23.1 REGARDING DIRECTOR DEFENDANTS' BREACH OF THEIR FIDUCIARY DUTY OF LOYALTY.

A. Scope of Review

This appeal of the Court of Chancery of the State of Delaware is on motion of the Defendants to dismiss a derivative suit under Chancery Court Rule 23.1 which requires a *de novo* standard of review. Beam ex rel. Martha Stewart Living Omnimedia Inc. v. Stewart, 845 A.2d 1040, 1048 (Del. 2004); see Brehm v. Eisner, 746 A.2d 244, 254 (Del. 2000) (applying *de novo* standard, overruling Aronson v. Lewis, 473 A.2d 805 (Del. 1984), abuse of discretion standard). The Court must accept as true all well-pled allegations of fact in the complaint, and all reasonable inferences from non-conclusory allegations contained in the complaint must be drawn in favor of the plaintiff. White v. Panic, 783 A.2d 543, 549 (Del. 2001); see Parnes v. Bally Entm't Corp., 722 A.2d 1243, 1247 (Del. 1999) (holding facts that are developed during the course of litigation may cast a very different light on the proceedings, but during the pleading stage the court must accept all factual allegations as true and give her the benefit of all inferences drawn from those facts).

B. Merits of the Argument

Director Defendants failed to discharge their fiduciary duty to Securance and its stockholders. This "duty of finest loyalty"

requires "not honesty alone, but the punctilio of an honor to the most sensitive." Meinhard v. Salmon, 164 N.E. 545, 546 (N.Y. 1928). A fiduciary duty arises with power, thus the extent of the duty must be commensurate with the power to act. John C. Carter, The Fiduciary Rights of Shareholders, 29 Wm. & Mary L. Rev. 823, 823 (1988).

This Court held in Rales:

[A] stockholder is not powerless to challenge director action which results in harm to the corporation. The machinery of corporate democracy and the derivative suit are potent tools to redress the conduct of a torpid and unfaithful management. In such instances, stockholders often do not make a demand on the board of directors, and instead file suit claiming that demand is excused.

Rales v. Blasband, 634 A.2d 927, 933 (Del. 1993) (citations omitted).

As the Director Defendants have sustained or systematically failed to fulfill their duty of loyalty, which led to the severe depreciation of the corporation's market capitalization and future earnings potential, Marshall now brings this action on behalf of the corporation against those unfaithful directors.

The Court of Chancery erred as a matter of law in granting Defendants' motion to dismiss the complaint as Marshall adequately plead demand futility in her derivative complaint pursuant to Court of Chancery Rule 23.1.

- 1. The duty of loyalty includes a failure to act in good faith, particularly where circumstances are present which would cause suspicion for directors fulfilling their fiduciary duties.**

A board of directors has the "full power to manage and direct the business and affairs of a Delaware corporation." Quickturn Design Sys., Inc. v. Shapiro, 721 A.2d 1281, 1292 (Del.1998) (emphasis in original; citations omitted); see also 8 Del. C. § 141(a) (2007);

Spiegel v. Buntrock, 571 A.2d 767, 772-73 (Del. 1990) (holding that a basic principle of the General Corporation Law of the State of Delaware is that directors, rather than shareholders, manage the business and affairs of the corporation). Additionally, “[i]n discharging the statutor[ily] mandate[d managerial duties], the directors have a fiduciary duty to the corporation and its shareholders.” Quickturn, 721 A.2d at 1292 (citing Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 179 (Del. 1986); Guth v. Loft, Inc., 5 A.2d 503, 510 (Del. 1939)). While Defendants may attempt to argue Delaware Code section 141(a) stands for director independence and freedom from inquiry, this section is not intended to give infinite authority to act without accountability.

Being the director of a corporation typically gives an individual a high rate of compensation along with great power in their capacity to influence the corporation. Concurrent with this compensation and power comes a duty of loyalty to the corporation and its stockholders, even at the expense of the Director. Guttman v. Huang, 823 A.2d 492, 506, n. 34 (Del. Ch. 2003). The fiduciary duty of loyalty is not limited to cases involving mergers, acquisitions or other potential conflicts of interest, it also encompasses where the fiduciary fails to act in good faith. Stone v. Ritter, 911 A.2d 362, 370 (Del. 2006).

The Court in Caremark held it vital for a board to exercise good faith in ensuring a corporation’s information and reporting system is adequate to timely bring to the board’s attention matters needing their attention. In re Caremark Int’l Inc. Deriv. Litig., 698 A.2d 959, 970 (Del. Ch. 1996). Chancellor Allen furthered this requirement

of good faith in establishing adequate internal reporting, stating a "failure to do so under some circumstances may, in theory at least, render a director liable for losses caused by non-compliance with applicable legal standards. Id. (stating a judicial review is necessary to determine proximate cause of an injury, but leaving the determination of causation for individual judiciaries to decide).

2. Demand was excused pursuant to Court of Chancery Rule 23.1 as Director Defendants were not independent and disinterested, facing a substantial likelihood of liability.

Delaware Court of Chancery Rule 23.1 provides, in pertinent part, "[t]he complaint shall also allege with particularity the efforts, if any, made by the plaintiff to obtain the action the plaintiff desires from the directors or comparable authority and the reasons for the plaintiff's failure to obtain the action or for not make the effort."

Here, the standard established in Rales governs the determination of demand futility because Marshall did not challenge a particular action of the board. Stone, 911 A.2d at 367; see also Rattner v. Bidzos, 2003 Del. Ch. LEXIS 103, at *24 (Del. Ch.) (applying the Rales test and holding the business judgment rule has no role in the case of inaction by the board of directors). In Stone, this Court applied the Rales test to excuse demand, affirming:

[A] court must determine whether or not the particularized factual allegations of a derivative stockholder complaint create a reasonable doubt that, as of the time the complaint was filed, the board of directors could have properly exercised its independent and disinterested business judgment in responding to a demand.

Stone, 911 A.2d at 367 (citing to Rales, 634 A.2d at 934, where this Court further rejected Defendant's proposal to adopt a universal

demand requirement or a requirement that plaintiff must demonstrate a reasonable probability of success on the merits).

In Rattner, the court advised derivative plaintiffs to use the "tools at hand" before filing complaints, specifically suggesting 8 Del. C. § 220 to be helpful in gathering information for the pleadings requirement of Court of Chancery Rule 23.1. Rattner, 2003 Del. Ch. LEXIS 103, at *49. However, in Grobow, this Court has recognized that a Court of Chancery Rule 23.1 motion normally precedes discovery, making it more difficult for plaintiffs to plead sufficient facts that would normally become available to them later. See Grobow v. Perot, 539 A.2d 180, 186 (Del. 1988). As Marshall has not had the opportunity for discovery and an investigation of the corporation's books and records, short of a recorded admission of guilt, would not provide more insight into the facts asserted herein, this Court should weigh her well-pled facts in her favor.

- a. **Marshall alleged facts sufficient to establish reasonable doubt that the Defendant Directors were disinterested in this action as the entire board approved the Compensation Plan, 2004 consent agreements, and subsequently failed to uphold their duty of good faith in their oversight responsibilities.**

Vice Chancellor Noble, in Rattner, applying the demand excusal test from Rales, stated: "demand is excused if the particularized facts of the Amended Complaint create a reasonable doubt that, at the time the original complaint was filed a majority of the Board could have exercised *disinterested* and *independent* business judgment in responding to [Marshall]'s demand." Rattner, 2003 Del. Ch. LEXIS 103, at *26 (emphasis added). Here, Marshall has unilaterally filed

an original complaint, but even without assistance from discovery she has asserted particularized facts which show a reasonable doubt that the Director Defendants are disinterested.

This Court held in Rales,

Directorial interest also exists where a corporate decision will have a materially detrimental impact on a director, but not on the corporation and the stockholders. In such circumstances, a director cannot be expected to exercise his or her independent business judgment without being influenced by the adverse personal consequences resulting from the decision.

. . .

[A reasonable doubt of disinterest] determination indicates that the potential for liability is not "a mere threat" but instead may rise to "a substantial likelihood."

Rales, 634 A.2d 936; see Rattner, 2003 Del. Ch. LEXIS 103, at * 30

(holding the "mere threat" of personal liability does not constitute a disabling interest, but a "substantial likelihood" prevents a director from impartially considering a demand); see also Kahn v. Portnoy, 2008 WL 5197164 (Del. Ch.) (holding a director may be interested if the challenged transaction is so egregious on its face that it gives rise to a "substantial likelihood" of liability).

If Marshall had only alleged a breach of duty by approving the Compensation Plan, only the three Director Defendants who received the bonus compensation would have had a reasonable doubt of disinterest. Pl. Compl. ¶ 30. However, Marshall pled multiple red flags which potentially implicate all members of the board of Securance. As the suspicion of misconduct permeated for three years, following the known act of misconduct involving the 2004 consent agreements, each individual Director Defendant has a "substantial likelihood" that this

Court will hold them personally responsible for their breach of duty of loyalty in exercising oversight, proximately causing the ensuing damages. Pl. Compl. ¶¶ 52, 55.

Therefore, as the Director Defendants face a substantial likelihood of personal liability, and are thus prevented from acting impartially in considering a demand, demand must be excused.

b. In the alternative, this Court should remand this action to the Chancery Court with leave for Marshall to amend her complaint to more fully discharge the requirements of Chancery Court Rule 23.1.

Even in light of Marshall's factual allegations involving board misconduct, should this Court find she has failed to create a reasonable doubt as to the Director Defendants' level of disinterest, this Court should remand this action to the Chancery Court with leave for Marshall to amend her complaint in accordance with Court of Chancery Rule 23.1. See Aronson, 473 A.2d at 818 (remanding with instructions that plaintiff be granted leave to amend his complaint to bring it into compliance with Court of Chancery Rule 23.1).

II. THIS COURT SHOULD REVERSE THE COURT OF CHANCERY'S DECISION AND HOLD THAT SECURANCE'S DIRECTORS AND MANAGERS BREACHED THEIR FIDUCIARY DUTIES OF LOYALTY AND GOOD FAITH BY FAILING TO ADEQUATELY OVERSEE AND MONITOR THE DECISIONS OF THE COPORATION IN THE FACE OF RED FLAGS ALRETING THEM TO SUSPICIOUS ACTIVITY.

A. Scope of Review

This appeal of the Court of Chancery's grant of Respondent's motion to dismiss for failure to state a claim upon which relief can be granted should be reviewed de novo. Wal-Mart Stores, Inc. v. AIG Life Ins. Co., 901 A.2d 106, 112 (Del. 2006). On a Court of Chancery Rule 12(b)(6) motion, a reviewing court must: 1) accept as true all well pleaded facts; 2) make all reasonable inferences in favor of the plaintiff; and 3) only dismiss the complaint if it can be determined with reasonable certainty that there is no set of facts that can be reasonably inferred upon which the plaintiff could prevail. Kahn, 2008 WL 5197164 at *4 (Del. Ch.).

B. Merits of the Argument

The board of directors of a corporation are fiduciaries who owe a triad of duties to the corporation's shareholders: the duties of care, loyalty, and good faith. Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 361 (Del. 1993). Directors have an affirmative duty to protect the interests of the corporation, but to also refrain from doing anything that would injure the corporation. Guth, 5 A.2d at 510.

When determining whether directors are protecting the best interests of the corporation, their decisions should be reviewed to see if they fall within the category of "bad faith". See Ryan v. Lyondell Chemical Co., et al., 2008 WL 4174038 at *2(Del. Ch.). The

Court of Chancery defined that bad faith is an "intentional dereliction of duty, a conscious disregard for one's responsibilities," as well as, "deliberate indifference and inaction in the face of a duty to act." In re Walt Disney Co. Deriv. Litig., 906 A.2d 27, 62 (Del. 2006).

In protecting the interests of the corporation, directors must exercise oversight over corporate affairs, finances, and employees in a good faith manner. Caremark, 698 A.2d at 970. The Chancery Court ruled in Caremark that directors must:

[E]xercise 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 questions, so that it may satisfy its responsibility.

Id. For directors to be held liable for a breach of duty of oversight, they must either have "utterly failed to implement any reporting or information system or controls," or after implementing a system or controls, "consciously failed to monitor or oversee its operation thus disabling them from being informed of risks or problems requiring their attention." Stone, 911 A.2d at 370. When there are "red flags" present to alert directors to potential problems within the corporate control system, they cannot ignore them and adequately exercise their duty of oversight. Id.

The Court of Chancery erred in granting Defendants' 12(b)(6) motion to dismiss. We ask this Court to determine with reasonable certainty that there are facts pled by Petitioner which can be inferred that she can prevail on a duty of oversight claim where Respondents have failed to carry out that duty in good faith.

1. **Securance and its directors breached their fiduciary duty of loyalty by failing to meet in good faith the Caremark standard for oversight liability.**

The Delaware provision on director liability, set forth in 8 Del. C. § 102(b)(7), exculpates directors from personal liability in four situations. Two of those situations apply here: for any breach of the director's duty of loyalty to the corporation or its stockholders; and for acts or omissions not made in good faith or which involve intentional misconduct or a knowing violation of law. Id. This Court in Stone ruled that director liability for failure to oversee the corporation occurs "where directors fail to act in the face of a known duty to act, thereby demonstrating a conscious disregard for their responsibilities, they breach their duty of loyalty by failing to discharge that fiduciary obligation in good faith." Stone, 911 A.2d at 370.

A predicate for a corporation to exercise their fiduciary duty of oversight occurs when an activity triggers the directors to be suspicious that something is wrong. Graham v. Allis-Chalmers, Mfg. Co., 188 A.2d 125, 130 (1963). Absent cause for suspicion, directors are under no duty to install a system of reporting to find wrongdoing. Id. When there is cause for suspicion present and monitoring controls are required, directors must utilize their duty of oversight by adhering to the standard delineated in Caremark. Justice Holland articulated this Caremark standard succinctly in Stone by stating that director oversight liability attaches when "the directors utterly failed to implement any reporting or information system or controls,"

or "having implemented such a system or controls, consciously failed to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention." Stone, 911 A.2d at 370.

While in this case, Petitioner does not allege that Securance has failed to implement a system of reporting, she does argue that the directors have consciously failed to oversee the operations of the system they have instituted. Pl. Compl. ¶ 49. The board of directors was entrusted with the management of a publicly held corporation and part of that management involves supervising the corporation's officers. Pl. Compl. ¶ 50.

Securance directors consciously failed to oversee the operation of the corporation after Securance had fraudulently evaded its Medicare refund obligations. Pl. Compl. ¶ 49. After the Fraud Control Units for the four states which Securance was withholding Medicaid funds from alerted the company of their investigation, no internal investigation was commenced by the board of directors to determine if there was merit to their allegations. Pl. Compl. ¶ 28. The voluntary resignation of three of Securance's Senior Managers who pled guilty to conspiracy to falsify data also put the directors on notice of impropriety in their reporting system. Pl. Compl. ¶ 50. This notice was a "red flag" that other financial information, not just profit margins, may have also been falsified and required them to examine it with a "critical eye." Pl. Compl. ¶ 51. However, the board failed to investigate the company's financial situation to ferret out any other falsified information. Pl. Compl. ¶ 52.

- a. **Trusting subordinates is requisite for corporate success, but directors remain potentially personally liable for failing to act in good faith in discharging their oversight responsibilities.**

"Director liability for a breach of the duty to exercise appropriate attention . . . may be said to arise from 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 (citing generally Veasey & Seitz, The Business Judgment Rule in the Revised Model Act, the Trans Union Case and the ALI Project: A Strange Porridge, 63 Texas L. Rev. 1483 (1985)) (emphasis in original).

Directors are entitled to rely on the honesty and integrity of their subordinates until something occurs to put them on suspicion that something is wrong, which when left unheeded, develops the potential for personal liability of the directors. Graham, 188 A.2d at 130. "If he has recklessly reposed confidence in an obviously untrustworthy employee, has refused or neglected cavalierly to perform his duty as a director, or has ignored either willfully or through inattention obvious danger signs of employee wrongdoing, the law will cast the burden of liability upon him." Id.

Here, as Marshall plead in her derivative complaint, Director Defendants have created the potential for liability by both cavalierly neglecting their duties as directors and ignoring willfully or inattentively obvious danger signs of employee wrongdoing. Pl. Compl. ¶¶ 52, 55. As Marshall alleged, which this court must accept as true and infer all reasonable inferences in her favor, the Director Defendants should have been on notice multiple times and

systematically failed to respond as an ordinarily careful and prudent man would under similar circumstances. See Graham, 188 A.2d at 130 (holding a higher standard than the traditional 'reasonable person' standard for those responsible for managing a corporation); see also Caremark, 698 A.2d at 968 n.16 (stating it is doubtful we want business men and women making decisions as a hypothetical person of ordinary judgment and prudence; instead, a person facing personal liability should act as "prudent" "sensible" or even "rational").

b. The directors failed to adhere to the Caremark standard by consciously failing to act in the presence of "red flags".

Merriam-Webster defines a "red flag" as a warning signal or as something that attracts usually irritated attention. Merriam-Webster New World Pocket Dictionary, 271 (4th ed. 2006). Red flags in the corporate oversight context mean essentially the same as their colloquial definition. In re Citigroup Inc. S'holders Litig., 2003 WL 21384599 at *2 (Del. Ch.), explained that red flags should put directors on notice of conduct that show weaknesses within the corporation's internal controls. Chancellor Lamb stated that "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." Id.

Delaware courts have been reluctant to impose director liability where the presence of red flags are mere allegations of wrong doing instead of specific instances of misconduct. The Court of Chancery in Guttman, 823 A.2d 492 (Del. Ch. 2003) declined to find a Caremark claim where shareholders failed to allege that directors were on notice of the presence of red flags. In Guttman, the plaintiff's

complaint pled that corporation's board had knowledge of the company's accounting problems because the corporation inflated stock prices by evening out bad earnings in their profit margins. Id. at 494. The plaintiff also alleged a red flag in that the board of directors should have been aware of reporting problems because of managers and managers selling large quantities of personal stocks because of inflated market prices. Id. at 497. However, the court refused to accept these contentions because plaintiff failed to detail any specific problems with the corporate compliance system and provided only conclusory information on the system's functioning. Id. at 507. Because the plaintiff asserted only conclusory statements that red flags existed, he could not meet the Caremark standard for oversight liability. Id.

The United States Court of Appeals for the Seventh Circuit, applying Delaware law ruled that ignoring Food and Drug Administration orders and being assessed excessive fines for those violations raised red flags that the board of directors had a duty to oversee and investigate. In re Abbott Lab. Deriv. S'holder Litig., 325 F.3d 705, 802 (7th Cir. 2003). In Abbott, shareholders brought a derivative action against the corporation when continuous failure to comply with FDA regulations over a six year period caused stock prices to decline after the corporation was assessed over \$100 million in fines for its non-compliance. Id. at 801.

The Seventh Circuit applied the law from Caremark where director liability was "predicated on ignorance of liability creating activities where there were no facts to indicate the directors

conscientiously permitted a known violation of law by the corporation to occur." Id. at 806 (quoting Caremark, 698 A.2d at 971-72.) Unlike the plaintiffs in Caremark, the defendants in Abbott could not claim ignorance where the FDA had sent warning letters to their audit committee outlining actions the corporation needed to pursue to come into compliance with their regulations. Id. Plaintiffs did not allege that Abbott's reporting system was inadequate, but that the directors failed to act in the face of their duty to address the Warning Letters. Id. The directors were required to sign Securities and Exchange Commission disclosure forms acknowledging their non-compliance as well. Therefore, the court concluded that the alleged facts raised red flags which implied that the board had long-term knowledge of the violations and knowingly failed to exercise their oversight duty faithfully. Id.

Here, the Court of Chancery erred in dismissing Marshall's complaint which alleged that the Defendants were put on notice that Securance's compliance system was inadequate by the presence of red flags. The court below interpreted "red flags" or "cause for suspicion" to mean actual or probable employee misconduct that the board was aware that if ignored would "support an inference of conscious indifference to oversight responsibility." Op. 24.

The board of directors cannot assert that there was insufficient cause for suspicion within their compliance system because the 2004 consent decrees gave them actual notice of fraud within the corporation effectuated by Securance officers. Pl. Compl. ¶ 40. While the consent decrees disavowed an admission of wrongdoing, the

directors, who were all directors in 2004, had an affirmative duty to assure continued compliance. Pl. Compl. ¶ 40. If the directors took an involved and engaged approach at reviewing the corporation's financial records they would have been able to avow themselves to information that Medicare funds were not being distributed back to their represented states. The directors consciously failed to monitor the financial records which would have displayed to them the conflated figures that the corporation's managers were presenting to the national market.

c. The Directors breached their fiduciary duty of loyalty by acting in bad faith for not examining Securance's records with a "critical eye".

Directors are entrusted with the best interests of the corporation and its shareholders when acting in a fiduciary capacity. Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985). The Supreme Court of Delaware further ruled that a director's fulfillment of his fiduciary duty requires more than the mere absence of bad faith or fraud. Id. The Court stated that the "representation of the financial interests of others imposes on a director an affirmative duty to protect those interests and to proceed with a critical eye in assessing information." Id. While directors are entitled to rely on the honesty of their subordinates, this reliance only extends until something occurs to make them suspicious that something is wrong. In re Baxter Int'l, Inc. S'holders Litig., 654 A.2d 1268, 1270 (Del. Ch. 1995) (citing Graham, 188 A.2d 125 at 130). When a director has been alerted of suspicious activity, this should trigger the fiduciary duty to oversee with a "critical eye".

In Smith, shareholders brought a class action suit against Trans Union Corporation and its board of directors for undervaluing the price per share of corporate stock during a leveraged buy-out transaction. Smith, 488 A.2d at 864. The stock price suggested by Van Gorkom, the Chief Executive Officer, was calculated by using the average high and low prices of the stock over its market history, instead of valuing the stock's future potential. Id. at 869. The Court ruled that the two hour meeting of directors before approving a multi-million dollar merger transaction was a breach of fiduciary duty for failing to fully protect the financial interests of its shareholders. Id. at 897. Thus, when using a critical eye in examining a corporation's financial affairs, directors must make an informed decision when carrying out their fiduciary obligations. Id. at 872.

While examining the corporation with a critical eye usually falls under the fiduciary duty of care, Marshall requests this Court to extend its critical eye analysis to breach of oversight duty. The alleged breach in this case fits squarely into the critical eye analysis because of the financial responsibility that Securance and its directors owe to the corporation's shareholders. If the directors had been assessing the corporation's financial situation with a critical eye and on an informed basis, they would have become aware of the rapid and absurd increase in stock price from \$42 per share in 2002 to \$110 per share in 2008. Pl. Compl. ¶ 25. While this fact standing alone might be construed by the directors to be success of the company, the directors could not attribute this price increase

alone in the face of known fraud by Securance's managers in 2004. Pl. Compl. ¶ 40.

Securance began offering stock for public sale at \$42 per share in 2002. Pl. Compl. ¶ 7. Securance managers orchestrated a fraud to report overstate medical loss ratios and transferred any funds under the 80% benchmark was siphoned into an overseas account to deflect attention. Pl. Compl. ¶ 18. Due to the fraudulent transfer of funds Securance stock rose from its initial \$42 offering to \$110 per share in 2007, accounting for a market capitalization of \$4.6 billion. Pl. Compl. ¶ 7. The Directors could not effectively oversee the corporation's financial situation, including investigating their medical loss ratios, without becoming aware of huge discrepancies between those reported and those actually incurred. Pl. Compl. ¶ 23.

2. Securance Officers have the same fiduciary relationship as directors toward corporate shareholders and thus are liable to Securance's shareholders for breach of their duty of oversight.

Under 8 Del. C. § 102(b)(7), "a corporation may adopt a provision in its certificate of incorporation exculpating its *directors* from monetary liability for an adjudicated breach of their duty of care." (Emphasis added). However, directors cannot be exculpated from liability from breach of loyalty or good faith. Id. The issue of whether a corporation's officers are held to identical fiduciary duties as directors was recently an issue of first impression for the Delaware Supreme Court. Gantler v. Stephens, 2009 WL 188828 at *9 (Del.).

The Court held that the fiduciary duties of care and loyalty that corporate officers owe to its shareholders are the same as those of directors. Id. at 9. The defendants in Gantler, both directors and officers, were named for breach of fiduciary duty for rejecting merger offers and abandoning the sale of the company. Id. at 5. The determination of officer liability hinged on whether the failure of Director Stephens and Officer Safarek to prepare due diligence materials for the interested buyer was a breach of fiduciary duty. Id. at 10. The Court determined that Stephens violated his duty of loyalty for not preparing the due diligence statements for the prospective buyer because his failure to produce the statements within a reasonable time resulted in withdrawal of merger offers. Id. While Safarek as an officer could not act independently of Stephens as a director, the Court inferred that because Safarek assisted Stephens in sabotaging the due diligence statements, he was held liable for breach of fiduciary duty of loyalty as an officer. Id.

Here, Officer Defendants, as the most senior non-directors of the corporation, owe the same duties of loyalty and care to stockholders as directors. Pl. Compl. ¶ 6. Officer Defendants retained various positions overseeing operations, legal counsel, and accounting. Pl. Compl. ¶ 6. Officer Defendants were presented with the same "Compensation Plan" as the directors for approval and thus had the same knowledge that this plan provided specific incentives for senior executives. Pl. Compl. ¶ 38. These Officer Defendants were the direct supervisors for the three incarcerated managers and were unaware that fraud was occurring within their own departments. Pl. Compl. ¶ 56.

Because the Officer Defendants avoided red flags that put them on notice that financial reporting irregularities were occurring and then systematically failed to investigate those matters, they cannot say they have in good faith fulfilled their fiduciary duty of oversight.
Pl. Compl. ¶ 57.

CONCLUSION

For the foregoing reasons, Appellant respectfully requests that this Court reverse the decision of the Court of Chancery and hold that Marshall alleged particularized facts to show Defendants face a substantial likelihood of liability and demand is excused under Court of Chancery Rule 23.1. Moreover, Appellant requests this Court hold that Marshall alleged facts with particularity to which this Court can infer with reasonable certainty that Marshall can prevail on a duty of oversight claim and award Marshall all the equitable remedies prayed for herein. In the alternative, Marshall requests this Court reverse the Court of Chancery's decision and remand with instructions that she be granted leave to amend her complaint. Marshall requests 30 minutes to be heard orally.

Respectfully submitted,

Team C